



Managing Inflation Risk

by JOHN TUOHY

"If people ever allow banks to control the issue of their currency, first by inflation and then by deflation, the

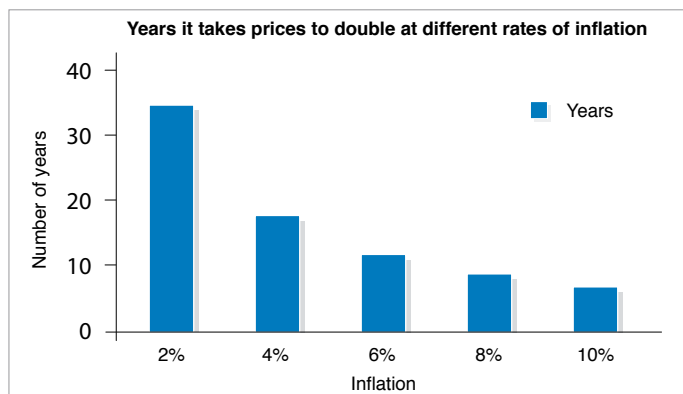
banks will deprive the people of all property until their children will wake up homeless."

- Thomas Jefferson.

Markets are buzzing with talk of inflation. Understanding how inflation will impact liabilities and assets is a major priority for both defined benefit and defined contribution schemes.

Inflation erodes the future value of money such that a euro saved today will not buy a euro's worth of goods and services in the future. This is a crucial point when you consider the primary role of a pension for any individual (regardless of whether it is a defined benefit or defined contribution pension) is to fund their desired standard of living in retirement. The achievability of that standard of living is, in part, a function of the price of goods and services when they retire.

Inflation is very corrosive and even small changes can have a big impact on the cost of goods and services. The following chart shows how quickly the price of a basket of goods doubles for different levels of inflation.



Even moving from two per cent to four per cent inflation means that instead of taking 35 years for a basket of goods to double in cost, it takes just 18 years. Think of it another way: if inflation is four per cent instead of two per cent, your retirement income needs to be double what you had planned just to afford the same standard of living.

Defined contribution schemes

The majority of defined contribution (DC) scheme assets are invested in a default fund and trustees are responsible for selecting this. Therefore, if you are a trustee of a DC scheme,

your members expect you have carefully considered inflation risk and ensured that the investment strategy of the default fund has sufficient elements in it designed to mitigate this risk.

Many trustees are embarking on a fundamental review of default funds as they recognise that the traditional balanced and consensus funds are high risk and wholly inappropriate as default funds. This creates an opportunity to deal comprehensively with inflation risks. Don't miss it. Members will thank you.

Defined benefit schemes

Inflation is an even more complex risk to deal with within defined benefit schemes. This is because many schemes essentially write insurance contracts that promise members protection from inflation. If this type of insurance is not appropriately managed there is a significant risk of liabilities growing faster than assets resulting in deficits being generated or increased.

The starting point to managing inflation is to understand the nature of the pension promises made. Questions include:

- Are pensions designed to increase in line with salary or consumer price inflation?
- Using a liability-hedged valuation, what percentage of the past service liability is in respect of funding future pension increases?
- How much would the liabilities increase if inflation expectations were increased?
- Is there a cap on pension increases (for example, four or five per cent) that limits the exposure to unexpected inflation?
- For active members what is the risk that salary inflation will result in a future funding problem?
- What actions can be taken to limit the scheme's exposure to inflation risks?
 - Benefit changes?
 - Choice of investment assets?
 - Use of inflation hedges or other types of insurance?

What provides the best protection?

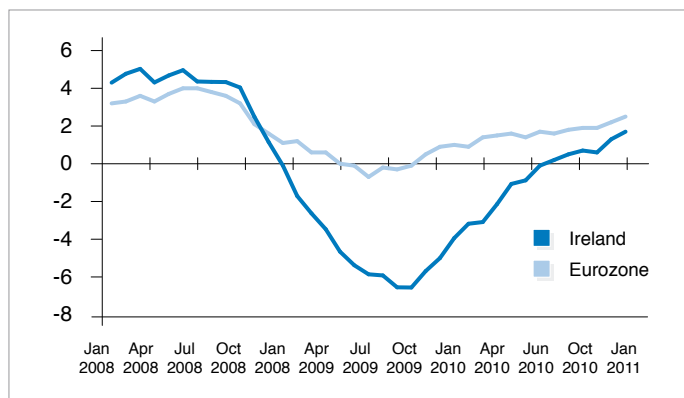
Providing the best protection depends on the type of inflation you are trying to hedge and the availability of traditional assets, swap contracts or derivatives to hedge that particular inflation risk. The major asset classes each respond very differently to inflation.

