CORE DATA research

Investing in a Time of Rising Inflation

Institutional investors on their biggest risks and portfolio design drivers

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FIVE KEY TAKEAWAYS

1 Inflation Dominates Investors' Risk Calculus

Inflation is seen by institutional investors as by far the biggest risk to their portfolios in the next 12 months, with 34% selecting it, nearly three times as much as for the next biggest risk, central bank tapering (12%). Inflation fears are highest among North American investors (40%), at the largest investors with $50 billion or more in assets (40%) and at pension funds (43% at corporate pension plans).

2 Equity and Bond Market Risks Add to Inflation Concerns

Two central bank responses to inflation are seen as the next biggest risks by investors. Central bank tapering, which could trigger an equity market fall, is seen as the biggest risk by 12%, while 10% go for interest rate rises and their impact on bond markets as the biggest risk.

3 The Endowment Model Seen as Best Portfolio Design

The endowment model is seen as the best portfolio design for returns over the medium to long-term by nearly a third (30%) of investors. Perhaps surprisingly, more (20%) prefer the traditional 60:40 equity/bond portfolio to allocation by risk factors (18%) or the 'large Canadian' portfolio (16%), which has a much greater exposure to real estate, infrastructure and private markets.

4 Investors Prize Uncorrelated Assets in Portfolio Design

Diversifying into uncorrelated assets is seen as the most important element in designing a portfolio in the current climate by nearly four in ten investors (37%), ahead of generating yield and the use of skilled active managers (both 31%), although these findings vary regionally.

5 More Europeans see ESG as Core Element of Portfolio Construction

ESG investing is seen as one of the most important elements of portfolio design by far more investors in Europe (34%) compared to North America (14%) and Asia Pacific (20%). In contrast, hedging against higher inflation is seen as one of the most important elements by a quarter of investors across all three regions.

Methodology:
CoreData Research surveyed 378 institutional investors around the world in November 2021.

INTRODUCTION

For most institutional investors, investment markets in the last decade have been eventful, but ultimately rewarding. A key feature of this period has been central banks using quantitative easing (QE) and very low, even negative, interest rates to support growth, as economies rebuilt after the global financial crisis. With this help, both economies and investment markets have arguably been artificially boosted, damping down the natural cycle of boom and bust.

Looking at the big economic and investment picture, there are reasons to think that this era of relative stability is coming to an end. One sign is that some recently reported annual results by investors suggest that market returns could have peaked. According to business publication Forbes, six of the elite Ivy League college endowment funds made average returns of 42% for the fiscal year 2021. Other US endowments enjoyed even higher returns; the Massachusetts Institute of Technology saw a return of 55.5%, while Washington University in St Louis reported an endowment return of 65% (source: *Elite University Endowments Soar as Higher Ed Divide Grows*, Forbes, October 15, 2021). While these results are wonderful for the institutions concerned, they are exceptional. Mean reversion is as close to an iron law in investing as is possible, so extraordinary gains in one period usually mean that returns will fall in other periods.

Secondly, there are macro-economic changes already in play, such as a retreat from globalisation and other factors, from the impact of forces from climate change to digital technology. An insightful paper from Australia's sovereign wealth fund, the Future Fund, *A New Investment Order*, August 2021, gives a concise explanation of these forces and how they are creating a new environment for investors. The paper states: "Significant changes are underway in the world, catalysed or accelerated by Covid-19. We believe that the investment thinking that has delivered strong returns over recent decades needs to be revisited."

Up to now, investors have weathered the impact of the Covid-19 pandemic remarkably well. Government support for employers and employees has prevented recession and mass unemployment in many countries, at the cost of adding more debt to government balance sheets. However, the peculiar economic impact of the pandemic, in disrupting supply chains and creating shortages, and in delaying consumption through 'stay at home' orders, has added to inflationary pressures. Both headline inflation rates and underlying core inflation rates are rising in major economies such as the US and the UK. Is this inflation a result of temporary shortages which will then decline as normal service returns? Or will it be more permanent, as inflation expectations among populations rise and policy makers struggle to bring inflation under control? There is a growing view that an era of very low inflation is ending, so investors now have to factor inflation into their thinking in a way that they have not had to for decades.

This report looks at how investors view the risks currently facing them, from inflation to asset bubbles and other threats. It also asks which of the main investment portfolio models they see as best suited to current conditions and the most important elements for investors in designing an investment portfolio to cope with today's challenges. The views of nearly 400 investors from around the world on these topics shed light on how investors currently assess the risks facing them and view portfolio design. For additional perspective on the findings, CoreData Research is very grateful to two experts on investing, Professor Andrew Clare, Chair in Asset Management at City University of London, and Richard Wiggins, who is a senior adviser and editorial board member at the CAIA Association, which seeks to improve knowledge and best practice on alternative assets. Richard was previously an investment strategist at Aramco, the Saudi Arabian oil company. Their views help articulate the various challenges now facing institutional investors.

