# The perils of yesterday's logic for DC pension investors

## James Fouracre explains the new status quo for DC pension portfolios

Increasing inflation volatility represents the greatest challenge to pension investors for a generation. A new regime and the collapse of the financial market status quo requires us to reimagine defined contribution (DC) pension portfolios. No longer can we rely on yesterday's logic.

Why do we have such conviction in inflation volatility and what does this mean for DC pension investors? The reason the answers to these questions matter is that investing for inflation volatility is not the same as investing for inflation. Confusion in this respect will be costly to pension investors.

Our policymaking elite take it for granted that inflation is the outcome of an isolated economic mechanism and can be managed by a technocratic, independent central bank which understands the mechanism. Milton Friedman summed up this mechanistic view by saying "inflation is always and everywhere a monetary phenomenon". Fine for economists, but social and political contexts shape the dynamics of inflation in disparate and confounding ways.

It is tempting to simply invest for the inflationary endgame. After all, turbulence passes eventually. But inflation volatility could be with us for some time. And, when inflation is on a downswing, a pension portfolio positioned solely for inflation risks losing a wing.

To survive the turbulence of inflation volatility, pension investors will need a hedged portfolio. DC portfolios will need to be intricately constructed – active, for sure, as no static portfolio will survive. And the hedges may be expensive.
A portfolio positioned for resilience, rather than optimisation, will sometimes have a weighty cash balance. Cash is an uncomfortable asset to hold in an inflationary world, but it is an essential quiver – storing the portfolio arrows needed to pick off opportunities as they arise.

Beyond the immediate liquidity challenges, pension investors will have to steer portfolios through the twists and turns of more abrupt economic cycles interacting with liquidity cycles and changing policy reaction functions. It may take time to play out, but we know trip wires lie ahead. And inflation will fall sharply again when financial and economic volatility coincide.

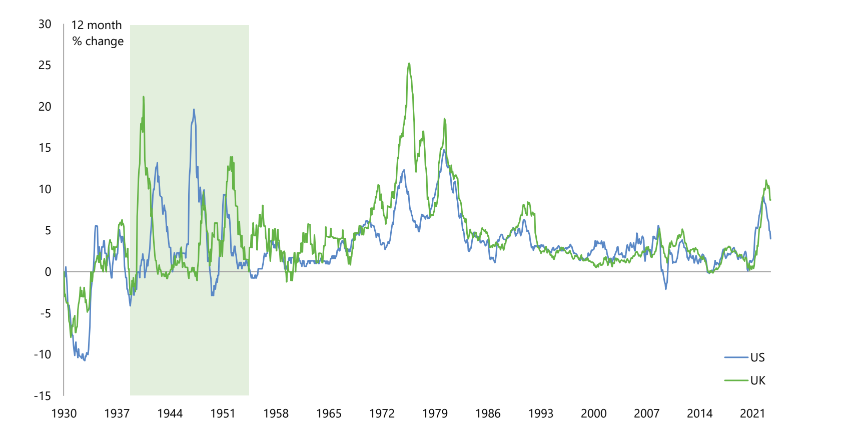
Inflation volatility will eventually give way to inflation, but investing now solely for the inflationary endgame would be a mistake. Peter Drucker, the father of modern management thinking, said: "The greatest danger in times of turbulence is not the turbulence. It is to act with yesterday's logic."

Turbulence lies ahead, that's for sure. The message to investors: portfolios will need to be steered on this journey, requiring new skills, new ways of constructing portfolios and imaginative thinking.

It is time to flick the switch off autopilot.

### A new era of inflation volatility lies ahead

CHANGES TO SUPPLY, LABOUR AND POLICY ARE LIKELY TO RESULT IN A MORE INFLATION-PRONE REGIME




Source: Bank of England, ASR Ltd/ Refinitiv. Data to May 2023

Written by Ruffer director, UK institutional, James Fouracre

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