



Fighting inflation risk in global portfolios

It's one of the biggest questions bedeviling investors today: how to deal with inflation, and whether to do so actively or passively. Last month, *Investment Magazine* partnered with QIC Global Fixed Interest to bring together some of Australia's leading investment minds to tackle that very question. Present at the discussion were:

SEAN HENAGHAN, investment director – multi-manager

and investment solutions at AMP Capital Investors;
JOHN COOMBE, executive director and head of consulting – Sydney, at JANA Investment Advisers;
SUSAN BUCKLEY, managing director of QIC Global Fixed Interest;
DON RUSSELL, chairman, NSW State Super and investment committee chair at LUCRF Super;
KRISTIAN FOK, deputy managing director, senior consultant and actuary, Frontier Investment

Consulting;
JEFF ROGERS, CIO at ipac Securities;
JON GLASS, CIO at Media Super;
GRAHAM HARMAN, director of capital markets research at Russell Investments;
KIRSTINE SODERBERG, senior investment consultant, manager research at Towers Watson;
GERARD PARLEVLJET, CIO at Commonwealth OSF;
KEN PHOLSENSA, investment analyst, Local Government Super;

KENT WILKES, senior portfolio manager, global fixed interest at QIC; and
SIMON MUMME, editor, *Investment Magazine*.
SUSAN BUCKLEY conveyed early in the discussion that an increasing number of people – within and outside the investment industry – saw inflation on the horizon:
 We're seeing more concern on the street about inflation than

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we've ever seen before. I've had more acquaintances ask me about the price of bananas in the last couple of days than ever before! I'm concerned for our clients over the next three to five years that they will have adequate protection from rising inflation. I see that we have great opportunity to build better solutions or portfolios to protect our clients in that sort of environment. So concern, yes; but I see the opportunity for us as well.

The discussion turned to the role played by the US in rising inflation expectations.

JOHN COOMBE: The US is doing everything opposite to what Europe's doing. Europe has cut costs, raised taxes, and is trying to do the European thing and get their balance sheet under control. The US is doing the complete opposite: trying to grow out of it, and hoping like hell that they don't have deflation, but inflation which allows them to pay off the debt at some point in the future at a much lower cost to the underlying taxpayer.

I'm concerned for our clients over the next three to five years that they will have adequate protection from rising inflation. I see that we have a great opportunity to build better solutions or portfolios to protect our clients in that sort of environment.

Now, it's all well in theory, but we've never seen it work before.

SEAN HENAGHAN: They have a lot of inflation-linked liabilities that are unfunded.

JOHN COOMBE: Yeah. Assuming they don't break the social contracts, it's a black hole that's getting bigger every day. Congress just seems to be living in a fantasy land where they think they can grow out of it. That's the biggest worry to me because they could actually spiral and do a Japan. They could get it all wrong, and you could just spiral into a Japan, where you've spent the balance sheet, you've wasted the money, but you haven't actually achieved what you wanted to achieve, which was stimulate growth and inflation at the same time. That would have vast consequences for all of us in terms of equity markets and bond markets.



SIMON MUMME: So which portfolio solutions would be appropriate for a scenario like that?

JON GLASS: I think we're all in the dark, to some extent. We've all heard these grand statements that small-cap stocks will help you when inflation is high, that direct property will be good, and perhaps infrastructure. But I've never seen anyone back that with some really good convincing statistics. It's not proven.

KRISTIAN FOK: It also depends on the drivers of inflation. If we're talking about commodities and food prices as the drivers, it is a very different portfolio to consider than if wage pressures were pushing inflation upwards. If you think about Australia as being a supplier of commodities and food, and its impact on our currency, you might find actually, for us, it's not so bad because we actually get cheaper goods imported, and we have a far stronger ability to generate revenue through exports. So talking about inflation as one thing is, I think, probably a little bit too simple, and unfortunately that also makes it

difficult to work out what should we do.

KIRSTINE SODERBERG: You could have deflation in one country and inflation in another country, depending on those drivers.

GRAHAM HARMAN: A lot of those assets are correlated highly to growth, not necessarily to inflation. But when you are looking at inflation-linked bonds, you've got that explicit link to inflation built into the accrual stream.



