

When faced with rising inflation and rates, investors should diversify.



MARCH 2022



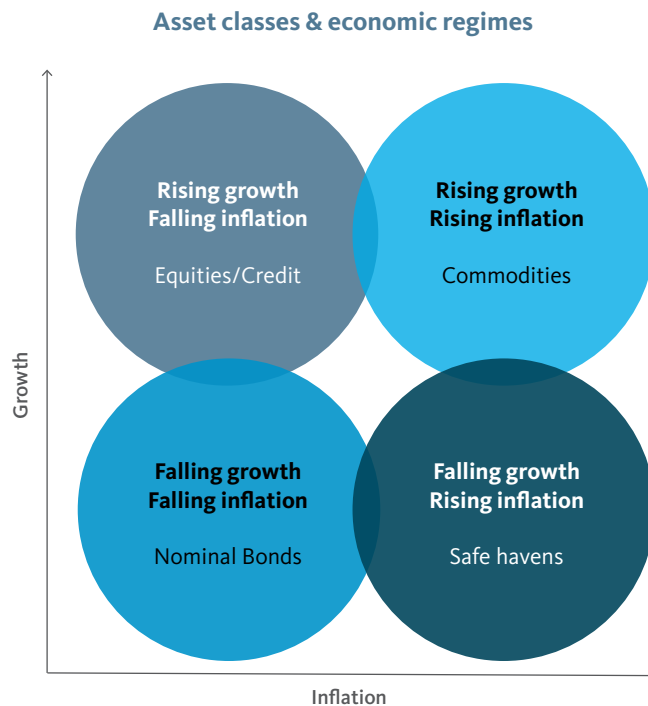
Ryan Schneck
Director, Portfolio
Strategies Group

SNAPSHOT

- Just as inflation has proved that it lives on—despite being pronounced dead many times in the recent past—we believe balanced portfolios, like the “60/40,” will continue to live prosperous lives.
- However, not all balanced portfolios are created equal. Diversification within the equity and fixed income components, as well as diversification at the total portfolio level, can help to combat the effects of higher inflation and higher interest rates.
- Active positioning can seek to take advantage of the opportunities presented by a shifting economic environment, but regardless of what the future may hold, we believe a strategically well-diversified portfolio can be resilient across different economic regimes.

The economic environment of the current era has generally been characterised by healthy economic growth and well-behaved inflation. Viewing the economic environment through this lens, as depicted in Exhibit 1, illustrates that the economic backdrop has been favorable for the traditional balanced portfolio, such as the ubiquitous “60/40.” But the investing landscape is changing. What does this mean for equities, fixed income, and balanced portfolios going forward?

EXHIBIT 1: SHIFTING LANDSCAPE



Source: SEI, for illustrative purposes only.

In early 2020, the COVID-19 pandemic upended financial markets and crushed global growth, inflation and risk assets. Thanks to unprecedented levels of globally coordinated fiscal and monetary policy, along with the rapid development of vaccines, financial markets quickly rebounded. Many equity markets made new highs and growth was exceptionally strong.

While these were welcomed developments, a spike in inflation to multi-decade highs has not been as positive. Many central banks—most notably the U.S. Federal Reserve (Fed)—initially considered high inflation to be transitory. More recently, however, the Fed has eliminated its use of the word transitory to describe inflation. With high inflation will likely come higher rates—in fact the Fed, Bank of England, Bank of Canada and many emerging-markets central banks have already begun to raise rates, while other central banks may soon follow.

