Investment Insights
Protecting a Client's Portfolio from Inflation

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Morningstar Investment Management LLC
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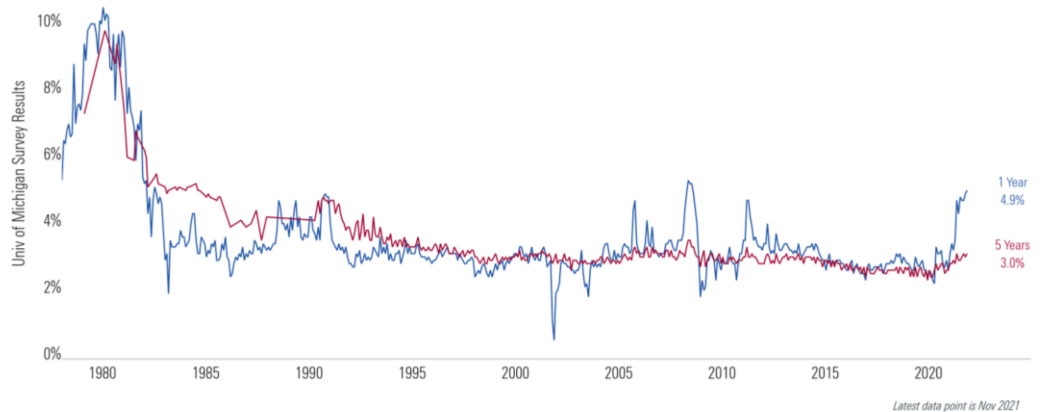
When it comes to the most insidious risks facing investors, inflation may well top the list. Its impact on portfolios doesn't appear until investors compare gains to the climbing cost of living. To achieve any meaningful progress toward financial goals, investors need to clear the inflation hurdle.

Exhibit Inflation Expectations are Rising as We Enter 2022. 12-month and 5-year Survey Results



Source: Clearnomics, University of Michigan, Morningstar Investment Management, as of October 31, 2021. This is for illustrative purposes only.

Beating Inflation is Investing 101

For many years, clearing the inflation hurdle hasn't been difficult. With a stable supply-and-demand balance, the cost of living has broadly risen at a predictable, modest pace. Meanwhile, falling rates, expanding valuations, and individual company successes have fueled broad-market gains at a rate well above historical norms.

But when inflation does materialize, particularly at higher levels, its impact can be widespread devastation. Investors with shorter time horizons, who typically have greater exposure to bonds, are particularly vulnerable. A significant portion of the total return generated from bonds comes from income, which, for most bonds, is predetermined (hence the term "fixed" income). As inflation rises, the "fixed" income delivered by the bond is worth less. In response, investors may sell bonds, driving prices down and further hurting returns.

Among investors with shorter-term horizons are retirees, who no longer generate wages that could potentially rise to inflation-adjusted levels.

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But it's not just the bond investor who faces risk during periods of inflation. While equity markets aren't subject to the same "fixed"-income conundrum, their total return can also be in jeopardy; their dividend payments are worth less, and their earnings can suffer from higher input costs, particularly if they are not in a position to pass along higher prices to their consumers. As earnings come under pressure, so can their ability to generate inflation-beating returns.

Even high-flying growth stocks aren't immune to inflation. In fact, growth stocks have historically shown greater vulnerability to inflation than their value brethren. The explanation involves the expectations around earnings: as inflation rises, so do interest rates, which means investors expecting higher earnings from growth companies discount them back to present day with a more penalizing level of interest rates.

This leaves us with two questions as we enter 2022:

1. If inflation is inconsistent—and unpredictable—how do you protect your portfolio from it?
2. If you could predict it, given that both bonds and stocks are vulnerable to it, is there anything you can do to protect against it anyway, even if you could see it coming?

On the first point, you don't need to know with certainty that inflation is coming. We view portfolio construction as an exercise of probability, weighing one market environment against another. We build portfolios for a range of environments and rarely make binary calls on particular outcomes.

