Russell Investments

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Manager Insight

Impact of inflation on investment strategy

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Although the debate on inflation continues, it is not causing much concern for most in the developed world. Both the US and UK central banks have yet to raise rates, and the April ECB rate hike may now seem to have been a mistake after it recently suggested it may need to pause. Equally, many of the emerging markets have certainly experienced inflation with higher food and fuel costs, which together have sizeable representation in official inflation numbers. Central banks there have raised rates amongst other measures to reign in rising prices. Those who say inflation is not a problem, are basically looking at the demand side, and point to the ample excess capacity and labour in the system. Conversely, others say that we need to be wary of cost-push inflation through rising commodity prices and inflation generally in emerging markets, which will spill over to the developed world. We asked some of our underlying managers to give their perspective on the threat of inflation, and how it could potentially affect their investment strategy.

The likes of our Global High Dividend and European Equity managers are inflation conscious, while our Commodities and India Equity managers feel that inflation is not an issue; and finally our Listed Infrastructure and Global Dynamic managers present a more neutral view on the matter.

Faisal Rahman, CFA, Portfolio Manager, Russell OpenWorld

Fund: OpenWorld Global High Dividend
Manager: Thornburg Investment Management

Manager insight: Inflation is working its way around the world across most sectors. The most noteworthy areas of inflation include metals, energy, and agricultural goods. These higher input costs are pressuring margins for many companies. Normally, there would be some upward wage pressure that could partially offset the costs to end-consumers. This is occurring in some emerging markets, but not so much in the mature economies of Western Europe and the U.S. where the economies continue to suffer from weak economic growth. The fund has increased exposure to certain companies that may perform better in this environment. Given inflation concerns, a number of consumer staples had sold off to levels where they became attractive investments.

As a result, we increased exposure to such branded consumer staples as Coca-Cola, Philip Morris, and McDonalds. Given their strong brands, these companies may have the pricing power to offset sustained inflation. Another sector that stands out is the telecommunications sector. In this case the input prices for equipment are certainly on the rise, but the commodity and energy costs are only a small portion of the sectors costs. In this case, inflation has less of an impact on margins than other factors that are more within the industry's control. Further, we have investments in energy companies that should be direct beneficiaries of rising oil prices.

Hermes Sourcecap

Fund: **OpenWorld Europe Focus Equity**
Manager: **Hermes Sourcecap Ltd**

Manager insight: We have been voicing our concerns over inflation for well over a year now, and at the end of last year said that inflation will be the big theme in 2011 and the markets will see-saw with the possible policy responses. Much of this inflation is supply driven, i.e. cost push, and, therefore, policy makers will have to be sensitive to the demand side when making decisions to counter-act these price pressures. In that regard, we prefer to own stocks at the sharp end of the price-curve, such as primary resource producers (materials), rather than those companies who are suffering from unavoidable increases in input prices (industrials).

Inflation, as a theme, is still an important component of the portfolio structure but, unlike in 2010, we have to look increasingly at the negative consequences for the corporate sector rather than just the winners from global price increases. Stock selection, therefore, is becoming of paramount importance as the coordinated global monetary stimulus of the last two years begins to generate distinct winners and losers.

We expect omission to be an important and continuing feature in achieving good relative performance over the rest of the year for two reasons: the first is that we expect an uneven response from individual company profits to rising input costs and the increasing cost of capital. Not all companies have sufficiently flexible cost bases, robust brands or strong-enough balance sheets to cope with a challenging environment even if demand is improving. As a result, profit warnings will be an ongoing feature of corporate life and will create many “elephant traps” for the unwary investor. The second differentiating factor will be the steady rise of corporate activity where the strongest companies will use their balance sheet flexibility or their highly-rated equity to acquire weaker players, or will retire equity through issuing cheap debt if their credit rating allows it. These forces will create a tricky environment but a potentially rewarding one for good stock pickers.

Fund: **OpenWorld India Focus Equity**
Manager: **Quantum Advisors Private Limited**

Manager insight: Moderation in India inflation in food articles and textiles items will be largely responsible for lower inflation in 2011-12. In 2010-2011 inflation was high largely because of higher demand - a result of higher income among urban and rural households. Wage inflation in 2011-12 is not likely to be as high as in 2009-10 and 2010-2011. Consequently on the margin, demand will be muted and should result in lower inflation.

