Diversification is the key hedge against inflation

Added 04 June 2010 by Jerry Haworth, director, 36 South

Inflation is the rise in the general level of prices of goods and services in an economy over a period of time. It is generally viewed as bad, especially for people who have already earned the majority of their lifetime earnings.

For them, inflation can be a travesty as it renders savings relatively worthless by the time most come to spend them, normally in old age.

Is inflation really coming?

Governments can create money out of thin air. Even worse, they monetise their debt by buying back their debt obligations with freshly printed money (figuratively speaking). The majority of people don't know how they do this and what impact it has on their lives. Up to now governments have used this very useful facility sparingly but the extent of the global financial crisis (GFC) has meant they have been given implicit permission to monetise huge swathes of their debt, as well as to print massive amounts of money to counteract the deflation emanating from the GFC. History has shown this to be the prime cause of inflation so, on a balance of probabilities, we are in for a spate of significant inflation.

But the economy is "on the mat" which will keep prices down surely?

Inflation and economic depression can co-exist. Zimbabwe is an extreme case in point – hyperinflation in the middle of a politically inspired mega-depression in the real economy.

Can one hedge against inflation?

Yes, but there are more possible answers than there are ways to barbeque a steak. Everyone seems to have their own idea what is the best inflation hedge:

Shorting interest rates in the belief that rates rise in inflationary times: This is generally true but most people believe that any "hedge" should be in long dated interest rate products as governments can manipulate shorter dated interest rates (less than one year) in order to keep them low. In fact, governments can keep the long dated end low as well by buying back all their debt with freshly printed money, something they like doing as it reduces their debt burden.

If an investor uses this as the only inflation hedge then they run the risk that inflation is high whilst interest rates are low rendering the hedge ineffective.

Overweighting the portfolio with property and equities: Property and equities are generally regarded as real assets or claims on real assets which will track inflation. Again, this is generally true but they could initially be a very poor hedge whilst inflation is accelerating. This is because they are yield-based assets. For example, assume a property is yielding $100,000 per annum which equates to a 5% yield rate. The value of the property is $2m. Fast forward three years, inflation is now 20%, interest rates are 15% and relevant property yields are 20% in order to remain an attractive investment. The property is now only worth $500,000 as it has to produce a yield of 20%. This is a price reduction of 75%.

This example shows that yield-based investments can perform poorly whilst inflation is accelerating but that they should also stabilise and be a relevant hedge whilst inflation is high yet stable.

Gold, other precious metals, art, commodities: These are good inflation hedges as they are real assets whose value is not derived from yield therefore avoiding the problems listed above.

The only downside to this hedge is that if there is stagflation, where inflation is accompanied by a severe recession or depression, then the lack of demand for some real assets will weigh on prices i.e. the reduction of copper demand due to falling construction spending.

Gold scores highly as an inflation hedge because it is neither a yield-based asset nor does its price depend of the state of the economy. However, central bank manipulation could be a factor as they have a vested interest in keeping gold low. A rapidly rising gold price indicates that people are losing faith in fiat (paper) money.

Inflation-linked bonds, structured notes etc: Governments have perfected the art of keeping the indices, upon which nearly all of these bonds are based, low. Theoretically, it is a reasonable hedge but often falls short in practise.

Long volatility hedge funds: Inflation is nearly always accompanied by high asset volatility so volatility hedge funds should perform well in this environment. They are, however, usually inaccessible to the man-in-the-street.

As it can be seen, there are hedges available but there are times and conditions under which each of the various hedges will be sub-optimal and could actually work against a portfolio. The best hedge against inflation is a diversified strategy that covers a number of the strategies listed above.
In this way, a portfolio will be hedged in some meaningful way whatever happens.