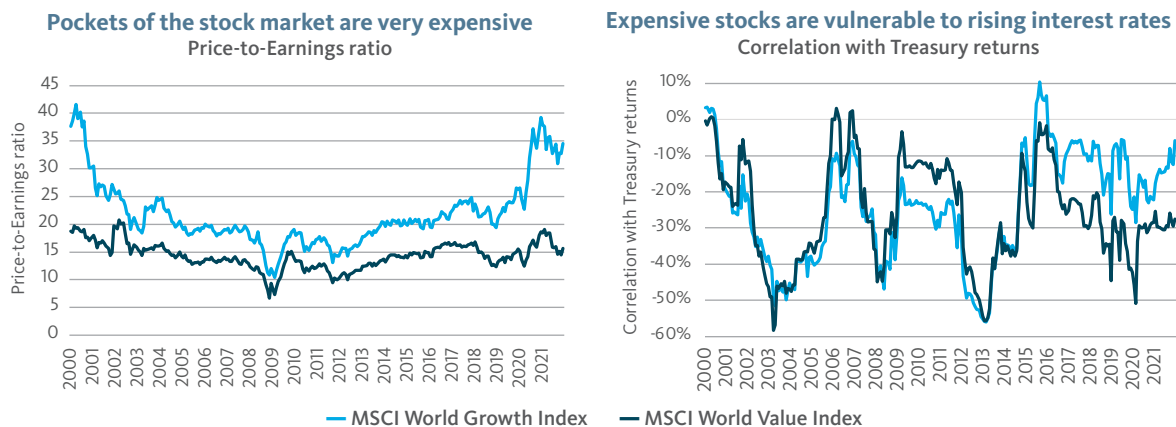
These developments suggest that the economic environment may be shifting away from the upper-left-hand quadrant of Exhibit 1, i.e. a higher growth and lower inflation regime, toward the upper-right quadrant, representing a higher growth and higher inflation economic regime. While no one can say with certainty which type of economic environment will prevail, we believe the global economy is at a turning point. Investors may feel helpless as these regimes change, but we believe diversification can help their portfolios be prepared for whatever the future may hold, including a higher inflation and higher interest rate environment.

Diversification at every level: Equity

With central bank mandates to maintain stable inflation, interest rates and inflation are highly correlated. While the effects of higher inflation and interest rates are often considered more impactful for fixed-income markets, there are important implications for equity markets as well. The changing investment landscape may continue to create more volatility in equity markets, as we have seen thus far in 2022. While we remain positive on the overall direction of risky assets, we believe that continued changes in equity market leadership are likely. In fact, higher rates and inflation could fuel a continuation of the rotation that started in late 2020. This is when we first saw meaningful reversals in many long-standing trends—including the relative performance of U.S. versus global stocks, emerging versus developed markets, small cap versus large cap, value versus growth, and inflation-sensitive assets versus traditional stocks and bonds, to name a few.

One area that we would highlight as potentially being most impacted is the distinction between expensive and more attractively priced stocks. A simple and common way of making this comparison is through value and growth indexes. Exhibit 2 (left panel) shows that the valuation gap between value and growth stocks remains very wide, globally, despite some of the market rotation that has already occurred. There are still pockets of very expensive stocks that were exacerbated by the COVID-19 crisis and the bidding up of so-called stay-at-home stocks. Because of the two-steps-forward, one-step-back nature of the recovery, due to the delta and omicron variants of the virus, we believe the rotation was interrupted and still has a long way to go before relative valuations are normalised. Rising interest rates could well be the catalyst causing expensive stocks to re-rate and reprice. Indeed, as shown in the right panel of Exhibit 2, the fortunes of growth stocks are significantly more tied to the fortunes of the bond market, as compared to value stocks. Growth stocks are much more correlated to Treasuries than value stocks, which could have important relative performance implications going forward.

EXHIBIT 2: CHALLENGING ROAD AHEAD FOR EXPENSIVE STOCKS



Monthly data from January 2000 to December 2021. Returns for the purpose of calculating correlations are gross total returns in USD, unless otherwise noted. Indexes used are MSCI World Growth Index, MSCI World Value Index, and Bloomberg Global Treasury Index (USD-hedged). Source: Bloomberg, SEI. As of December 31, 2021.

This bodes well for broader, more diversified equity portfolios, especially relative to portfolios that have become concentrated in large technology stocks, over-valued stay-at-home stocks, growth stocks, or the expensive areas of the market that we believe are particularly vulnerable to rising interest rates. In contrast, we believe SEI's actively managed equity portfolios are well positioned for the environment ahead. More generally, we believe active management should fare well versus market-cap-weighted, passive indexes that have become top-heavy in some of the aforementioned problem areas.

