



BNY MELLON

## **Positioning Portfolios to Manage Inflation Risk**

**by Jeff Saef, Managing Director, Investment Strategy Office at the Bank of New York Mellon**

Hello, I'm Jeff Saef, Managing Director of the Investment Strategy Office at The Bank of New York Mellon, and I'm here today to talk about multi-strategy investment solutions.

We're finding that in the wake of the worst financial crisis since the Great Depression, many institutional investors are taking a hard look at their asset allocation structures. Specifically, they're reviewing the defenses they have in place for possible future shocks.

While economists are still arguing about whether inflation or deflation is the bigger short-term risk, we think institutions should take the time now to consider how well positioned their portfolios are to manage the longer-term threat of rising inflation.

Massive amounts of global liquidity combined with record low interest rates appear to be setting the stage for rising inflation. Anyone who remembers the high inflation of the 1970s and early 1980s will appreciate the damage this invisible enemy can wreak.

At the same time, we believe many endowments, foundations and pension plans have not yet positioned themselves adequately to protect their portfolios against inflation. While they may not perceive this threat as immediate, we believe they should make adjustments before inflation becomes a reality. Otherwise, they could pay a premium for inflation-hedging assets once inflation expectations pick up.

That is why we have introduced a Real Asset Strategy aimed at providing inflation protection, enhanced diversification and the potential for excess return. We combine allocations to inflation-sensitive equities, inflation-linked bonds and actively managed commodities. Each asset class has a dedicated, specialist portfolio manager, who draws on deep expertise in each of these areas. These managers operate the Real Asset Strategy as officers of The Bank of New York Mellon and are affiliated with our specialized investment advisors.

### **Not a Buy and Hold Investment**

We believe inflation protection is not a buy and hold investment. Different kinds of inflationary regimes likely call for different weightings of inflation hedges. Depending on whether inflation was rising, falling or remaining relatively benign, certain inflation-sensitive asset classes have performed better than others. That is why we believe a dynamic approach that can adjust asset class weightings as inflation conditions change can be a better strategy than a static allocation to real assets.

## **Allocating to Inflation-Hedging Assets**

We know inflation can have potentially devastating consequences on the purchasing power of investments. That's why we think investors should act now to position their portfolios for a potentially higher inflation environment. We believe a well-diversified mix of global natural resource equities, actively managed commodities, emerging market and real estate equities, and global inflation-linked bonds offers the most effective toolkit. In our Real Asset Strategy, we periodically review and adjust the allocations within a controlled range to take advantage of potential dislocations and opportunities in the marketplace.

## **Tailoring an Inflation-Hedging Strategy to Your Needs**

The appropriate implementation strategy for inflation hedging will depend on your investment objectives and risk tolerance. One of the first questions is whether to take an integrated or a do-it-yourself approach. The choice of inflation-hedging asset classes and weightings will vary according to your inflation sensitivity (perceived or realized), your volatility tolerance, and the liquidity trade-offs you're prepared to accept.

As for investment approaches, you should consider the pros and cons of active versus passive management as well as a static or opportunistic asset allocation approach. When it comes to managers, there is the choice between specialists and generalists, which could have important implications for the depth and breadth of their expertise. Finally, it's important for investors to recognize the multiple layers of risk allocation involved in deciding upon an appropriate inflation hedging strategy. These range from the choice of asset class, manager, region, currency and individual security.

These are all factors we have addressed in designing our Real Asset Strategy. Because the strategy requires successfully managing unconventional and sometimes highly volatile asset classes, we believe the ability of The Bank of New York Mellon to draw on the specialists residing in our multi-boutique structure puts us in a better position than other asset managers to combine niche managers known for their experience in these important asset classes.

The recent financial crisis reminded us of lessons many investors seemed to have forgotten in the euphoria of rising markets. Perhaps one of the most important is that the time to "weatherize" your portfolio against changes in economic conditions is before a storm hits: we believe long-term investors should think carefully now about their defenses against long-term inflation.

*BNY Mellon Asset Management is the umbrella organization for BNY Mellon's affiliated investment management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation, of which The Bank of New York Mellon, The Boston Company Asset Management LLC and Standish Mellon Asset Management Company LLC are wholly-owned subsidiaries.*

*Products or services described herein are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. However, this material is not intended, nor should be construed, as an offer or solicitation of services or products or an endorsement thereof in any jurisdiction or in any circumstance that is otherwise unlawful or unauthorized. The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.*