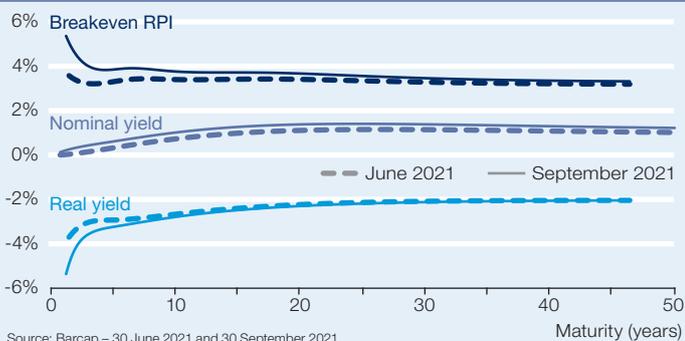
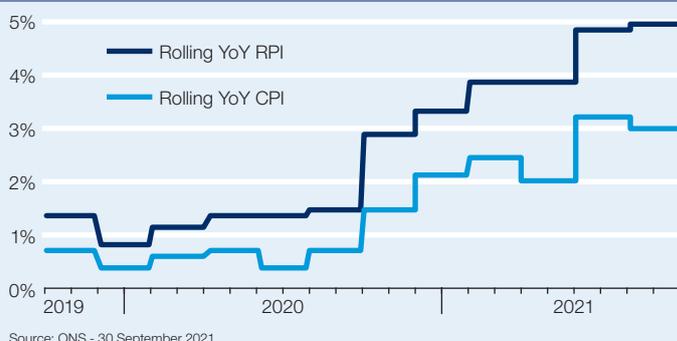


