What to Do in Case of Sustained Inflation

By James Montier   *Wed, Oct 20, 2021*

'Are you interested in an inflation hedge (something that closely tracks inflation) or a store of value (something that will preserve purchasing power)?' asks the GMO value-investing guru.

We have a relatively sanguine view on the likelihood of inflation becoming ingrained in the system (much as it pains us to agree with the Fed). However, the dark arts of macroeconomics are notoriously tricky, and we have often talked of the need to build robust (as opposed to optimal) portfolios – effectively, portfolios that can withstand multiple outcomes. As such, it behooves us to consider how to deal with inflation in the context of your portfolio.

The first choice you must make is to determine whether you are interested in an inflation hedge (something that closely tracks inflation) or a store of value (something that will preserve purchasing power). For long-term investors, the latter is probably of more interest. A focus on the store of value naturally leads to a search for real assets. Despite conventional wisdom, commodities in general haven't been a good store of value.

The 'best' real asset we have found is equities. They make a terrible inflation hedge but over the long term publicly traded companies are the businesses that charge prices and pay wages, so their cash flows should be real if these two elements are roughly matched. Thus they act as a store of value in the longer term. Of course, you can do better than simply buying equities, you can buy cheap equities. This is like being offered inflation insurance at a discount.

Hedging Inflation Risk Today

We have a relatively sanguine outlook on inflation, as discussed in "Part 1: Inflation – Tall Tales and True Causes." Perhaps you don't share our view. Or perhaps like us you are always interested in how to build a robust portfolio (one which can survive a lot of different outcomes). Either way it is time to turn our attention to how to protect your portfolio from an inflationary outcome.

As with all ‘tail risk’ insurance you need to ask yourself three questions.

1.What are you trying to hedge?

In this case, we need to consider the sources of inflation. Unfortunately inflation seems to follow the Anna Karenina principle. As Tolstoy put it, “Happy families are all alike; every unhappy family is unhappy in its own way”. The ‘good’ news is that the labour market dynamic is truly key for an inflation to take hold so pondering this aspect may make it slightly easier to think about, rather than trying to find the proximate cause.

2. How will you hedge?

We will explore some of the options that you might choose to pursue in the next section of this paper.

3. How much will it cost to hedge?

As always, it is important to remember that insurance is as much a value-based proposition as anything else in investing. So you need to be sure to analyse the cost of the insurance that you are buying.

Before we look at the potential ways you might try to hedge inflation, we need to make a distinction between what we might call hedging and a store of value. We think this is a vital distinction. To us, the term hedge implies a tight correlation with inflation (and therefore takes you into the world of swaps and caps, etc.). The concept of store of value is probably more important to a long-term investor.

We think of this as an asset that should outperform inflation but isn’t necessarily closely correlated with inflation (especially in the short term). Equities (assuming fair value for a second) are a real asset and we should expect their underlying cash flows to keep pace with inflation over the long term. As such, they meet the criteria for a store of value. However, due to behavioral issues, sometimes valuations get compressed in inflationary times, so they don’t correlate well with inflation as a hedge. Hence, they are a store of value but not an inflation hedge. Figuring out which of these two dimensions is important to you is vital when it comes to the choices you will make.

Let’s turn to the various instruments that might be thought to act as either a hedge or a store of value when it comes to inflation.

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