

Why Inflation-linked bonds are a great match for pension funds

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Published: August 2020

South Africa saw the formal introduction of inflation-linked bonds (ILBs) into the domestic listed bond market in March 2000, with the introduction of the R189 with a real coupon of 6.25% (matured 31 March 2013).

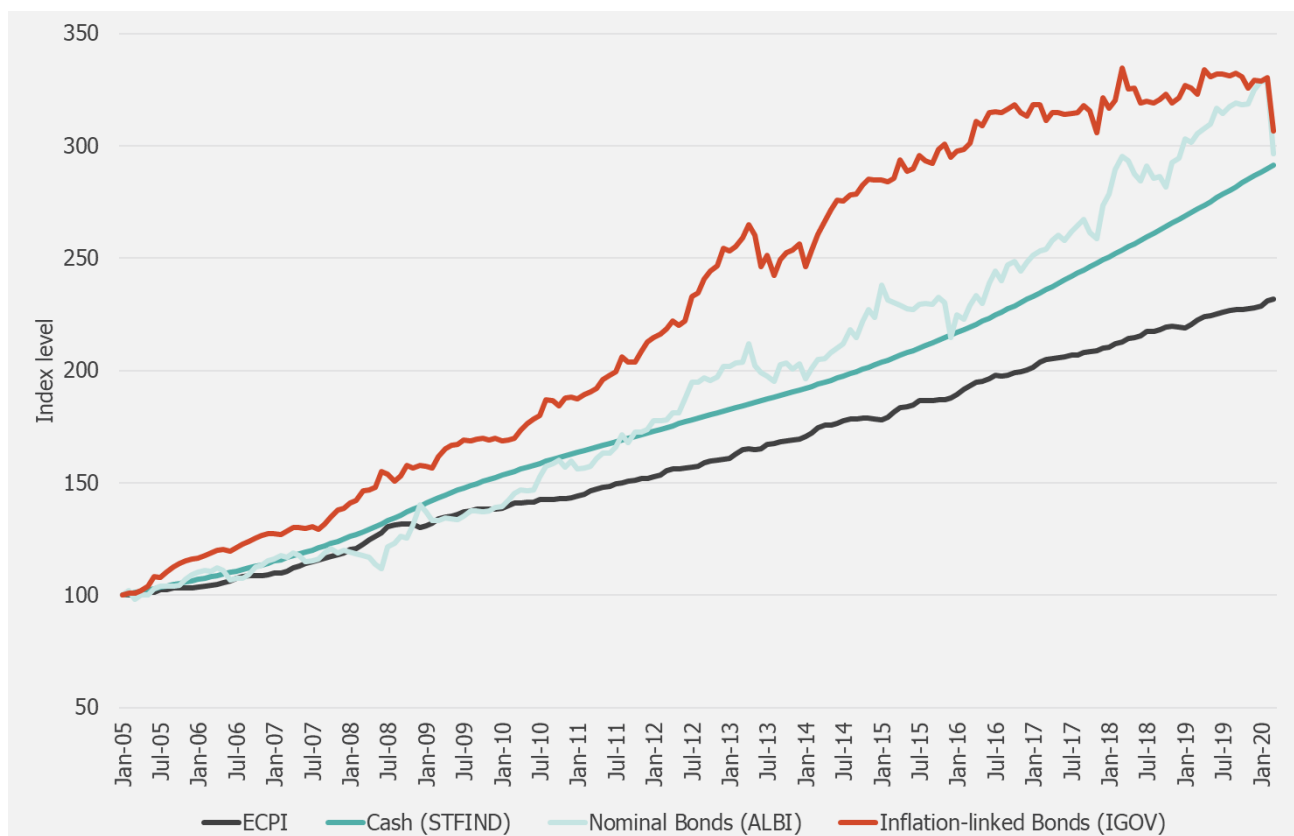
Before that, inflation-linked instruments were trading in the domestic market but those trades occurred primarily in the unlisted debt market dominated by local banks.

Coming into their own

Initially ILB auctions took place monthly and auction sizes were small, which meant the purchase of these bonds amounted to a buy and hold strategy. However, the domestic listed inflation-linked market has experienced significant growth over the past 20 years and auction frequency and size have increased over time. The total market capitalisation of inflation-linked bonds listed on the Johannesburg Stock Exchange as at 30 June 2020 stands at R469.6 billion compared to total listed debt of R2.8 trillion.

National Treasury remains the largest ILB issuer with a market capitalisation of R402 billion, with ten different bonds and maturities ranging from 2022 to 2050. (Issuance of ILBs in the unlisted space continues but the size there remains relatively small.) Thus, the market for ILBs has developed to such an extent that investors, especially retirement funds, can consider it a separate asset class and make a separate fixed income asset allocation, relative to nominal bonds and cash.

