Inflation Risk:

Persistent or Transitory is the Wrong Question

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Persistent … or transitory? It's the inflation question that has been weighing on the markets over the last year. As each economic data point trickles out, it is analyzed and re-analyzed, with that focus in mind. But it may be the wrong question to ask.

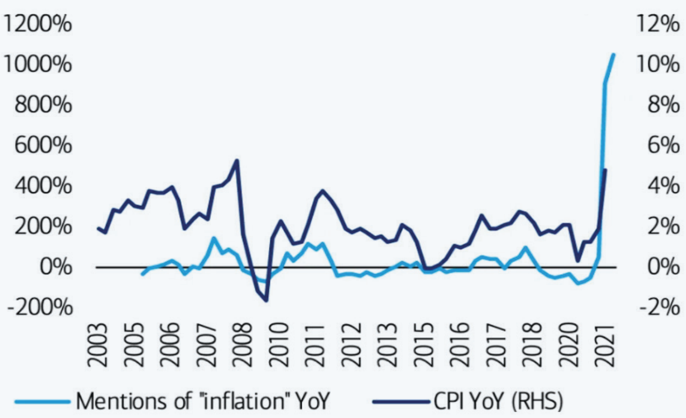
Instead of pondering whether inflation is a real threat, a more pertinent question is whether your clients' portfolios are prepared for it. Too often, the answer is no. This is because the average portfolio is not well suited for handling a variety of adverse market conditions. And over the last decade plus, they haven't needed to be.

Most advisors and allocators continue to build 60/40 or 70/30 stock and bond portfolios. These standard allocation models have worked well since the 2008 financial crisis when the most important investment decision was simply to stay off the sidelines, maintain an allocation to stocks and bonds, and let a market rebound and falling interest rates take care of the rest.

But the threat of inflation, and rising interest rates that would eventually follow, serve as a cautionary reminder that market conditions change and old threats often re-emerge.

Inflation Concerns Mount

Mentions of inflation during S&P 500 companies' earnings calls have risen over 1000% year over year.



Source: BofA Global Research, Bloomberg. 2003-6/30/21. Consumer Price Index year over year is represented on the right hand side of the graph.

Key Takeaways

- Instead of wondering whether inflation is a persistent or transitory threat, a better question is whether your client's portfolio is prepared for it.
- Advisors can modernize portfolios by including asset classes and strategies that are uncorrelated to stocks and bonds, and are resilient to different market conditions and risks.
- Proper diversification is a constant mindset, not a reaction. By including a blend of low-correlating strategies, advisors may create a client experience with better outcomes and is easier to manage.

As the chart shows, inflation is a growing concern. Instead of gauging whether the threat is real, investors may benefit from proactively building a portfolio that can better withstand it.

Advisors can prepare portfolios by including asset classes and strategies that are uncorrelated to stocks and bonds, and are resilient to different market conditions and risks.

For example, in an inflationary environment, commodities or real estate can help buffer against – and even benefit from – inflation. To protect against rising rates, advisors and their clients could seek out alternative income strategies that are uncorrelated to bonds yet still offer the potential to deliver high income. Better yet, combining several low-correlating solutions (i.e., a sleeve) within a traditional portfolio can help it to better withstand a variety of adverse market conditions.

To protect against rising rates, consider alternative income strategies that are uncorrelated to bonds yet still offer the potential to deliver high income.

Inflation and rising rates may be the topic du jour today, but market conditions continually change, and new threats may surface tomorrow or years from now.

Instead of trying to pinpoint when a threat will occur and making just-in-time allocation calls, investors may be better served by modernizing their overall diversification approach with an allocation to a blend of low-correlating strategies that can do well in different environments – an approach designed to add resilience to portfolios by capitalizing on the unique strengths of each strategy as events or changing market environments occur.

The Questions You Should Be Asking

Rather than spending time asking whether a new market risk such as inflation is real or transitory, advisors should ask these questions:

- What are the near-term and long-term risks I am concerned about?
- Should these risks occur, is there a portfolio shortfall from holding only equity and fixed income?
- Can I show my clients what I've done within their portfolio to address potential risks?
- Is there anything in the portfolio that would actually benefit from the perceived threat?

And most important:

- If a particular market condition happens, will any of my clients fall short of reaching their goals?

When an advisor blends different strategies and asset classes that are uncorrelated to equity and fixed income, they can answer these questions with confidence. The key, however, is to think about these issues proactively. Proper diversification should be a constant mindset, not a reaction. By evolving portfolio construction to include a more diverse set of strategies and asset classes, advisors may create a client experience with better outcomes and less volatility.

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