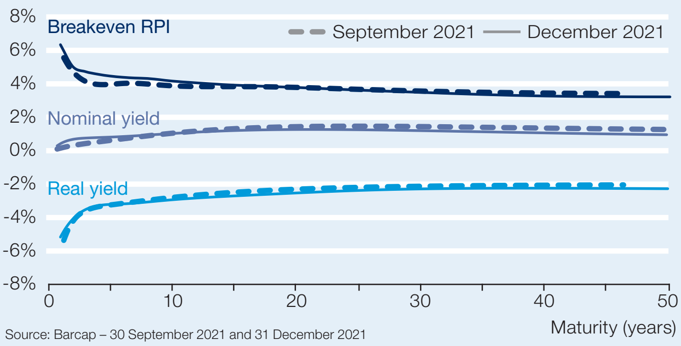
Market Monitor: Q4 2021

Alpha Real Capital

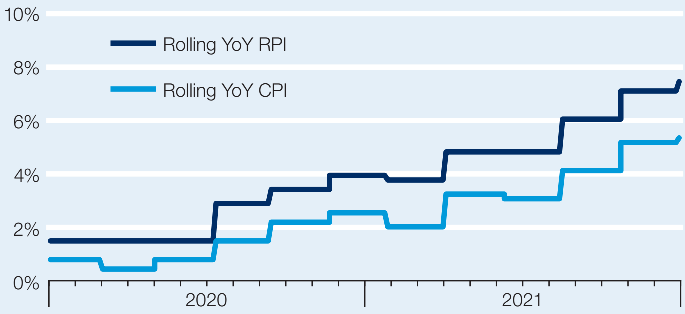
Rates, inflation and credit spreads

Gilt yield curves



Source: Barcap – 30 September 2021 and 31 December 2021

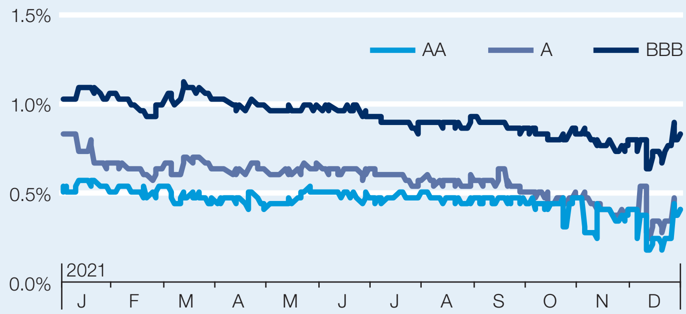
12 month rolling inflation



Source: ONS - 31 December 2021

- Despite the Bank Rate rise in December, Real Gilt yields decreased slightly over the quarter at the medium and long end of the curve. Nominal Gilts showed an increase in the short end, resulting in a flattening of the curve as the medium and long term went in the opposite direction. The short-term increase is primarily driven by rising Bank Rate and inflation expectations: RPI (CPI) rose c. 7.5% (c. 5.4%) 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 have continued to benefit from a "flight to quality"; credit spreads for UK Investment Grade bonds remain tighter than pre-Covid levels. The uncertainty around the Omicron variant in November last year increased the spread volatility, explaining the upward trend recorded before the year end.

Credit spreads



Source: S&P Capital IQ 10 year non-financial GBP bonds – 31 December 2021

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 and Renewables remained stable, reflecting heightened investor demand post the resilient performance of these assets during the pandemic.

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.

Sources: Alpha Real Capital (for illustrative purposes only and for typical transactions available to pension schemes in these asset classes). Data as at 31 December 2021. The future returns and opinions expressed are based on Alpha Real Capital internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Alpha Real Capital nor as advice of any nature. Source of corporate bond spreads: S&P Capital IQ 10 year non-financial bonds – 31 December 2021.

Real assets can Really match your Real liabilities

Real liabilities and inflation hedging

Pension scheme liabilities are mainly "real" in nature. This means pensions promised to members will be uplifted for inflation (mostly RPI linked) both before pension payments start, and also once in payment. This feature is designed to preserve the purchasing power of pension promises. This is great for pension scheme members, especially given current levels of inflation.