Figure 1: Indexed fixed income asset class returns



Source: Futuregrowth, Iress

Risks to long-term inflation

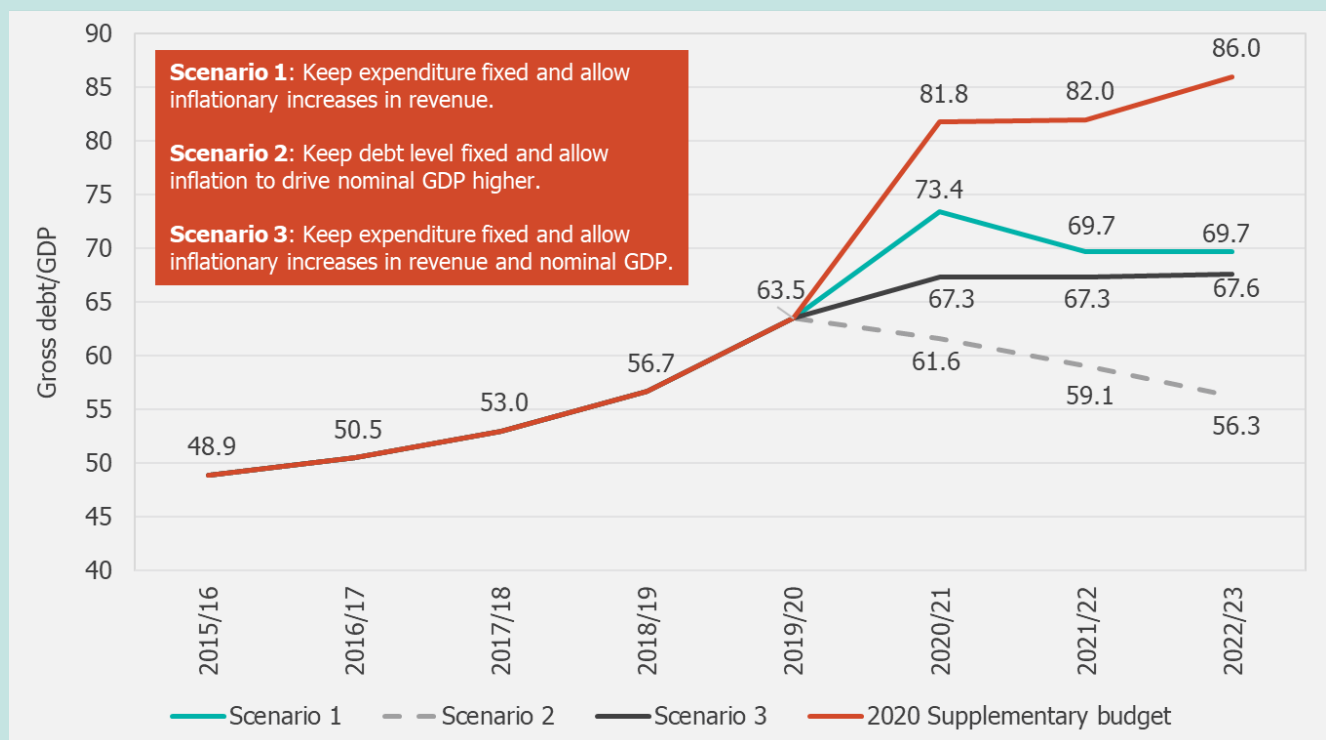
Although inflation is currently expected to remain benign over the near term, the rapid and potentially unsustainable increase expected in South Africa's debt burden over the coming years could cause inflation to head structurally higher once again.

Governments often reduce unsustainable debt burdens by cutting expenditure aggressively (i.e. with austerity measures), but in South Africa's case, this might be a difficult policy choice given the already low growth environment we find ourselves in. Alternatives such as defaulting or debt restructuring are options which are likely to have long term negative implications for the country's credit risk profile and could be incredibly damaging from a longer-term perspective.

A much stealthier way to erode a debt burden would be to inflate it away.

This was the strategy adopted during the post-World War 2 era by both the UK and the US, when it came to reducing their then elevated debt burdens. If push comes to shove, a structurally higher inflation rate could be more palatable than a possible default or socially unpopular and potentially counterproductive austerity measures.

