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Quality assets provide the best insurance

Fighting inflation

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With fears of rising inflation spooking investors, it is timely to consider which equity investments can best protect against inflation's corrosive impact.

Market experts believe value and quality companies are expected to outperform the sharemarket during inflationary periods, while high growth stocks won't do as well.

Recent data reveals the Consumer Price Index (CPI) in Australia rose 0.8 per cent in the June quarter and 3.8 per cent over the year, the greatest rise since September 2008.

Elsewhere, the consumer price indexes (CPI) of G7 economies registered the highest increase since the end of global financial crisis in 2009 in the second quarter of 2021.

Index provider MSCI recently examined how different equity factors have performed in different inflationary environments from 1979 to 2021.

The index provider found that value, small caps and low volatility stocks performed best during periods of high inflation, while growth companies performed best when inflation was low.

Quality companies were less sensitive to inflation and outperformed the global sharemarket, as measured by the MSCI World Index, in all inflationary scenarios.

This is supported by research from global fund manager Robeco that found factor strategies targeting quality companies show relatively stable outperformance patterns over time and do not show a lot of sensitivity to macro environments, including the inflation rate.

Value stocks are those that have low prices relative to their financial fundamentals such as earnings, while quality companies boast healthy balance sheets including strong earnings and low debt, and size refers to small or large companies. Growth investors focus on capital gain typically by buying high growth stocks.

Research by fund manager Vanguard also finds that value stocks are expected to outperform the growth factor in inflationary periods.

Vanguard expects value stocks to outperform growth stocks in US equities over the next 10-year period by 5 per cent to 7 per cent per year. That forecast assumes inflation will average 2 per cent over the next decade.

"Obviously, from Vanguard's perspective, we would advise investors that diversification is the best way to control portfolio risk, but it may make sense to consider a tilt towards value securities to potentially enhance returns or restructure your portfolio if you are currently underweight value stocks," says Inna Zorina, a factors expert in Vanguard's Investment Strategy Group.

Time factor. Our advice to investors is to invest for the long term, says Inna Zorina, of Vanguard.

"However, our advice to investors is to invest for the long term. Factor-based investing can offer benefits and outperformance, but that is over the long term. We haven't found any evidence that you can time factors."

Exposure to factors can be achieved through a variety of investment products, including actively managed funds and exchange traded funds (ETFs), including the Vanguard Global Value Equity Active ETF (Managed Fund).

However, getting exposure to a single factor isn't always easy, says Steven Tang, head of consulting with Zenith Investment Partners.

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> Inna Zorina, Vanguard

"Unlike a traditional cap-weighted index, there is no defined single way to construct a factor index, with varying methodologies applied. For instance, in value, there are different metrics used to measure it and the weighting applied varies between methodologies," says Tang.

"Assuming you wanted to implement a portfolio tilted to the above factors via ETFs, while there is a large universe available, pure exposure to some factors, in particular value, momentum and growth, aren't as accessible in ETFs.

"However, to the above point, accessing the small cap factor could be done through traditional small cap market cap index ETFs or, to a lesser extent, through an equal weight ETF," says Tang.

"More broadly, if inflation was your key concern, there are asset classes outside of equities that should be considered, including commodities and inflation-linked bond," Tang says.

Drew Meredith, managing director at financial planning firm Wattle Partners, favours the quality factor though all economic scenarios, including inflationary periods. "The inflation risk, in our view, is overstated, but regardless, it will drive markets in the short to medium term," says Meredith.

"In this environment, investors should seek higher exposures to the quality factor and be wary of overweighting the momentum factor that has largely driven returns over the last decade.

"We suggest using a simple, low-cost multi-factor strategy as the core of our Australian equity exposure and then complementing this with either individual stock weightings or factor allocations," he says.

It is also worth noting that factors ETFs typically charge higher than those charged on broad-based ETFs.

"Factors require additional nuance and analysis along with rebalancing within their indices, rather than just tracking and adjusting for the largest companies at any given time. This requires additional resources," says Meredith. AFR