JOHN COOMBE: Though it depends on how they calculate inflation, and whether they cheat on the calculations, and then change the basket of goods that go into the inflation calculation. You think you're protected, but you're not really because they changed it. Ask the Americans about it.

GRAHAM HARMAN: Going back to the point about, dare we say it, a good news story within all of these different sources of cross-sectional inflation. For heaven's sake, what are commodities doing running two years into an economic

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Jeff Rogers, Susan Buckley and John Coombe

expansion? They should be running eight years into an economic expansion. Is it one possible scenario that, you know, growth comes through, growth comes good, and we don't have the disaster scenario, commodities are going down just when capacity use is tightening up, and we get a 'Get Out of Jail' card. It's got to be one possibility.

ipac's JEFF ROGERS said it was important to define what one meant by 'inflation':

There's 'big' inflation, you know, double-digit inflation; and then there's 'uncomfortable' inflation, outside the 3 per cent band, that requires a policy response. In that 'uncomfortable' scenario, certain equity strategies work as well as debt strategies, whereas in a 'big' inflation scenario, nothing's going

to work.

SUSAN BUCKLEY: It doesn't seem like it's an environment where we're going to be in a 1970s-type of world very soon. That sort of risk scenario is a long way down the track. But it does seem like an environment where the central banks are going to be lagging behind the inflation pressures coming out of the great global financial crisis. We see it with the US Federal Reserve – this time around, they're likely to be much slower, rather than being pre-emptive. We're getting a bit anxious that they're going to be late, and the genie will be let out of the bottle, and all of a sudden we're in this environment of 4-to-5 per cent inflation, which is very different to what we've experienced over the last 15 years.

JOHN COOMBE: Inflation

at 4 or 5 per cent? I can't picture it. Where's all the wages pressure?

SUSAN BUCKLEY: China. We've seen the minimum wage in China go from RMB400 a month in December 2000, to RMB1,100 a month now in Shanghai.

The discussion turned to whether an active or passive approach was best when managing inflation-linked bonds and other securities

SUSAN BUCKLEY: I think if you've got any passive global exposure at the moment, you need to be getting rid of that as fast as you can. Real yields in the US out to four years are negative – US four-year real yields at -0.6 per cent. That is expensive. If you're holding short-end TIPS [Treasury Inflation Protected Securities], I think that's the most expensive part of the bond



Jon Glass

market. Why? Because the Fed has conducted these unconventional policies, expanded its balance sheet, been buying bonds, buying TIPS, the Middle East investors are actually buying TIPS because they want inflation hedged. Everyone's buying TIPS because they think it will protect you. Real yields are being driven to what I regard as unprecedented levels.

Now, towards the 10-year part of the curve, there is around 0.9 per cent real yield. Considering where rates will actually go, I'm really worried about real rates more than nominal rates, so that should be actively managed. The US is obviously a big part of a global inflation exposure, so I think that passive portfolios are quite vulnerable there, but generally our philosophy is that you want to manage your inflation protection and separate out that interest rate risk in your portfolio, and that requires some level of active management. We can debate the degree of active management required, but what you really want is that inflation exposure and

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to manage the interest rate risk through the cycle because at times, it's going to hurt you badly when you want the most protection.

SIMON MUMME: Which securities can you use to manage this interest rate risk?

SUSAN BUCKLEY: You can use derivatives or cash. We favour derivatives, such as interest rate swaps or inflation swaps, because they're very liquid and you can target particular parts of the curve.

The conversation turned to holistic approaches to managing inflation risk by employing assets other than fixed income instruments.

GERARD PARLEVLLET: People used to say equities were a good inflation hedge, but the longer term numbers will show you it's not necessarily so. Why aren't they? Because it really comes back to pricing power, doesn't it? If there's inflation and the company's got pricing power, then it's okay in an inflationary environment. If it doesn't have pricing power, the

margin's getting eroded away. So I'm wondering whether people should be thinking: when we talk about active approaches to fighting inflation, how do you target it actively among everything you invest in, not just on the bonds side?