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| Cash | Inflation generally drives up interest rates, although there is a lag effect. Cash therefore tends to yield a higher return when inflation accelerates. Nominally higher returns may not however be sufficient to generate a positive real yield over the longer term. |
| Bonds | Inflation erodes the real value of both fixed coupons and repayment of principal. The increase in interest rates that usually accompanies higher inflation is also negative for bond values. |

| | |
|-------------------------------|---|
| Inflation-linked bonds | With both coupons and repayment linked to rising prices, inflation-linked bonds arguably provide the most precise protection available. |
| Equities | Dividends and stock prices are traditionally expected to grow in line with GDP but volatility can be high. Stocks tend to do best when inflation is low and steady, and fall with the extremes of either high inflation or deflation. |
| Property | Rental yields and asset values generally rise in line with inflation. Volatility can again occur over the short and medium term. |
| Commodities | Raw material prices are a significant component of inflation and investment in commodities provides protection in this regard. This protection is most pronounced in the later stages of economic growth cycles. |

If your liabilities are linked to consumer price inflation, index-linked bonds are often regarded as the best match. However, there are some practical implementation challenges.

First off, while Irish and Eurozone price inflation are correlated they are by no means the same thing (see chart below)

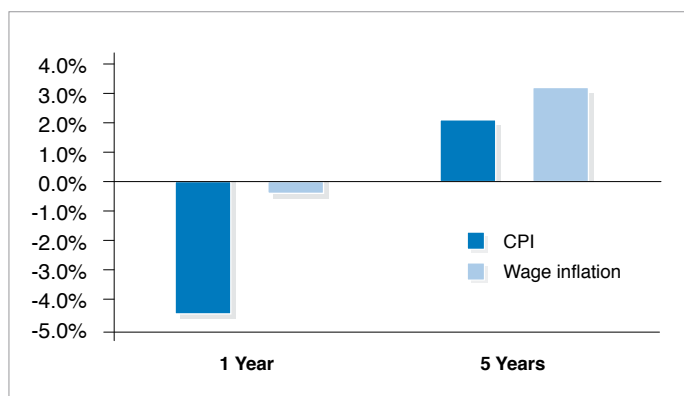


Price inflation in Ireland versus Eurozone as a whole

Source: Central Statistics Office (Ireland), Eurostat (Eurozone), January 2008-January 2011

The difference between Irish and Eurozone inflation is an issue given that available index-linked bonds tend to be linked to some measure of Eurozone inflation.

Another problem is that inflation-linked bonds are not the solution if what you are trying to hedge is salary inflation. In fact no asset provides a direct link with earnings increases. The chart below illustrates the divergence between price and earnings inflation in Ireland in recent years.



Price inflation versus wage inflation in Ireland

Source: Central Statistics Office, all periods end 31/12/2009

Laying aside the fact that euro inflation-linked bonds may not provide a perfect hedge for Irish inflation (either price- or wage-based), a further hurdle presents itself. As the recent recession has driven investors to become ever more risk-averse, the popularity of inflation-linked bonds has increased to the point

where yields have collapsed. Both the US and the UK have seen yields fall on occasion below zero while Eurozone yields remain very low. Many question whether this can provide long-term value, even considering the comfort derived from a more matched position. If your liabilities have an inflation cap of say four or five per cent then inflation-linked bonds are indeed an expensive option as you are paying for a level of protection (against unexpected inflation) that you don't need.

Inflation is a dangerous risk if left unchecked. Take the time to understand and manage it.

'Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man'

- Ronald Reagan



Have alternative assets lived up to expectations?

by MICHAEL MCCARTHY

Equity markets recovered strongly in 2009 and 2010, outperforming many other risk assets including alternative investments. Does this mean that alternatives have not performed as expected, or that equities should once again be the preferred asset class?

