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Investing in equities during raging inflation - 4 things to know

Most people don't like inflation. Whether you're Chancellor of the Exchequer, a small business owner or just a householder trying to make ends meet, rising prices are never welcome. No wonder Ronald Reagan called it "as violent as a mugger, as frightening as an armed robber, and as deadly as a hit man".

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Part of what makes it so dangerous is that mostly you don't notice it. Even though experience tells you that £100 today will buy you less than it did ten years ago, the erosion is normally so gradual that you don't feel it happening.

In 2022, of course, things are different. Rising prices have had a very real impact in a short space of time. Energy and food costs in particular are going up and putting pressure on household budgets. The Bank of England announced last week that prices have risen by 10.1% compared to a year ago — far in excess of the Bank's 2% target (Bank of England 19 October 2022).

Investors in particular could be forgiven for thinking that they too have been violently mugged. True, there've been worse years for equities. But what has made 2022 exceptionally tough for investors is that bonds have fallen in value as well as stocks. Bond markets react badly to rising inflation as it causes interest rates to rise. Even a small rise in interest rates tends to have a negative effect on bond prices, particularly for bonds with longer maturities; in other words, prices fall as yields rise. Yet both inflation and interest rates have risen far faster than forecasters were predicting.

As a result, almost all investors have seen a substantial hit to their portfolios. These include the most adventurous investors, with 100% exposure to equities, and the most cautious, with all of their assets in bonds. Balanced portfolios, like the trusty 60:40, have fallen substantially as well. There was, in other words, nowhere for investors to run or hide.

The 4 key things to know from the GSI inflation study:

It's highly unlikely your portfolio won't be hit.

Predicting future inflation rates is extremely hard.

Markets may bounce back strongly when inflation falls.

A diversified, factor-based approach makes sense.

The question - what should investors do now?

The question is, what should investors do now, given the inflationary environment we find ourselves in?

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The temptation at times of great economic uncertainty is either to flee the markets altogether or else sign up for an expensive active investment strategy. But new research by Global Systematic Investors suggests that sticking broadly with a systematic, evidence-based approach is much more sensible.

Here are four key takeaways from the GSI study:

1. It's highly unlikely your portfolio won't be hit

The bad news is that whatever you invest in, it probably won't insulate you from the effects of inflation. Cash is an obvious example. Bonds fall in value too as a direct result of increasing yields.

Equities also tend to fall in value during inflationary periods. High inflation, i.e., rising prices, increases economic uncertainty, and companies are often unable to pass on the increased cost of raw materials to their customers. Both issues are likely to reduce company profitability.

Because commodity prices usually rise when inflation accelerates and they are often a major source of inflation, investing in commodities may provide portfolios with a hedge against inflation. The problem is, of course, that investing in commodities now is like closing the stable door after the horse has bolted. Prices have already shot up, and the possibility of further rises in inflation is effectively baked into them.

Sticking with an existing investment strategy is sensible in inflationary periods.

2. Predicting future inflation rates is extremely hard

Of course, things would be so much simpler if we knew, in advance, how much further prices would rise or how long inflationary periods would last for. But it's extremely difficult to tell beforehand. Some forecasters are very downbeat, others more optimistic, and they can't all be right.

A US study in August 2021[1] showed that higher inflation (roughly rates of more than 5%) is sometimes temporary, lasting just a few months. But there are several examples of high-inflation periods lasting at least two-and-a-half years. On two occasions since the Second World War, they've lasted around four years. The most recent example came in the economic boom of the late 1980s.

Indeed, while forecasters believe that inflation has already peaked in some countries, we may still be some way off that point in the UK. The Bank of England expects the rate of inflation to peak at 11% and then remain above 10% for a few months before starting to come down but warns that it's likely to stay at "elevated levels" throughout 2023.

Markets recover, often quite quickly. US equities in particular, tend to rebound strongly after inflationary periods.

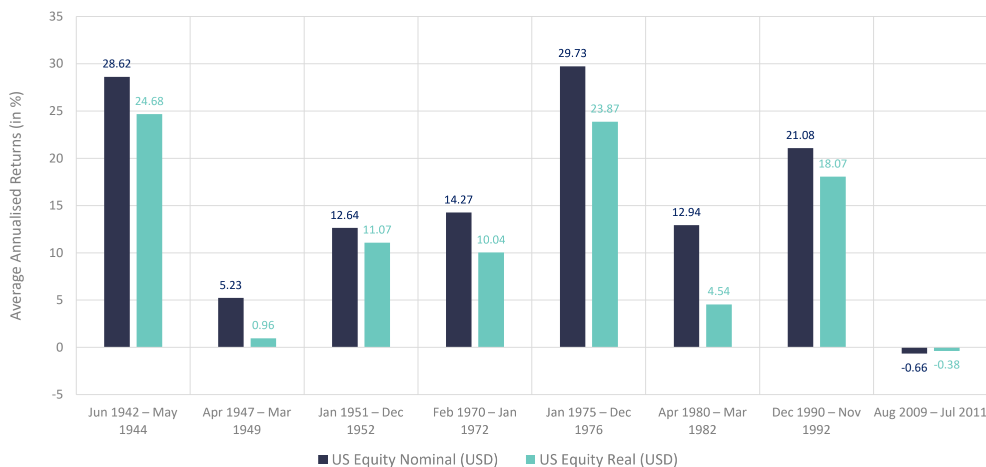
Difficulty is, it's hard to predict when markets will rise again.

