

MILLIMAN REPORT

Inflation – A Risk Rediscovered?

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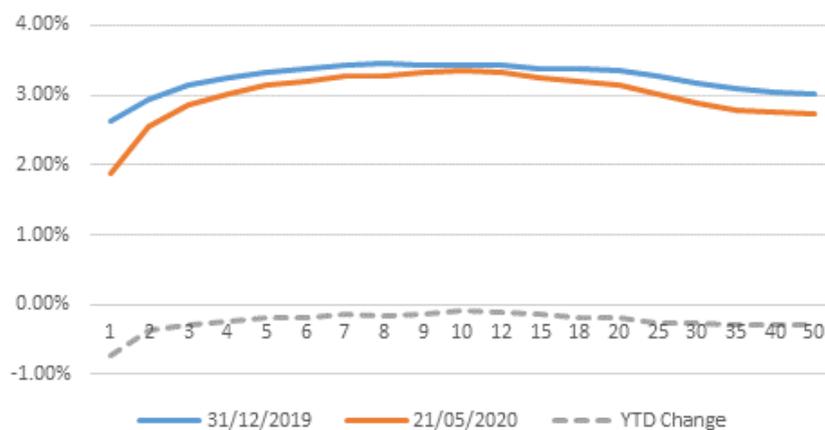


Inflation – A Risk Rediscovered?

Inflation has for many years now been low and stable and consequently it seems unlikely to be top of the list of risks to which members perceive themselves to be exposed. But will this relatively benign situation continue? To be frank we really don't know, but it seems fair to say that there is now greater uncertainty around the outlook for inflation than there has been for some time. The reason for this being the Covid-19 public health crisis and the measures taken to mitigate it whose range and scale has been, to repeat a now overworked adjective, unprecedented.

Investment markets are pricing in that the rate of inflation (as measured by the RPI) will remain low and positive for the foreseeable future with expected rates a little below those which applied before the impact of Covid-19. This is illustrated in the following chart:

FIGURE 1: GBP INFLATION SWAP



Data source: Bloomberg

This outcome is though in no way assured and there is an active debate now around the possibility that while the immediate future is likely to see inflation subdued as the deflationary impacts of Covid-19 dominate, the longer term effects of the current crisis may see a return to higher (possibly much higher) rates. The reasons for this have been explored in some detail elsewhere¹ in particular noting the exceptional monetary and fiscal expansions being undertaken by central banks and governments in an attempt to mitigate the economic damage arising from the lock-down measures imposed to help control the spread of Covid-19. We don't discuss these measures further here but rather contemplate a scenario in which inflation does re-emerge at rates well above current central bank targets. We now consider the implications for members who are approaching retirement.

¹ For example see FT "Investors warn Covid-19 crisis is paving the way for inflation" on 15/05/2020 <https://www.ft.com/content/6394aab8-e8f7-4c20-b563-6683e7505201> and The Economist "Covid-19 could lead to the return of inflation—eventually" on 18/04/2020 <https://www.economist.com/finance-and-economics/2020/04/18/covid-19-could-lead-to-the-return-of-inflation-eventually>

MEMBERS APPROACHING RETIREMENT

The focus for these members will be to provide an adequate and equally importantly a sustainable income for their impending retirement. But what do we mean by sustainable? In a world of very low inflation a constant income in nominal terms might suffice.

