# The most effective portfolio inflation hedges: Implications for asset allocation and glide path construction

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## Executive summary

Financial assets, in general, perform very poorly in high inflation environments, with negative inflation-adjusted (real) returns being the norm.

- Among fixed income assets, Treasury Inflation Protected Securities (TIPS) do a decent job of mitigating the negative effects of inflation, which may or may not translate into positive real returns. In terms of fixed income, the optimal inflation-hedging strategy is mostly defensive in nature. It entails including TIPS in the fixed income bucket and shortening the duration of the mix. This is particularly important with short-dated horizon funds in glide path construction.
- When limited only to financial assets, the energy equity sector provides the best potential inflation hedge, with positive inflation-adjusted return potential. When the asset class set is expanded to real (physical) assets, however, it provides the best overall option to hedge against inflation and provide positive real returns. This provides an offensive opportunity to enhance and protect upside return and is appropriate in an asset mix or glide path with higher equity allocations. It can also be appropriate when utilized in carve-outs in near-dated horizon glide path funds in scenarios where inflation expectations are higher than the long-term average.
- Among real assets, commodities perform better than real estate as an inflation hedge, but real estate can provide lowly correlated second-order inflation protection. Gold, which is often used by investors as a standard option to hedge inflation, can be effective, but better alternatives exist.
- The best empirical inflation hedge is a broad-based commodity fund, which provides statistically significant positive real returns with an impressive “hit ratio” (percentage of returns that beat inflation) during high inflation periods. Commodity or natural resource funds are widely available and a good proxy for broad-based commodity indices.
- REITS are also widely available but less effective than direct real estate funds in terms of their inflation-hedging ability.

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