investors CHRONICLE

Inflation-proof your portfolio

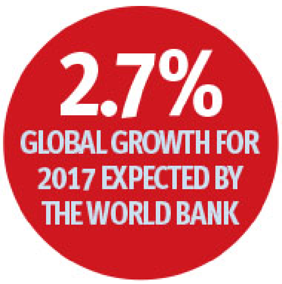
‘Marmite-gate’ was one of the first and most well-publicised examples of the effects of the post-referendum decline of sterling. Tesco (TSCO) temporarily removed Marmite, as well as other Unilever (ULVR) products, from its website after the consumer goods manufacturer announced plans to increase UK prices to compensate for currency-related inflation. While the consequences of higher inflation run much further than a shortage in your favourite yeast extract, the episode highlights the driving force behind it.

An important difference between the rises in inflation during the past eight months and that witnessed during periods such as the late 1980s is that it has not been backed up by a substantial uplift in economic growth. Indicators suggest inflation is being caused by ‘cost-push’ rather than ‘demand-pull’. January retail sales grew at their slowest level since November 2013 – just 1.5 per cent, according to the Office for National Statistics. UK GDP has also been predominately stable during the past year, suggesting there has not been a step up in aggregate demand. Instead an increase in commodity prices and a weakening of sterling have pushed up costs.

However, this is not just UK-specific – there are pockets of inflation around the globe. US consumer prices inflation (CPI) hit a five-year high of 2.5 per cent in January. US President Donald Trump’s pledges to increase public spending, plus a rally in the oil price, have been the main driving forces behind this rise. Protectionist policies, which could block cheaper imports, could also add to inflationary pressure. Meanwhile, Brazil has only just managed to get once-soaring inflation under control, after years of fiscal intervention to keep interest rates low. Neighbouring Venezuela is still battling ultra-high inflation as a result of the paring back of commodity demand.

However, global growth has remained sluggish, last year hitting a post-financial-crisis low of 2.3 per cent, according to data from the World Bank. The organisation expects an uplift to 2.7 per cent for 2017, yet this is the same level achieved during 2014 and 2015.

> **Theoretically, rising inflation puts pressure on valuation multiples as earnings outlooks are lowered”**



Yet UK inflation expectations – as measured by the forward five-year break-even swap rate – are at their highest level since 2009 (see chart). Meanwhile, the Federal Reserve has signalled it is more likely to increase interest rates several times each year until 2019, as inflation has started to creep up. It is worth noting that the Fed uses the Commerce Department’s personal consumption price expenditures price index rather than CPI to measure inflation. The Bank of England has also started to come under pressure to increase the base rate as inflation is expected to surpass its 2 per cent target later this year. However, the central bank expects the rate of inflation growth to slow to 1.6 per cent in 2018 and 1.7 per cent in 2019.

Rising inflation can be detrimental to certain types of assets, including equities. Theoretically, rising inflation puts pressure on valuation multiples as earnings outlooks are lowered. Increased costs put pressure on company profit margins, as a result of rising input costs. The extent of this profit margin squeeze will depend on the rate and degree of inflation. There are caveats to this.

If inflation is high but stable, inflation expectations are more likely to be priced into the value of equities.

However, a jump in inflation – accompanied by increasing interest rates – can be more detrimental. It is also worth noting that we have also experienced much higher rates of inflation during previous periods, for instance during the aftermath of the 2008 financial crisis. Now, though, we are starting from a lower base of inflation.

Profit margin squeeze

Ultra-low interest rates have encouraged investors to pile into real assets and equities in recent years, pushing up valuations. Certain types of companies are better placed to deal with an increase in costs. Pricing power is the most important factor, as companies with higher, but more importantly stable, gross margins should find it easier to pass on higher input costs to their customers. Likewise, companies with a strong brand typically have stronger pricing power.