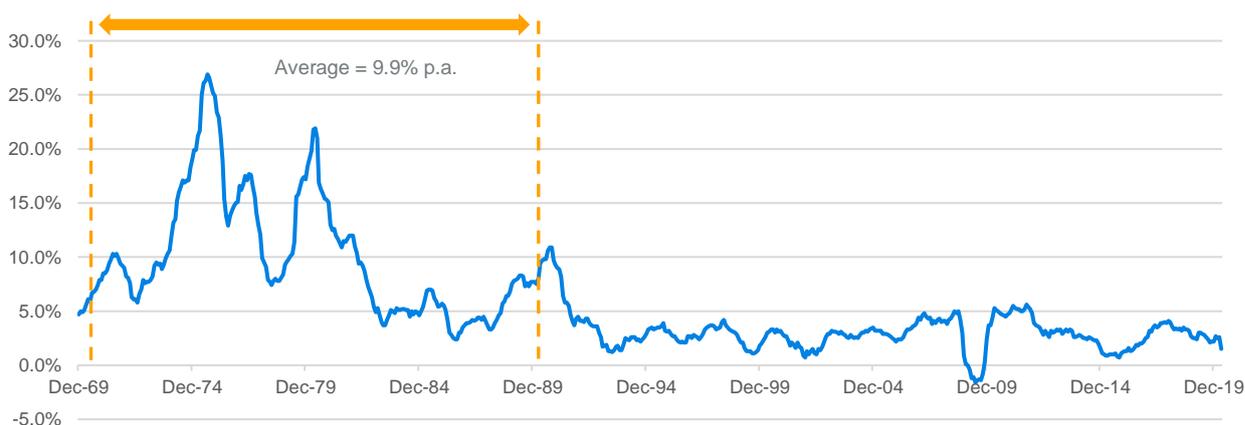
In the UK, ONS data shows that average inflation-adjusted spending for the 75+ age bracket is 20% lower than that of the 50-64 bracket (although the 65-74 age bracket is only slightly lower than 50-64).² This implies an average 1-2% per annum fall in nominal spending during retirement, though the decline is not linear with most occurring in the later years in retirement.

Average UK CPI³ inflation since the turn of the century has been 2.0%. This shows that the fall in nominal expenditure of retirees has largely offset the higher cost of living.

For those that have been in Defined Contribution (DC) schemes, and purchased a fixed lifetime annuity on retirement, we can see that the decision to not explicitly manage inflation risk is actually quite understandable and has manifested itself in the annuity market via typically low customer take-up of inflation-linked payments. However, as inflation rates increase so does the risk that a fixed nominal income fails to maintain a reasonable standard of living for retirees.

Looking back at history, we see from the start of the 1970's to the end of the 1980's, UK RPI⁴ inflation averaged 9.9% per annum, with this being quite volatile at times too. A 20-year period of such high inflation has been a reality in the not too distant past. In such a scenario, would it be realistic for retirees to reduce their spending to mitigate such an erosion of purchasing power?

FIGURE 2: UK RPI INFLATION (PER ANNUM RATE)



Data source: Bloomberg

² Tables A14, A15 and A16 of Household expenditure by gross income quintile group from the Office of National Statistics, for financial year-ending 2018. Data has been converted from a per-household, to a per-person basis.

³ UK CPI excludes housing costs and so may be more representative for a typical retiree that has paid off their mortgage – the equivalent figure for UK RPI was 2.8% p.a. We note however, that inflation-linked annuities are generally only available based upon RPI.

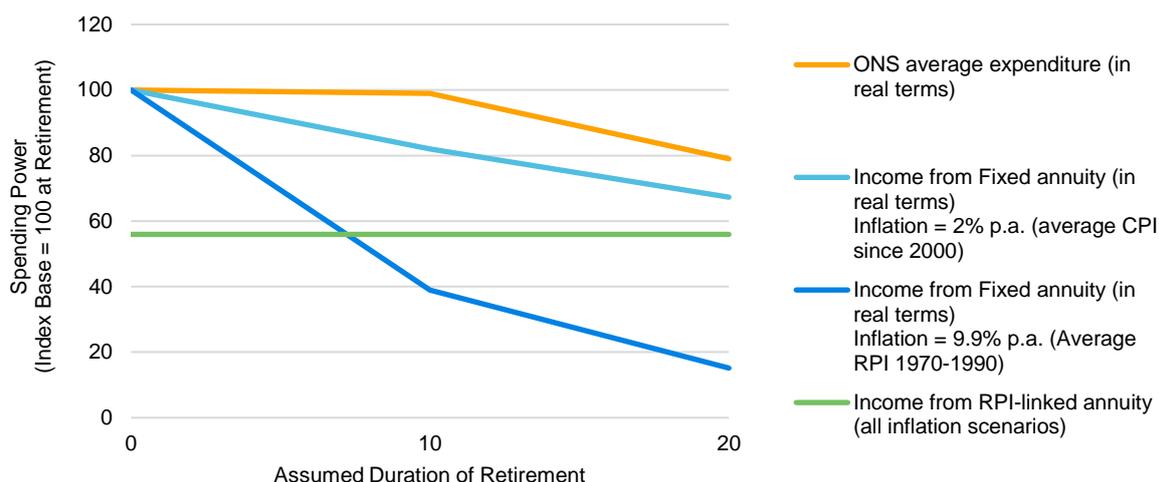
⁴ UK RPI was the main available inflation measure during this period. CPI has only started more recently.