Rates, inflation and credit spreads

Gilt yield curves

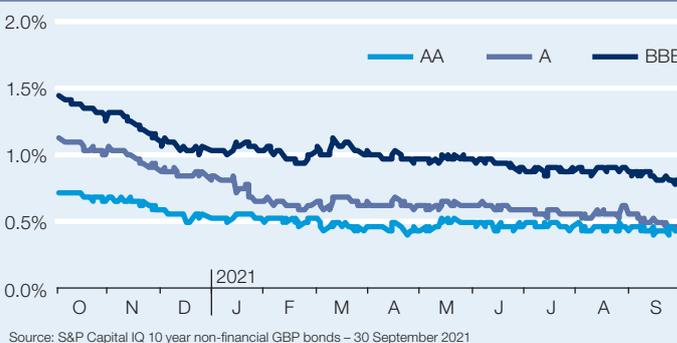


12 month rolling inflation

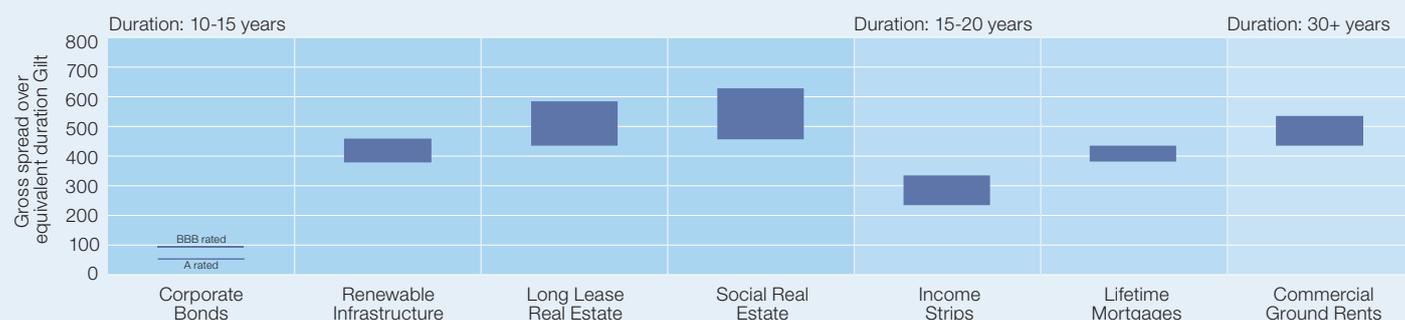


- Real Gilt yields decreased slightly over the quarter at the short and medium end of the curve while Nominal Gilts increased at all maturities resulting in a parallel upward shift of the entire curve. The increase is primarily driven by rising inflation: RPI (CPI) rose c.4.9% (c. 3.1%) in the last 12 months.
- After hitting a two-year high in May, actual inflation continued its upward trend over the quarter. Shortages in goods and the labour force; supply-chain bottlenecks; higher commodity prices and the government unwinding pandemic support measures were key drivers of the recent uptick. These are likely to continue in the short term.
- Investment Grade bonds continue to benefit from a “flight to quality”; credit spreads for UK Investment Grade bonds remain tighter than pre-Covid levels. This signals investors are not yet prepared to move away from ‘safe haven’ assets.

Credit spreads



Secure income market update



Spreads remain compelling for secured long income assets

- As the Covid-19 period lasts, resilience continues to be demonstrated across Long Lease real estate markets, most notably for high quality Income Strips, Social Real Estate and Commercial Ground Rents.
- Spreads over Gilts for Long Lease, Income Strips and Commercial Ground Rents remained unchanged from the previous quarter.
- Spreads for Social Real Estate have decreased by 25bps reflecting heightened investor demand post the resilient performance of these assets during the pandemic.
- Spreads for Renewable Infrastructure have decreased by 25bps, this can be attributed to the parallel upward shift in the Nominal Gilts curve.
- Despite the recent increase in Nominal gilt yields, Lifetime Mortgages continue to remain broadly unchanged due to pricing adjustments.

Asset class definitions

Renewables Infrastructure: 15+ year inflation-linked cashflows from unlevered wind and solar infrastructure assets subject to Feed-in Tariff (FIT) or Renewable Obligation Certificate (ROC) regimes.

Long Leases: 15+ year inflation-linked leases on commercial real estate. Traditional sale & leasebacks fall within this market.

Social Real Estate: 15-20+ year inflation-linked leases on operational real estate across the housing, healthcare and education sectors.

Income Strips: 30+ year inflation-linked leases on commercial real estate where the lessee has an option to purchase the real estate back at the end of the lease for a nominal amount (e.g. £1).

Commercial Ground Rents: 100+ year inflation-linked leases on commercial real estate, with a higher degree of rental and value cover than a traditional sale & leaseback.

Lifetime Mortgages: portfolio of loans from individual borrowers aged 55+ seeking to release equity from their property; the coupon rolls up (rather than cash-pay) and the mortgage is repayable on death or when entering long-term care.

Will inflation take off? How can this risk be managed?

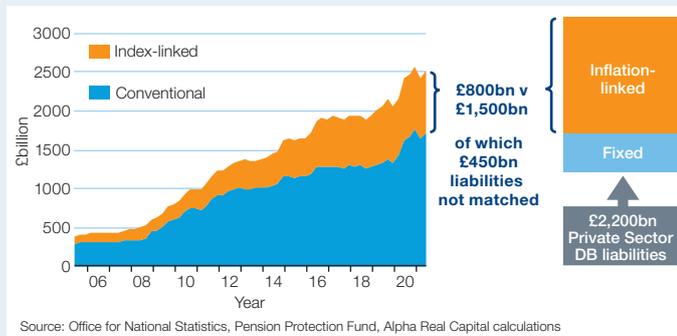
These are currently key questions for investors. Recent UK annual inflation prints have been high. August saw CPI at 3.2% and RPI at 4.8% - the highest they've been in almost a decade. Inflation is expected to remain elevated over the next year. Investors are therefore rightly considering inflation risks and how to manage them, but are there enough inflation linked assets?