DEEP DIVE: Lowering the debt-to-GDP ratio

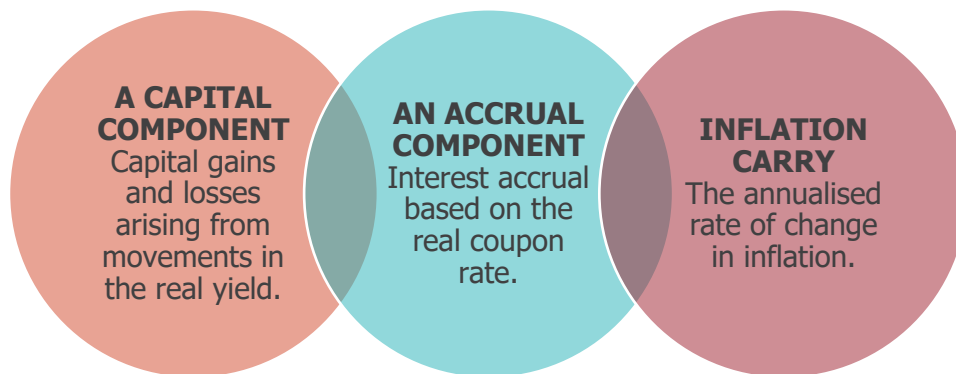


Keeping expenditure levels fixed and allowing increases in inflation to drive revenue higher would open up an opportunity to make in-roads into South Africa's stubbornly high budget deficit. This would in turn slow the *growth* of debt. Similarly, when considering the *level* of debt (i.e. the debt-to-GDP ratio), it follows that allowing inflation to drive nominal GDP higher would result in a lower debt ratio - if the debt level were to remain fixed or if it grew at a slower pace than nominal GDP. This is because the denominator in the debt-to-GDP ratio (i.e. GDP) increases at a faster pace than the numerator (i.e. debt), in turn driving the ratio lower.

So why are ILBs such great assets for retirement funds?

Retirement funds, specifically defined-benefit pension funds, need to pay benefits to their members. These benefit payments escalate annually at the rate of inflation and are considered a liability to the pension fund. To fund this liability, the pension fund invests all pension premiums received in investments that - on aggregate - must at least keep pace with inflation.

When disaggregating inflation-linked bonds, we find that they have three major sources of return:



Inflation carry: the star attraction

The inflation carry is the return component that makes ILBs such an attractive asset class for pension funds. The pension fund especially want to have this exposure when inflation remains stubbornly high or is rising. In a country like South Africa where the inflation rate has historically been structurally high - and as a pointed out earlier could once again be structurally high - the inflation carry ensures that the value of the inflation-linked bond is not eroded by inflation.

An additional benefit of inflation carry is that you earn it over the life of the bond. What that means is that if a bond issued in 2010 pays a coupon in 2030, the coupon will be indexed (adjusted) by the inflation rate from the date of issue of the bond to its payment date. This will apply to all coupon payments received over the life of the bond, as well as the capital repayment when the bond matures.

Alpha transport strategies using ILBs

When you take a portfolio view of ILBs, the sources of return increase when you add yield enhancement from credit assets. It is Futuregrowth's view that, generally speaking, the yield enhancement from listed ILB credit instruments (e.g. bank and State-Owned Enterprise issuers) is not sufficient for the specific credit risk. Thus we choose, instead, to lever off our nominal credit process to find suitable yield enhancement for all our portfolios, including our yield enhanced inflation-linked bond funds. We then make use of derivatives or repo trading strategies to ensure that the correct real interest rate risk is reflected in the portfolios. Over the past few years we have extended our yield enhanced inflation-linked bond capabilities to a number of products, as reflected in the table below.

Table 1: Futuregrowth's inflation-linked bond capabilities

ILB mandate	Description	1 year*	3 years*	5 years*
Passive Inflation-linked	Passive fund	-3.40	0.70	2.04
Core Inflation-linked	Active inflation-linked bond fund with diversity and reasonable yield enhancement	-2.17	1.43	2.62
Benchmark: JSE ASSA Inflation-linked Bond IGOVI Index		-3.27	0.75	2.08
Yield Enhanced Long Duration ILB mandate	Description	1 year*	3 years*	5 years*
Yield Enhanced Long Duration ILB	Credit alpha transport inflation-linked bond fund	-11.50	-2.74	0.20
Benchmark: JSE Composite Inflation-linked Index 12+ Year (CILI 12+ Year)		-10.58	-3.71	-1.22
Power Inflation-linked mandate	Description	1 year*	3 years*	5 years*
Power Inflation-linked Fund	Renewable energy credit alpha transport inflation-linked bond fund	-8.30	-1.45	2.10
Benchmark: RSA I2038 Bond		-9.27	-3.63	-0.63
Infrastructure & Development Bond ILB mandate	Description	1 year*	3 years*	5 years*
Infrastructure & Development Inflation-linked Bond Fund	Infrastructure credit alpha transport inflation-linked bond fund	-13.10	-3.77	n/a
Benchmark: JSE Composite Inflation-linked Index 12+ Year (CILI 12+ Year)		-10.58	-3.71	n/a

Updated: 30 June 2020

*Annualised/Source: Futuregrowth

We have been building well diversified credit portfolios for our clients for more than 20 years. We believe our inflation-linked products are well suited to form part of the asset allocation of any balanced retirement fund.

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