



INFLATION CONSTERNATION

What is Federal Street doing about it?

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We've been asked by many of our clients about whether we are concerned about inflation and if so, what we are doing about it. The purpose of this article is to discuss why it has become such a hot issue, discuss how we believe our clients are currently protected in the present environment, and how we may consider doing even more if the conditions warrant.

For some background, we faced a financial crisis of enormous proportions in 2008 that resulted in a recession affecting most global developed economies. In order to combat this, the Federal Reserve Bank here in the U.S, as well as central banks of other developed nations, took measures to stimulate growth. They did so in both conventional and less conventional ways. Not only were interest rates reduced but governments injected capital into troubled organizations, created massive spending programs to offset declining employment rates, purchased securities in the open market to keep long term interest rates low and support prices, and kept the door open for additional spending. The government intervention was greatest in the U.S. and in Europe where large banking institutions were the most damaged. The magnitude of the global spending has been unprecedented and has resulted in heightened levels of concern about its future inflationary impact.

If, when and how inflation occurs are questions on the minds of not only investment professionals but economists around the globe. The debate is fierce and bifurcated with some predicting Japanese style deflation while others predicting inflation at levels we've never seen here in the U.S. While we ourselves are not economists, we are monitoring the debates and certainly understand the reasons for the differing views. And, as those debates continue, we look ahead to understand how either inflation or deflation may impact our clients' portfolios.

With the wealth that our clients have built over their lifetimes, inflation could be detrimental as the purchasing power of their assets declines over time. If a client's portfolio does not increase with the level of inflation, it is very difficult to make up for that loss in purchasing power as prices don't generally cycle up and down like asset values. That is why we have built in an expected level of inflation into the foundation of our asset allocation policy. This seems pretty basic but it is important in understanding our long term approach to addressing inflation.

Acknowledging inflation in our clients' long term strategic asset allocation policy is only one way of protecting against inflation. In addition to this, many of our clients have built into their policy

an allowance for real growth (that is, growth after the impact of inflation). How this growth is achieved is generally through heavy reliance on equity investments where stock prices are expected to increase faster than inflation. By building in this cushion for real growth, our clients can be protected when short term inflation exceeds the long term expected rate already built into their asset allocation.

But all of this is done to protect from a general (or gradual) increase in the level of inflation, not necessarily a sudden increase or sustained level of high inflation. Also, it does not acknowledge the type of inflation taking hold. For example, oil prices increased from \$19 a barrel in 2001 to \$147 a barrel in 2008. This 674% price increase had disparate effects on the population. If you were a consumer of oil, you were severely hurt as this dramatic price change increased your cost of living or your cost of doing business. The higher your use, the more you were effected. Incomes did not generally go up to help overcome this price increase nor were many businesses able to pass on the higher costs if oil was a cost of production. If you were an investor in oil, you benefited. If you were simultaneously invested in oil and a user of oil, oil price increases may have been a non-event to you as your appreciated investment offset the increase in your oil costs.

The oil price inflation described above is just one of many types of inflation that can take hold. There are other single sources of inflation like real estate, healthcare, raw materials, and other types of energy. Protecting yourself against those areas of inflation that have the greatest impact on you is optimal—for example, many companies hedge themselves against future price increases of supplies. The question becomes: so why can't you? The answer is you can, but it can be costly and perhaps unnecessarily bumpy. For example, in the oil example above, after oil hit its peak of \$147, it came crashing down 80% only 6 months later. In addition, there is an opportunity cost of hedging because as with any type of insurance, you forgo an opportunity elsewhere by paying the insurance premium. For clients who have particular spending needs tied to areas where inflation expectations are high, targeted hedging is generally recommended as the benefits generally outweigh the costs. For most clients, however, it is usually enough to try to protect from overall price increases, recognizing that while there can be pockets of high inflation, they are generally outweighed by areas where inflation is more moderate. In our oil example above, our clients generally did not need to hedge themselves against the increasing price of oil because of its relatively minor allocation in their overall respective budgets.

We've covered inflation hedging for single sources of inflation, but what if government stimulus creates inflation across the board? There are a couple of ways our clients are protected through their strategic asset allocation. For one, their characteristically healthy allocation to equities will necessarily include companies that are able to weather inflationary periods by either passing along price increases to customers or, perhaps, even benefiting from inflation themselves. If inflation results in a decline in the U.S dollar, our clients' international equities should benefit, offsetting any price increases associated with the dollar's decline.

Finally, our preference for active, third party managers as opposed to indexing strategies adds a layer of protection from the impact of macroeconomic issues like inflation. As a reminder, we

recommend our clients invest with exceptional third party investment managers, each of whom has an expertise in their respective areas of investing. For example, we have a traditional small cap growth manager who was able to identify a great company that was a supplier to the oil industry, and was therefore able to benefit not only from their own organic business growth but also from the increase in oil prices that helped to drive demand in their industry. Because that company was strong irrespective of the change in oil prices, its stock price did not experience anywhere near the 80% drawdown that oil did between June 2008 and February 2009. In addition to traditional managers, hedge fund managers have the most tools at their disposal to navigate the macro environment, buying stocks or bonds that they believe will appreciate while shorting those that they believe over-valued. To address the macro economic issues we are facing, some of those managers can invest in other areas outside of stocks and bonds and have, in fact, invested in such areas as gold and some have even shorted sovereign credit. We are relying on them to help us navigate a potential inflationary situation by not only protecting their respective portfolios but by also investing to benefit from inflation.

We've discussed our strategic asset allocation process and our recommendation of active third party managers as two ways our clients can get protection against inflation. If we find ourselves in a situation where this is not enough, we can act accordingly. For example, adding real assets like commodities, real estate, and timber will typically combat high inflation since the price of these assets will move directly with inflation. However, real assets are usually illiquid and volatile so we need to be certain of sustained high inflation before adding these assets. What about Treasury Inflation Protected Securities (TIPs)? It is not clear whether these will provide better inflation protection than our clients' equity allocations. Unfortunately they do not necessarily measure the true levels of inflation, which, combined with the fact that the opportunity cost of holding these 2% yielding securities is so high, we have chosen to pass on this type of instrument for now. Also, we have explored various types of insurance like derivatives and even some of the more esoteric strategies that should do well in inflationary environments, however, the costs outweigh the benefits given the fact that inflation does not appear to be imminent at this point in time.

The debate over inflation continues and we are correspondingly attentive to the pertinent issues. Between our multi-dimensional asset allocation process and our reliance on exceptional third party managers, we believe that we have the tools to help weather most economic and market environments. If we feel that these two factors will not be enough, we will thoughtfully intervene to help further protect our clients' portfolios.

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