



# Managing your inflation demons

Pension scheme trustees are having to re-think all areas of what they do as the ripple effect of Covid-19 continues to reverberate every aspect of their portfolios and investment strategies.

Inflation is just one part of the puzzle that needs to be considered and, while it is risk that has always been on trustees' minds, 2020 has pushed their inflation worries to another level.

"A significant proportion of UK pension scheme liabilities are inflation-linked, so a rise in inflation expectations/pricing increases the size of those schemes' future liabilities to pensioners", says Insight Investment head of market strategy, Robert Gall. And whilst some pensions may have caps and floors on their inflation commitments, generally a rise in inflation, if unhedged, would lead to a worsening in a scheme's funding position, he warns.

What this could all mean in numbers, adds Gall is that "a 1 per cent rise in inflation expectations across the curve for a scheme with a 20-year average inflation sensitivity will increase their liabilities by 20 per cent".

## Summary

- There is clear evidence that the fear of a rise in inflation is heightened at the moment.
- There are both temporary and permanent reasons for this.
- A 1 per cent rise in inflation expectations across the curve for a scheme with a 20-year average inflation sensitivity will increase their liabilities by 20 per cent.
- Most schemes may be prepared but some more than others.
- There are numerous ways schemes can manage their inflation worries.

► **Fears of a rise in inflation may be keeping trustees up at night but, with the right approach, pension funds can do their best to ensure they are well protected, whatever the future brings. Francesca Fabrizi explores**

Union Investment head of fixed income, Christian Kopf, describes the impact of higher inflation as an erosion of the real value of pension assets; while in addition, he says, "higher inflation volatility could weigh on stock market valuations".

Of course, inflation risk is nothing new, and the industry has been building hedges for this risk for over a decade, adds Gall, "so it is a risk that, for most schemes, is controlled and managed".

Despite this, there is clear evidence

that the fear of a rise in inflation is heightened at the moment, with a number of reasons for that increase in concern. "Some of those reasons are temporary," says Mercer head of asset allocation, Rupert Watson, and some more permanent, "and it is important to distinguish between the two".

In terms of the temporary, he says, we are about to see a largish jump in inflation measures in most parts of the world, including the UK, as economies re-open. "This has nothing to do with

so-called economic fundamentals, but is solely because economies are reopening. For example, the price of hotels, airfares – the sorts of things that last summer were very cheap – this summer, will go up.”

We will also see, argues Watson, a number of things as measured on a yearly basis go up, such as petrol prices. “This time last year when oil prices were down \$20, a litre of unleaded was somewhere near £1. Now, a litre of unleaded is somewhere near £1.20. That’s a 20 per cent increase.”

It is also possible that there is a further spike in inflation this year as consumer spending on certain things “goes berserk”, he warns. “People are itching to get out and, because of that, there might be a shortage in supply of the sorts of things we want to do. Businesses, not least because they have been shut for some time and have been struggling, may take the opportunity to put their prices up while we, as consumers, are likely to be less price sensitive. That might lead to a temporary increase in the price of certain things.”

Looking further ahead, there are reasons to believe that we may be entering a slightly higher inflation environment, says Watson, and that, in part, centres around central bank desires. “I have a lot of sympathy with the view that the level of inflation is a policy choice and that governments and central banks choose the inflation rate. They can’t exactly say ‘we want x per cent’ and it will happen, but over a long period of time, they have a lot of control over the inflation rate. Also, having spent the last several decades saying lower inflation is good and we need to guard against any kind of inflation, now there is a more balanced message that we need to ward against deflation,” he says.

“We have seen the US Federal Reserve moving to an average inflation target, emphasising that inflation has under-shot over the past 10 years or so and that, going forward, they wish to make back any shortfalls in the inflation rate, their so-called average inflation

target. That suggests looser policy at least in the short- to medium-term than would otherwise be the case, leading to slightly higher inflation than in the longer time horizon.”

The UK and other countries have not followed that quite so explicitly, he says – they are all making more noises, reinforcing that too low an inflation rate is as much a problem as too high an inflation rate, “and so policy, we think, is generally shifting in the direction of higher inflation”.

Finally, he adds, there are some fundamental reasons that are shifting in the direction of higher inflation, including some aspects of de-globalisation: “Companies rethinking their supply lines is, at the margin, mildly inflationary. We shouldn’t overplay that, but outsourcing everything to the cheapest possible point in the world does not make sense if there are vulnerabilities and fragilities in supply chains.”

Of course, there also remain lots of deflationary forces out there, he adds, ranging from automation and lots of things related to technology, and they will continue to exact a deflationary force.

To summarise, he comments: “Our best guess in terms of the profile of inflation is that we get a reasonably sharp pick-up in inflation this summer that ultimately proves temporary, and then we go back to slightly more normal levels of inflation for a period of time, meaning a year or two. Then, as we move to 2023/4 and the second half of the decade, we will see slightly higher inflation than we saw before the Covid-19 crisis.

“That means, in practice, the US being a bit above its US inflation target, possibly the same in the UK, and in the Eurozone and Japan, inflation remaining below target but perhaps not as below target as they have been.

“All in all, we are forecasting higher but not high inflation – but of course there are a range of potential outcomes, and some of the higher inflation outcomes are a little more likely than they were a couple of years ago.”

