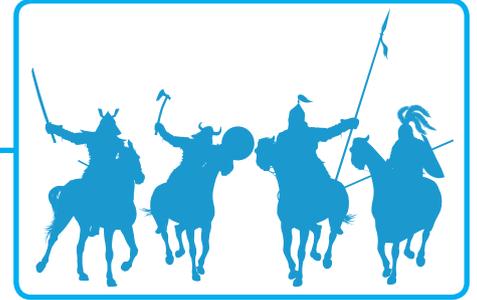


Apocalypse now?

Four horsemen of the apocalypse



In recent years, investment authors have reached to the shelf marked “attention-grabbing-metaphors” to create an investor’s equivalent of the “four horsemen of the apocalypse”. Originally, these were war, famine, pestilence and death. Now, the investment version serves as a way of focusing on the most serious risks to portfolios.

One such author is William J. Bernstein who looks at the long sweep of investment history, focusing on what causes a permanent loss of real capital.¹ He identifies the “four horsemen” as:

- **Inflation** – Particularly severe, prolonged inflation
- **Deflation** – A symptom of prolonged low economic growth or depression
- **Confiscation** – Government confiscation of assets or very high taxation
- **Devastation** – Wars and natural disasters

Another set of apocalyptic horsemen comes from Robert J. Klosterman; he focuses on the management of an individual’s portfolios and the “evils” that work against investors

in achieving their goals.² His list of horsemen includes:

- **Inflation** – An ever-present risk through the erosion of spending power
- **Volatility** – Even short-term volatility can be a risk to a long-term investor if they have to sell, or panic during a temporary low
- **Group think** – following fads and running with the herd is typically negative
- **Global disruptions and transformations** – this applies to industries, technologies and political systems. While some are positive, being on the wrong side of these mega-trends can be costly

The common factor across both sets of horsemen was inflation, so let’s focus on this. We need to be alert to inflation risks for two reasons: first, inflation directly eats away at the real value of investors’ savings. With cash rates a long way below inflation it creates an additional challenge to investors seeking positive real returns on their portfolio. Second, a scenario where there is a sharp upward revision to inflation expectations would increase the chance of negative returns on both

fixed income assets (excluding inflation-linked bonds) and riskier asset classes (such as equities) at the same time.

SHOULD WE BE CONCERNED ABOUT HIGHER INFLATION NOW?

Yes and no. There has been a lot of talk in financial markets recently about “reflation”, which has coincided with both Trump’s election and a recovery in the global economy. The chart below shows the Inflation Surprise Index which measures how inflation statistics around the world have surprised relative to expectations. More recently it has shown a clear trend towards higher inflation data. The last time this occurred was worryingly close to the beginning of the financial crisis in 2007-08.

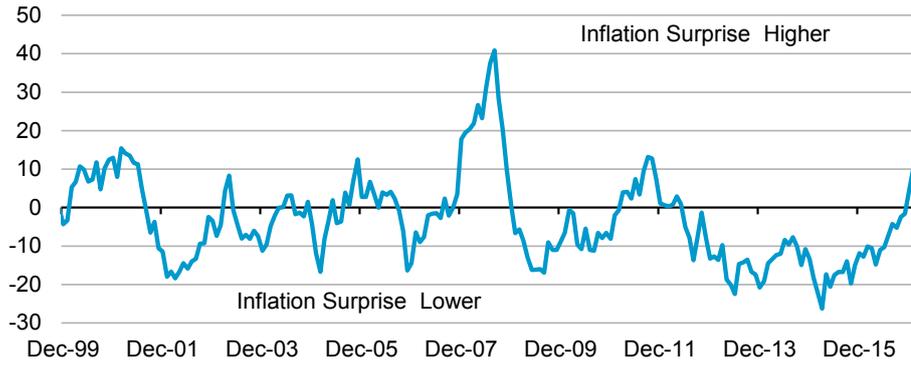
There are risks that this rise in inflation continues, particularly in the US, and is something investors should take seriously:

- The US economy is closing in on ‘full employment’
- President Trump’s plans for corporate tax cuts and higher

¹W. J. Bernstein, Deep Risk: How History Informs Portfolio Design, 2013

²R. J. Klosterman, The Four Horsemen of the Investor’s Apocalypse: The four evils that will crush your portfolio, and how to fight them, 2015

Figure 1. Global Inflation Surprise Index (Citi)



Source: Citigroup, Bloomberg L.P.

as well. Over longer-periods of time, equities, listed infrastructure and property also tend to act as a reasonable inflation hedge, albeit with shorter-term volatility in an inflation shock.

We can also monitor where economies are in the stage of the economic cycle and position our dynamic portfolios accordingly. For example, inflation risks are highest in the “late-cycle” stage of an economic expansion as growth runs out of spare capacity. As discussed above there are risks that US inflation will move higher so we have been running with a higher allocation to the L&G Global Inflation-Linked Bond Index Fund, where over 60% is made up of US inflation-linked bonds.

In our view, the inflation horse remains in the stable, but it is getting a bit restless. We have both time and a range of methods to protect portfolios from this fundamental risk. As for the other horse men, we think diversification and a disciplined investment approach are vital in managing these risks. Look out for future articles where we will delve further into these risks and how they can be managed.

government spending could provide a boost to demand for goods and services

- Fewer immigrants entering the workforce and an aging population could well hinder the supply of goods and services, further exacerbating the demand issue above
- Loosening banking regulation and a potentially weakened Federal Reserve

However, we aren’t expecting a sudden, significant increase in inflation. Compared to history, the chances of apocalyptic hyperinflation, as seen in the 1970s or in Germany during the 1920s, is very low. We know that if inflation gets out of control it’s often hard to rein in. Throughout the 1990s and 2000s, Central Banks took steps to counter this risk and used inflation targeting to make sure the inflation horse never bolted from its stable. The chart below shows the ten-year ahead inflation expectations of professional economists. This still points to broadly stable long-term inflation expectations, and therefore only a low risk of an inflationary spiral whereby higher inflation leads to higher wages, which leads to higher inflation.

HOW CAN PORTFOLIOS BE PROTECTED AGAINST HIGHER INFLATION?

The other good news is that we can build portfolios to withstand moderately higher inflation. Within the Multi-Index Funds, we factor a degree of inflation protection into our long-term strategy by incorporating assets that perform better in high inflation environments. Inflation-linked bonds are one example and typically make up at least half of our sovereign bond allocation in the portfolios. Using commodities, commodity-producer equities, or currency exposure to commodity exporters (including many high yield emerging market currencies) is another way we can insulate client money from the risk of inflation. As demand for goods and services increase, the price commodities used to produce those goods rises

Figure 2. Survey of Forecasters - 10 Year US Inflation Rate



Source: Philadelphia Fed Survey of Professional Forecasters, Bloomberg L.P.

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