How should you be hedging for inflation?

It appears that the darkest days of the Covid-19 pandemic are behind us. In the last 14 months, the global economy has shown tremendous resiliency, and as we continue to work through a rattled supply chain, businesses begin to reopen.

While companies have been busy trying to keep their doors open, the United States central bank has been busy printing 3 trillion dollars of new money which has dramatically increased the current money supply.

This money is here, and here to stay.

The fear of the crippling tax, known as inflation, is lurking over our global economy. What can you do as a long-term investor to protect your purchasing power against inflation?

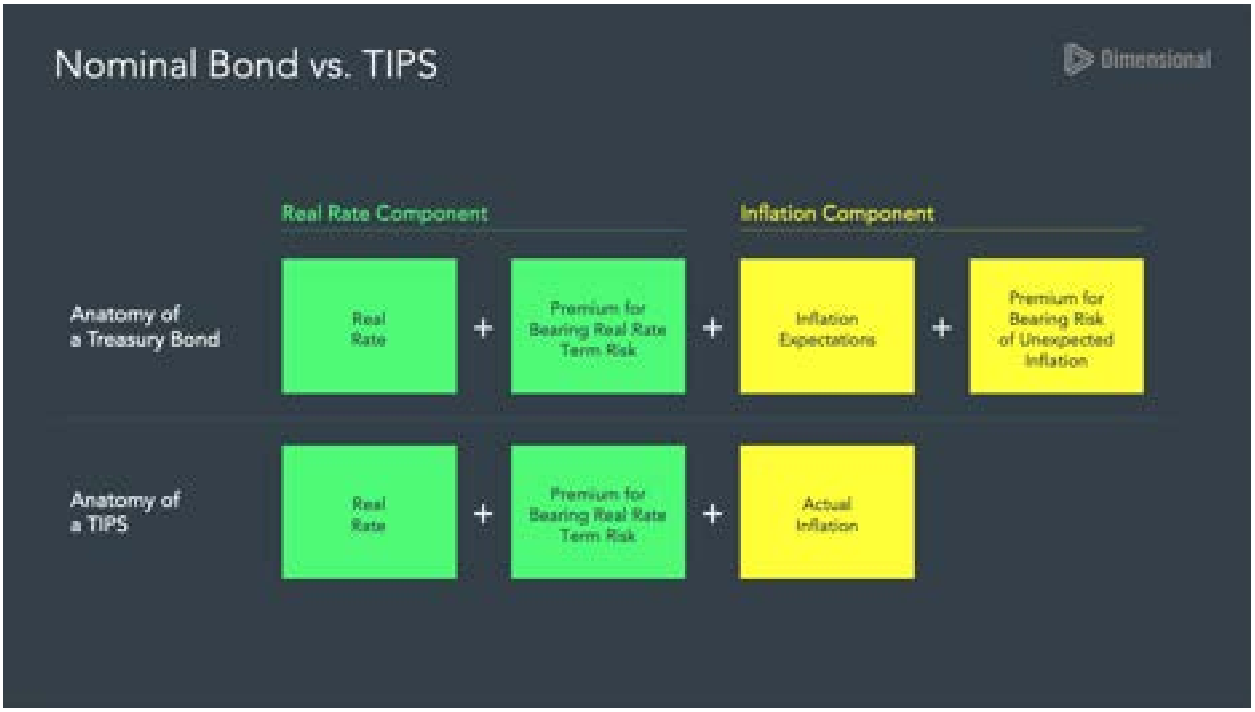
Many investors turn to assets like gold, Treasury Inflation-Protected Securities (TIPS), or equities/stocks to protect their purchasing power.

It is not news to anyone that inflation could ramp up as consumers begin spending money at a higher rate. What investors are now worried about is unexpected inflation. To hedge against this unexpected inflation investors are looking for assets that correlate positively with unexpected inflation, have a positive real return, and reasonable volatility to “hedge” or protect them against inflation.

This asset does not exist.

Gold and other commodities are often looked to in inflationary times as a hedge. The academic literature has found very little correlation between gold prices and unexpected changes to inflation. This combined with Gold’s volatile short-term price movements make it an unreliable inflation hedge.

TIPS are a compelling asset to own as an inflation hedge given the name. They are indexed to inflation in order to protect investors from a decline in the purchasing power of their money. As inflation rises, TIPS adjust in price to maintain their real value. The principal value of TIPS rises as inflation rises. Inflation is the pace at which prices increase throughout the U.S. economy, as measured by the Consumer Price Index (CPI)*. The image below, from Dimensional Fund Advisors, helps decipher the different components of TIPS vs Nominal Treasury Bonds.



In short, TIPS have been a great hedge against unexpected inflation, but only when your investment horizon matches up perfectly with the bond's maturity. But this does not eliminate the short-term real return on a long-term protected bond.

We can continue to analyze different assets that provide a correlation to unexpected inflation with positive real returns and low volatility, but there does not seem to be such an investment vehicle.

Historically, equities have provided investors with positive long-term real returns. Ownership in companies has provided a great long-term solution to maintain purchasing power. Intuitively, it makes sense - if you are able to own companies who are selling the same goods and services that are going up, their revenue will likely track with these prices at a minimum.

One of the worst inflationary time periods in the U.S. was the 17 year time period from 1966 - 1982. It is known for one of the worst time periods in history to retire. During this time the S&P 500 returned an annualized 6.8%. However, if you just owned the S&P 500 during this time you had a 0% real return after counting inflation.

It is interesting when you look at what happens when you own equities outside of the S&P 500 during times of high inflation. Global diversification (owning companies all around the world) has a compelling story during times of inflation. In the previously mentioned 17 year time period where U.S. stocks earned a 0% real return, a globally diversified portfolio outpaced U.S. inflation. This is a trend that has held during other periods of time with high inflation.

Along with global equity diversification, there are some other compelling equity factors that may provide some sort of inflationary hedge. There has recently been a fair amount of research looking into the performance of value stocks during periods of high inflation. Larry Swedroe, chief research officer at Buckingham Strategic Wealth, recently wrote an article discussing the value premium performance during high inflationary times.

Below is a summary of value premium performance during different levels of inflation.

- When inflation was between 0 and 3 percent, the value premium was 3.1 percent.
- When inflation was greater than 3 percent, the value premium was 6.6 percent. When it was below 3 percent, it was 2.4 percent.
- When inflation was greater than 4 percent, the value premium was 6.2 percent. When it was below 4 percent, it was 3.2 percent.**

There are some limitations when you just look at historical value premium performance. Different influences such as the Federal Reserve's monetary policy response in times of high inflation can make this data less reliable. However, of the research that has been done, the value premium has shown up in times of high inflation.

Should you be making adjustments to your asset allocation to protect against inflation? Is there an ideal inflation hedge?

It is hard to find any empirical evidence that suggests there is an asset class that can consistently hedge inflation with the goal of positive real returns and low volatility.

Research suggests that overweighting a portfolio towards value stocks and some ex-US exposure may lead to a well-positioned portfolio when periods of high unexpected inflation arise. However, having a diversified portfolio with a long-term approach, surrounded by an evidence-based philosophy, seems to be a good way to weather a variety of storms.

Just remember, it is always the right time to be properly allocated based on your personal goals.

Data resource references:

*[**https://www.investopedia.com/terms/t/tips.asp**](https://www.investopedia.com/terms/t/tips.asp)

[https://alphaarchitect.com/2021/04/15/inflation-and-the-value-premium/**](https://alphaarchitect.com/2021/04/15/inflation-and-the-value-premium/)

https://us.dimensional.com/