Liability-driven investors need to watch inflation

Key points

- *Insurers need to manage the key long-term risk of inflation despite the short-term deflationary impact of COVID-19 over the next few years.*
- *Investing in real assets such as property and infrastructure can help manage inflation risk.*
- *Active management is more important in a low-return environment.*

Insurers should be considering ways to protect their portfolios against an unexpected breakout of inflation despite the short-term deflationary impact of the COVID-19 pandemic, according to speakers at the Frontier annual conference.

Frontier Advisors' Head of Liability Driven Investing, Elie Saikaly, recommended real assets such as property and infrastructure that offer positive real yields.

"For example, something like a PPP infrastructure portfolio, high-quality healthcare, or real estate portfolio as a hedge against superimposed inflation," he said at a conference session on liability-driven investing.

He also recommended insurers consider:

- Floating rate debt, which may reduce the duration of portfolios and provide some additional carry.
- Green bonds, which have a high-quality credit rating and can improve insurers' ESG score.
- Actively managing equities to avoid stocks that perform poorly in an inflationary environment.
- Active equity options such as puts or calls to improve capital efficiency.
- Adopting a "barbell approach" to fixed income.

"So, holding a high-quality, active allocation in cash and short-dated securities with some term deposits, offset by a long duration government bond portfolio to hedge against that deflation risk. And sometimes you may be able to achieve a better outcome than targeting your liability benchmark under a deflation or indeed an extreme inflation scenario."

While the economic shutdowns prompted by the coronavirus pandemic have been deflationary in the short-term, the outlook for inflation over the next five to 10 years was too hard to forecast, according to an audience poll at the session.

Insurance Commission of Western Australia diversifies

Insurance Commission of Western Australia's (ICWA) Chief Investment Officer, Julie O'Neill, said inflation remains one of the key risks for insurers.

"Our feeling is that central bank policy and fiscal stimulus will be sufficient to get inflation going in the longer term. And so consequently, we believe that we can continue with our long-term strategy and that we will come out of this hopefully very nicely."

ICWA's Main Fund targets returns 3% above CPI annualised over rolling seven-year periods and its Motor Vehicle (Catastrophic Injuries) Fund targets 3.25%.

"We've got a number of asset classes there that are giving us an element of inflation protection. Specifically, inflation-linked bonds, which is 4% of the portfolio, and we have a large portfolio of real assets, which is made up of property at 15% and infrastructure assets at 10%," O'Neill said.

It is also considering adding industrial property and private equity to its portfolio through an active management approach.

Saikaly said active management would become even more important in a low-return environment.

"Alpha does become more important than beta – not from a strategic sense, but in the sense that in a lower return environment, the proportion of your return from alpha will be greater from an ordinary standing start situation."

Key questions the panellists answered

- *(14:30m) What type of assets typically do well in steady inflation, deflation or inflationary environments?*
- *(17:45m) Is the Insurance Commission of Western Australia considering investing in gold?*
- *(18:55m) In light of the low-return environment and the potential for negative real yields, what portfolio changes is the Insurance Commission of Western Australia considering?*