3. Markets may bounce back strongly when inflation falls

It's almost always a bad idea to sell once prices have already fallen sharply. Why? Because eventually markets recover, often quite quickly, and it's very hard to predict when prices will start rising again. As the chart below demonstrates, US equities in particular tend to rebound strongly after inflationary periods.

Chart 1: US Equity Returns after Inflationary Periods

Annualised Returns in the 24 months after Inflationary Periods



Source: https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html and The Best Strategies for Inflationary Times Neville, Draaisma, Funnell, Harvey, and Van Hemert (2021).

For example, in the two years that followed the crisis caused by the OPEC oil embargo in the early 1970s, US stock markets rose almost 30%.

Of course, inflation could persist for longer than analysts anticipate. But, by the same token, it could ease off far sooner. If you switch into cash now, it might provide you with some emotional relief in the short term, but it could mean missing out when prices recover.

4. A diversified, factor-based approach makes sense

As I've already explained, most major asset classes are negatively affected by inflation. But is there anything you can do to try to reduce the damage? GSI's research suggests there is.

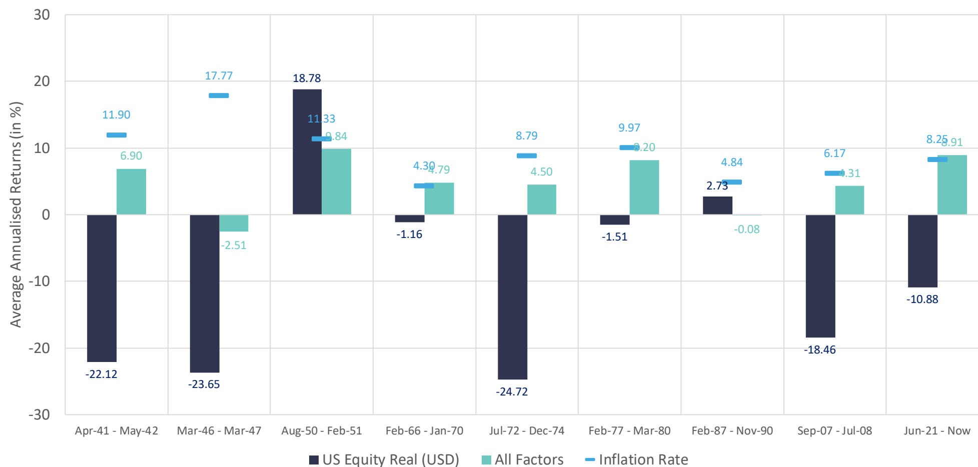
Bernd Hanke, the study's author, says: "The best strategy in times of inflation is to stick with an asset allocation that gives you the highest expected risk-adjusted return overall. Global diversification can help protect returns. In addition, you can also use a factor approach as a potential cushion."

Factor-based investing means increasing your exposure to different risk "factors" which, research has shown, tend to produce higher returns over time. These include small companies, value stocks, companies with high profitability as well as high-momentum stocks.

As the chart below shows, focusing on factors, on average, has been a successful strategy over time, regardless of inflation.

Chart 2: US Equity and Factor Returns during Inflationary Periods

Average Annualised USD Returns for each Inflationary Period. Only returns that cover a period of twelve months or more are annualised.



Source: https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html and The Best Strategies for Inflationary Times Neville, Draaisma, Funnell, Harvey, and Van Hemert (2021).

Conclusion

These are uncomfortable times for investors, and the sad fact is that fund managers and even many financial advisers will try to exploit that discomfort and sell you a strategy that appears to provide a solution.

But no one has a crystal ball — either about inflation and the economy, or the future direction of the financial markets. The best approach is to stay calm and disciplined, and to stick to a strategy that's founded on data and evidence.

Focusing on factors, on average, has been a successful strategy over time, regardless of inflation.

[1] Neville, Draaisma, Funnell, Harvey, and Van Hemert, 2021, The Best Strategies for Inflationary Times, Journal of Portfolio Management 47(8), 8-37 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3813202

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