CONCLUSION

There are several conclusions which can be drawn from this research. On the biggest risks to their portfolios, inflation is clearly the main threat for most investors. Central bank tapering and interest rate rises and their impact on bond markets are also tied into inflation as risks. While investors are concerned about rising inflation, they are also concerned about policy steps to deal with it and their impact. In addition, inflation hedging is now seen as an important element in portfolio design by around a quarter of investors.

After inflation and all it entails, investors are also concerned about the risks from asset bubbles bursting, whether it is a bubble in the Chinese property market, or in developed markets, such as with tech stocks. The danger for investors is that at the same time as they have to cope with rising inflation, they could also face asset bubbles bursting. These risks could coincide, because central bank tapering and rate rises to tackle inflation could trigger an adverse market reaction. As a result, over the next year or so, global investment markets could become much harder for investors, compared to the past decade.

This begs the question if investment portfolios, as they are currently designed, are appropriate for changing conditions. Perhaps based on some recent spectacular results, the endowment model is the most popular approach among institutional investors, while for very large funds, the large Canadian approach, with more emphasis on real estate and infrastructure, is more popular. Both these portfolio models could help investors and it is revealing that Professor Andrew Clare says a combination of the endowment model and the large Canadian model would be his preference and the choice of many UK pension funds.

The fact that a fifth (20%) of investors still want a conventional 60:40 portfolio could be seen as surprising, given the need for diversification and doubts over the ability of fixed income assets to provide this. But this approach arguably still provides a foundation, either with risk management added to it, or additional asset classes introduced to enhance its planned combination of growth and security. So, the 60:40 portfolio may live on, with modifications such as allocations to uncorrelated assets or hedges against higher inflation or equity drawdowns.

While investment markets since the global financial crisis have not been as bad for investors as they may have feared, the future could be very different. Covid-19 has provided a stress test for many investors on their operational efficiency and contingency planning. Now, rising inflation and a shift in government and central bank policies could test their investment capabilities. The results here show that investors are aware of these issues, so it must be hoped that their investment portfolios can continue to provide the returns and security needed.

A final thought - what if inflation isn't the biggest risk for investors?

"Inflation is the consensus risk but I think we've got it totally backward. We took the money supply, grew it exponentially and created not nearly as much inflation as one would have thought: 5-6ish. That's it? Now, on the other hand, if the economy were to really go downhill, like it did in 1974, then deflation is what we should be worrying about. What could bring the global economy down? Global GDP could drop for a lot of reasons; if China's economic juggernaut is slowing, rolling pandemics are here to stay, or an end to easy money. A slow, grinding multi-year decline with low volatility would be the perfect storm for heads of risk because it would foil a lot of hedges based on the VIX and short options strategies. Asset allocators have learnt to buy on the dip, but what will they do when there's a dip behind the dip? And a dip behind that dip?"

Richard Wiggins
Senior adviser/editorial board member CAIA, previously strategist at Aramco, Saudi Arabia

CoreData

About Us

CoreData Research is a global specialist financial services research and strategy consultancy. CoreData Research understands the boundaries of research are limitless and with a thirst for new research capabilities and driven by client demand; the group has expanded over the past few years into the Americas, Africa, Asia, and Europe.

CoreData Group has operations in Australia, the United Kingdom, the United States of America, Spain, Malta, and the Philippines. The group's expansion means CoreData Research has the capabilities and expertise to conduct syndicated and bespoke research projects on six different continents, while still maintaining the high level of technical insight and professionalism our repeat clients demand.

With a primary focus on financial services CoreData Research provides clients with both bespoke and syndicated research services through a variety of data collection strategies and methodologies, along with consulting and research database hosting and outsourcing services.

CoreData Research provides both business-to-business and business to- consumer research, while the group's offering includes market intelligence, guidance on strategic positioning, methods for developing new business, advice on operational marketing and other consulting services.

The team is a complimentary blend of experienced financial services, research, marketing and media professionals, who together combine their years of industry experience with primary research to bring perspective to existing market conditions and evolving trends.

CoreData Research has developed a number of syndicated benchmark proprietary indexes across a broad range of business areas within the financial services industry.

- Experts in financial services research
- Deep understanding of industry issues and business trends
- In-house proprietary industry benchmark data
- Industry leading research methodologies
- Rolling benchmarks

The team understands the demand and service aspects of the financial services market. It is continuously in the market through a mixture of constant researching, polling and mystery shopping and provides in-depth research at low cost and rapid execution. The group builds a picture of a client's market from hard data which allows them to make efficient decisions which will have the biggest impact for the least spend.

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