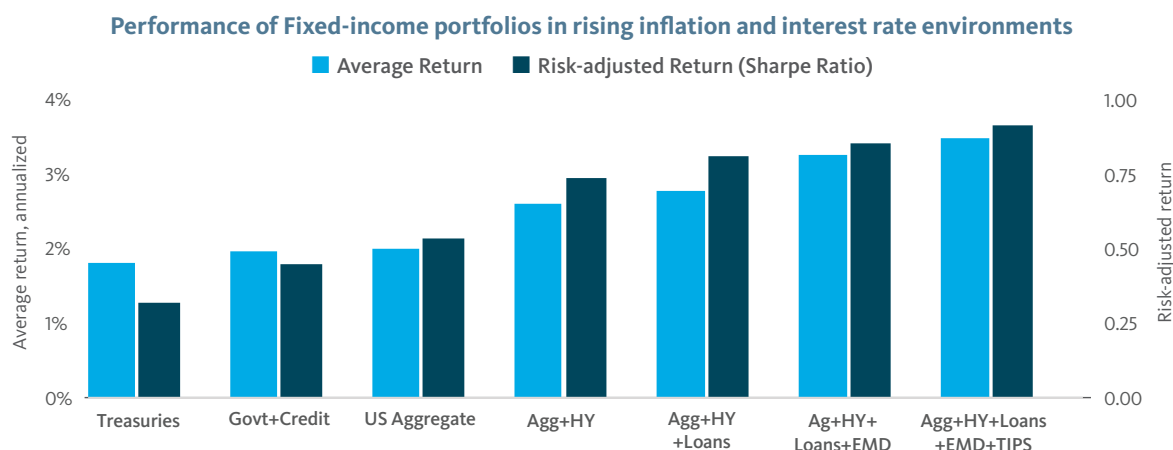
Diversification at every level: Fixed Income

Fixed income is probably the area that investors are most concerned about when it comes to the prospect of higher inflation and interest rates. This makes perfect sense given the inverse relationship between interest rates and bond prices. However, the rule of thumb stemming from this, perhaps simply stated as “rates up, bonds down,” is an over-simplification and may cause some misconceptions. First, we have to remind ourselves that “bonds down” only refers to bond prices, and the price return component of a bond's total return has, over time, been the smaller and less significant component of return. In fact, as we've shown in a previous paper (**Rising Rates and Bond Markets: Keep Calm and Clip On – August 2021**), during the bull market for bonds over the last 20 years—widely considered to be a golden age for bonds, driven by a secular down-trend in interest rates—only one-tenth of the total annualized return was price return (Bloomberg Barclays Global Aggregate Bond Index, 12/31/2001 to 6/30/2021). As shown in our paper, the coupon return has been by far the more significant contributor to total returns over the medium-to-long-term, and coupons should actually benefit from rising rates over time.

Second, bonds are not a monolith. Investors sometimes paint the entire bond market with the same brush, especially when it comes to the spectre of rising interest rates; however, there are many different areas and sectors of the fixed-income markets. For example, floating-rate debt would obviously not be nearly as impacted by a rising rate environment, and not subject to the “rates up, bonds down” principle. The breadth and diversity of fixed-income markets is good news for investors who remain concerned about the shorter-term challenges posed by higher inflation and interest rates. To demonstrate this, we looked at periods of rising inflation and interest rates over the past 20-plus years (data beginning in 1998) and examined the performance of different fixed income portfolios ranging from very basic and relatively undiversified to more fully-diversified.

The analysis in Exhibit 3 shows the benefit of additional layers of diversification—starting from a portfolio of U.S. Treasuries, then successively adding corporate debt, mortgage-backed, asset-backed and other securitized fixed income, high-yield bonds, floating-rate debt, emerging-market debt, and inflation-linked bonds. A fairly clear pattern emerges—during periods of rising rates and inflation, increased diversification improves performance, both in terms of historical absolute returns and risk-adjusted returns.