### Pension fund concern

So, how worried are pension funds and how worried should they be? “Pension funds should always be worried about a potential rise in inflation, given the nature of their liabilities,” Legal & General Investment Management (LGIM) head of rates and inflation strategy, Chris Jeffery, argues. “The question now is whether they should be more worried today than normal.

“Fiscal policy has not been used as the primary demand management tool for decades, but that all changed in 2020. We’re sceptical that this will fundamentally alter the inflation outlook, but a plausible case that it might is enough to raise concerns that are impacting inflation markets today.”

In terms of how significant the potential impact could be, Jeffery comments: “US household income is running around 3 per cent above the pre-crisis trend. Enhanced unemployment benefits and stimulus cheques have left the average US household in better financial shape than if the pandemic had never occurred. Moreover, the US Federal Reserve is committing to be more tolerant of short-term high inflation than in previous cycles.”

In the UK, there are not the same fundamental concerns, he adds, “but the lack of inflation-linked supply is an issue with the Debt Management Office’s remit for the next fiscal year, including plans to issue just 11 per cent (or £33 billion) in inflation-linked bonds.”

Highlighting a further influential factor, Kopf argues that, in the UK, people are also underestimating the potential effects of Brexit. “We believe the hit to cross-border supply chains will be much broader and be far more severe than people think. It’s a structural change to the economy and, as a result, we would expect the UK to face higher and more persistent inflation than elsewhere.”

In continental Europe, for instance, he expects inflation to start trending down again in 2022 since the driving forces behind rising prices, such

as supply-side issues related to the reopening from the pandemic, are generally transitory in nature. “But this is unlikely to be the case for the UK”, he warns. “It makes a difference whether certain goods are temporarily in short supply or whether you face continuous issues in getting goods across the Channel. Over time, however, the UK economy should be able to restructure and supply-side inflationary pressure will thus come off slowly after several years.”

### Options for managing inflation risk

So, what help is at hand for managing inflation risk and are pension funds doing enough? Generally, inflation is one of the things that clients are very conscious of when they think of the different risks that they face, says Watson. “Pension funds have liabilities – they tend to take great care on the matching side, on the bond side, of their total portfolios to line up their inflation exposure on their asset side so it roughly matches their exposure on their liabilities.

“In terms of growth-type assets, such as equities, one of the things we have been talking to our clients about is ensuring they have enough inflation protection. We have a view as to what will happen, but of course ultimately there are all sorts of things that are unforecastable, and we never advise clients to structure their investments so as to meet a particular outcome. We encourage them to think about structuring their portfolios so they are in a good position whatever the outcome is. Part of that is thinking about what happens if inflation

is consistently above target; do they have a significant degree of diversification, and protection against all outcomes?”

One obvious way to manage inflation concerns is to explicitly hedge inflation risk, adds Jeffrey. “Diversifying into foreign assets, and retaining the associated currency exposure, is a way to reduce idiosyncratic UK inflation risk. Investors should consider a diversified basket of real assets: equities, real estate, infrastructure and commodities are all examples of assets whose returns are directly or indirectly linked to inflation. Holding nominal assets alongside inflation-linked liabilities is the most important thing to avoid during any bout of rising inflation concerns”

Gall also highlights the benefits here of liability-driven investment (LDI): “By owning UK government index-linked bonds, schemes can build very close hedges to their liabilities and manage this risk. Most of our clients have built significant LDI portfolios and hedged a large part of both their interest rate and inflation risk, locking down this problem and removing the potential for an inflation shock to their funding position.”

The average corporate pension scheme, he argues, should be well protected (hedged) against the impact of rising inflation on the liabilities. What is less certain is the impact of high inflation on non-hedging assets such as equities or credit. Pension schemes hold around 20 per cent in equities and 40 per cent in credit. If higher inflation impacts the profitability of corporates (for example, due to debt affordability), these assets

might be adversely impacted.

“Local Government Pension Scheme funds do not have capped inflation-linked increases and have very low levels of hedging, so they are much more exposed on the liability and asset side (they generally also have much higher

equity allocations),” he concludes.

For Kopf, the easiest thing to do would be to enter into inflation swaps. He comments: “We are explicitly mandated by many of our clients to hedge pension fund liabilities against rising inflation. In addition, we observe that asset owners are becoming more interested in these type of hedges, since inflation is rising in the euro area, after several years of low inflation”

BESTrustees president, Alan Pickering, highlights that different types of scheme will have different approaches: “Those who are on a journey plan which includes matching as part of a de-risking strategy will have to review the relationship between matching and growth assets. There is always an opportunity cost in the latter if increased fire power is being used to protect against all risks.

“We must also not lose sight of the impact of inflation on defined contribution (DC) scheme members. This is particularly pertinent during the consolidation and decumulation phases. Where possible, we will need to take account of the cohort effect and engage in some segmentation so that we can take account of the proportion of later life income which comes from a pension scheme. The state pension and index-linked saving certificates may provide sufficient protection for certain segments of our DC population.”

In terms of whether pension funds today are generally doing enough, Jeffrey says it is hard to say. “On average, we have seen inflation hedge ratios rise steadily in recent years as part of a broader de-risking journey. However, that average masks significant disparity across schemes. Smaller schemes, for example, typically have less inflation protection than larger schemes.

“Corrupting the words of George Orwell, ‘all schemes are prepared, some are more prepared than others.’”

➤ **Written by Francesca Fabrizi**

