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THE BIG Q

How Top Advisors Are Responding to Changing Fed Policy and Higher Inflation

By **Steve Garmhausen**

The Federal Reserve is getting closer to hiking interest rates, and market volatility is spiking as investors adjust to a new regime of higher inflation. The inflation rate came in at a 40-year high of 7% last year, and it's pretty clear that this toothpaste isn't going back in the tube. Meanwhile, U.S. stocks are swinging wildly on a day-to-day basis. So for this week's Big Q, we asked advisors how they are positioning client portfolios for this new reality. Their solutions vary, from stocks with strong balance sheets, to commodities, to private credit. Oh, and speaking of toothpaste, prices for that item and other toiletries were way up last year.

Susan Kaplan, president, Kaplan Financial Services (LPL): Certain industries have the ability to pass on price increases they have due to inflation. And it's a critical competitive advantage. Companies with clear sustainable pricing power protect their profit margins. The highest of all are biotech and tech, software, semiconductors, hardware. At the bottom of the deck are groceries, transportation, and defense. I'd have 25% in tech, 20% in biotech, 20% in energy and 20% in financial—investment banks typically do very well in inflationary periods and pay dividends on top of it. And 15% in retail.

In terms of income generation, the investments would be in two camps. One would include dividend-paying stocks and balanced funds, which have some cash, some stocks, and some bonds, like the Vanguard Wellesley Income Fund or Vanguard Balanced Index Fund or Fidelity Puritan Fund. They're pretty good dividend payers, and yet you have growth potential.

Holly Newman Kroft.
Courtesy of Neuberger Berman

REITs always come to mind as an inflation-protecting vehicle, but I wouldn't recommend them. Commercial real estate has been clobbered with all the working remotely and businesses backing away from the big overhead of the space. Even with residential REITs, the problem is that in metropolitan areas one to three floors of apartment buildings are used commercially.

Thomas Moran, founder, Moran Wealth Management (Wells Fargo independent channel): We've been migrating to large-cap and mid-cap value. Value rallies historically last about six years, and we think it's going to be longer this time, with value sectors having underperformed for almost a decade. And we like higher-quality dividend-growth stocks. They seem to be weathering the storm. We think that's a good way for retired folks to have income keep up with inflation. We've actually been moving back to the international space, after having underweighted that for a long time. A lot of international stocks are more value-oriented.

We have natural resources like mining, energy, timber, water, agriculture. Anything coming out of the ground historically does well during periods of inflation. And we're doing some convertible bonds. Most times when rates go up, convertibles beat Treasuries. Normally I use individual securities, but with convertibles I use funds for liquidity and diversification. We use some liquid alternatives. We've been negative on bonds for a while. So we're looking for alternatives that we think will be at least a partial bond substitute.

Richard Saperstein, chief investment officer, Treasury Partners: In bond portfolios, the most important thing in this environment is short durations. We have a negative real rate of return, which we haven't seen since the mid-'70s. By shortening duration in bond portfolios, you [position for] changing Fed policy as well as the lingering concerns about inflation. Investors can look toward floating rate securities as well. We're buying callable municipal bonds, often called muni kickers. If they're not called, they kick to a higher rate if they

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go to maturity. The munis with short calls, let's say two to three years, are still providing value relative to taxable equivalent-maturing bonds. And they provide that kick benefit if they're not called.

On the equity side, in spite of the recent volatility, which we expect to continue, it's very important to avoid zero-cash-flow companies or companies that are burning cash and have large levels of capex (capital expenditures). These companies have been severely penalized in the past three months, and they will continue to be. Conversely, it's very important to look at companies with high levels of operating cash flow; they have the ability to adjust their capex and basically drive what kind of free cash flow they want to have.

I would also look at energy and commodities. The energy space in particular has been underinvested. We wouldn't be surprised if we saw higher energy prices, and that would be a direct hedge against inflationary forces.

Holly Newman Kroft, advisor, Neuberger Berman: We have very short or zero duration with our fixed income because we think the bond yields are going to rise. We don't have any TIPS [Treasury Income Protected Securities] in portfolios, because they are typically issued in five-, 10- and 30-year tenures and the duration is not in line with our views for how to best protect against inflation.

On the equity side, we are maintaining a focus on higher quality, and we have been shifting away from growth and more toward value. High-quality stocks do tend to do better [during inflationary periods]; there's less leverage so they're not as subject to the interest rates going up. And they have stable cash flows, so they're better able to weather volatility. So we think there's finally going to be a shift toward value outperforming growth.

On the alternatives side, we like commodities and liquid hedge strategies that will reduce volatility. Because in addition to inflation, we think that the volatility that we've seen recently will also persist.

Brian Tall, chief investment officer, Brighton Jones: In our fixed-income buckets, we're lower duration: If the duration of the Bloomberg Barclays Aggregate Bond Market Index is hovering around six years right now, durations in our portfolios are going to be closer to three-ish years. We're broadening our exposure to TIPS, to floating-rate bonds and private credit, and including slivers of high-yield and preferred stocks too.

In the equity bucket, growth stocks have had an incredible run for the past decade, and it's left international markets, small-cap, and value companies well behind. So making sure that your global equity bucket has a good balance between international and domestic, and probably favoring value stocks relative to growth, are smart things to do. I think that that mix of favoring international and value at the same time makes sense..

You're starting to see some individual investors say, "I don't want to own any cash. I don't want to have any short-term bonds, because yields are too low to cover inflation." But equity markets could tumble quite a bit in the event that inflation does persist. And [cash and short-term bonds] give you dry power to go shopping for equities at a lower price point. Giving yourself optionality is one of the most important things you can do at any point in time as an investor.

Frank Balas, director of investment strategy, GM Advisory Group: Our process to hedge against inflation will vary depending on what economic growth is doing. If growth and inflation are rising together, we favor being overweight stocks and commodities and underweight bonds. Within stocks and commodities, we favor exposure to cyclical sectors and assets that are more sensitive to economic activity, like energy and financial stocks, oil, and copper.

If growth is slowing while inflation is rising—stagflation—our strategy would look different. Which asset classes perform best and worst during stagflation depends on the magnitude by which growth and inflation diverge. Historically, gold has provided the most effective hedge against the most severe cases of stagflation because it is perceived to be the ultimate store of value and it is inversely correlated to real interest rates.

If stagflation risk rises, we would also favor reducing exposure to equities and bonds while emphasizing assets with lower interest rate sensitivity. This includes energy stocks, material stocks, and low-duration bonds, while also increasing exposure to commodities with a particular emphasis on gold. We do not believe we are entering a stagflationary recession, because we expect economic growth to remain elevated in 2022. However, inflation has remained stickier than we anticipated due to the lingering impact of the pandemic, and we're watching this risk closely.

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