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Inflation – the genie is not back in the bottle

For some considerable time our approach to managing portfolios has been to combine a mixture of so called fear and greed assets. The fear assets have included Gilts, other fixed interest securities, gold, property, and certain hedge funds aiming for non correlated absolute returns. The greed assets have mainly been equity funds, investing in high quality companies not just in the UK, but in the USA, the Far East and emerging markets.

This has been the right approach, because we are living in a turbulent environment in which it is too risky to invest entirely in equity markets, and yet it would probably be unwise to invest solely in lower risk asset classes. Why? Because when the tide turns, as it always does, the investor committed just to lower risk asset classes will be left behind. Worse still, they will often be lured into chasing the bandwagon, by which time it can often be too late.

We have intimated that the new fear asset may in fact not be any of the afore mentioned traditional low risk safe havens, but may in fact be equities. Equity markets have had a very challenging decade, in which there have been two substantial uplifts in values (2003-2007, and 2009- mid 2011), followed sharply by declines wiping out large proportions of the gains.

We are now at a point where equity markets such as the UK are already just over 20% above the low points seen in October, and many investors will be pondering whether this is the moment to take profits and be thankful for small mercies. We think not: shares remain underpinned by a smorgasbord of factors that should at least maintain current levels, and probably propel share prices higher. These supports include very attractive dividend yields, in many cases amply covered by profits; strong balance sheets and an enormous amount of liquidity in the system, increasing once again as QE gets underway in the UK. Above all, however, is the very real concern amongst investors that the inflation bogeyman is far from dead, just resting for a while.

It is this inherent, deep rooted anxiety which will encourage investors to maintain and increase their commitment to equity markets, the asset class which has provided investors with protection against the biggest fear of all, the relentless erosion of values which inflation causes.

This is a time to be bold and maintain a full commitment to equity markets.