Rising inflation also has the potential to eat away the value of dividend income, with higher discount rates applied to future earnings. Therefore companies that have a willingness or better ability to increase dividends are more resistant to the effects of increasing inflation. This should be funded via good cash generation, rather than mounting debt or falling cash on the balance sheet.

With this in mind, we carried out a stock screen to find companies listed on the FTSE 350, Alternative Investment Market (Aim) and FTSE All-Small with the most inflation-resistant characteristics. The criteria used for this screen are:

■ A dividend of at least 1 per cent.

■ A rising dividend during the past 10 years.

■ Dividend cover of at least two times earnings.

■ A gross margin within 10 per cent of its level five years ago.

■ A gross margin that has not fallen by more than 5 per cent in any single year.

■ Positive free cash flow generation during the five years.

The results can be seen in the table below. *EP*

Inflation-resistant shares

Name	TIDM	Market Cap	Price (p)	FW NTM PE	Dividend Yield (%)	Dividend cover	10-year DPS CAGR	DPS (£)	Gross margin FY (%)	Free cash flow (£)	Net cash/debt (£)	Test failed
Abcam	AIM:ABC	£1.72bn	850	35	1	2.24	32.4%	0.09	70.2	36m	71m	-
Ashtead	LSE:AHT	£8,52bn	1,712p	15	1.4	4.09	31.1%	0.23	96.0	732m	-2.70bn	-
IDOX	AIM:IDOX	£279m	70p	16	1.4%	3.75	34.9%	0.01	86.8	5m	-25m	-
Portmeirion Group	AIM:PMP	£102m	980p	17	3.2%	2.10	8.8%	0.30	58.3	2m	-10m	10-year rising DPS
Sanderson Group	AIM:SND	£45m	82p	15	2.9%	2.01	-0.8%	0.02	84.1	0m	5m	10-year rising DPS
Stilo International	AIM:STL	£7m	6p	-	1.5%	3.70	65.1%*	0.00	99.2	0m	1m	10-year rising DPS
Walker Greenbank	AIM:WGB	£137m	197p	16	1.5%	5.13	25.2%*	0.03	59.2	1m	3m	10-year rising DPS

Source: S&P Capital IQ *Three-year figures

Use funds to dodge risk

Inflation can eat away at your portfolio if you are not in the right assets. Funds can play a role in inflation-proofing your portfolio.

“Inflation has different impacts on different asset classes, but broadly speaking it can be seen as a type of long-term hidden or stealth tax (on your investments),” says Tom Stevenson, investment director at Fidelity International. “It is particularly a problem for investments that have a fixed return or a fixed income and over time can really savage the value of your investments.”

Bonds are undoubtedly the worst-hit by rising inflation as the fixed return they pay out is eroded when inflation creeps up. They are also hit by an effective double whammy if inflation is accompanied by higher interest rates – in this case the rate of interest they pay out is eroded by higher inflation and the bonds fall in value too as rates rise.

In rising inflation environments real assets such as infrastructure, gold, property and other precious metals perform well"

Buying an index-linked bond fund with interest payments that rise with inflation is one way to protect yourself. But there are risks. The bulk of these are government bond funds, which currently yield close to 0 per cent and are invested in long-dated bonds with high interest-rate risk. **Henderson Index linked bond fund** (GB0007466617), for example, is almost 40 per cent invested in bonds with a maturity of more than 30 years.

That puts you at significant risk of capital loss from your bonds, even if the income they pay does keep pace with inflation.

An alternative option is the **M&G UK Inflation linked corporate bond fund** (GB00B44JC482), which aims for a return at least consistent with inflation over any three- to five-year period. Unlike other index-linked bond funds it is invested in corporate bonds using derivative strategies and has a fairly short duration. Over 30 per cent of its assets are invested in bonds maturing in between three and five years and it invests only in investment-grade credit, meaning default risk on its bonds is low.

The main risk associated with an inflation-linked bond fund is getting the timing wrong and buying when inflation-linked bonds are already highly valued or investing in a falling inflation or low-inflation environment. You are also at risk of losing capital if rates rise and your bonds have long duration.

