Mercer

# Diversified inflation strategies

## Preparing for rising costs of living

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## The risk of higher inflation has increased — is your portfolio prepared?

The massive policy response to the COVID-19-induced economic shock is tapering off at a snail's pace even after a majority of adult populations have received vaccinations in developed countries. Many economies are in full recovery mode, with inflation reaching highs not seen in a decade in those that have fully reopened, such as the US and UK. This continued fiscal and monetary largesse has brought two questions to the front of many investors' minds: 1) whether the 2021 inflation surge will be transitory as central banks are hoping or become a more structural risk and 2) how to potentially protect portfolios[1] given numerous obstacles. For instance, traditional defensive, inflation-protected assets, such as sovereign linkers, have low or negative real yields. Other assets may perform during one type of inflationary environment but not another — there is no silver-bullet, single-asset-class solution. To help our clients navigate this environment, Mercer offers our series on inflation, including scenario analysis, single-asset-class articles and more diversified portfolio approaches.

The focus of this article is the more diversified approach that can solve some of the issues of single-asset approaches. We also discuss the complexities of implementation and management. The two main implementation paths are:

1. A do-it-yourself (DIY) approach that incorporates the existing portfolio exposures
2. An actively managed, external off-the-shelf inflation product, designed to add greater sector nimbleness

We will address the pros and cons of the two main paths to implementation and take a deeper dive into the off-the-shelf option of multi-asset diversified inflation hedge (DIH) strategies.

[1] https://www.mercer.com/our-thinking/wealth/inflation.html

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## Do-it-yourself inflation approach

There are practical challenges to implementing an inflation-hedging sleeve on your own. These include determining how much to allocate to each inflation-sensitive asset class and selecting managers for each. Managers would need to be monitored and possibly replaced when necessary. The portfolio would have to be rebalanced to maintain target exposures and reflect changes in the outlook. Critically, however, a do-it-yourself approach allows for consideration of the broader portfolio/asset allocation and the inclusion of illiquid, private assets. For many investors, these two advantages will outweigh the potential for better tactical asset allocation with an externally managed DIH strategy.

The DIY diversified inflation approach could be suitable for investors with a sufficient governance budget, specifically those with the ability to:

- Form actionable views on future inflation and growth
- Revisit those views regularly
- Implement them in the portfolio

The DIY approach can also help address specific risks, such as healthcare cost increases that may require a custom portfolio allocation.

Implementing a DIY approach is discussed in greater depth in our main inflation-protecting paper.

## The off-the-shelf option: Multi-asset diversified inflation hedge strategies

In general, we prefer a DIY approach for its more holistic method of building portfolio exposures. However, off-the-shelf products like DIH strategies can serve a purpose for certain investors. These include:

- Investors who lack the resources or governance structure to oversee manager selection, monitoring and rebalancing
- Smaller institutions, where minimum investment sizes for individual sleeves become an issue
- Defined contribution participants who may appreciate the flexibility to switch into and out of a single fund

For these institutions or individuals, an off-the-shelf external option, such as a DIH strategy, may be more practical.

So what do DIH strategies do? They seek to guard against rising costs of living by targeting **a real earning stream via liquid asset classes**. Having liquid asset classes is crucial, as active sector rotation is one component that differentiates these strategies. The exact assets and mix utilized are manager specific but typically include three complementary groups:

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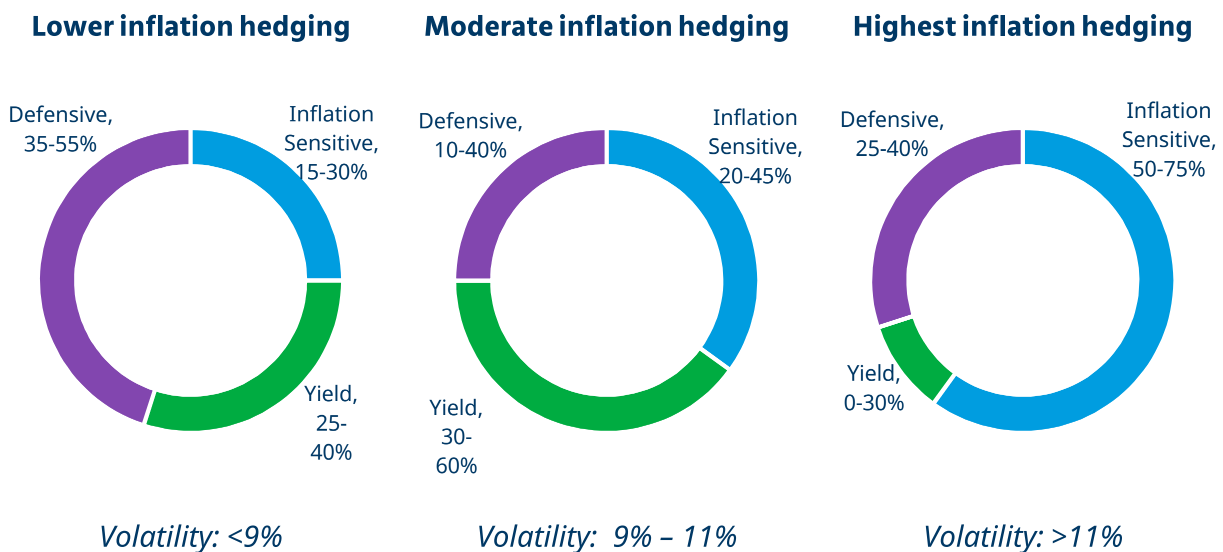
- **Inflation-sensitive assets, which exhibit a higher beta[2] to inflation[3]** (for example, commodities, precious metals, natural resource equities and midstream energy infrastructure)
- **Defensive assets, with lower inflation beta and possibly lower overall volatility** (for example, TIPS/ILBs and floating rate notes/bank loans)
- **Yield-oriented assets, which offer higher expected income but also more volatility** (for example, REITs, listed infrastructure)

There are definite patterns in the asset categories used by aggressive managers (as defined by average inflation beta) versus those with more moderate or limited hedging approaches. Aggressive managers focus on inflation-sensitive assets, whereas moderate managers take a more diversified approach with a tilt toward yield. Managers whose inflation hedging is more limited tend to focus on the yield and defensive categories.

The charts below illustrate typical portfolios for each category.

## Figure 1. Asset allocation samples




Source: Mercer; for illustrative purposes only.

With three different flavors, it is important to choose the DIH strategy in which the investor has conviction in the manager and one that meshes well with what is currently in its portfolio. This means having clarity on the desired exposures to inflation beta, equity beta and yield-oriented assets as part of the search process.[4] For example, investors whose portfolios have enough yield-

[2] Beta measures the sensitivity of an asset class to another variable, such as inflation or the broader equity market. An inflation beta of 2, for example, means that if inflation increases by 1%, the asset class is expected to increase by 2% based on historical observations. We measured inflation beta with US CPI. Other metrics include breakeven inflation (measured as TIPS less nominal bonds).

[3] Either to CPI or breakevens.

[4] We acknowledge that relative performance of DIH compared to other multi-asset strategies has been weak over the past decade. This is because these strategies have not yet been tested in a higher-inflation environment. We have been experiencing benign disinflation over the past 10 years, where DIH strategies are not expected to do well.

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oriented assets outside the inflation sleeve and sufficient risk tolerance could consider the highest inflation-hedging category, with higher weights to assets like commodities and natural resource equities.[5] Those in need of a more balanced exposure to inflation-sensitive assets that provide diversified earning streams but offer lower levels of volatility could invest in lower or moderate inflation-hedging strategies.

## Selecting a DIH strategy and manager

Once the type of DIH strategy is decided, the next step is to select a manager. Along with the standard keys for picking an active manager, three topics are particularly important for DIH managers. When it comes to selecting a manager, it is crucial to understand 1) how it arrived at its strategic asset allocation (SAA), 2) if actively managed, how it deviates from its SAA via its tactical asset allocation (TAA) and 3) the security-selection skill embedded in sub strategies.

Many managers define a custom benchmark — a strategic target allocation to each asset class included in the inflation-sensitive portfolio. We find that the highest-quality strategies incorporate a broader asset mix across inflation-sensitive, defensive and yield-oriented asset classes.