SIMON MUMME: Until the financial crisis, the investment environment was relatively benign but super funds still haven't been able to meet their CPI-linked liabilities. With all the inflation defences that investors have at their disposal – from



Kristian Fok

infrastructure linked to rising revenue streams like hospitals or toll roads, to equities, commodities, inflation-linked bonds – why haven't those liabilities been met?

GERARD PARLEVLLET: Because they've had one major bet in the portfolio, and that's been equity-directional. Everyone went on this equity binge, they didn't target equities that were going to protect for inflation, they just said, 'let's have this', and if the equity markets performed strongly, you got this great return, and if they

I'd like to find a cheap inflation hedge. If anyone knows of one, please give me a shout because that's the challenge, right?

performed poorly, you didn't meet it.

SEAN HENAGHAN: I think it's a little more subtle than that, actually. I think it was the leverage that crept into every asset class that created the problem.

GRAEME HARMAN: Just think about the maths. Let's say you've got a toll road worth \$100 and it's totally leveraged and earning \$5 of toll road toll payments and then inflation comes, and it's indexed, so you get \$5.50 next year. Meanwhile, if the 5 per cent you're paying on your interest has gone to 10 per cent because inflation is suddenly 5 per cent instead of zero, the arithmetic doesn't work, no matter how much the toll road's used and how much the tolls are CPI-linked.

SEAN HENAGHAN: If the world can de-leverage ahead of inflation becoming a problem, it becomes more manageable.

DON RUSSELL: Fortunately, my task is to achieve 4.5 per cent real returns over 10 years. But the duration of most chairmen tends to be less than 10. If we start skewing our approach to take account of



Don Russell

short run views about inflation in isolation, I suspect we end up doing a disservice to our objective and to our members. It's just one factor that you need to build in while you try and achieve these longer run targets.

KRISTIAN FOK: If you look at alternative investments that you might want to use for protection, to some degree the effectiveness of them really depends on the Government's response to inflation. So you can put in a very long-term, cash flow-oriented investment – like an infrastructure asset, for instance, with 20-plus years of cash flow. Now, if the Government's response is to actually raise interest rates, then that infrastructure asset's going to be very adversely affected in terms of valuations. If the Government concludes there's a high sensitivity to interest rates because so many people have mortgages, and decides to pull back on government spending, then that's a very different sort of argument in terms of the worth of that asset. So it is a very difficult task to try and future-proof a portfolio purely on inflation

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Gerard Parlevliet

I've never been in a market where we've had rising interest rates and the equity market behaved well

to fighting inflation?

JOHN COOMBE: Going passive means you're going to buy negative real rates in the UK and in the US. So you'd only want to buy that because you think that we're going into deflation. So that's why passive isn't logical today if you think inflation's coming. But if they were trading at real rates, there's nothing wrong with it.

KIRSTINE SODERBERG: The only reason I can think you would go passive is if most of your assets are Australian and you're primarily exposed to Australian inflation.

KRISTIAN FOK: It used to be that you could see through the market's vitals and get global diversification, and there was a view that there was some synchronisation going on, so if there's inflation, it's a global trend.

KRISTINE SODERBERG: But that's no longer the case. I think Australian inflation is the focus.

KENT WILKES: Passive approaches only work on one front, and that is if you live in a non-mark-to-market world, right? So if you want to get inflation protection

over 10 years, you can go and buy an inflation-linked bond with a 10-year maturity, and just hold it. But that's not the world we live in. We've been hearing people talk about investors losing patience – they're moving into term deposits – well, that's the world we live in. People have shorter timeframes. We think a rolling three-year period is the sort of a timeframe that applies to a retail investor and also for a lot of wholesale investors. They don't want to be saying, 'Oh, I'll get my money back in 10 years' time.' They want that inflation protection consistently. And inflation-linked bonds will not give you that on a mark-to-market basis.

