Protect the body – NFP investing in an inflationary world

By Perpetual Private Insights
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The Chicago Board Options Exchange's CBOE Volatility Index, more commonly known as VIX, measures the expected volatility of the US stock market for the next 30 days. It's a very specific index but it's also commonly used as a short-hand measure of broader volatility in investment markets. Sometimes called the Fear Index, it's risen 87% over the six months to 2 March 2022. Winter may be coming. But volatility is ***here***.

> "The market has shifted, given higher inflation is a different playbook from the last 20 years. If you think the strategies that have worked for the past decade or two are going to work going forward, then you may be in for a rude shock."
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> **Kyle Lidbury, Head of Investment Research, Perpetual Private**

According to Kyle Lidbury, Head of Investment Research at Perpetual Private, the recent market volatility marks a turning point in economics and markets, a turning point big enough to change the way NFP investors and those in charge of foundations and endowments need to think about their portfolios.

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The volatility

The trigger for all this volatility is the re-emergence of inflation. For many months, much of the debate about inflation was over whether it was simply a result of Covid-19-related supply chain issues. Given the lockdowns that wracked the world for two years – and the government stimulus and rate cuts designed to ease the associated economic pain - demand for goods soared, while suppliers struggled with staffing and capacity.

Ukraine, Russia and global markets

It's impossible to predict the course of the Ukraine/Russia war.

Whatever happens, financial sanctions and disruptions to global trade are likely to further inflame inflation. Russia and Ukraine are major energy and food producers and disruptions to their output will push up costs on these essential goods – thus affecting consumers around the world. That could have a negative effect on growth.

This combination – rising inflation and a threat to growth – makes life difficult for Central Banks, who need to calibrate a strategy that keeps inflation under control without risking recession.

As Kyle Lidbury notes in the video above, the most recent figures put US inflation at above 7% for the year-over-year period ending February 2022 and so the US Fed has stopped talking about 'transitory inflation'. More importantly it has started to get more hawkish about raising rates.

What could this mean for NFPs?

For NFPs, foundations and endowments, inflation is a real and present danger and protecting your corpus, your body of capital, is crucial. Inflation eats away at the value of your capital and by doing so cuts the future value of income that capital can earn.

To put that into context, over the past decade or so, NFPs only needed to grow their capital by less than 2% a year on average to protect it from inflation in Australia. However, over the 12 months to the December 2021 quarter, this rose to 3.5%. Whilst not at the levels of the US, this rate is more than triple that of the same period in 2020 which has real implications for NFPs' investment strategies, particularly if these higher levels are maintained.

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Each NFP is different, with different missions, investment strategies and spending strategies. But all NFPs should think about whether they have an appropriate allocation of growth assets in their portfolios. If the growth portion of the portfolio is too low, the real value of the corpus may struggle to keep up with inflation, which could reduce its ability to deliver the same level of assistance to programs and for communities.

This portfolio shift – an increased tilt to growth assets – may appear counter-intuitive in a volatile environment but as Kyle Lidbury explains, "Equities have proven themselves to be more effective historically, relative to bonds or cash as a hedge against inflation."

How to manage a more volatile, inflationary environment

Here's a brief guide to who we think the winners and losers in a rising-rate world may be.

- **Active can outperform**

In an inflationary world, security selection becomes more important. In equity markets, companies that can pass on input price rises to their customers will do better than those in hyper-competitive segments where pushing up prices means losing out on sales. Identifying and investing in those companies, and paying the right price to own them, is a job for an active manager, not an index-hugging algorithm.

- **A shift to value within equities**

One immediate effect of the threat of higher rates has been sharp falls in many growth stocks, such as tech stocks, and better share market performance by value stocks.

"Higher rates have a two-fold impact on growth companies," explains Kyle Lidbury. "Firstly, their potential earnings get discounted more heavily. Secondly, funding all that growth via debt becomes a lot more expensive and that means lower profits. It's why the big losers from recent market volatility have been high-growth, low-profit or no-profit tech companies. And why the future looks brighter for companies with predictable cash flows – like banks. And those that benefit from higher commodity prices – like miners."

- **Portfolio shift**

In the portfolios Perpetual Private manages for NFPs, foundations and endowments, the big shifts are those summed up above – a further move towards value shares and a preference for using active managers to identify quality assets gives portfolios a higher chance of delivering real returns, setting investors up with a better chance of success in volatile times.

Perpetual Private's investment team has also increased allocations to alternative investments – which includes unlisted assets, such as private equity, infrastructure and property, as well as sophisticated trading strategies that are less reliant on underlying market trends. These

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alternative assets often rely on the skill of the manager rather than underlying markets to generate returns.

"For NFP clients, alternative assets can provide another way to boost returns and combat inflation," says Kyle Lidbury. "They also add a really important extra level of diversification as they have a low correlation to more traditional asset classes such as equities and bonds. This means we can seek inflation-beating returns, whilst ensuring that the overall level of portfolio risk remains within expectations."

You can see more of the Perpetual Private Investment Team's thinking on 2022 market moves [here]

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