For a typical scheme, the value of real liabilities will be around 2/3rds of total liabilities. The rest of the liabilities may not be subject to increases or the increases may be fixed in nature. A key activity in pension scheme risk management over the best part of the last two decades has been to hedge inflation risk, that is reduce the risk that higher than expected inflation impacts the scheme's ability to pay future pensions.

Our research suggests pension scheme inflation risks are generally well hedged - using Liability Driven Investments, the typical pension scheme has hedged 70% to 80% of their inflation risk. You would therefore think that the current heightened inflation risk environment is something that scheme trustees do not need to lose much sleep over. However that is not necessarily the case. There are a number of reasons for this:

- Schemes invest across a range of assets that can perform badly in high inflation scenarios, such as equities, when inflation is high enough and persists. It may be that rises in input costs cannot be passed on to consumers, impairing the sustainability of profit margins and in turn equity prices.
- Schemes are getting closer to their endgame and need to bear down on inflation and interest rate risk. Whether the target is insurance buy-out, a low dependency run-off portfolio or going into a consolidation vehicle, all of these end destinations for pension scheme liabilities involve even higher inflation hedging levels than currently prevail. Investors backing these liabilities will therefore be faced with finding suitable matching assets, of which there is a shortage as we wrote in our recent paper 'Will inflation take off'.

In this note we want to highlight a little-discussed source of worry for Trustees. The high levels of expected inflation, together with caps applying to pension increases mean that a scheme's inflation hedge level may have moved well away from target. Given the uncertainty around future inflation, an inaccurate inflation hedge could be a source of surprise that derails a scheme's journey plan.

Is your inflation hedge accurate?

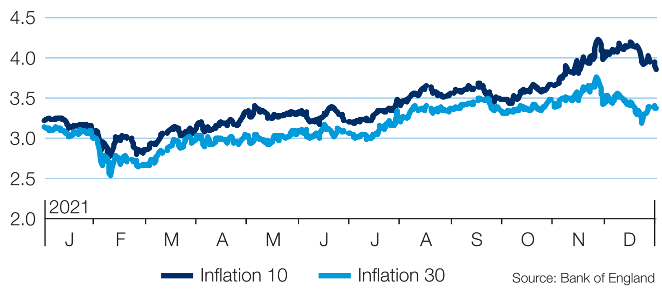
Pension scheme liabilities increase with inflation but those increases are generally 'capped'. A cap of 5% applying to each year's inflation uplift is common – so for a pension scheme that has annual inflation increases linked to December 2021, pension payments will increase by 5% and not the 7.5% RPI out-turn in December 2021. Another common feature is that inflation linkages have a floor of zero, such that pension payments do not fall one year to the next.

Ideally, to hedge such liabilities one would buy assets that have the same caps and floors. As the traditional LDI inflation-linked instruments do not have such features, LDI managers allow for the caps and floors by buying less of the inflation-linked asset. This is logical as in some scenarios the liabilities are effectively fixed in nature. LDI managers therefore keep a close eye on the level of inflation required in the assets, to maintain a scheme's intended hedge ratio. This aspect of LDI portfolio management is known as 'delta-hedging'.

Why is there a problem now?

Expected inflation levels are currently close to caps (see the chart below), and the level of inflation sensitivity in the liabilities will be volatile. This means managing to a target hedge ratio can be difficult in the current inflation environment. The requirement to trade assets frequently to maintain a target hedge ratio is likely to be costly. So what can be done?

10 and 30 year gilt inflation break-evens



Source: Bank of England

One option is to live with a volatile inflation hedge ratio. Schemes with low inflation hedge ratios may be able to tolerate this, however those closer to their end-game and with a high level of hedging may want to manage this risk more closely.

Real assets could really match your real liabilities

Given the scarcity of inflation-linked assets to match liabilities, secure-income real assets are a welcome source of supply. The private markets nature of these assets provides an opportunity to structure asset cashflow features to better suit investor requirements. Commercial Ground Rents (CGRs) are a good example of this in the context of our present discussion.

The contractual inflation-linked cashflows from CGRs perfectly match our clients LPI(0,5) liability payments. This means, to the extent that this is the matching instrument, inflation hedging remains accurate, and schemes can rest easy not needing to worry about so-called delta hedging!

So in addition to the attractive spread over to index-linked gilts, CGRs also provide a more accurate match to pension scheme liabilities and higher cashflows (see Q2 2021 UK Market Monitor).

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.

05 4882 0122