Look beyond traditional asset allocation for long-lasting inflation-linked returns

Despite the UK Consumer Price Index reaching a four-decade high, we believe the inflation peak is yet to come. We foresee a spell of above-trend inflation lasting until mid-to-late 2023 at least – much longer than many market participants anticipate. This means investors will have to seriously rethink portfolio positioning.

It is clear the elevated inflationary environment will favour a very different set of assets than those that generated strong returns in the period of low rates and low inflation witnessed over the last decade. While high growth, low profit (if any!) technology stocks achieved impressive returns before inflation took hold, they are much riskier assets to hold in a higher cost of capital environment.

We believe investors could reposition portfolios to focus on real assets, where value is intrinsically linked to inflation. Real estate, infrastructure and commodities are well known for their ability to deliver resilient returns in an inflationary environment. Within these, however, certain assets are better positioned than others.

In particular, investors should look for assets that can provide reliable inflation-linked cashflows over the long term – the ultimate safe haven in an inflationary environment. Real Estate assets that are rented out on inflation-linked leases to high-quality tenants, such as large institutional corporates can provide such security. In addition, certain sectors that fulfil fundamental consumer needs tend to be less cyclical and therefore likely to outperform during periods of macroeconomic uncertainty.

Grocery sector

Despite food prices being a key driver of the current high-inflation environment, the grocery sector remains fairly insulated from economic conditions due to the indispensable nature of this household expenditure. The grocery sector in the UK is dominated by large institutional corporates. So far, supermarkets have been able to pass on the majority of their inflationary cost pressure to the consumers and have managed to protect their margins.

Green energy

The other real asset sector we like in the current environment is green energy. The green energy sector sits at the confluence of two very powerful investment thematics; structural global energy price inflation and the net zero environmental agenda. Energy prices have soared and become a lot more volatile, and hence more and more corporates are looking to alternative energy generation solutions to source electricity at a lower cost than purchasing from the grid. Indexed purchase power agreements (PPAs) with the corporate to purchase the green electricity generated by solar arrays are increasingly popular as a solution. PPAs typically have an average duration of 15 years with the occupiers of the commercial properties on which solar arrays are installed, allowing long term stable inflation-linked returns.

Social housing

There are also opportunities for inflation-linked income in areas like social housing, which is supported by government funding and for which there is an undersupply. This sector also offers a clear social benefit in supporting the provision of appropriate housing for vulnerable individuals. Finding government backed inflation linked cashflows that can be sourced at a pick-up to index linked gilts has become somewhat of a holy grail for inflation savvy investors.

Should inflation tides remain elevated for the foreseeable future, those investors who cling to the assets that outperformed in the past may find themselves ill-equipped to navigate the potential choppy waters ahead. To weather this inflation storm, investors should recognise that the next period of the investment cycle will likely favour fundamental investing and real assets.

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