EXHIBIT 3: FIXED INCOME IS NOT A MONOLITH



Treasuries portfolio is 100% Bloomberg US Treasury Index, Govt+Credit is 100% Bloomberg US Govt/Credit Index. US Aggregate is 100% Bloomberg US Aggregate Bond Index, Agg+HY is 90% Bloomberg US Aggregate Bond Index and 10% Bloomberg US Corporate High Yield Bond Index. Agg+HY+Loans is 85% Bloomberg US Aggregate Bond Index, 10% Bloomberg US Corporate High Yield Bond Index and 5% Credit Suisse Leveraged Loan Index. Agg+HY+Loans+EMD is 75% Bloomberg US Aggregate Bond Index, 10% Bloomberg US Corporate High Yield Bond Index, 5% Credit Suisse Leveraged Loan Index and 10% Bloomberg Emerging Markets USD Aggregate Index. Agg+HY+Loans+EMD+TIPS is 65% Bloomberg US Aggregate Bond Index, 10% Bloomberg US Corporate High Yield Bond Index, 5% Credit Suisse Leveraged Loan Index, 10% Bloomberg Emerging Markets USD Aggregate Bond Index and 10% Bloomberg US Govt Inflation-Linked All Maturities Index. Total return data, quarterly, from 1998-Q2 through 2021-Q4. Sources: Bloomberg, St. Louis Federal Reserve, index providers, SEI. As of 12/31/2021. Past performance is not a guarantee of future results.

If we are indeed headed for a higher interest rate and higher inflation environment, diversification remains a fundamental principle of portfolio construction that can help, even in the world of fixed income where rising rates and inflation can be a significant headwind. You cannot paint all fixed income with the same brush:

- High-yield bonds can offer excellent diversification as they have higher coupon payments and less interest rate sensitivity (compared to investment-grade bonds).
- Loans are another attractive diversifier—their coupon rates float and will move higher as interest rates rise.
- Emerging-markets debt can also provide attractive yields and broadens interest-rate exposure beyond U.S. markets, bringing more comprehensive global diversification.
- Finally, inflation-sensitive bonds, typically referred to as TIPS (Treasury inflation-protected securities), often do better when inflation rises.

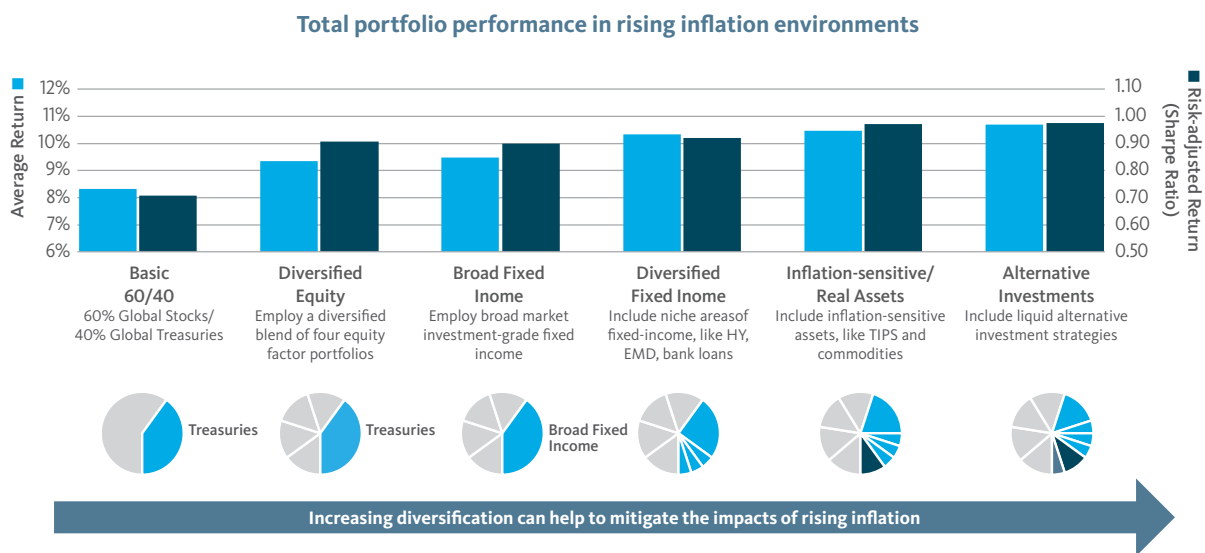
Diversification at every level: Total Portfolio

We can now evaluate how different total portfolios, with varying degrees of diversification, might cope with a higher inflation and rates environment. Taking a similar approach as our analysis of fixed-income portfolios, we focus on periods of the last 20-plus years (data beginning in 1998) where inflation or interest rates were on the rise.

