

Investing Through Inflation

What's an Inflation Protected
Portfolio?

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A Series of Papers - Index

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What's An Inflation Protected Portfolio?

***Summary:** There has not been an inflationary period in developed markets for over forty years. Which means there hasn't been a focus on managing a portfolio through an inflationary period. This paper illustrates an inflation protect portfolio.*

Try and act surprised when your grandchild comes home from school and asks “*did you know there was a time when interest rates were zero, like, for almost 12 years? And, like, the average person couldn't afford a house, like.*”. Anybody who in the last five years has stuck their toe into the housing market can attest to the frustration that you can't buy what you want, you buy what you can get. The image of your dream home gets chiseled down to the house that is available at a price you and your banker could tolerate.

Building a portfolio that will protect your assets through an inflationary period is much the same process. You count on your investment advisor to be your eyes and ears on the market just as you rely on your real estate agent to make sure the full opportunity set of available homes are brought to you. Unfortunately, in the exercise of inflation protection your advisor may not have the full opportunity set available.

The investment industry has supported an education program that leads to a chartered designation, the Chartered Financial Analyst (CFA). I took the course in the early 1980's and surprisingly, given the mountainous tome of the body of knowledge, retained a thing or two. Germane to this exercise what I distinctly remember was the curriculum declaring that inflation is notoriously difficult to manage. The US centric program noted that countries such as the UK, Australia and Canada had inflation protected bonds but these were not yet available in the US. In fact, not until 1997 when the US treasury issued their first. Notoriously difficult stuck in my mind.

The investment management industry is by and large conventional. The convention of Modern Portfolio Theory (MPT) has served it well both in terms of investment returns and also as the platform on which to run a high margin business. But. But it won't work through inflation.

MPT seeks to build an efficient portfolio by diversifying amongst assets of differing risk, reward and offsetting correlations to create an optimum portfolio at a reduced risk. Conventionally today's investment advisor is typically limited to the building blocks of cash, bonds and equities. Bonds and equities are each dissected into further tranches, each offering further differentiated risk, rewards. Moving out the risk scale

from short dated US government bonds leads to longer dated governments, to investment grade corporate, to high yield corporate. The scope expands to international sovereign offerings and so on. Likewise, the equity offering expands to large cap vs small cap vs international to emerging markets, and again, and so on. There's a near infinite range of possibilities from which an optimum portfolio can be drawn.

But. But the underlying assumption that diversification lowers risk through non-correlation is moot during inflation. The tool of choice for monetary authorities to tackle inflation has been to raise interest rates. The offsetting correlation assumption between bonds and equities is then no longer reliable making the theory of modern portfolio theory unstable.

You may counter that surely if domestic rates rise an international portfolio will provide protection. I parry with two observations; 1) any illusory gains made internationally will be scratched back by a currency effect, i.e. the foreign currency will likely depreciate against your domestic currency, and 2) notwithstanding recent developments suggesting the reversal of globalization, the developed world in aggregate has reached the same state of debt burden and money supply, i.e. there is no safe haven in the developed countries from inflation. In an inflationary environment the limited choices of cash, bonds and stocks is too limiting.

What then, if the conventional asset building blocks aren't up to the task? Start with the bond allocation. In order to preserve capital while earning income the fixed rate bond portfolio has to be converted to adjustable-rate income. The selection would include TIPs, floaters and swaps. Moving to equities the broad based fully diversified index approach has to become more focused. Focused on income earning businesses with real assets. It's not a time for passive broad index investing. It requires skillful active management to rotate through sectors and companies as the economy morphs through the inflation cycle.

New return sources outside of conventions need to be brought into the portfolio. Real assets in the broadest definition: natural resources, land, large scale heavy equipment, commodities. A finishing garnish would to add in a portfolio of alternative investments, i.e., hedge funds. The inflation battle will primarily be fought in the fixed income and currency worlds. Macro hedge funds are the apex predators in this terrain and will add diversifying value and returns through an inflation episode.

What does all this lead to? I've presented below three illustrative portfolios ranging from the conventional to an archetypal inflation portfolio and I've thrown Summerwood's current portfolio into the mix as well. The latter to show the degree of customization that can be brought to the exercise dependent on one's views and objectives.

Conventional Portfolio	Inflation Protected Portfolio	Summerwood Portfolio																																																																																																
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It has been 40 years since the developed countries have experienced inflation. An entire generation of investment professionals have cycled through the industry without needing inflation management skills. The current crop of investment professionals has limited basis or grounding to protect a portfolio against inflation. The approach I have outlined is the investment equivalent to a house built for inflation. Once we're through the inflation cycle we can all move into the homes we dream of.

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