Hedging Inflation with a Real Assets Investment Strategy

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For the last 30 years, investors have enjoyed relatively low levels of inflation. In this environment, balanced portfolios made up of both stocks and bonds have generally done a reasonable job of delivering returns above inflation.

But what happens if inflation begins to increase?
Inflation is, in fact, starting to show itself in various parts of the economy; from the grocery store to manufacturers’ loading docks. Part of the driver behind the increase in inflation has been the easy monetary policy enacted by the Federal Reserve. Historically, material increases in the money supply have tended to lead to heightened periods of inflation as the flood of money into the economy drives up prices of goods and services.

To cope with potential rising inflation, it is important to ensure that portfolios include meaningful exposure to a broader set of assets than just stocks and bonds, especially assets that tend to preserve value in an inflationary environment. This paper reviews the role of real assets in an investor’s portfolio and introduces a comprehensive approach to real assets investing.

“A inflation is, in fact, starting to show itself in various parts of the economy...”
INFLATION AND TRADITIONAL ASSET CLASSES

Investors tend to have the majority of their assets in one of three broad asset classes: equities, bonds or cash. In the low inflationary environment of the last 30 years, these three asset classes have generally served investors well from a diversification basis. When one asset class was down, one or both of the other two were generally up. If inflation begins to rise, however, traditional correlation and diversification assumptions for these three asset classes necessarily have to change, as none of them will respond well to an inflationary environment.

Bonds and cash are generally ineffective at protecting against purchasing power in rising inflationary environments. Bonds carry fixed coupons that do not adjust to changes in inflation while cash typically earns a yield below current inflation levels. As shown in the chart below, investors have generally experienced decent long-term nominal performance in cash and bonds, but the real return earned by investors after inflation has been much less impressive. Equities also provide an ineffective hedge against inflation.

Consequently, many investors with stock/bond portfolios leave themselves potentially exposed to negative real (after inflation) returns in a highly inflationary environment. Maintaining portfolio exposure to a diverse set of real asset/real return strategies offers an opportunity to offset that effect.

REAL ASSET/REAL RETURN ASSET CLASSES

No individual asset class or strategy can provide the perfect inflation hedge. Assets such as TIPS (Treasury Inflation-Protected Securities) have a direct linkage to inflation (via CPI), while others have an indirect association with inflation, where protection is more horizon- and economic cycle-dependent. Below, we review some of the asset classes commonly utilized in real return focused portfolios.

TIPS

Like most conventional bonds, TIPS are issued with a fixed coupon rate and maturity date. Unlike conventional bonds, however, the principal value changes monthly based on CPI. The inflation adjustment is based on a two-month lagged value of the CPI-U (Consumer Price Index for Urban Consumers). While TIPS may offer a direct linkage with CPI via the principal adjustment factor, they suffer from basis risk (the risk that the CPI does not adequately reflect investors’ actual liabilities) and from market risk (the real yield of TIPS can vary widely due to investor perception).

While TIPS tend to act as the most direct hedge against inflation, the opportunity cost to hold TIPS during certain periods can be high. In fact recent TIPS issuances have seen real yields close to 0%.
Commodities

When high inflation is associated with strong global economic growth, commodities can play a supporting role in hedging against associated inflation. As the demand for commodities grows, commodity prices increase, ultimately pushing up consumer prices. Dollar-denominated commodity prices can also be impacted by the declining value of the US dollar (which may stem, for example, from monetary-led inflation), as it reduces the cost for foreign buyers who then increase their demand for commodities.

Global Natural Resource Equities

Investments in natural resource equities can provide investors with exposure to a broad spectrum of natural resources. Energy stocks are a common holding, but other areas such as agriculture, mining, and clean technology sectors are often represented as well. These investments have historically shown a high correlation with inflation.

Many commodity-related companies own long-term unhedged resources in politically secure regions of the world. In a period of sustained commodity price increases, these companies may benefit to a higher degree than direct commodity investors.

In addition, commodity-related firms can benefit from other factors, including productivity gains. Many resource-related firms have relatively static extraction costs. In these situations, increasing commodity prices may lead to progressively faster earnings growth.

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Global Publicly Traded Real Estate (REITs) and Master Limited Partnerships (MLPs)

Over longer periods of time, real estate prices tend to correlate with increases in inflation. Owners of properties, often with fixed-rate debt, are able to increase rents to their tenants, often through CPI-linked lease agreements. Prices of real estate tend to increase as a consequence of the higher income flow.

Master Limited Partnerships (MLPs) generally operate in natural resource-related businesses and may generate income from extraction, transportation, storage or distribution of resources. Revenue is typically generated by collecting volume-based fees from energy exploration and production companies. Many pricing structures may also include direct exposure to commodity prices or changes in the Producer Price Index.

REIT and MLP performance do tend to correlate with periods of economic growth, however, and are most effective at hedging inflation during these periods.

Other Asset Classes

At times there may be investment opportunities in other asset classes, including infrastructure, timber, currencies and floating rate bonds. Individually, these sectors provide varied inflation-hedging characteristics and may provide additional diversification benefits to the real return portfolio during certain economic periods.

ALTERNATIVE STRATEGIES

In addition to the core strategies, a comprehensive real return strategy may also include an allocation to more active strategies capable of protecting some of the extreme downside risks of traditional inflation-hedging asset classes like commodities and REITs.

