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# Understanding Inflation and Deflation: How Nonprofits Can Tackle Potential Risk In Portfolios

Institutional investors take heed—inflation is on its way to a portfolio near you. The only problem is, no one has quite figured out when yet.

While not an immediate threat, industry experts have found that inflation is on the horizon, which makes how institutions address the drivers of a greater inflationary environment and construct their portfolio accordingly all the more significant.

"The story starts with inflation, but no one knows the timing of when that is going to be a problem," said **Ellen Safir**, founder and ceo of **New Century Advisors,** which manages both U.S. TIPS and global inflation-linked strategies. "Everyone recognizes that the table has been set, given tremendous stimulus packages and deficits—and understanding the history of how countries get themselves out of deficits is true growth and inflation."

Thus far in 2010, nonprofits have cautiously increased their allocations to TIPS or inflation-linked assets. **Florida International University**, **New Jersey Institute of Technology** and **Fairfield University** have already allocated to commodities and other types of inflation-linked strategies through passive or active mandates with **State Street Global Advisors**, **Chilton Capital Management** and **Blackstone Group**, respectively, which is just a small indication of what may be to come for managers that utilize an inflation-linked strategy.

Also, a number of universities, including **Macalester College**, the **University of West Florida Foundation** and **Texas Permanent School Fund** are currently discussing such investments.

Other nonprofits, such as the $62 million **Ventura County Community Foundation**, recognize that while inflation is something to pay attention to, it is not an immediate threat to the portfolio.

"Have we talked about inflation? The answer is yes we have talked about inflation protection and how to best position the portfolio," said **Hugh Ralston**, president and ceo of the foundation. "The question is two, three, five years out, but I think it is a matter that the committee has looked at and is certainly on the horizon, but not a threat now."

## Drivers of Inflation

Safir said her analysis of The Federal Reserve Agency's views on inflation shows that based on market expectations, there is an anticipation of higher inflation than we have now, which as of February was 2.14%. However, while a greater percentage than before is foreseen, the market is still looking at less than 3% inflation by 2014, according to Fed data.

"Historically, inflation in the U.S. hasn't stayed below 2% for very long and we also have a bias in the U.S. to prefer inflation to deflation because, after all, national experience with deflation was monumental," Safir said. "Data suggests that there continues to be downward pressure on headline inflation, but

that the core has not moved down that much…so I think these pension plans and foundations are thinking of this asset class as an all-purpose hedge and inflation hedge."

**Ron Albahary**, cio of investment consulting firm **Convergent Wealth Advisors**, says that while deflation is a portfolio concern in the near-term, looking out longer-term there are risks that inflation could spike due to the huge monetary stimulus or in response to a debasement of the dollar. Albahary, who is currently drafting a white paper on the topics of inflation and deflation, cited the massive economic stimulus, commodity prices, global economic recovery and demographic trends in the emerging world as drivers of inflation.

In addressing the stimulus, Albahary said that if the Fed is successful at increasing the monetary supply given the doubling of the monetary base, monetary theory suggests that a permanent change in the country's money supply will eventually lead to a similar change in its price level. As a result, long-term inflation should be highly correlated with the rate of growth of money supply.

"In the long run, the correlation between money supply and inflation is very strong. However, it is markedly weaker in shorter time periods," he said. "I looked at the period of January 1971 to July 2005 and the correlation coefficient increases as you extend the time period analyzed. It is a low of 0.36 for the 2-year averages, 0.60 for the 4-year averages and 0.71 for the six year averages. While banks have restrained their issuance of credit, they are in dire need of repairing their balance sheets through increased profits and, as such, with the incredible steepness of the yield curve, it is hard to imagine banks won't ramp up lending to take advantage of the spreads; thereby, fueling consumption and thus inflation."

In addition, the Consumer Price Index (CPI), one of the many inflation indicators, was unchanged in February, the U.S. Bureau of Labor Statistics reported March 18. Over the last 12 months, the index increased 2.1% before seasonal adjustment.

"One measure in the CPI that has a strong effect on the CPI is housing costs, and housing costs certainly are not going up as well. They make up over 40% of the CPI numbers," said **George Dunn**, an executive director of Convergent. "So headline CPI inflation is something we don't believe is likely to be a big problem for a while until we get plant capacity utilization up, get unemployment down and put pressure on basis."