42.5%
THE AMOUNT TWENTYFOUR DYNAMIC BOND RETURNED OVER 5 YEARS

Patrick Connolly, chartered financial planner at Chase de Vere, says: "Inflation-linked bond funds are in theory a great idea because they protect investors against rising inflation, but the reality doesn't always work out like that.

"The income and capital payments from these bonds are affected by the rate of inflation – a higher rate means a higher return. That works fine for the income aspect, but the price of index-linked bonds is affected by the expectations of the rate of inflation. If people think inflation will go up, they are willing to pay a premium for inflation-linked bonds and the price goes up too. The problem comes when people expect inflation to rise and it doesn't rise as much, because then the capital value comes down the other way."

But Mr Stevenson says: "The best time to buy an inflation-linked bond is when no one is remotely worried about inflation," but he adds, "inflation remains at a fairly low level and they are not too overvalued so this is not a bad time to have some inflation-linked bonds in your portfolio."

Although their coupons are not inflation-proof, a short-dated bond fund or strategic bond fund with a high weighting to index-linked bonds could also be a cautious bond route in a rising inflation environment. Darius McDermott, managing director at Chelsea Financial Services, says: "AXA Sterling Credit Short Duration Bond only invests in bonds close to maturity." That means it has low interest rate sensitivity and its high yield could keep pace with inflation if it does not rise materially.

IC Questions: How do you protect your investments from

INVESTORS CHRONICLE

Published on Feb 22nd 2017
by Investors Chronicle

Play

Strategic bond funds such as **Fidelity Strategic Bond** (GB00B469J896) and **TwentyFour Dynamic Bond fund** (GB00B57TXN82) are able to invest across the bond universe depending on which assets look the most appealing and can hold index-linked bond funds as part of a diversified mix. In five years TwentyFour Dynamic Bond has returned 42.5 per cent and currently yields over 5 per cent.

Real assets

In rising inflation environments real assets such as infrastructure, gold, property and other precious metals perform well. Infrastructure tends to be particularly appealing as the contracts underlying these investments are often tied to inflation, but getting access to this sector can be difficult due to the high premiums funds trade on.

First State Global Listed Infrastructure (GB00B24HK556) is one open-ended option that avoids that problem. Names such as BHP Billiton (BLT) and Rio Tinto (RIO) are large weightings and the fund yields slightly less than many of the investment trusts in this area, but it has an appealing ongoing charge of 0.83 per cent.

Gold is one of the most popular ways to hedge against inflation, but can be highly volatile and many argue against it as the precious metal does not yield anything. Investors can either access gold equities via gold mining funds such as **BlackRock Gold & General** (GB00B99BDY18) or via exchange traded commodities (ETCs) such as **ETFS Physical Gold** (PHAU) that hold the metal directly. Gold has been rallying since the start of the year as investors holding it in recent years suffered big losses during 2013 and 2015.

Inflation-proof equities

Broadly speaking, equities are better places to be than bonds in a rising inflation environment and some companies profit from inflation by being able to pass on price rises to customers. UK equity income funds that are exposed to companies with good pricing power and high barriers to entry are good places to be invested as these also throw off a dividend, which helps your returns outpace inflation.

In fact, according to the Association of Investment Companies, £100,000 invested into the average UK equity income investment company on 31 December 1996 would have generated an initial annual income of £3,700 by 31 December 1997, which would have grown to an annual income of £8,516 in the year to 31 December 2016. Annual dividend growth was 4.5 per cent in that period, some 2 per cent ahead of inflation (annualised retail prices inflation over the period is 2.78 per cent).

Investment trusts include **City of London** (CTY), which has raised its dividend ever year for 50 years – longer than any other investment trust – and also delivered healthy long-term returns. According to fund manager Job Curtis the UK banking sector is likely to benefit from rising inflation, if higher interest rates follow, and the trust’s holdings in **HSBC** (HSBA) (a 4.3 per cent weight) and **Lloyds** (LLOY) (2.1 per cent of assets) would benefit.

