Investment Tutor Surgery

Chris Wagstaff looks as whether inflation is really a threat and, if so, what the implications are for defined benefit pension schemes

Is inflation really a threat?

The recent retail price inflation (RPI) numbers – RPI being the measure of inflation most relevant to defined benefit (DB) pension schemes – have certainly given trustees reason to raise an eyebrow or two. But are these numbers just a statistical blip, as many suggest, reflecting a bounce back from when prices were declining at the deepest point of the recession (so-called "index base effects"), or is inflation's ugly head about to reappear more permanently? (Ugly in as far as its effects are felt most noticeably by those on fixed incomes, savers – who lose at the expense of borrowers – and DB pension schemes whose liabilities can become severely bloated).

Delving into the history books is instructive. Inflation has historically been a function of economic cycles, "supply side shocks", such as wars and oil price crises and political interference in economic policy. However, when the Bank of England was granted operational independence over the setting of interest rates in 1997, many thought inflation had been consigned to the history books. Indeed, until only a matter of months ago, deflation, rather than inflation, was the biggest risk to be avoided.

So what are the chances of inflation becoming more deeply entrenched than many are forecasting? Well, whilst it is highly unlikely that the UK is about to return to the dark days of the 20+ per cent inflation (the definition of an inflation crisis) that characterised the mid/late 1970s, since 1500 the UK has suffered inflation of crisis proportions 5 per cent of the time. In addition, history tells us that the most important determinant of the strength of an economic recovery and its knock on effect to prices is, without exception, the depth and severity of the downturn that preceded it. Moreover, the history books also point out that a government abusing its monopoly power on currency issuance can have adverse consequences for inflation, "as too much money chases too few goods", as economists put it. The potential inflation risks that might be unleashed by the sheer volume of Quantitative Easing (QE), or money creation, undertaken by the Bank of England since last March are, therefore, particularly salient.

In addition, there are also the "cost push" inflation concerns surrounding the dramatic rises we've seen in energy and commodity prices and, of course, the reinstatement of 17.5 per cent VAT. Given that most of these costs are imported and are beyond the control of the UK, a sterling currency crisis could further exacerbate matters. However, at least there remains considerable slack in the UK's productive capacity and wage inflation, historically one of the key drivers of price inflation, is fast becoming a distant memory against the backdrop of rising unemployment and falling productivity in the workplace. Indeed, there are those who, given the lack of wage inflation and low capacity utilisation, maintain that the risks are still weighted towards deflation.

How does inflation affect the investment policy of defined benefit pension schemes?

Notwithstanding the fact that most DB schemes cap their RPI liabilities at five per cent, inflation remains one of the greatest risks to which DB schemes are exposed, so is yet another factor to consider and mitigate. Indeed, incorporating higher future assumed inflation rates into the value of scheme liabilities more than doubled the size of FTSE 100-sponsored DB scheme deficits over 2009. However, if recent trustee surveys are anything to go by, DB pension scheme trustees are certainly cognisant of these potential risks and, judging by the sheer volume of inflation hedging that took place towards the end of last year, trustees have been taking concerted measures to guard against a re-emergence of inflation. The consequence of this has been to dramatically inflate the price of hedging instruments, such as inflation swaps, to a level significantly above the Bank of England's medium term implied RPI target of 2.75 per cent – a key "anchor" for inflation expectations.

Therefore, trustees have started to look at alternative means by which to hedge inflation. Acknowledging that one of the biggest risks to inflation is a sharp decline in sterling, rather than hedging inflation outright, a number of schemes have begun to look at using currency derivatives as a means by which to protect themselves. In addition, many DB schemes have moved from final salary to career average earnings, some have imposed caps on future accruals relating to pay rises and according to the NAPF, in its annual survey of members, 79 per cent of schemes are seeking flexibility over increasing pensions in line with inflation. Interesting, as schemes cannot reduce pensions in payment, deflation is potentially just as problematic as inflation.

It goes without saying that inflation should always be a factor when determining a scheme's asset allocation as it is real, or inflation adjusted, rather than nominal, returns that matter. Notwithstanding funding, covenant and governance issues, in the face of inflation, DB schemes should consider diversifying more concertedly into "real" assets, such as commodities and those assets with explicit inflation plus cashflows, such as leased property, social housing and infrastructure debt. Suffice to say, pension schemes would be elated if the government took the initiative to issue more long dated index-linked gilts, one of the simplest and most effective hedges against inflation, but hasn't taken the opportunity to do so. Perhaps because it fears the return of inflation! ■

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