Inflation risks remain elevated; there is no denying that a high inflation scenario looks more plausible now than at any time in recent memory. Investors are therefore rightly considering inflation risks and how to manage them. At the same time, pension schemes are moving closer to their endgame faster than expected.

Together, this means that pension funds are not only wanting to de-risk but many more can actually afford to do so. While this is of course a good thing, it does mean demand for inflation linked assets remains high. All of this leads to the question of whether there is enough supply to meet demand?

There is not enough current supply

The chart below illustrates the (im)balance of supply and demand by comparing the dominant sources of both; UK private sector defined benefit ('DB') schemes are currently the largest source of demand index-linked gilts market. Despite the stock of index-linked gilts (and nominal gilts!) increasing substantially since 2005, there is still not enough to meet demand.



Rounding for simplicity, total UK DB pension fund liabilities come in at around £2,200bn*, of which c.£1,500bn are inflation linked. Given there are only £800bn of index-linked gilts, straightforward arithmetic indicates there is a shortfall of £700bn. However as many schemes use LDI techniques, the portion of inflation-linked liabilities that are matched is actually higher at around 70% – or £1,050bn. That still leaves 30% or c.£450bn of un-hedged inflation linked liabilities.

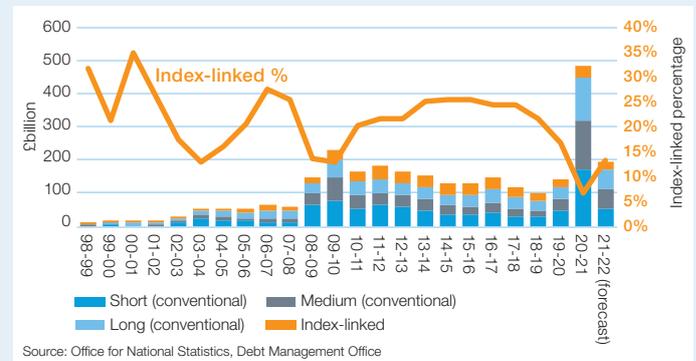
* For those interested – we have estimated the pension fund liabilities as the value of full buy-out liabilities using Pension Protection Fund figures. (Purple Book 2020 and August PPF 7800 Index). We have assumed 2/3rds of liabilities are inflation-linked.

Future supply of Index-linked Gilts won't meet demand

It is worth looking beyond the headline numbers.

Firstly, despite the high level of gilt issuance practically every year since the financial crisis there remains a shortfall of index-linked gilts.

Secondly, while the absolute levels of index-linked gilts issuance has been high at an average of c.£30bn a year since the financial crisis, the proportion of total issuance that is index-linked has fallen dramatically from a high of 25% to as low as 5% more recently. So, while the governments financing needs are expected to remain substantial in the medium term, the supply of index-linked gilts is unlikely to satisfy demand.



The third point to make is that pension schemes want to match long dated liabilities. This means they need long dated index-linked gilts. However if one looks at the composition of the current supply, out of 31 index-linked gilts only 14 have a maturity of more than 20 years, and only 3 of these have a maturity greater than 40 years, representing only c.14% of the total market value of index-linked gilts. In fact the longest dated gilt (maturing in 2068) was introduced in 2013. With no extensions in maturity for nearly a decade and relatively low issuance at the long end, the duration of the index-linked gilt portfolio has fallen.

Are there other sources of inflation linked assets?

In summary, there are not enough index-linked gilts, they are mostly not long-dated enough and future supply is not expected to be great. Demand on the other hand is expected to grow.

Unfortunately, there are not many other sources of supply for long-dated inflation linked assets. Given this imbalance, Commercial Ground Rents (CGRs) may be the low risk, higher yielding alternative that investors are looking for.

Compared to index-linked gilts, CGRs provide a better cashflow profile, an attractive risk-adjusted spread as well as offering inflation protection. All of these features, coupled with the supply shortage of index-linked gilts means a growing number of investors (including insurers) are investing in CGR.

