



## Cost of inflation

**George Henderson, Government Bond Manager, asks if schemes sacrifice too much growth when hedging inflation**

Terms such as pension deficit, inflation and breakeven inflation crop up time and again within UK investment circles, owing to the need among UK pension funds to reduce inflation risk. This need largely originates from accounting rules and the fact that pension scheme costs generally increase as expected inflation rises. This often becomes a fixation for involved parties.

However, with so much focus and investment driven by inflation, investors can lose sight of the value of the scheme's assets. They must therefore ask themselves: are my hedges against inflation sacrificing too much growth; will my assets grow faster than my liabilities; and, what is the intrinsic cost of my inflation protection?

Inflation investors need to remind themselves that an inflation-linked bond, while a good hedge for inflation, is still a bond. A bond's value is expressed as a yield and, in the case of inflation-linked bonds, this is a real yield. This should be a prominent consideration in investment decisions.

So, how has the real yield behaved in the UK historically and how do current values compare? Having been as low as 0.4% p.a. earlier this year, 2040 inflation-linked bonds currently have a real yield of 0.7% p.a. Translating this into wealth, a buy and hold investor will increase their spending power by 23% over the next 30 years. By comparison, real UK GDP has increased by 94% over the last 30 years.

Within a global context, the 2040 UK real yield is 0.5% p.a. lower than a European equivalent and 1.0% p.a. lower than an American equivalent. Buy and hold investors in these foreign bonds will be 20% and 40% wealthier respectively in 30 years time than a UK investor. This discrepancy with the UK can be partly explained by the hefty premium UK pension schemes are willing to pay.

How can schemes avoid paying this premium?

As inflation-linked bonds are an expensive asset class to begin with, investment alternatives are numerous. Without compromising on default risk, UK conventional government bonds are a sensible starting point. Inflation must exceed 3.4% p.a. for the next 30 years before conventional bonds underperform their inflation counterparts. This inflation level is well above the UK's CPI mandate of 2.0% (though UK inflation-linked bonds track RPI which tends to be a little higher).

Global index-linked products are also a worthy alternative as they offer a higher yield for government risk. The differing inflation paths in various regions are a legitimate concern, but one which dissipates over an increased investment horizon and in a globalised world. Investors should also ensure holdings are currency-hedged so their assets are unaffected by currency moves.

Another alternative, though more difficult to compare, is risk assets. But with equities posting negative ten year returns over the recent past, investors must be comfortable that they can accommodate large fluctuations in value.

In conclusion, while inflation is a legitimate concern for UK pension schemes, trustees must consider whether they are prepared to sacrifice growth potential for inflation protection. As this value aspect of pension fund assets is often overlooked and overridden by the desire to de-risk, UK inflation assets can become very expensive. Fortunately, alternatives do exist and investors should strongly consider UK conventional bonds and global index-linked products.

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