Starting from a very basic, relatively undiversified “60/40” portfolio, we build toward a fully diversified portfolio—a generic representation of SEI’s portfolio construction philosophy—as shown from left-to-right in Exhibit 4. We first move away from a market-cap-weighted equity portfolio, broadening the equity exposure to an equal-weighted blend of four factor portfolios: Quality (focus on profitability characteristics), momentum (stocks exhibiting positive price or earnings momentum), value (attractively priced stocks), and low-volatility stocks. This equal-weighted blend serves as a rudimentary proxy for active management and the general philosophy with which SEI approaches actively managed equity. Second, we expand fixed income across a broad investment-grade portfolio; third, we further diversify into niche areas of fixed income; fourth, we include inflation-sensitive assets; and finally, an allocation to liquid alternative investment strategies is included.

Exhibit 4 shows a clear pattern of improvement in portfolio performance—a testament to the power of diversification to help deliver a better experience during rising inflation environments, in terms of historical average returns and risk-adjusted returns.

EXHIBIT 4: DIVERSIFICATION CAN FIGHT INFLATION...

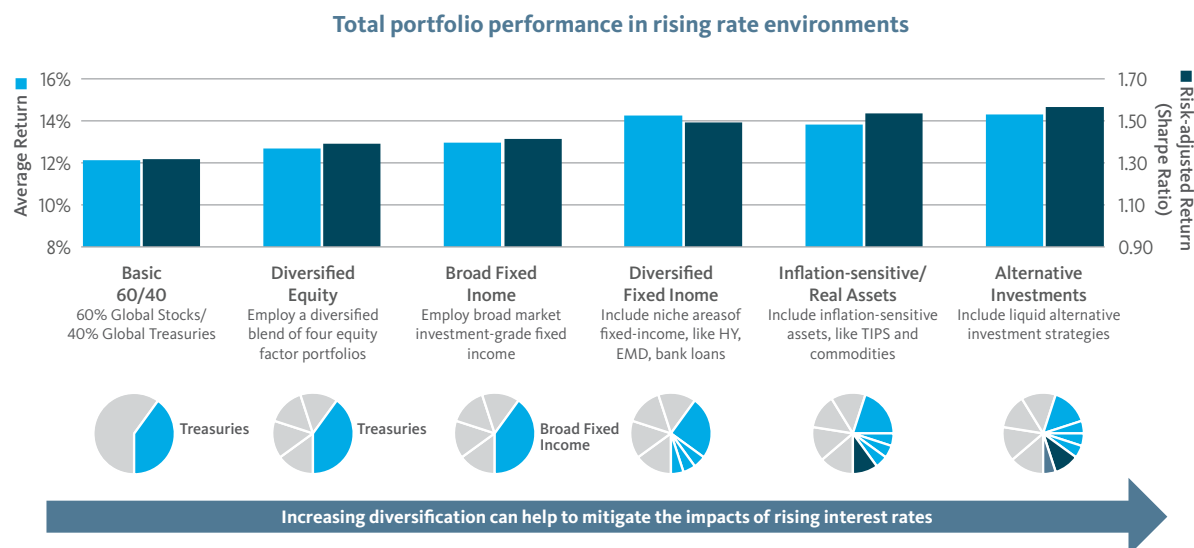


Quarterly data from 1998-Q1 to 2021-Q4. Average returns and Sharpe ratios are measured over the subset of quarters where inflation was higher than the previous quarter, i.e. rising inflation, as measured by the aggregate rate of inflation for G-7 countries reported by the OECD. For the complete specification of portfolios, please see Exhibit 6. Source: OECD, Bloomberg, SEI. As of December 31, 2021. Past performance is no guarantee of future results. This chart contains back-tested portfolio performance. The indices used in the construction of these portfolios also utilize back-tested index performance. For an explanation of the limitations of back-tested performance please reference the explanation under Important Information.

