Inflation is currently at very low levels in many countries, so it’s easy to be complacent about it. But inflation is always a potential threat, and can make such a drastic difference to the outcomes for investors, that it should always be considered when designing and managing a long-term investment strategy. A key way to combat inflation in such an investment strategy is with a flexible asset allocation that can be easily adjusted to manage risk and capture opportunities for returns.

Why recent history might lead to complacency

Since the early 1980s, inflation rates in the world’s major economies have fallen dramatically and with them, the average levels of interest rates and bond yields. Lower inflation and interest rates provided a massive tailwind for share markets over that period. As a result, anyone fortunate enough to commence their investment journey towards retirement at the end of 1981 has had an amazingly good time of it – their returns were effectively turbocharged.

Chart 1 shows for the period from December 1981 to June 2014 the real (after inflation) and nominal (before inflation) returns from the major asset classes Australians invest in. Despite numerous setbacks along the way – including the largest financial crisis the world has seen in decades towards the end of the period – the investors who started their investment journey in 1981 have fared extremely well.

A typical diversified fund, including 70% in Australian and global shares, achieved a real return of over 7% per annum over that period. Not only that, but every major asset class within a diversified strategy delivered very solid real returns.

| Chart 1: Returns from December 1981 to June 2014 (% p.a.) |
|-----------------|-----------------|
|                 | Nominal | Real |
| Australian cash | 8.0      | 3.9  |
| Australian bonds| 11.0     | 6.8  |
| Australian shares| 11.5 | 7.3  |
| Global shares - unhedged| 11.2 | 7.0 |
| Global shares – hedged| 13.2 | 8.9 |
| Typical diversified fund*| 11.5 | 7.2 |
| CPI inflation | 3.9        | -    |

Source: Global Financial Data, MLC.

*Diversified fund asset allocation is 5% Australian cash, 25% Australian bonds, 35% Australian shares and 17.5% in each of hedged and unhedged global shares.
That was then...

The strength of these returns is less surprising when we consider the economic and market conditions at the end of 1981. Federal Reserve Chairman Paul Volker was using extremely tight monetary policy to attempt to wring the high inflation of the 1970s out of the system. US official interest rates and long-term treasury yields were in double digits.

World share markets were cheap on a range of traditional metrics – for example, US and Australian share markets’ price to earnings ratios were around eight times! Inflation was stubbornly high and investors found it difficult to believe that it would ever be brought under control.

As it turned out, inflation was brought to heel, bond yields steadily declined and share market valuations improved dramatically.

…this is now

Woody Allen famously remarked that 80% of success is just showing up.

But for investors starting their journey towards and beyond retirement, success isn’t just about showing up; it’s when you show up – when you start investing. For diversified fund investors, showing up in 1981 was a recipe for success. But what about today?

After the strong returns of the past year or so, share markets can hardly be described as cheap. Valuations are generally not as stretched as they have been at other stages in history (such as in 1999) but they are not cheap. At the end of August 2014, share market PE ratios were around 17 in Australia and 20 in the US – not eight.

Globally, inflation is now low. Official interest rates, too, are at multi-decade lows in Australia, near to zero in the US, the eurozone and Japan and just 0.5% in the UK. For very conservative investors, real returns (nominal deposit rates less current inflation) are negative right now, and likely to remain so for some time.

Although government bond yields have risen this year, bond yields remain close to historic lows in the world’s major bond markets. If current low inflation rates persist, an investor holding a 10 year government bond to maturity from today is likely to earn very modest real returns at best.

What if inflation rises?

So things don’t look rosy for investors wanting real returns even if low inflation rates continue. But what if inflation goes up? With governments either unwilling or unable to use fiscal policy to boost economic growth, the burden of promoting growth has fallen on central banks.

The US Federal Reserve and a number of other major central banks have kept monetary policy extremely loose, culminating in the extraordinary quantitative easing measures of recent years. If higher inflation is the unspoken objective of all this, or if higher inflation occurs as an unintended outcome, it’s something markets are largely unprepared for. Even slightly higher inflation rates would be enough to wipe out any chance of a positive real return for investors buying government bonds today.

Traditional diversified funds and assets can’t reliably deliver real returns

Despite the strong returns shown in chart 1, traditional asset classes like shares and traditional diversified investment strategies can’t guarantee solid real returns. Indeed, there have been extended periods in history when real returns from traditional asset classes and diversified funds have been very poor or even negative.

Chart 2 shows rolling five year real returns from a typical diversified strategy since the end of 1930. There have been long periods where real returns have not only fallen short of a common investment objective such as CPI plus 5%, but have been negative: most recently, in the five years to the end of 2012.

A diversified strategy is based on the notion that not every asset class delivers all the time, and that selecting which asset classes will deliver, particularly over shorter time periods, is extremely difficult. But there have also been periods when none of the traditional asset classes deliver anything like the kind of real returns investors require.

It’s critical to bear this in mind when designing and managing a long-term investment strategy, because it’s real, ie, after-inflation returns, that matter. Real returns are particularly important for retirees, as they don’t have a rising income to provide protection against inflation and must rely on the performance of their investments.

How can inflation risk be managed?

There’s no silver bullet – no way to guarantee that a particular real or after-inflation return objective will be achieved. Buying investment protection – either on capital or income – will suit many investors, especially those most scarred by their GFC experience. But these strategies protect nominal capital or nominal income, which could still leave investors exposed if market returns don’t keep pace with inflation.

Even buying a portfolio of inflation-linked government bonds and holding them to maturity won’t ensure the real return will be an adequate one. Real yields on Australian inflation-linked government bonds are currently around 1.2%, but have traded as low as 0.6% in the past five years.
Keeping it ‘real’ in retirement planning: why returns above inflation matter

Active managing asset allocation can help

Generating adequate after-inflation returns over time is not a task investors should leave to chance. To maximise an investor’s chance of achieving an adequate real return, an investment manager needs to actively manage the asset allocation of their diversified portfolio with the aim of achieving a real return.

This means constantly assessing the potential risks and returns of each asset class in a diversified portfolio as markets change: investing in assets when the risks of doing so are likely to be adequately rewarded by attractive real returns, and holding back from investing when they are not. This is quite different to the approach of traditional diversified funds, which have a near static asset allocation between growth and defensive assets and therefore largely reflect market performance – good or bad.

To aim for above-inflation returns, it’s also necessary for investment managers to look beyond traditional assets to non-traditional assets and strategies when creating diversified portfolios. The more diversified the portfolio’s ‘building blocks’, the more potential sources of return.

If a diversified portfolio is managed this way, investors should be able to receive much better protection in the inevitable adverse market environments, yet continue to enjoy the upside when markets perform well.