Fortunately, our research suggests that many of the assets best suited for inflation protection are also relatively well priced. These assets include:

- **Short-duration bonds or cash** (fixed payments have very short durations and thus can reset as rates rise)
- **Equities that are positively correlated to inflation**, such as energy stocks
- **High-quality companies** with high degrees of pricing power that can pass along rising input costs

However, there are also sources of protection we don't like. For example, inflation-protected bonds (including Treasury Inflation-Protected Securities or TIPS) are a common go-to source; however, these are less attractively priced, in our view. The same applies to high-yield bonds and floating-rate bonds, both of which benefit from improving credit profiles during inflationary periods but are also unattractively priced. As a result, we have limited exposure to these asset classes, despite their inflation-protection properties.

Key Takeaways Regarding Inflation

Inflation is a well-known risk facing investors and we take it seriously. In 2022, as always, we believe inflation is worth protecting against, but we caution investors away from trying to predict inflation outcomes with precision.

The key is to understand how each asset may help in different inflation outcomes, assessing the total portfolio impact and whether it will deliver on its objective. It's worth noting that some assets that have been in vogue for the past few years—especially U.S. growth stocks—strike us as not only overpriced but also as vulnerable in an inflation shock.

Those considerations above aside, over the past several decades inflation has been more a specter in investors' minds than an actual reality they need to face, and today's market could very well prove to be more of the same. It's for that very reason that we think along the lines of probability rather than forecasts and account for a range of market environments. In the end, if inflation once again fails to materialize as a

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real threat, we do not believe our portfolios will be at a disadvantage; the driving thrust of their positioning is valuations, not inflation.

Highlight of Our Convictions

Steering investors to more traditional asset classes, our investment team monitors over 300+ markets across equities, fixed income, and currency. We highlight our conviction level across some core assets, including a micro-thesis on the key drivers.

Asset Class		Overall Conviction*	Key Long-Term Drivers
EQUITIES	United States	Low to Medium	Valuations are not as compelling as international markets. Investor optimism was bordering on excessive, which remains a concern to us.
	Europe ex-U.K.	Medium	We find the opportunity set in Europe to be diverse. The recovery continues to take shape, with sector selection important.
	U.K.	Medium to High	Investor sentiment has improved, following a long period of negativity. The reward for risk continues to appeal.
	Japan	Medium	We still cite structural reform, providing upside to earnings drivers. The relative appeal is moderate.
	Emerging Markets	Medium	Recent weakness has improved the opportunity set in emerging markets, although the overall appeal is still moderate. Risks need to be managed.
	Germany	Medium to High	German stocks offer solid balance sheets and upside to earnings—without the eyewatering valuations in some other markets.
	South Africa	Medium	While sensitive to cyclical earnings and concentration risk, valuations reflect these concerns. Our view has moderated though.
FIXED INCOME	Government Bonds – U.S.	Low to Medium	Yields are still incredibly low and no longer cover inflation risks. The defensive attributes are appealing, but unlikely to contribute to returns.
	Government Bonds – U.K. & Europe	Low	Gilts, Bunds and other EU Treasuries have terribly low yields. Longer-dated bonds are particularly sensitive to inflation risk with poor return prospects.
	Investment-Grade Corporate Bonds	Low to Medium	Yields are unattractive in an absolute sense, with a narrow spread to government bonds. We are wary of valuation risks if the recovery stutters.
	High Yield Credit	Low to Medium	Yields no longer compensate for the risk taken. Defaults remain low, but credit risk should not be ignored.
	Emerging-Markets Debt (Local)	Medium to High	Emerging market debt in local currency (which we prefer over hard currency) continues to offer healthy relative yields, even accounting for risk.
LISTED PROPERTY	U.S. REITs	Low to Medium	U.S. listed property remains broadly unattractive on an absolute basis, carrying high debt and concentrated exposure.
	Non-U.S. REITs	Low to Medium	Continues to rank behind other opportunities on both an absolute and relative basis, although South African REITs continue to stand out.

Source: Morningstar Investment Management, conviction levels confirmed at November 12th, 2021.

*Overall conviction is a long-term judgement built on a five-point scale from "Low" to "High". Typically judged on a 10-year horizon, a "Low" means that reward-for-risk is likely to be subdued, whereas a "High" means reward-for-risk is appealing. This incorporates our four pillars of conviction including 1) absolute valuations, 2) relative valuations, 3) fundamental risk and 4) a contrarian scorecard.

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