As the following chart shows, traditional inflation-hedging assets can experience extremes in returns and drawdowns in excess of the equity market. Allocating to long/short and other diversifying hedged strategies may serve to limit some of the volatility, and particularly the downside risks of some inflation hedging asset classes.

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A few aspects of the commodity markets, in particular, provide unique opportunities for active managers to outperform traditional indices. First, the varied commodity sectors do not move in unison with each other, providing greater opportunities for managers to take disparate fundamental views on various commodities. While the correlation between commodity sectors has moved up in recent years, it remains well below equity sector correlations. Commodity sectors also display a wide dispersion of returns from year to year. Well-positioned active managers, therefore, have an opportunity to provide differentiated returns from the index. Of course, this dispersion also reinforces the importance of ensuring broad manager diversification to reduce the significant drawdowns that can occur with concentrated manager exposure.

Many passive commodity strategies are challenged by the rolling of futures contracts. For the last several years, most commodities markets have traded with a futures curve that is in contango. Contango is the state where a commodities future price is higher than its spot price. Passive commodity investors typically invest in near-term contracts that often are at the steepest part of the futures curve. As a result, they experience negative “roll yield” as futures contract “roll” down toward maturity. Active managers, on the other hand, have the flexibility to invest at various points along the curve where the roll yield may be less pronounced. Additionally, they may also sell futures in a steep part of the curve to capture the roll as a premium.
Commodity Hedge Funds

A recent study, “Protection Potential of Commodity Hedge Funds,” by Pierre Jeanneret and Stefan Scholz of Man Investments and Pierre Monnin of Swiss National Bank, isolated a portfolio of hedge funds that trade in commodity-related instruments and compared their performance against major commodity indices.

The authors found the commodity hedge funds strongly outperformed commodity indices over the last ten years. They did so even while maintaining a high correlation to the indices throughout the period. Their advantage seems to lie in their ability to manage portfolio beta (risk) during highly volatile periods. For example, during 2008 and 2009, the volatility of the indices doubled as commodity prices rapidly fell and then rose again while the hedge funds, as a whole, maintained a consistent volatility pattern throughout the crisis and rebound.

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Directional Commodity
These strategies typically encompass managers who are making directional investments on individual commodities. Managers may be utilizing fundamental and/or technical factors to support their views. Fundamental drivers may include factors such as demand, refining utilization, warehousing, weather, substitution, yields, etc., while technical indicators including volume, open interest, trends, etc., may also be considered. As a whole, directional commodity managers tend to show some positive correlation with commodity markets in most environments.

Equity Related Long/Short
Natural resource equity-related strategies relate to funds that will focus on investing in companies (usually via equity securities) that are involved with the extraction, refinement and/or distribution of natural resources. These may provide exposure to areas that may not be accessible to passive commodity investors such as water, clean energy, and certain commodities with limited futures interest. As a whole, Equity L/S managers tend to maintain net positive exposure to the equity market.

Relative Value
Relative value strategies tend to be less directional and focus on relative mispricings between related commodities or commodity-related equities. Commonly, they may trade by going long in securities they deem to be fundamentally cheap, while shorting overpriced assets. Managers may also make inter-market trades (e.g. Brent vs. WTI crude), inter-month trades (e.g. May vs. October corn futures) and inter-commodity trades (e.g. corn vs. soybeans futures). Many relative value managers may show very little net market exposure, making them effective volatility dampeners within a portfolio.

REIT Related Hedge Funds
Like the commodity long/short strategies, REIT long/short managers seek to exploit mispricings in the liquid real estate market on a firm-to-firm basis. Since REITs offer both equity and bond characteristics, potential arbitrage and relative value opportunities are plentiful. In addition, real estate long/short managers may take positions in other real estate-related areas such as real estate operating companies and homebuilders.

A DIVERSED APPROACH
As discussed above, both traditional and alternative investment strategies may play a role in inflation hedging. An active, diversified, inflation-hedging strategy that encompasses exposure to a variety of real asset classes and strategies is important in protecting against inflation in a variety of economic environments.

The pie chart below shows a sample approach to diversified real asset portfolio:

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**Tax-Aware Construction**

One of the challenges with implementing a real asset portfolio is that many real asset strategies tend to be tax-inefficient, with high levels of ordinary income and short-term gains. A carefully constructed portfolio, however, can help mitigate some of these inefficiencies. Some tax-aware strategies include: tax-managed natural resource equity portfolios that seek to harvest capital losses; utilizing 13-month commodity-swap contracts to achieve long-term capital gains treatment; and investing collateral for swap and futures contracts in municipal bonds instead of Treasurys. These tax-efficient strategies have the potential to improve after-tax returns for taxable investors by minimizing short-term gains and ordinary income.

**SUMMARY**

The last 30 years have witnessed a period of low inflation. Increased commodity demand and excessive monetary stimulus have the potential to lead to higher long-term levels of inflation in the future. Investors should carefully review their portfolio allocations to ensure that they are prepared for such an environment.

A comprehensive portfolio approach to real return investing is important as no individual asset class or strategy can serve as a low-risk long-term hedge against rising inflation. Combining a portfolio of tax-efficient direct real asset exposure with a healthy dose of active strategies can be a smart way to maintain attractive long-term returns, enhance portfolio inflation protection, and lessen downside risk.

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