In investment markets, as in much else in life, memories can be short and a sense of perspective is needed to form a considered view. A good starting point is to revisit the rationale for investing in alternative assets. Their role is to diversify the sources of return in reward-seeking assets away from a reliance solely on equities by providing a variety of return drivers which have a low correlation with equity returns. The objective is to match equity returns over time while reducing portfolio volatility by providing a smoother pattern of returns. Given this expectation, how have alternatives performed over the past three years?

| | 2008 | 2009 | 2010 | 2008-2010 3 years total |
|-----------------------|--------|-------|-------|----------------------------|
| Currency | 3.5% | 0.9% | 3.5% | 8.1% |
| Commodities | -39.6% | 20.6% | 15.6% | -15.8% |
| Hedge funds | -19.1% | 18.6% | 10.9% | 6.5% |
| World equities | -42.1% | 27.0% | 9.6% | -19.4% |

Returns 2008-10 in US dollars

Source: Barclay Currency Traders Index (currency); average of Thomson Reuters/Jefferies CRB Index, S&P GSCI Commodity Index, Dow Jones-UBS Commodity Index, Rogers International Commodity Index (commodities); Dow Jones Credit Suisse Hedge Fund Index (hedge funds); MSCI (world equities)

Equities have clearly been on a rollercoaster ride over the three years but despite a strong recovery in 2009 and further gains in 2010, at end December 2010 they were still almost 20 per cent below December 2007 levels. This pattern is echoed in commodities. However, currency and hedge funds provide a different picture with both providing positive returns over the full period.

Currency

Returns have been positive over the three years despite the fact that the carry trade, one of the major currency strategies, has been unprofitable during this period. The carry trade

buys high interest rate currencies and sells low interest rate currencies, and this strategy has not worked in the context of risk aversion where investors seek refuge in the traditional safe haven (and low interest rate) currencies such as the US dollar, Japanese yen and Swiss franc. The extreme compression of interest rates across developed markets due to monetary policy and quantitative easing, leading to official interest rates of one per cent or lower in many countries, has also distorted this trade. However, we are already seeing a pattern of rising interest rate in emerging markets in response to inflationary pressures, and similar pressures are beginning to appear in developed markets too, so the carry trade may be set for a comeback. However, picking currency managers is challenging and while the index has done well there is a wide dispersion of returns amongst managers.

Commodities

Correlations between equity and commodity markets are relatively low over time but are highly variable over shorter periods. Data from Barclays Capital show a correlation between the S&P 500 Index and the GSCI Commodity Index of 88 per cent in 2010 compared to 50 per cent over the past five years and lower still over longer periods. This makes intuitive sense. When economic growth is slowing, demand for raw materials and energy reduces and company profits also come under pressure; a similar pattern is evident, but in the opposite direction, when economic growth starts to recover. The point of departure comes in the later stages of economic recovery when rising demand pushes up commodity prices while capacity is constrained. For equity markets, this creates the risk of pressure on margins as the price of raw materials rises, and the threat of higher interest rates to curb inflationary pressures. This is the 'sweet spot' in commodity markets and we have seen evidence of this in the strong performance of commodities in recent months.

As well as providing a hedge against inflation, commodities also provide protection against event risk. Extreme weather conditions last year ranging from drought in the Ukraine to excess rainfall in North America and flooding in Queensland have raised the prices of agricultural commodities. More recently, political instability in Tunisia, Egypt and elsewhere in the Middle East has created uncertainty over oil supplies leading to a rise in crude oil prices.

Hedge funds

The pattern of hedge fund performance over the last three years also echoes the performance of equities, but to a much smaller extent than commodities. In particular, the volatility of returns is much lower than in equities and the cumulative return is positive. The headline performance numbers for hedge funds reflect the averaging of performance across a range of strategies, from volatile returns in strategies with high correlation to equities such as arbitrage and emerging markets to more stable returns from strategies with low correlation to equities such as managed futures and global macro. The ability to navigate between these different strategies can enhance returns through the economic cycle.

In summary

The following table compares performance in US dollars over the years 2008-10 between a portfolio of 100 per cent global equities and a portfolio of 80 per cent global equities and 20 per cent in an equally weighted basket of currency,

commodities and hedge funds.

| | 2008 | 2009 | 2010 | 2008-2010 3 years total |
|----------------------------------|--------|-------|------|----------------------------|
| 100% equity | -42.1% | 27.0% | 9.6% | -19.4% |
| 80% equity + 20% alternatives | -37.4% | 24.3% | 9.7% | -14.6% |

The addition of alternatives has reduced portfolio volatility (compared to an equity-only portfolio) over the period, with the added bonus of improving returns. Alternatives have therefore more than fulfilled their role of diversifying returns and reducing risk.

