Managing Inflation?

It may be too early to tell how the Omicron variant of COVID-19 will affect the Bank of England's decision to raise interest rates. Despite their initial concern, the Bank decided to increase rates in December and, with market expectations appearing to reflect a belief that the current inflationary environment is not transitory, further increases may be on the way.

So when it comes to preparing your portfolio for inflation, what should you do?

Of the myriad of factors to consider, we list a few important steps below. As they relate to selecting a manager – from structuring the ideal asset allocation and evaluating market conditions (Step 1), to ranking the best managers (Step 2) and analysing how they might perform within a portfolio (Step 3) – each step is connected and critical to achieving the best results.

1. Asset Allocation & Market Assessment

A portfolio's asset allocation forms the initial foundation in which to manage for inflation, and a solid foundation requires having the right resources and structure in place. For asset allocation decisions, a

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formal Capital Investment Committee ("Committee"), whose members have relevant, diverse investment expertise, will often lead to the best governance to oversee this important work.

This Committee will undertake two important functions – 1) Quantitative analysis – using external data and proprietary-generated analytics, the committee will be able to effectively assess markets and asset classes and, 2) Qualitative assessment – using the quantitative data, as well as their experience in understanding how markets function, committee members will be able to offer invaluable insights on which course of action to evaluate and pursue.

For example, if increasing inflation were prevalent, the committee would assess whether it's a longer-term trend, or a short term (transitory) reaction to economic conditions from the COVID-19 pandemic. They would examine which asset classes or sectors would likely benefit or struggle from either of these outcomes, and which strategies or investment approaches to deploy.

It's reasonable to assume that inflation must be assessed within the context of the overall market environment. At Collidr, one area we monitor closely is volatility. Using our proprietary research and tools, we categorise the markets, and how individual assets or securities will be expected to behave, into three levels of volatility (or 'regimes') – low, medium or high – to determine which strategy might help manage the risk of rising inflation.

Table 1 is an illustration of this how this analysis – inflation in a 'high' volatility regime environment – would help identify possible benchmarks or strategies to target. We will choose the benchmark category of 'Alternative Global Macro' to move on to the task of how to identify and short-list the best managers.

Table 1: Best Performing Benchmarks

Best-Performing Benchmarks In Chosen Regime

Show 10 entries Search:

Asset	Ticker	FirstDate	AnnReturn	Regime
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Alternatives Global Macro	HFRIMI Index	2004-12-31	18.611%	High Vol
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Source: Collidr

2. Manager Ranking & Research

Choosing the best manager for a specific asset exposure or 'benchmark category' may appear daunting at times, and for many, will require time, resources, and a rigorous process. To start, understanding the drivers behind a manager's investment performance, and how they might fit within a portfolio, is critical to achieving the best results. For this summary, we will use the term managers and funds interchangeably.

At Collidr, our fund selection process is driven by our unique behavioural approach and technology, which differentiates us from traditional research firms. Before we illustrate how one might select a manager or fund to counter the risk of rising inflation, let's review two of the important tools we use to help in the selection process.

Volatility Regime Ranking

Volatility Regime Ranking is a tool which screens and ranks funds according to how they are expected to behave during different levels of volatility or 'regimes'. As mentioned, Collidr classifies these regimes as 'low', 'medium' and 'high'. Within this context, fund rankings are then determined by calculating volatility across a number of different global markets, to see how they have performed in each regime. As there is a statistical association between the classification of these volatility regimes and future performance, we can use this analysis to see which funds might perform best in each regime with a forward-looking view.

Behaviour Rankings

Once a fund is selected for a specific benchmark category via the volatility ranking process, the next step is to assess its performance in rising or falling markets. This can be achieved by looking at the historical risk-adjusted benchmark returns in up and down markets, then comparing the corresponding risk-adjusted performance of funds in that benchmark category over those periods. By examining funds this way, we can measure the statistical significance of that performance to help understand behaviour and rank funds accordingly.

The combination of cluster and volatility regime rankings allows us to determine the most suitable manager(s) for a category, given the expected range of volatility. For our example, the focus was to find a fund that could generate alpha in a rising inflationary, risk-off market scenario.

That led us to selecting a fund ranked high in the 'Alternative Global Macro' category, one with an ability to adapt to changes in volatility while sourcing alpha via inflation trades. Then we examined the fund's credentials in our cluster rankings, to see how it behaved in historically rising or falling markets vs peers.

