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Where to invest when inflation is running hot: Expert tips on the best stocks, funds and trusts to protect your wealth

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By Tanya Jefferies

Alarming inflation forecasts are prompting investors to look at ways to ensure their portfolios can withstand the strain.

Consumer prices rose 5.5 per cent last month, and the rate is expected to hit 7 per cent in April.

At a time of uncertainty - with the threat of a Russian invasion of Ukraine still hanging over financial markets - we round up expert views on what to beware of and investments they believe can ride out price rises.

What investors should bear in mind about inflation

'Current high rates of inflation mostly reflect price rises that have already happened, but even looking forward, the Bank of England expects inflation to run above 5 per cent over the next 12 months' says Laith Khalaf, head of investment analysis at AJ Bell.

'Meanwhile the average cash Isa is currently paying just 0.34 per cent in interest, so many people will naturally find themselves turning to the stock market to help fend off inflation.

'Companies at least have the opportunity to pass price rises onto consumers. In fact, that's largely what causes inflation, as measured by the Consumer Price Index.'

Khalaf warns that over the course of the year there is absolutely no guarantee stock investments will beat inflation, but over the longer term they are one of the key defences savers have against rising prices.

Meanwhile, expectations that the global economy will pick up this year will be overturned if there is a war in Ukraine. Khalaf says inflation might even get worse due to disruption of the gas supply.

But assuming this does not happen, he notes: 'The Bank of England reckons CPI inflation will be back to 2 per cent by 2024. Maybe so, but the Bank's forecasting capabilities haven't exactly won any awards in recent times.

'However, inflation is extremely unpredictable, and we should acknowledge it might possibly tail off. Investors should therefore take a balanced approach with their finances, which means not betting the entire farm on a continued inflationary environment, while also picking some investments which can do well if inflation proves stickier than the Bank of England expects.'

John Moore, senior investment manager at Brewin Dolphin, says: 'With inflation at its highest level in over 30 years, investing in the stock market is trickier than it has been for a long time because the current high inflationary, low interest environment has led to market volatility and uncertainty.

'At the same time, investors need to make their money work harder for them. The key to this is having a diversified portfolio which can bear the brunt of unpredictable changes in the market.'

Moore adds: 'If current geopolitical tensions escalate your investment strategy may need to reflect this and prepare for volatility.

'Although each geopolitical event is different, and despite the human costs, historical volatility induced by geopolitics tend to fade and settle. Disinvesting when volatility picks up has been a consistently bad investment strategy.'

Where to consider investing when inflation is running hot

Companies with pricing power

The kind of companies that can prosper in an inflationary environment are those with the power to pass their costs on to customers, according to Khalaf.

'Consider the fashion brand, Burberry, for instance. If you're willing to shell out £2,000 for a Burberry trench coat, chances are you're in a wealth bracket where inflation is a dim and distant problem, so a few extra pounds on the price tag aren't likely to put you off a purchase.

'Companies with brand strength like Diageo and Apple have also shown the ability to push through price increases, but at 25 times and 27 times forward earnings respectively, these stocks trade at very lofty valuations.

'So while these businesses may be able to protect profit margins against inflation, the stock price may be vulnerable to inflationary pressures.'

Khalaf adds that ethical investors won't be interested in the following, but tobacco stocks like BAT and Imperial Brands have pricing power because of the addictive nature of their key products.

Financial stocks

Banks can benefit from inflation, albeit indirectly, because they make a return from taking deposits and lending them out, says Khalaf.

'The difference between the rates at which they borrow and lend should increase with rising interest rates.

'Increased living costs do have the potential to mean more bad loans for banks, but rising wages, combined with savings stashed away by consumers during lockdowns, should mean the vast majority of people will continue to be able to service their bank debt.'

Khalaf also says that as most of the mortgages sold recently have been fixed rate, interest rate rises will take a while to affect many borrowers.