If history is any guide, a basic 60/40 balanced portfolio would be expected to underperform a truly diversified portfolio when inflation is on the rise. History suggests that properly diversified equity and fixed-income exposures, along with inflation-sensitive assets and alternatives, can provide the best opportunity for gains, while also improving the expected risk-adjusted return.

Next, in Exhibit 5, we’ll use the same framework of analysis, but focus on periods of rising interest rates. Again, we see a similar pattern during rising interest-rate environments—a significantly improved experience, in terms of historical absolute returns and risk-adjusted returns.

EXHIBIT 5: ...AND RISING RATES.



Quarterly data from 1998-Q1 to 2021-Q4. Average returns and Sharpe ratios are measured over the subset of quarters where interest rates were higher than the previous quarter, i.e. rising interest rates, as measured by the yield on the Bloomberg Global Treasury Index. For the complete specification of portfolios, please see Exhibit 6. Source: Bloomberg, SEI. As of December 31, 2021. Past performance is no guarantee of future results. This chart contains back-tested portfolio performance. The indices used in the construction of these portfolios also utilize back-tested index performance. For an explanation of the limitations of back-tested performance please reference the explanation under Important Information.

History shows that, during higher inflation and higher interest-rate environments, portfolio performance may improve when moving from a relatively undiversified portfolio to a fully diversified portfolio. Further, we believe diversification helps to build a more resilient portfolio across different economic regimes.

As laid out in Exhibit 6, these analyses made use of generic, global index data for the purpose of drawing some basic, but fundamental, conclusions. We chose indexes such that they provide a rough approximation of how we approach diversification and the type of well-diversified portfolios that SEI brings to bear.

EXHIBIT 6: SPECIFICATION OF PORTFOLIOS

Progressively more diversified portfolios for use in analyses

	Basic 60/40	Diversified Equity	Broad Fixed Income	Diversified Fixed Income	Inflation-sensitive / Real Assets	Alternative Investments
MSCI ACWI Index	60%					
MSCI ACWI Quality Index (Net)		15%	15%	15%	13.75%	13.75%
MSCI ACWI Momentum Index (Net)		15%	15%	15%	13.75%	13.75%
MSCI ACWI Enhanced Value Index (Net)		15%	15%	15%	13.75%	13.75%
MSCI ACWI Minimum Volatility Index (Net)		15%	15%	15%	13.75%	13.75%
Bloomberg Global Treasury Index (USD-hedged)	40%	40%				
Bloomberg Global Aggregate Bond Index (USD-hedged)			40%	25%	20%	15%
ICE BofA US High Yield Index				5%	5%	5%
J.P. Morgan EMBI Global Diversified Index				5%	5%	5%
Credit Suisse Leveraged Loan Index				5%	5%	5%
Bloomberg Global Inflation-Linked Index (USD-hedged)					5%	5%
Bloomberg Commodity Index					5%	5%
HFRI Fund of Funds Composite Index						5%
	100%	100%	100%	100%	100%	100%

Source: Quarterly data from 1998-Q1 to 2021-Q4. All returns are gross total returns in USD terms, unless otherwise noted. Source: Bloomberg, SEI. As of Dec. 31, 2021.

Our Views and Positioning

We have demonstrated that, empirically, a properly diversified portfolio is expected to outperform a portfolio with more basic diversification. Strategic allocations are generally the most significant determinant of portfolio returns, but SEI's investment process also includes identifying opportunities across capital markets to help enhance returns and manage risk.