The power of our behavioural ranking tools illustrates how it can help identify an appropriate idea based on rigorous quantitative analysis. It allows us to shift through many fund ideas in this sector/category and select the most appropriate one based on how it should behave during a particular market volatility regime - high volatility in this example – but also how it has behaved in various – both rising and falling – market environments.

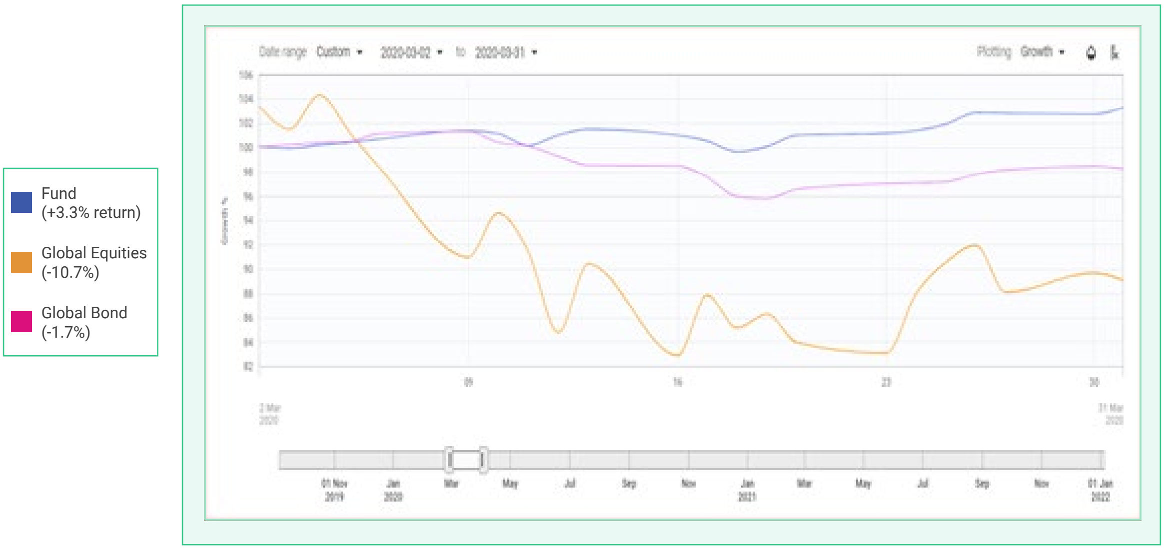
In addition to the techniques outlined, the team uses several other research tools to study manager behaviour. These include ‘exposure analysis’ – how much of the fund’s returns are explained by a range of market factors, as well as ‘stress testing’ – testing how a fund performs against different benchmarks and peers to identify (stressed) correlation patterns and expected drawdowns* under extreme market conditions. We also assess the likelihood of ‘tail-events’ (extreme returns), in addition to up and down ‘market capture’ ratios. These tools and insights allow us to establish the behavioural expectations of a fund under various market conditions.

2. Manager Ranking & Research

In the previous stage, the rankings supported our understanding of a particular theme – inflation – and how a macro manager might be expected to behave vs. peers in an environment of rising inflationary expectations and higher volatility. The manager identified through this process demonstrated a level of expertise in generating alpha – based on a macro view (conviction) of rising inflationary risks in the markets – while delivering low portfolio volatility.

Its uncorrelated relationship vs global equities, and low correlation vs global bonds, supported the view from our ranking process that it could help protect clients’ capital and generate positive returns in risk-off conditions. This was evident during the pandemic sell-off when it achieved an absolute, positive return vs global bonds and global equities, as shown in Chart 1.

Chart 1: March 2020



Source: Collidr/Bloomberg

(*drawdown is the peak to trough decline performance for an investment during a specific period, usually expressed as a percentage.)

Chart 2 shows the same fund again, looking at its drawdown profile vs the same indices for the period 2020-21. In the chart you can observe that it tends to exhibit a much lower drawdown profile in stressed periods vs global bonds, such as in March 2020 and again in Q1/Q2 2021, when inflationary expectations drove bond yields higher.

Chart 2: 2020-21 drawdown

Source: Collidr/Bloomberg

Once a manager has been shortlisted following these steps, the next stage would involve assessing how they might fit within the portfolio, and the role they might play in improving the overall risk/return profile.

By evaluating all relevant risks, applying the right structure and resources, and knowing when different market conditions require different assets and strategies, you're able to position your portfolio accordingly. In the end, it's important to always remain vigilant, for the next major crisis could be just around the corner.