MANAGING INFLATION RISK

So how might members manage the risk of higher inflation?

Firstly, we may see more members seek the protection of an inflation-linked annuity. However, this protection will, for a given fund size, result in a much lower level of income through the early stages of retirement, producing a pattern of spending power that may not align well with members' plans and needs as can be seen in the graph below. We may see some further innovation in this area with benefits offering partial protection covering say inflation above 2% p.a. up to a maximum of 5% p.a.

FIGURE 3: IMPACT OF INFLATION ON SPENDING POWER



Data source: Milliman analysis; Money Advice Service; ONS

An additional consideration is how readily insurers will be able to meet increased demand – one key factor will be availability of suitable assets to hedge the inflation risk. An asset class traditionally used is index-linked gilts. However, we note a plan by the UK Debt Management Office (DMO) to reduce the proportion of gilt issuance taken up by index-linked in order to reduce the government's inflation exposure – this even before Covid-19. A report from HM Treasury notes “As part of the government's responsible approach to fiscal risk management – and as set out at Budget 2018 – the government will look to reduce the proportion of index-linked gilt issuance in a measured fashion as a share of total issuance over the medium term, in line with the 1 to 2 percentage point reduction planned for 2018-19”.⁵ More recently, an update on financing plans for the 2020-2021 fiscal year noted “The DMO also anticipates continued regular issuance of index-linked gilts including via auctions, although such issuance is expected to comprise a relatively small proportion of the overall financing programme in 2020-21”.⁶

Such plans may of course reverse if there is great demand for index-linked debt but greater supply may not be necessarily that attractive if there is a belief that inflation will help reduce the UK's Debt / GDP ratio.

Private issuers may increase supply – strong demand may encourage issuance if index-linked debt can be issued more cheaply reducing firms' overall cost of capital, though there is a clear risk to firms if revenue growth fails to keep pace with the indexation of debt payments.

⁵ Source: HM Treasury https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785550/debt_management_report_2019-20_final_web.pdf see para 2.23

⁶ Source: <https://www.dmo.gov.uk/media/16478/sa230420.pdf> see para 6

For those going down the drawdown route then it is easier to say what is unlikely to work well (cash and nominal bonds) than what is. However, broadly speaking members would be expected to seek exposure to asset classes offering scope to maintain their real value over the long-term. Candidates here are:

- **Index-linked debt** – though as noted already supply may be limited.
- **Property** – is a relatively illiquid asset and so in the context of members having to realize assets on a regular basis to deliver an income this represents a real risk. This was highlighted in March 2020 when a number of commercial property funds suspended redemptions owing to high market volatility and material uncertainty around valuations.
- **Equities** – draw their fundamental value from the flow of future distributable company profits (dividends). Over the longer term, for businesses to remain sustainable, they typically have to be able to pass on cost increases to their customers in the form of higher prices with the aim of at least maintaining profits in real terms. Companies may absorb cost increases in the shorter term to some extent, but investors would typically expect some minimum level of profit margin over the longer term. So while short-term equity returns may not necessarily keep pace with inflation, there are reasonable grounds to expect equity returns to do so over the longer term.

Equities within a member's fund can support retirement income directly through the dividends received. However, the current Covid-19 crisis is leading to a broad-based reduction in dividend levels and it is currently unclear how long this will last.⁷ Therefore, for those taking an income from a drawdown fund, there is an increased likelihood of having to sell equities to maintain their desired level of income. This may, understandably, make members who are close to or in retirement nervous of equity exposure – capital values can be volatile and having to realise assets at depressed prices will, other things being equal, accelerate the exhaustion of a member's retirement fund. Therefore, it can be valuable to have a strategy in place that delivers additional cash just at this time, to help members reduce the need to sell equities when times are bad.

Risk managed overlays, such as the Milliman Managed Risk Strategy,⁸ are not intended to manage inflation risk directly. Nevertheless, they can offer a cheap and effective way to limit the downside risk that comes with exposure to assets such as equities. Thus, they act as a safety net, to cushion most of the sharp falls experienced in the equity markets, and help give retired members the confidence to invest in equities and benefit from the inflationary mitigation they may provide.

⁷ <https://www.ftadviser.com/investments/2020/04/09/income-suffers-as-28bn-dividends-axed/>

⁸ Please refer to our post "Milliman Financial Risk Management" of 30 April 2020.

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