In addition to the easing of demand, agricultural output is projected to grow briskly in 2012. Record production of food grains should ease the pressure on food inflation. Production of non-food crops is expected to grow briskly as well. Recent decline in food prices are already reflecting the higher output. We do not see the threat of inflation and the consequent increase in interest rates to result in a dramatic drop in the rate of growth in GDP. As such we are not changing our assumption of a long term rate of growth in GDP of 6.5%. Our company valuation sheets are based on these long term growth assumptions. However at company specific level, we are conscious of the fact that some will be able to pass on all the cost increases and some may not, due to changing market conditions. Our buy/sell limits and the upside potential on companies will accordingly change. Weight of the individual stocks in the portfolio will eventually reflect these changes.

Fund: OpenWorld Commodities Long Neutral
Manager: Mount Lucas Management LP

Manager insight: In the U.S. we think it is unlikely that rising/high commodity prices will spill into the Core CPI. For that to happen, high commodity prices would need to overcome the headwind of high unemployment which is maintaining a cap on wage pressures. Without higher wages, inflation will be limited.

As far as rates, we see a continued low rate environment in the short term with rates rising in the U.S. faster than in Europe in the medium term. This event would be good for the Dollar putting pressure on both Gold and Energy prices (absent any additional Middle East developments). Grain prices are likely to remain bullish with very tight supply situation. Sugar prices will be under pressure as supply is moving from a deficit (last year) to a surplus (this year).

Fund: OpenWorld Global Listed Infrastructure
Manager: Rare Infrastructure Limited

Manager insight: Inflation – structural or cyclical – infrastructure doesn't care. Infrastructure companies generally benefit from increased inflation as prices for their activities are generally linked to inflation. Mostly, this is headline inflation (although UK utility prices are linked to RPI, and some other countries use local variants) and generally it has a ratchet effect. That is, once prices have gone up, they don't come down – bad for consumers but good for shareholders. Given the current and increasing inflation outlook in Europe, the portfolio is tilted toward those stocks that will benefit the most, in particular, the UK and European utilities where not only prices are increased by RPI/inflation, but also the value of their asset bases (which , in turn, drive higher future returns).

Fund: Global Dynamic Bond

Manager: Strategic Fixed income LLC

Manager insight: Clearly headline U.S. CPI is likely to continue upward for a time due to higher energy and food prices. Even if the month over month increase in CPI moderates to 0.2 per month over the next few months the year over year rate will likely still be 3.5% by autumn or sooner. Most of the core measures we look at are running at about 1.0% to 1.2 % year over year and we do not see them going over 2% this year. There is no price pressure from the labor market where average hourly earnings have been running below 2% since October, 2009. Real average hourly earnings are negative. Without higher real wage and higher real personal income growth we believe headline inflation will moderate. Deflation still exists in the housing market and we see this continuing throughout the year. Higher mortgage rates will only serve to depress housing further if interest rates do rise. We think inflation indexed link bonds have been more correlated to risk markets and are not particularly attractive at current levels. If second half U.S. growth is as disappointing as first quarter growth we would favor U.S. nominal over index linked bonds with duration in excess of the benchmark index.

Currently, at the portfolio level we like U.S. nominal coupon bonds and are currently overweighted relative to the benchmark index. This is a contrarian view especially compared to PIMCO. Other bond markets that we favour include New Zealand, Australia, and Canada. Our view towards these markets has little to do with the inflation outlook but more to do with the integrity of these markets monetary policy. In Europe we are overweighted in Norway and Denmark.In these markets we like the fiscal situation of these countries relative to other European markets. With respect to the U.S. dollar we probably will maintain an underweight. The end of QE2 may be positive for the U.S. dollar because the Fed's balance sheet will not continue to expand. However the Fed has already stated that they will continue to reinvest proceeds from pre-paid mortgages and maturing Treasuries so the balance sheet does not shrink. This does not help the USD. In addition, if they reinvest the proceeds from the potential asset sales of securities like Maiden Lane into Treasuries this will not help the USD. This is especially true in conjunction with rising interest rates outside the U.S. market.

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