

Pensions: Will QE2 sink your pension fund?

As the queue of European governments set to default grows ever longer, the Bank of England announces quantitative easing 2 (QE2). Pension schemes are afraid – very afraid.

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What is quantitative easing?

Quantitative easing is just a pseudonym for printing money. In the electronic age, the Bank does not even have to run the presses – it, in fact, generates the money electronically. This money is then used to fund the banking system by buying assets, bonds, loans and stocks, from it. The bank then has more cash and less assets and it can then invest in more loans, companies, etc..., which ultimately stimulates the economy.

Why quantitative easing?

Quantitative easing is implemented to stimulate the economy. With the European debt crisis stalling growth, the Bank of England is fearful that the UK will slip back into recession. With interest rates at close to all time lows, the Bank cannot lower rates – so it has to inject cash.

The impact of quantitative easing

QE has two likely impacts.

- Keep long term interest rates low, or even reduce them.
- Increase inflation.

Rates

QE is always sold as a mechanism to reduce long term interest rates.

The cash is used to buy longer dated [government] bonds. Simple economics dictates that as demand for an asset rises, so does its price. Bond yield mathematics ensures that as bond prices rise, their yield falls. The mechanism is clear and the results reasonably certain.

Inflation

The second impact of QE is less frequently mentioned by the Bank of England. Pumping cash into an economy tends to create inflation. There is a time lag between the cash arriving in the economy and the

Quantitative easing has two economic impacts:

- Reducing long term interest rates (the intended impact)
- Increasing inflation (the unintended impact)

This mix is precisely the wrong one for pension funds.

resulting increase in production that the investment of that cash might generate. This means that, at least in the short term, there is more cash chasing the same economic output – the driver of inflation. QE 1 is thought to have added 1.5% to the rate of inflation.

Does quantitative easing work?

QE is really a last ditch policy that is not often used. It is therefore relatively untested and its impact and success are reasonably unknown. The stimulus cash should drive the economy, but there is little control over where it ends up. The flood of cash can just as easily drive inflation too high which is ultimately detrimental to the economy. It remains to be seen if QE is effective, but it does have an immediate impact on pension funds.

The impact of QE on pension funds

The one thing for certain is that in the short term QE will be detrimental to pension funds. The impacts of reducing long term rates and increasing inflation are precisely the wrong ones for pensions. A pension fund is a long term investor, so long term investment returns matter to a pension. It drives the growth of the scheme's assets. Most UK pensions have liabilities that are linked to inflation. Rising inflation increases these liabilities. So QE will reduce the asset growth of pension funds and increase their liabilities.

Positioning for QE

BRAVE Partners has been commentating some time that the economic crisis would drive inflation (see ["Is now the time to have an inflated expectation of your pension fund?"](#)). Pension funds should therefore ensure that their investment will increase in value with inflation.

Mallow Street

Unfortunately for pension funds Easy Street seems some way off, but in the meantime the excellent Mallow Street does offer a useful port of call for high quality discussion and ideas.

What is clear is that there are considerably more inflation linked liabilities in pension funds than there are inflation linked assets in the UK. Pension funds therefore need to invest in inflation responding assets that match as well as possible.

Christopher Cloke Browne
Managing Partner
BRAVE Partners LLP

One of the recent discussions on Mallow Street has been around inflation linked investing. What is clear is that there are considerably more inflation linked liabilities in pension funds than there are inflation linked assets in the UK. Pension funds therefore need to invest in inflation responding assets that match as well as possible.

Whilst there are concerns over matching and issues around mark-to-market shortfalls triggering contributions from the (weakened) sponsor – another issue entirely - as early as 2009, BRAVE Partners was suggesting that pension funds invest in equities and not bonds due to inflation concerns (see ["A scheme to give me my pension at](#)

65"). At that time the firm suggested investment in energy as a pension fund strategy

If anything, the firm's recommendation of investment in energy is only more vigorous now, in 2011, than it was in 2009.

The right energy

However, energy investments are not without risk. There are still many that are highly speculative. Many technologies are not proven as long term economic, or even viable. However, some attract huge valuations as the industry rolls through a series of trends and fashions (see "[The Va Va Voom of biofuels](#)" for comment).

Pension investments need to be for the long term and cash generative. Finding the right, commercially viable, technologies is essential to this. However, cash generation itself is not enough.

Freesun not freebird

BRAVE Partners has reviewed several investment opportunities in "free solar" businesses. These are businesses that invest in small domestic solar installations that it installs on houses (see "[FIT for a King](#)"). The business allows the homeowner to use any of the power generated as rent for the roofspace, but the business collects the feed-in tariffs. These feed-in tariff cashflows are ideal pension fund assets – long dated and inflation linked with an unlevered IRR of around 10%. However, analyzing these businesses further reveal hidden risks that maybe make them less attractive to pensions:

- There is a risk that the government will retrospectively change the feed-in tariffs. This did happen in Spain and New South Wales in Australia.
- There are legal risks in ensuring that the rights on the panels persist through a change of ownership of the property. These can be dealt with, but it has to be done in the right way.
- There is an expense risk. The average UK home changes hands 3 times in 10 years. Solar feed in tariffs last for 25 years. Once a property is onto its fourth or fifth owner, they might disconnect or remove the (now old) solar panels. Whilst the owner of the panel has rights to compensation it will be costly and time consuming to monitor and enforce these, especially if this becomes widespread.

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BRAVE Partners' services

The BRAVE Partners have a strong engineering background. The firm maintains a strong scepticism of many alternative energy technologies. This has meant a slower growth for the firm's energy business. However, over the first months of 2011, BRAVE Partners is identifying a core client base with strong commercially and technologically viable alternative energy businesses.

The firm can assist pension funds and their investment advisors to evaluate these businesses and technologies. This will assess the impact that they might have on the inflation risk to the pension schemes which must be rising by the day.

Interaction

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- The latest round of quantitative easing (QE2) announced by the Bank of England might stimulate the economy, but it will lower long term interest rates and raise inflation.
- This combination is a double whammy for pension funds that will suffer lower asset growth and increased liabilities.
- There is an insufficient amount of direct inflation linked assets, so pension funds will need to find proxy assets for inflation.
- BRAVE Partners has a long track record in this area. The firm identified the issue as early as 2009.
- BRAVE Partners can assist pension funds in identifying the optimal inflation responding assets.

enquiries@bravepartners.com

www.bravepartners.com

+44 844 997 0271