DIH strategies vary in their ability to add value over the custom benchmark through tactical asset allocation between — and security selection within — the underlying strategies. Along with SAA, we assess these value-add sources in the context of well-considered idea generation, portfolio construction and implementation. Among industry practices in this domain, we look for robust performance attribution to demonstrate TAA and security-selection skill.

Other characteristics relevant for investors are fund structure and cost. Simpler strategies, with fewer or no alpha inputs (if passively managed) and less dynamic SAA, are likely to have lower fee structures. Some strategies employ a fund built of external specialist managers. An extra layer of fees creates a higher cost for these strategies and may affect the assessment process. Whether to go active or passive ultimately depends on the investor’s fee and governance budget and the existing portfolio. On our current recommended managers list, we have both highly rated active and passive approaches.

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Looking ahead, in our opinion, the risks are now tilted toward higher inflation, for reasons which we have outlined in our main inflation-protection paper. We believe DIH strategies are one viable option to potentially mitigate the impact an inflation outbreak may have on portfolios.

[5] We note that commodity investment via futures markets may not be suitable for investors with certain views on responsible investment, as explained in our paper (*https://www.mercer.com/our-thinking/wealth/responsible-investment-in-commodities.html*). Further considerations arise for investors seeking decarbonization of equity portfolios.

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## Other multi-asset strategies and inflation hedging

Alternatively, there are two other groups of multi-asset strategies, some of which have inflation-hedging characteristics. These are idiosyncratic multi-asset strategies and core/risk parity multi-asset strategies. Both of these categories tend to be used as total portfolio solutions, unlike a DIH strategy, which typically serves as more of a "completion" strategy.

### Figure 2. Spectrum of multi-asset strategies

| Core/risk parity: passive | Core/risk parity: active | Idiosyncratic: asset allocator | Idiosyncratic: absolute return |
|---|---|---|---|
| Moderate-to-high equity beta/correlation<br>Low reliance on manager skill<br>Low fees | Moderate-to-high equity beta/correlation<br>Low –to-moderate reliance on manager skill<br>Moderate-to-high fees | Variable equity beta/correlation<br>Moderate reliance on manager skill<br>Moderate-to-high fees | Low-to-moderate equity beta/correlation<br>Moderate-to-high reliance on manager skill<br>Moderate-to-high fees |

Source: Mercer.

Idiosyncratic multi-asset strategies have a real return objective over the long term but may tactically move in and out of asset classes based on fundamental valuations. Such an objective implies that no matter what the future growth and inflation outlook, the portfolio aims to beat inflation and grow in real terms. These strategies have a broader strategic asset allocation and may have exposure to all asset classes, including equities, fixed income, real assets, currencies, etc.

Idiosyncratic multi-asset strategies mostly add value through top-down views and typically add less value through bottom-up security selection. Core and risk parity multi-asset strategies may also include a broad mix of assets but offer lower cost and more static portfolios, possibly incorporating leverage. Among strategies in these other multi-asset categories, we note some shifting toward inflation-defensive assets since 2020, including higher allocations to gold, TIPS and commodities. However, these multi-asset strategies tend to be "all-weather" strategies that we would expect to consistently add value on a real-return basis, with stronger real returns when inflation is expected to be more consistent or muted. In contrast, the SAAs of dedicated diversified inflation multi-asset strategies tends to lead to a return that is typically leveraged to inflation changes. We expect these strategies to perform significantly better in rising-/higher-inflation environments and struggle more during falling-/lower-inflation environments.

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## Conclusion

The events of 2020 and 2021 are the latest examples of Yogi Berra's insight, "It's tough to make predictions, especially about the future." Just like we rarely know the cause of a financial crisis before it occurs, so too are we unlikely to call the exact source for a future surge in inflation. However, we do feel confident in saying that compared to pre pandemic times, the risk of structurally higher inflation and a more volatile inflation environment has increased, whether the 2021 inflation surge turns out to be transitory or not. For that, we believe portfolios must be prepared.

Although we prefer the more holistic, do-it-yourself approach where feasible, diversified inflation hedge strategies also have a role for many investors. If DIH strategies are more suitable for you, selecting the right strategy will require knowing your portfolio objectives and informed manager selection. Your Mercer contact can help at both stages of the process.

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