**Don't Forget About Deflation**

When analyzing the drivers of inflation and their effects on portfolios, **Celia Dallas**, co-director of research at **Cambridge Associates**, said that deflation cannot and should not be ignored.

"Both are a possibility, because the more deflationary pressures there are, it raises the prospect of inflation down the road because of the stimulus policy put in place," she said. "From our perspective we see both inflation and deflation to be risks to (hedge) against, but I think it's a bit dangerous to choose between one or the other. [The question is] when you look at positioning your portfolio for one and not the other, 'what are the implications if I'm wrong?'"

In addition, Convergent's Albahary said that if economic growth stagnates and a double dip recession is experienced, there is the possibility of falling into a deflationary spiral as the Fed is potentially limited in additional options to stimulate pricing levels. Disinflation (the current environment) is not the concern, he said, but rather an extended period of deep decline in prices of all assets.

Among the many drivers of deflation, he said he believes that the low velocity of money, exceptional productivity and significant slack in the economy has contributed to a deflationary environment.

"It is difficult to look at the numbers and not question where growth is going to come from and, as a result, wonder what could possibly spark inflation," he said. "Based on the last 50 years worth of history, the velocity of money has dropped off a cliff as the Fed has flooded the system with money but consumption hasn't risen which means one has to ask, 'is the Fed pushing on a string?'"

### Where Managers Fit In The Discussion

Dallas said Cambridge Associates has been thinking about assets that do well in an environment of high or rising inflation and assets that would do well in times of deflation, citing Treasuries as an example. The concern, however, is trying to buy them when they're relatively expensive, Dallas said, which is a bit challenging for institutions. But, if investors such as nonprofits, which advocate the benefits of long-term investing, can look at it as a long-term move, they should be able to reluctantly swallow the price risk.

"There are different sorts of inflation, and no perfect hedge against that, but investors should think about owning a variety of assets with a closer link to inflation like bonds, but not expect to generate a high return where yields are today," Dallas said.

Dunn of Convergent said that based on a historical view of the markets, one could consider real estate as a long-term hedge against reasonable levels of inflation, which at least at this time would be less costly than Treasuries.

"As inflation rises, historically rents will rise. That will also be a function of the supply-demand balances in the commercial real estate markets and vacancy rates are currently rising," he said. "But long-term, real estate does provide some inflation protection and buying distressed real estate today would be a way to purchase assets at low prices."

**Justin Abercrombie**, head of quantitative equity products at **Schroder Investment Management**, said he recently met with an investment advisor that works with foundations and the advisor was interested in the firm's quality strategy, which has a bias toward companies with strong balance sheets, not only because of the types of companies the strategy invests in but also because those companies typically carry high yielding dividends.

"When you buy an equity, it is more like a real yield as opposed to a nominal yield on a bond," he said. "They are much more powerful inflation protection through time."

Abercrombie said how inflation arrives will also determine its impact on the markets to an extent.

"If inflation rose dramatically and interest rates rose dramatically as well, in the short term that would be bad for all equities in general," he said.

While Abercrombie sees embedded protection in high quality equities, Dunn cautioned investors against putting great amounts of faith in conventional stocks and bonds during an inflationary atmosphere.

"If you look at periods of rapid inflation, like the '70s, stocks do not do well in rapid inflation because the stock market sells at a lower price to earnings multiple when inflation is higher and therefore, as you could have a rapid decline in stock prices," he said. "Conversely, a bond earning 5% will require a higher yield if substantially higher, so bond yields rise as inflation rises so bonds purchased today would lose value in an inflationary environment. So moving beyond a conventional stock and bond portfolio to other assets that benefit from inflation would be a useful strategy today if you're really concerned about inflation."

Albahary added that to mitigate the impact of inflation, investors may want to increase exposure to real assets (including commodities/gold) and commodity currencies, securities linked to inflation such as Treasury Inflation Protected Securities and certain MLPs.

"Investors may want to consider high yield bonds, despite their significant rise, since their higher yields provide some offset to inflation," he said. "Keep in mind, over the long run, equities tend to perform in line with historical averages even if inflation is relatively high as long as it is stable."