Contact Alpha Real Capital

Please get in touch with your usual Alpha Real Capital representative or contact:

Client Solutions

+44 (0) 207 391 4780

clientsolutions@alpharealcapital.com

Alpha Real Capital

For more information about Alpha Real Capital LLP, its funds and key personnel visit: www.alpharealcapital.com

Alpha Real Capital is authorised and regulated by the Financial Conduct Authority.

Important notice: This document has been issued by Alpha Real Capital LLP. This document and any related materials are intended as general marketing only and do not in any way constitute or form part of any offer, invitation or solicitation to sell or issue or to purchase, subscribe for, underwrite or otherwise acquire any securities nor shall they or any part of them nor the fact of their distribution form the basis of, or be relied on in connection with any contract or investment decision in relation thereto. Promotion of interests in investment funds is restricted in the EEA under the Alternative Investment Fund Managers Directive 2011/61/EU (the AIFM Directive) and, consequently, this document is only directed at persons in the EEA to whom interests in investment funds such as that contemplated by this document may lawfully be marketed pursuant to the AIFM Directive. In the United Kingdom, this document is intended for distribution only to persons who: (i) have professional experience in matters relating to investments, who are investment professionals, high net worth companies, high net worth unincorporated associations or partnerships or trustees of high value trusts and investment personnel of any of the foregoing (each within the meaning of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005) (FSMA); or (ii) to whom it may otherwise be lawful to communicate it (each a Relevant Person). This document is not directed at and may not be acted on by anyone other than a Relevant Person. Persons who are not Relevant Persons should not rely on this document, nor take any action upon it, but should return it immediately to Alpha Real Capital LLP. By accepting this document and not immediately returning it, by your action, you warrant, represent, acknowledge and agree that: (i) you are a Relevant Person; (ii) you have read, agree to and will comply with the contents of this Important Notice; and (iii) you will not rely on, and will conduct your own analysis and/or other verification in relation to, any data set out in this document and will bear the responsibility for all and any costs incurred in doing so. Where this document is communicated to you by an unauthorised person, this communication is exempt from the general restriction in section 21 of FSMA on the communication of invitations or inducements to engage in investment activity. The information contained herein is not to be used for any other purpose or made available to anyone not directly concerned with your evaluation of the possibility of requesting further information regarding the content of this document. The distribution of this document and other information in connection with Alpha Real Capital LLP may be restricted by law in certain jurisdictions and persons into whose possession any document or other information referred to herein comes should inform themselves about, and observe, any such restrictions. Any failure to comply with these restrictions may constitute a violation of the securities laws of any such jurisdiction. If you are in any doubt about the investment to which this communication relates, you should contact an authorised person specialising in advising on investments of the kind in question. No reliance may be placed for any purpose whatsoever on the information or opinions contained in this document or on its completeness. This document is not intended to provide, and should not be construed as or relied upon for legal, tax, financial, business, regulatory or investment advice, nor does it contain a recommendation regarding the purchase of any interests in any entity. No liability whatsoever (whether in negligence or otherwise) arising directly or indirectly from the use of this document is accepted and no representation, warranty or undertaking, express or implied, is or will be made by Alpha Real Capital LLP or any of its affiliates or any of its respective directors, officers, employees, advisers, representatives or other agents (Agents) for any information or any of the opinions contained herein or for any errors, omissions or misstatements. None of the Agents makes or has been authorised to make any representation or warranties (express or implied) or as to the truth, accuracy or completeness of this document, or any other written or oral statement provided. Some statements contained in this document, or in documents referred to in it, are or may be forward looking statements. Actual results may differ from those expressed in such statements depending on a variety of factors. Any forward looking information contained in this document has been prepared on a number of assumptions which may prove to be incorrect and accordingly, actual results may vary. Past performance is not a guide to future performance. The information contained in this document is strictly confidential and may not be released to any third party without the prior written agreement of Alpha Real Capital LLP.