Evenlode Income (GB00B40Y5R17)) is an open-ended fund that has delivered strong inflation-beating returns in the past. The fund’s largest holdings are in **Unilever** (ULVR) and **Diageo** (DGE) and it yields 3.7 per cent. In five years it has returned 92.8 per cent against 64.1 per cent for the UK Equity Income sector.

The risk of investing in UK equity income funds today is that valuations in the UK market look high and bond-like stocks, particularly in the consumer staples and utility sectors, are trading on very high multiples. Mr Curtis says: “On a dividend yield basis the UK market doesn’t look too expensive, but on a price/earnings basis it does look quite expensive.”

By contrast, value-style cyclical stocks, which have been unloved for several years but have staged a comeback in 2017, could be an alternative place to look. **Fidelity Special Situations** (GB00B88V3X40) has a reputation for selecting undervalued stocks and includes large weightings to financial and oil holdings, which look set to benefit from a higher inflation world. *KB*

Lessons from history

Inflation will rise this year. Economists expect CPI, which was 1.6 per cent in the year to December 2016, to reach 2.8 per cent by the end of 2017. This poses the question: what does this mean for asset prices?

Not much, according to recent history. Since January 2000, the correlation between CPI and annual changes in the All-Share index has been 0.1 – which is statistically indistinguishable from zero. And that between CPI and gilt returns has been zero. This means that there’s as much chance of gilts and equities doing well as doing badly when inflation rises.

This shouldn’t surprise us. Inflation is more predictable than many macroeconomic indicators because it can rise simply as past price falls drop out of the data and because prices are slow to respond to shocks such as a fall in the pound. This predictability means that markets should see changes in inflation coming and so discount them in advance. This being the case, there should be no correlation between inflation and asset prices. And to a large extent, there isn't.

Things aren't quite so simple, though. For one thing, there is one asset whose price is linked to inflation: gold. In sterling terms, this tends to rise when inflation does. This doesn't, however, mean gold is a sure bet. The correlation between annual changes in the sterling price of gold and inflation is only 0.36. This means that while there's a better than 50-50 chance of gold rising when inflation is high, it's well short of a certainty.

For example, gold fell in 2013 when inflation was well over 2 per cent – the sort of rate we're likely to see later this year. Also, there are a few stock market sectors that have been linked with inflation in the past. Since 2000 inflation has tended to be good for engineers and chemicals stocks and bad for construction – though again the correlations are well short of unity. This is perhaps because the same weak pound that raises inflation also raises exporters' profit margins – a tendency investors have been slow to discount in the past.

And it's likely that construction stocks suffer due to the higher raw materials prices and wages that inflation causes – not to mention the higher interest rates that should eventually accompany higher inflation. There is, however, another problem here. So far, I've considered actual inflation.

It's possible, though, that higher inflation will lead to higher expected inflation; except in severe recessions, actual inflation has often led to higher expected inflation. Now, in the recent past higher inflation expectations have been good for equities. Here, though, history might be misleading. A rise in inflation expectations because of a stronger economy is indeed good for shares.

But a rise accompanied by higher wages – or that leads to higher interest rates – would be an altogether different matter. The risk for shares is that rising inflation this year triggers higher wage costs and higher interest rates. If this happens, profits would eventually be squeezed by a combination of higher costs and the weaker domestic demand that follows from higher rates.

It's possible, therefore, that higher inflation will indeed be bad for domestically-oriented equities. Investing in overseas equities might not protect us from this: they would suffer if sterling bounces back, not to mention the significant possibility that global markets will fall. Nor would cash protect us.

While this would benefit from rising interest rates, it will lose us money in real terms before rates rise. The only certain protection against inflation is in index-linked bonds. These, however, offer negative real returns. But then insurance is always expensive when everyone wants to buy it. *CD*

visible-status-Registered story-url-Inflation proofing_COVER feature_240217.xml