Presented by Dimensional Fund Advisors & ASI Wealth Management

Client Question of the Week:

What Should I Be Doing About Inflation?

- It may be an understatement to say that inflation is a popular subject. The Consumer Price Index was up 6.2% in October from the year prior[1]. With holiday shopping and end-of-year compensation discussions happening, rising prices are a concern for many investors.
- The CPI measures a basket of goods and services, but your basket may look different from the index. A few specific pockets of goods, such as energy and used vehicles, may be contributing significantly to the recent increase. The Core Price Index, which excludes food and energy, rose 4.6% in that same time period[1]. The effects of inflation can be nuanced and vary per person.
- **Prices include expectations for inflation.** On average, hundreds of billions of dollars of treasury bonds are traded daily[2]. Market participants incorporate their expectations around future inflation into their trades. As new information develops, they may reassess their expectations.
- While the market is making its best estimate of inflation, there is a risk that those expectations are wrong. Because of that, the market will demand a premium for bearing the risk on unexpected inflation; this premium is reflected in the price of nominal bonds (bonds that aren't inflation-protected).
- Some investments touted as "inflation-sensitive," may not behave the way investors are hoping. While some of these assets may have evidence of correlation, such as energy stocks and commodities, the assets' nominal returns have been around 20 times as volatile as inflation[3]. This volatility may not be best suited for investors concerned about the variability of their purchasing power.
- History shows us that stocks have outperformed inflation over time. Over the past three decades through June 2021, the S&P 500 had an annualized return of 8.5% after adjusting for inflation[4]. Dimensional's recent article Will Inflation Hurt Stock Returns? Not Necessarily explores how in that time, **there was not a reliable connection between periods of high inflation and stock returns.**
- But what about periods with double digit inflation, like the 1940s and 70s? We find similar results going back to 1927 through 2020. Exhibit 1 shows the real returns in years with above average inflation (5.5%) of asset classes ranging from various bonds, stocks, sectors, and even equity premiums. Each of these assets outpaced inflation except for T-Bills[4]. (T-Bills are short-term debt issued and backed by the full faith and credit of the US government.)
- For those investors who are sensitive to unexpected inflation, there are options available. One option, Treasury Inflation-Protected Securities (TIPS), are linked to changes in consumer price. An alternative is buying short-duration corporate bonds while using

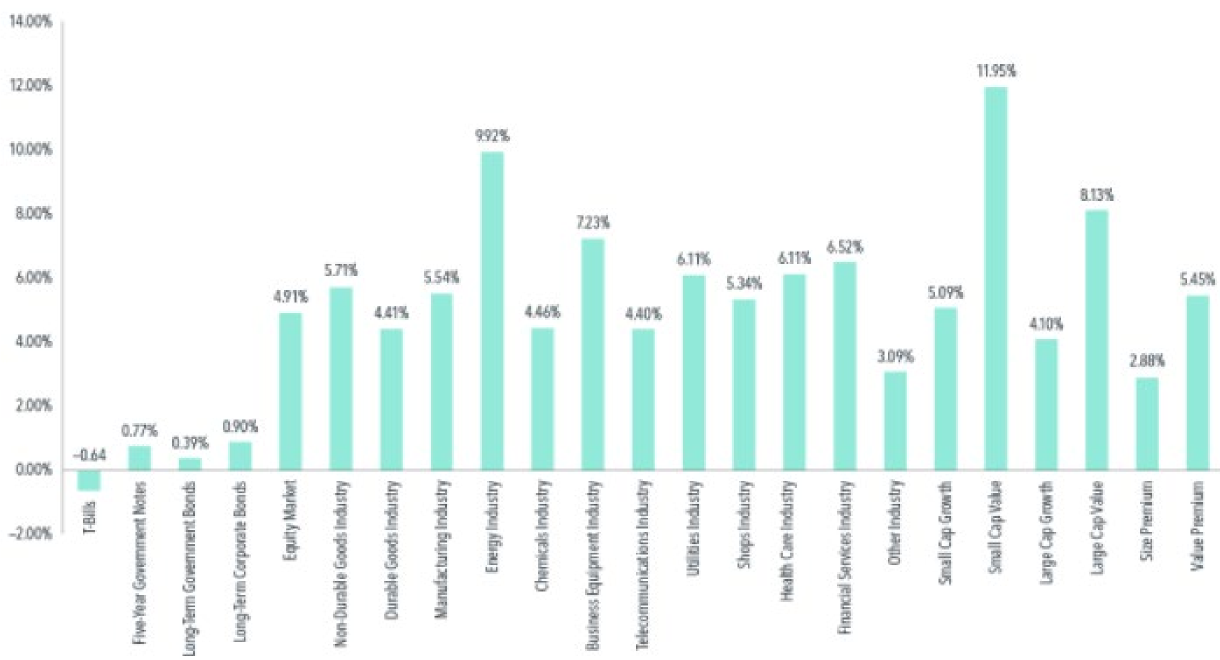
inflation swaps to protect against rising prices. This strategy involves more credit risk but offers higher expected returns and allows greater diversification relative to TIPS.

- The best answer to the question *What should I be doing about inflation?* may be boring. Timing markets around inflation expectations can be difficult and risky. Instead of trying to outguess the market, investors may find comfort learning that the market incorporates expectations around supply chains, demand, government spending, and yes, even inflation. By working with a financial advisor, you can develop a personalized plan that you can stick with in a variety of environments.

EXHIBIT 1

Keeping It Real

Average annual real returns in years with above-median US inflation, 1927–2020



Past performance is no guarantee of future results. Indices are not available for direct investment.

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