'Lloyds for instance, offers investors a slow and steady UK-focused bank, which should throw off a decent dividend, again a bit of help against inflation.

'HSBC, by contrast, is a global bank, and in fact most of its profits now come from the faster growing far eastern region, though that of course carries its own risks.'

Commodity stocks and Exchange Traded Commodities

'Investors might also think about investing in the key sources of inflation, in particular energy and raw materials,' says Khalaf.

'It would be hard to see inflation continuing to be elevated without these prices also increasing, which would be positive for producers like Shell, or Rio Tinto, or indeed a more diversified metal and mining fund like BlackRock World Mining.'

'Some inflationary expectations are already baked into share prices in these sectors though, which explains their positive share price performance in the last six months. These stocks are also extremely volatile, so a considerable risk appetite is required before jumping on board.'

Khalaf warns those tempted to invest directly in commodities like oil and gas through ETCs (Exchanged Traded Commodities, which work like Exchange-Traded Funds) that they normally use derivatives to gain exposure, and often come with complex costs.

This means there can be a disconnect between the price movement of the commodity and the return from the ETC, so they should only be considered by sophisticated investors, he notes.

Cyclical funds

Cyclical investments are more likely to benefit from an economic recovery, while defensive ones are better at withstanding economic shocks.

Khalaf says if you're simply looking to tilt your portfolio towards more cyclical sectors in a low cost, simple way, a FTSE 100 tracker like the iShares Core ticks a lot of boxes.

Energy, resource and financial stocks make up around a third of the index, so this isn't a pure play, he notes.

'For an active fund, Jupiter UK Special Situations also has around a third of its portfolio invested in financials, energy and resource stocks, and the manager's quality value style looks well-placed to come back into favour in an inflationary environment,' he adds.

Durable consumer brand companies

John Moore of Brewin Dolphin tips companies historically considered 'defensive' as worth considering in a high inflation environment.

'Household names such as Unilever, Nestle, Diageo, and Heineken could be a reliable addition to anyone's investment portfolio. Their products are regarded as non-luxury, small ticket items such as nappies, toilet paper, dishwasher tablets and non-perishable food goods such as mayonnaise and tomato ketchup.

'Consumers typically continue to buy these products no matter what the inflationary environment looks like, and even if the price of these goods continues to rise.

'One word of caution though, these businesses think long term and might take on short term pain in order to get to their desired objective, so there can be bumps along the way.'

But Moore says these stocks have 'strong, efficient supply chains and long-term pricing power', and offer an income yield of between 2 and 3 per cent a year.

Healthcare investment trusts

'If there is one thing that the pandemic has shown, it is the importance of healthcare spend and innovation,' says Moore.

'The constant technological developments in biotech and artificial intelligence have ensured that large healthcare and pharmaceuticals providers are at the forefront of innovation.

'In the current market, it is best to look at funds or trusts, rather than individual stocks. BB Healthcare Trust offers exposure to some of the more entrepreneurial names in the sector and an income yield of around 3 per cent a year.

'On the other hand, Worldwide Healthcare Trust and the Polar Capital Global Healthcare Trust are also worth considering as they invest in more established and well-known companies.

'It is worth watching the Worldwide Healthcare Trust as it has some relative performance to make up in the short term to protect its excellent long-term record.'

Specialist property trusts

'When constructing a diversified portfolio that can potentially protect the real value of your capital, investors should consider real estate,' says Moore.

'However, the last 18 months have challenged some perceptions of the sector and the relevance of commercial property, in particular retail and office space.

'While the high street may have had a tough time during lock down, supermarkets did not and along with logistics warehouses, which are essential to online offerings, the demand for these assets are a good inflation protection due to their long lead times on rental income.

'You could consider TR Property Investment Trust as it invests in real estate within healthcare, supermarket assets, student and social housing, storage boxes, and logistics warehouses.'

High quality companies

'These are businesses that typically generate high returns on the capital that they deploy, that are well financed and therefore can invest in organic growth opportunities or select acquisitions,' says Moore.