Sovereign bonds / annuities

As we went to press with our last newsletter, a budget announcement had just been made regarding the issuing of new sovereign bonds to facilitate sovereign annuities, with an expected launch in January. Political events have knocked this timetable off course and we await details of a new government programme to provide clarity on a revised timetable.



Defined contribution: time to review your default fund

by REBEKAH BRADY

With changing patterns in retirement and the decision by the government to widen access to approved retirement funds, it is time for trustees of defined contribution schemes to re-evaluate the suitability of default investment options.

The importance of the default is not to be underestimated: recent research shows that it is commonly used by between 80 and 90 per cent of members.¹ Many schemes use a 'lifestyling' strategy as their default, in line with Pensions Board recommendations. It's a simple concept that has been around for decades. Traditional lifestyle arrangements gradually move investors through single asset classes with different risk and reward characteristics as they progress towards retirement. Switching typically commences 10 years before the target retirement date.



The strength of this structure lies in driving volatility down as the date of annuity purchase approaches. Most structures retain a high proportion of government bonds at retirement, providing additional protection against adverse movements in annuity rates. While this protection is clearly valuable, we see lifestyling in its traditional guise as a somewhat crude instrument.

¹ NAPF and Aon Consulting research, 2009

Lack of management within the growth phase

In common with other forms of pension investment, lifestyle strategies have predominantly used global equities during the return-seeking phase. A more diversified approach including alternative growth assets such as property, commodities and hedge funds should provide better protection against long-term volatility, while still producing reasonable returns.

The effective implementation of dynamic asset allocation should smooth the short- to medium-term volatility during this phase. The trustees, with the assistance of their advisers, should consider prevailing economic conditions, investment market outlooks and scheme-specific considerations, at least on a quarterly basis, to decide the appropriate position on the risk spectrum. Assigning allocation ranges to each asset class included in the fund will allow trustees to 'dial-up' and 'dial-down' risk as they see fit.

Switching at the worst point

Neither the investment manager nor the investor has control over the timing of the automated re-allocation, regardless of market conditions at the point of switch. During 2008 and 2009, when most equity markets tumbled and then rallied, many investors were locked into a fixed programme of switches where they suffered the worst of the losses, but failed to benefit from the subsequent recovery.

Government bonds do not present a universal panacea for workers approaching retirement. For those who neither want nor need to lock into annuities with their entire fund, bonds could prove a risky investment, particularly with current yields at low historic levels. If inflation picks up, yields could rise rapidly, triggering significant loss in value at the very time investors need protection.

Changing personal circumstances

The assumption underlying lifestyle strategies is that at the target date the money will be required in cash to provide a lump sum plus annuity purchase. But more and more people now find they don't want to or can't afford to retire on the date they originally forecast. A more flexible approach to retirement dates has become commonplace, with workers often accumulating several different pension pots, drawing income from one while continuing to accumulate benefits in another.

IAPF DC trustee investment guidelines

Trustees should ensure that sufficient communication exists to enable members to be aware of the important features of the investment options available to them and should provide for appropriate default strategies for members.

The end of compulsory annuitisation has moved a step closer with the Finance Act 2011, which requires all new defined contribution schemes created after 29 January 2011 to offer alternative retirement funds (ARFs) to members. ARFs can be invested in a wide range of assets and can be used for purposes other than pension income, such as the funding of bequests. An entirely different lifestyle strategy will be appropriate for investors who intend moving funds to an ARF on stopping work, with continuing exposure to growth assets likely to be appropriate.

People's attitude to risk may also simply change, for example if they lose their job or get divorced.

All of the above require a more fluid approach to lifestyle strategies.

Communication with members

Clear communication with members will be key in any revision.

Trustees are, understandably, reluctant to offer members anything that can be construed as advice. However, as guardians of the assets, there is a requirement for trustees both to understand members' needs and to ensure default options remain appropriate. Annual communications should encourage members to reassess their circumstances. Risk-profiling and objective-setting questionnaires should also be considered. It is vital that the limitations and risks of any strategy are set out, with variability in outcomes clearly communicated. Members approaching their selected retirement age should be given the option to delay or accelerate switching.

The goal of trustees is to minimise the possibility of unanticipated disappointment at retirement for members. A selection of default strategies, tailored to be flexible to members' needs together with a clearly thought out communication strategy, will help trustees achieve this goal.



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