Inflation Benchmarking Needs A Rethink

Stirling Larkin
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Multi-asset investors enjoy many benefits across their portfolios but they often succumb to the curse of misunderstanding the impact of 'real' inflation.

Investment managers traditionally employed a fairly simple taxonomy to break down the investment universe to their clients – cash and bonds were safe assets, property represented a slightly riskier class of investment, while shares had the highest level of risk.

Typically, an investor would invest their money across these asset classes to suit their investment goals and circumstances. By diversifying their investments, the investor could relax, safe in the knowledge that if one group of investments did not perform well, the others would take up the slack, ensuring consistent returns.

We understand that inflation is a reflection of a general increase in prices, directly representing the purchasing value of money, but what we still struggle with is how it should be measured.

However, since the global financial crisis of 2008, it has been important to question valuation mismatches within and across asset classes. The greatest distorter of these is often dubbed "asset inflation".

Australian ultra high net worth investors are in a challenging position given that private banks typically asset-allocate larger portfolios across both conservative (bonds, listed stocks) and exploratory bounds (venture capital, alternatives).

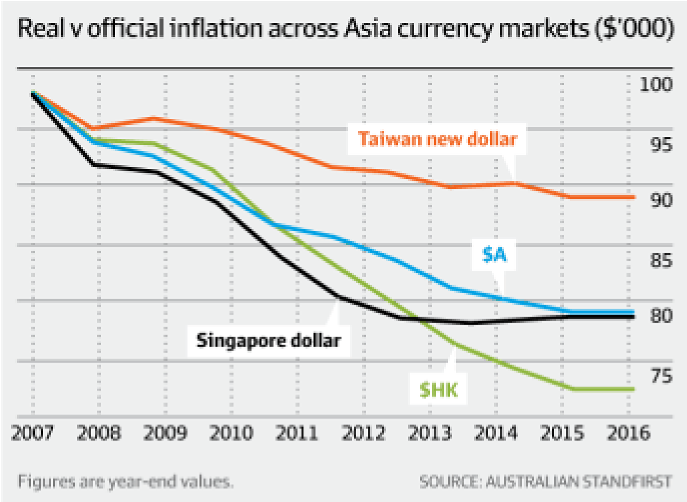
Investors need to know about different ways of measuring inflation, which can be a welcome sign of growth but also a factor that erodes value if not managed mindfully.

In this contemporary era, we understand that inflation is a reflection of a general increase in prices, directly representing the purchasing value of money, but what we still struggle with is how it should be measured.

The astute global investor knows that benchmarking investments – whether they be made domestically or abroad – against a conventional consumer price index (CPI) is a foolish path. CPI was never meant to be used in the vast and wide ways that it is in today's global economies.

Price development

To understand why, it is helpful to look to its genesis and ask why it was created in the first place. In 1917 the US Bureau of Labor Statistics first set out to devise a measure of prices in order to learn what it cost an American family to meet its basic needs.



This meant more than simply sending surveyors across the country to record the cost of a specified basket of goods, as the bureau had previously done. It meant figuring out how prices shaped consumption and how new goods pushed out old ones.

Without that, as the economist Zachary Karabell correctly highlights, the CPI used to measure inflation today, might still include horsewhips and the IBM Selectric typewriter.

It was never intended to be used as an investment benchmark. During the post-war years (1945-1970), this though, is how it came to be employed.

Until the 1970s, most investors were not particularly interested in inflationary measurements. But the so-called "great inflation" of the 1970s, when official inflation levels exceeded 10 per cent, saw the index propelled to the centre of public debate.

It also moved investment conversations away from prima facie results, to ones where inflation adjustments were included. Today, we refer to this as real versus nominal returns – anyone with money in term deposits will know those terms well.

Preferred gauge for policymakers

In 1977, in the US, insisting that the traditional methods of measurement were making things seem worse than they really were, government statisticians introduced "core CPI", which measures inflation without taking into account goods such as petrol and food, whose prices frequently change.

On this, Karabell argues that, for most people, those are the goods that matter most coupled with the fact that many of their investments had been made in industries and sectors directly confronting such inflation.

Regardless, the core CPI became the preferred gauge for policymakers around the developed world, precisely because it removed goods with volatile prices, which could easily skew perceptions.

Abstracting the true nature of inflation today is paramount and thinking for oneself becomes the best investment one can make.

Stirling Larkin is chief investment officer of Australian Standfirst.