He tips Microsoft, Estee Lauder, Google owner Alphabet, Apple, LVMH and medical device company Thermo Fisher.

Funds and trusts profiting from monetary policy changes

Moore suggests considering investment trusts such as Personal Assets Trust or Ruffer which blend gold with inflation-linked bonds, high quality companies and alternative assets. He notes the latter has also dabbled in Bitcoin.

'If you prefer an even more specialist approach, then consider looking at BH Macro that is managed by Brevan Howard, one of the leading hedge funds managers.

'This investment trust offers access to underlying funds that typically benefit from changes in interest rates and volatility so while not a focused inflation hedge, it is well placed to capture some of the potential fallout and change that might happen and the trust has a low to negative correlation to equity markets.'

Companies owned by wealthy families

'Several of Europe's richest families hold some of their investments in publicly listed companies that any investor can buy into,' says Rob Burgeman, senior investment manager at Brewin Dolphin.

'These vehicles offer the opportunity to hitch your wagon to some of the most experienced long-term investors around and exposure to a diverse set of assets, some of which might not be available through other means – for example, private companies, private equity deals, or even land.'

'One thing you can guarantee with them is that they are unlikely to correlate with the wider market. What they care about is long-term capital preservation in real terms.

'They are not terribly concerned with how the stock market is doing in the short term and they are more focused on the net asset value of these companies than the share price.'

He suggests investors take a look at RIT Capital Partners, the investment vehicle of the Rothschild family, which has delivered an average annual return of 10.49 per cent over 10 years.

There is also Caledonia Investments, owned by the Cayzer family, Exor, owned by the Agnellis, Investor AB, owned by the Wallenbergs, and Peugeot Invest.

Gold

'Gold often comes to mind whenever inflation raises its head,' says Laith Khalaf of AJ Bell.

' Unlike barrels of oil and cubic metres of gas, gold bars are (relatively) easy to store, which means there are some ETCs available which hold physical gold, such as iShares Physical Gold ETC, so you don't have to worry about the complexities of derivative pricing.

'Gold can be volatile however, and there is little to link its performance to inflation, other than conventional wisdom. Indeed, the gold price has been trading at around $1,800 an ounce for most of the last year, and the recent inflationary surge hasn't pushed the price up in the way that gold bugs might have expected.'

He says this might be partly because higher interest rates aren't good for gold, because it doesn't pay an income. So, cash and bonds become relatively more attractive when interest rates are on the up.

'Gold is an asset which can be expected to perform differently to others though, and is a bit of an insurance policy against disasters elsewhere in markets, so it can work as some diversification in a portfolio.

'Typically for private investors exposure should be limited to 5 per cent to 10 per cent or so.'

What else do you need to consider?

Cash

It is necessary for short term spending needs, but clearly very exposed to the ravages of inflation, says Khalaf.

'You should only look to hold an emergency buffer of three to six months' expenditure.'

Bonds

Government bonds, particularly those of long duration, are also extremely vulnerable to rising interest rates, adds Khalaf.

'Investors should review any exposure they have to this asset class. Index-linked gilts in theory offer some protection from an inflationary storm, but are currently priced so high they act more like a fig leaf than a weather-proof jacket.

'The 10-year RPI linked gilt is currently yielding minus 2.5 per cent, which means that if you hold it to maturity, you will receive back 2.5 per cent less than inflation each year for 10 years. So not too appealing either.'

Stocks on high valuations

'We may also see some highly valued areas of the stock market struggle too,' says Khalaf. 'There are some stocks, particularly in the tech sector, where their elevated price is built on expectations of future earnings, rather than profits they are making in the here and now. Tesla is a good example.

'However inflation, and higher interest rates, make distant cashflows in years to come less valuable, and in fact this calendar year we have already seen some frothy areas of the market sell off as a result of this dynamic.

'Sustained inflation, or fast interest hikes, could see this play out further.'