The Most Reliable Real Asset Inflation Hedges

For the last three decades, the policies of central banks have kept inflation relatively stable. But this has not always been the case. For example, the 1930s saw deflation, or negative inflation, that devastated industry and agriculture, while the 1970s saw sustained high inflation diminish the standard of living. For investors, inflation erodes purchasing power and undermines the funding of future goals. And while financial markets generally do a good job of pricing assets for expected inflation, unexpected inflation remains a risk.

Investors commonly turn to real assets – the so-called hard assets of real estate, infrastructure and natural resources – to mitigate this risk as well as for portfolio diversification. But are they really an effective inflation hedge? And if so, which are the most reliable?

In addition to evaluating real estate, infrastructure and natural resources, they also looked at Treasury Inflation Protected Securities (TIPS), which investors also commonly use to protect against inflation.

Inflation Can Erode Purchasing Power

Bond Returns During the High Inflationary Environment of 1973-1982

	ANNUALIZED RETURN	ANNUALIZED REAL RETURN	REAL GROWTH OF $1	STANDARD DEVIATION	MAXIMUM REAL DRAWDOWN
INFLATION	8.67%				
LONG TERM GOVERNMENT BONDS	5.76%	-2.91%	$0.74	12.79%	-50.80%
INTERMEDIATE TERM GOVERNMENT BONDS	8.00%	-0.67%	$0.93	8.13%	-32.16%
LOW DURATION PORTFOLIO	8.30%	-0.37%	$0.96	4.18%	-21.58%
TREASURY BILLS	8.46%	-0.21%	$0.98	0.97%	-13.33%

As it turns out, their findings show that not all real assets are so real, at least when considering inflation sensitivity.

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REITs and infrastructure are likely not reliable inflation hedges

Perhaps counter to conventional wisdom, public infrastructure and real estate investment trusts (REITs) show no reliable inflation sensitivities.

Private real estate might help mitigate inflation

The asset class demonstrates inflation sensitivity, but the result could be due to how the underlying assets have been priced (i.e., appraisal-based), as the results are inconsistent with those of REITs, which own fundamentally the same underlying assets.

Natural resources equities are likely one of the best tools for protecting against inflation

Both natural resources and commodities show a strong sensitivity to inflation. However, while both fare similarly on this measure, equity-based natural resources demonstrate a more favorable risk/reward profile relative to commodities.

TIPS are the only true inflation hedge for investors with multi-year financial goals

Statistically, TIPS demonstrate a positive though relatively moderate sensitivity to inflation. But these results are likely skewed by the near-deflationary environment of the 2008-2009 global financial crisis and are limited by a lack of longer-term data.

In practice, TIPS are structurally indexed to inflation; the principal of a TIPS bond adjusts annually in line with upward or downward changes in inflation. And as the team demonstrated with another research analysis, “Risk-free” Goal Funding,” this inflation adjustment effectively guarantees that TIPS hedge inflation for investors who align them to fund multi-year financial goals, such as lifetime consumption. These findings provide useful, broadly applicable insight, as unexpected inflation can undermine the successful funding of future goals. While the role of real assets is to both diversify and mitigate inflation risk, TIPS and natural resources may be your best tools when it comes to the latter..