We believe that the recovery from the COVID-19 crisis and its associated themes—improved economic growth, gradually higher interest rates, elevated inflation, and changes in market leadership—will continue. Fiscal responses to the pandemic have been extraordinary and significantly more coordinated than they were during the global financial crisis. Despite geopolitical uncertainty and the potential for tightening measures, the global economy is still likely to grow faster than the more-sluggish pace of recent times. This could mean ongoing upward pressure on interest rates and inflation and, at times, higher volatility. This type of market environment should favour strategic portfolio diversification, including inflation-sensitive assets, and active management.

We believe the very-expensive areas of equity markets, as well as companies with suspect profitability characteristics, are particularly vulnerable in this reflationary environment. Many of our equity strategies have moderated exposure to expensive mega-cap stocks in favor of more attractively priced and cyclical areas that stand to benefit from the economic recovery and normalisation of historically wide valuation differentials. Generally, this includes reduced exposure to select technology and consumer discretionary stocks, especially those that appear overvalued and have lost momentum, while adding exposure to more attractive opportunities in sectors like financials, industrials, and energy.

Within emerging markets, stock selection favours semiconductors, which should benefit from strong demand, over internet-related stocks; while fixed income favors debt in local, emerging-market currencies that have more attractive real yields and tend to be favourably correlated with inflation. Both equity and fixed-income strategies are approaching China with caution— reducing or avoiding exposure, particularly in the real estate sector.

Similar to equities, high-yield bonds should be supported by a recovering economy, including a default rate that is anticipated to continue falling in 2022. We also find industrials attractive in this space, and maintain a significant allocation to bank loans, which helps to reduce overall interest-rate sensitivity. U.S. investment-grade fixed income added to floating-rate debt positions based on relatively attractive valuations and to help limit sensitivity to interest rates. Positions in financials and industrials were increased, particularly shorter-term issues, while trimming overall risk exposure in corporate credit.

Active positioning reflecting our macroeconomic outlook (implemented within the SIMT Dynamic Asset Allocation Fund) includes additional exposure to commodities and positions designed to benefit from higher interest rates and higher inflation. Commodities have benefited from improving economic growth and higher inflation, and we still hold a positive view on a broad exposure to the asset class. Commodities should also continue to benefit from ongoing supply-and-demand imbalances throughout the world.

Diversification is key

Despite our expectation that interest rates could gradually drift higher, bonds and other portfolio hedges remain an incredibly valuable part of the total portfolio—playing a crucial role in diversification and managing the overall risk of the portfolio. Even if we assume that fixed-income returns will be lower than they have been, investment-grade bonds remain one of the few genuinely diversifying asset classes in most portfolios.

Regardless of the economic outlook, diversification remains fundamental to constructing portfolios that can be resilient across different economic regimes, including a higher inflation and higher interest-rate environment. It is always difficult to time major regime shifts in growth, inflation and rates—that is one of the reasons we believe clients should maintain proper diversification. If you are already invested in one of our well-diversified portfolios, we believe you are well positioned for this phase of the markets and beyond. If you are not invested in a well-diversified portfolio, there is never a bad time to remedy that. As always, it is important to take your goals and risk tolerance into account when making investment decisions.

Important Information

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This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments. Alternative investments are subject to a complete loss of capital and are only appropriate for parties who can bear that risk and the illiquid nature of such investments. Commodity investments and derivatives may be more volatile and less liquid than direct investments in the underlying commodities themselves. Commodity-related equity returns can also be affected by the issuer's financial structure or the performance of unrelated businesses. Use of futures contracts, forward contracts, options and swaps is subject to market risk, leverage risk, correlation risk and liquidity risk.

Diversification may not protect against market risk. Past performance does not guarantee future results. Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

In regards to back-tested performance in Exhibits 4 and 5: Portfolio results shown do not represent the results of actual trading but were achieved by means of the retroactive application of a model designed with the benefit of hindsight. Models assume that portfolios are rebalanced quarterly and all cash distributions are reinvested. Performance does not reflect the deduction of fees.

Hypothetical portfolios also contain back-tested index performance. Back-tested index performance, which is hypothetical and not actual performance, subjects the hypothetical portfolio to further inherent limitations because it reflects application of an index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns. Past performance is no guarantee of future results.

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