JOHN COOMBE: The real argument is: in a world where you're getting, say, 2.5 per cent to 3 per cent on cash over inflation, it's a completely different world to being in America where you're getting bigger negative real rates. Now, if I was in America, I wouldn't want to own any cash securities. I'd want to be totally invested anywhere else than there, right? But in Australia, it is a different argument, and yet – I'm playing devil's advocate here – we actually haven't adjusted our asset allocations. We've left them where they were in the 1990s and into the 2000s, and if anything, everyone went from a 70/30 split allocation to equities and bonds to 80 to 90 per cent of the risk in portfolios coming just from equity risk. We're in a different world, and yet we literally haven't changed our asset allocations.

DON RUSSELL: My 4.5 per cent over inflation is still worth



Kent Wilkes

We advocate being benchmark unaware, and making sure that you break down inflation risk and interest rate risk

on that mandate and get penalised if they underperform.

KENT WILKES: You'd get rid of a lot of problems that are inherent in benchmarks, such as the moral hazard issues in inflation-linked bond benchmarks, and you'd get rid of excessive interest rate volatility and excessive interest rate risk.

SEAN HENAGHAN: It would be good for the consulting industry, John [Coombe], because you'd have to develop some whiz-bang monitoring frameworks. But in reality I don't think that's a target for equity managers – it's a multi-asset mandate.

JOHN COOMBE: Anyway, the only thing you can actually say today is if I buy anything, I'm paying top dollar for it. So if I'm buying anything now that I think is going to protect me from inflation – whether it's commodities, property, infrastructure assets – I'm paying top dollar for it.

SUSAN BUCKLEY: What about a NSW Treasury Corporation inflation-linked bond at 3.1 per cent? That's not bad.

So the best strategy is actually to

reaching for. If we settled for 2.5 per cent real and just put it in cash, it's costing the people of NSW \$600 million a year versus 4.5 – because we're an underfunded defined benefit scheme.

KENT WILKES: You can reach for that with assets like commodities, which aren't explicitly aligned with inflation outcomes, and you're going to incur massive volatility. Some years you're going to be way over, and other years you're going to be a long way under. But there are assets out there that are explicitly linked to inflation-linked liabilities, so at least you're halfway there.

JOHN COOMBE: If you think we're going to have rising inflation, you're going to have rising interest rates. And maybe it's just my age, but I've never been in a market where we've had rising interest rates and the equity market behaved well. And other assets didn't behave well either, actually

JON GLASS: Should we just give every asset manager a CPI plus 4.5 per cent benchmark, and see if they're prepared to step up and take



short US four-year real yield, buy Australian real yield and get a pick-up of 310 basis points. And you put that in your CPI plus 4 per cent portfolio.

JOHN COOMBE: So we're counting on NSW performing better than the US Government.

SUSAN BUCKLEY: Yes, that's true. That's reasonable!

DON RUSSELL: Historically, that bet's turned out pretty well. When Jack Lang refused to pay his debt, the Commonwealth stepped in.

SIMON MUMME: Ken, you've had considerable experience in managing fixed income. What would you like to see your bond portfolio doing at the moment to fight inflation?

KEN PHOLSENA: Right now we've got like a few passive portfolios, but looking at the

bond portfolio alone probably is not going to be enough for us to protect ourselves. For instance, we are also looking at an alternative investment and active equity index. We don't really look at inflation in a very deep way. Just looking at our liabilities and trying to match them are probably much more important to us.

SIMON MUMME: Today we are contrasting the merits of active and passive ways of managing inflation. What are some of the risks in passive inflation-linked bond strategies?

KENT WILKES: If you look at the traditional approach that's been taken, which in Australia is typically people running to a benchmark like the UBS Aggregate inflation benchmark. That has a duration of about nine years, and

also has a lot of interest rate risk, which is a key risk.

We're at a low point in the cycle, in which most people think yields are probably going to be higher in the next two years or so. So with nine years' duration risk, for every 100 points that yields move higher, you're losing a lot of capital. So that's the key risk.

There's also the moral hazard issue. For instance, when a new bond is issued in the market, people who follow a benchmark have to invest in it because if they don't, they produce a higher tracking error. We advocate being benchmark unaware, and making sure that you break down inflation risk and interest rate risk and be look at them in terms of how can you achieve a real rate return in the portfolio. ■

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