M&G Insights

M&G Investments

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Higher inflation and volatility: Is your portfolio diversified enough?

Amid the current conditions of higher inflation and market volatility as a result of the Russia-Ukraine war and ensuing sanctions, many investors are concerned about the impact on their portfolios. If you are investing for the longer term, your portfolios should have two characteristics to help mitigate the downside that comes with these conditions: they should be well-diversified and have adequate exposure to risk assets.

Broad diversification, which includes some exposure to risk assets (like equities), is key in helping mitigate portfolio downside in volatile conditions, and holding equities is one of the best ways to protect your longer-term investments against rising inflation. Many longer-term investors have been holding fewer equities than would be advisable in the past two years or so due to the perceived higher risks of the Covid-19 crisis, and so may not have their longer-term portfolios correctly positioned. Consequently they could be at greater risk of underperforming inflation.

As shown in the table, equity returns have significantly outperformed inflation over the long term.

	3 Years	5 Years	10 Years	20 Years	30 Years
FTSE/JSE All Share Index return(%)	14.6	14.6	15.0	15.5	14.6
CPI (%)	7.5	7.4	7.0	6.8	7.2
Real Return (%)	7.1	7.2	8.0	8.7	7.4

Average real returns over various rolling periods, from September 1985 – December 2021. Source: Morningstar.

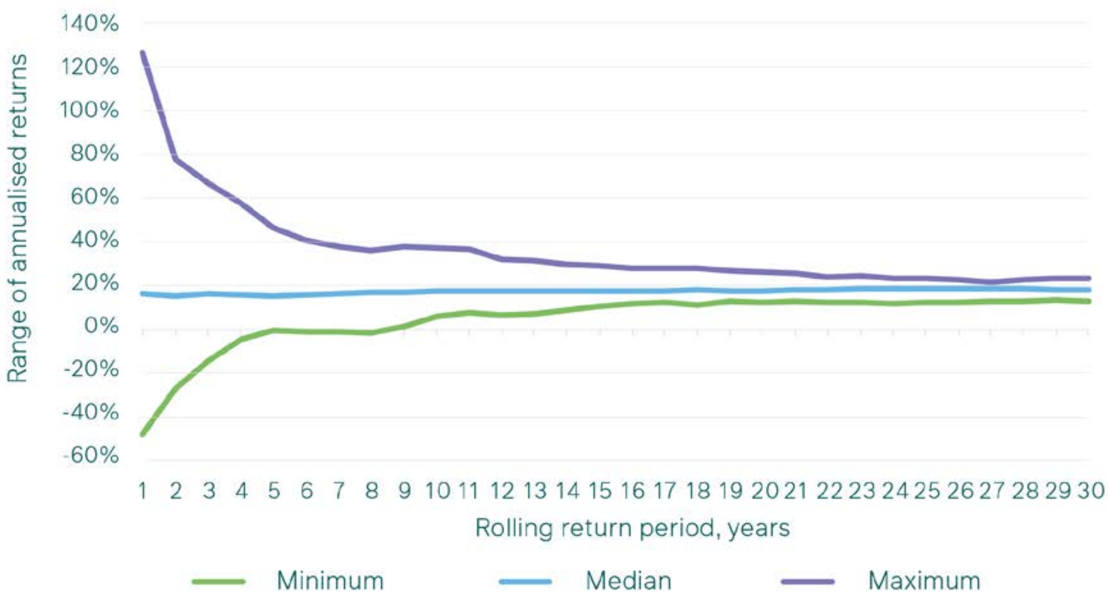
While equities generally serve as a good hedge against inflation, it's important to recognise that some equities perform better than others in higher inflationary and rising interest rate environments. Resources, for example, typically benefit from higher commodity prices, while banks are able to charge higher interest rates. Conversely, rising prices adversely impact sectors such as Retailers, where earnings are directly dependent on consumers, who will now have less money to spend amid higher inflation. Having the correct level of exposure to the right mix of stocks is therefore essential, as simply holding equities won't necessarily provide you with adequate protection.

Because equities are inherently more volatile relative to other asset classes over shorter periods, adding them means you will also be increasing your portfolio risk. You should therefore have a good basic understanding of the risks associated with this asset class, and how best to manage them.

Managing risk

Holding equities for longer helps to lower the risk of recording significant losses. To demonstrate this, the below graph shows the range of equity returns achieved from the FTSE/JSE All Share Index for every rolling period since 1965. What is evident is that although the shorter-term periods have very wide ranges of outcomes (i.e. from returns of over 120% to losses of over 40%), as these periods lengthen, the extreme gains and losses narrow to be significantly closer towards the average over time – and by year nine there are no negative outcomes. When combined with their potential to generate significant above-inflation returns, equities make for a sound hedge against inflation.

Range of Returns available from the FTSE/JSE All Share Index
30 June 1965 to date



Source: Morningstar from 30 June 1965 to 31 December 2021

Get diversified

Diversification within equities is also vital for managing risk, as it is across asset classes. This increases the various sources of income and earnings for your portfolio. At M&G Investments, our two flagship multi-asset funds, the M&G Balanced and M&G Inflation Plus Funds, hold a diverse mix of assets, including equity, property, bonds and cash – all of which tend to perform differently under varying market conditions. This enables the funds to generate returns across different market cycles, while absorbing varying degrees of market volatility.

The primary purpose of these portfolios, however, is to generate meaningful returns for investors – in fact, the Inflation Plus Fund has an explicit return objective of CPI+5% (before fees, over a rolling three-year period). The extent to which we hold certain asset classes is determined by the funds' investment mandates, but also by our long-held experience regarding the appropriate weights of each asset class necessary to achieve the expected return outcome over time, while taking into account changing market conditions and asset valuations at all times.

For example, in our most recent positioning for the M&G Balanced Fund, we have just over 50% of the fund invested in SA equities and listed property, plus nearly 20% in foreign equities – so, broadly speaking, we believe a total 70% exposure to risk assets is currently required to meet the fund's benchmark return (the average return of the ASISA Multi-Asset High Equity category) over time. Historically, this has averaged around CPI+6%. Meanwhile, the fund's bond weighting totals approximately 24% and its cash holdings are around 6%.

Looking at the M&G Inflation Plus Fund, its weightings are currently: equity and listed property 44%; bonds 48%; and cash 8% (across both local and offshore markets). It is holding fewer risk assets to achieve its less-demanding return objective, and more fixed-income assets to cushion the return downside, given that the fund has a secondary objective of reducing the risk of capital loss over any rolling 12-month period.

Therefore, in the current conditions we believe longer-term investors should be aiming to have similar exposure to risk assets as these funds, depending on their individual risk appetite and return goals. Those with an investment time frame of five years or longer, with a higher return target, could consider a Balanced-type fund holding over 70% in risk assets, while those with a lower risk appetite or three-year time frame should consider a low-equity multi-asset fund like Inflation Plus.