Protection against Inflation Risk

Dossier  Inflation-Linked Bonds – Preserving Real Purchasing Power and Diversifying Risk

Macro Global  Will "Helicopter Money" Bring Inflation?

Column  Sustainability in Institutional Asset Management
Editorial

Dear Reader

Inflation is not headline news at the moment. But it is conceivable that continuing monetary accommodation from central banks could eventually lead to significant inflationary pressure. In this issue of Trends, we examine the question of what conditions could lead to higher inflation rates, and give our forecast.

We also place a focus on the only asset class that offers effective protection against inflation: inflation-linked bonds. And we explain why, contrary to popular opinion, real estate and gold do not really protect you against inflation.

In addition, we take a look at sustainable investments. These are becoming increasingly important, not least in institutional asset management. Amongst other things, we discuss which selection criteria come into play and give an overview of the different investment approaches. And, as usual, we also report on other markets and trends.

Incidentally, this is the last edition of Trends in this current format. Not only is the magazine being redesigned but, in the future, it will also be published monthly. The first edition of the new Trends will be out this spring.

We hope this edition makes for enjoyable and thought-provoking reading, and provides you with some investment ideas.

Yours sincerely

Robert Parker
Senior Adviser:
Investment Strategy
and Research
Asset Allocation

Driven by the Central Banks

Patrick Bucher, Head of Global Asset Allocation

Investors are hanging on central bankers’ every word like never before. And the central bankers are in turn making every effort not to frighten the nervous investor community with their forward guidance. Investors’ fears are quite understandable, given that current central bank policy is in uncharted waters.

The monetary environment is undoubtedly one of the key drivers of prices on financial markets. But investors’ current focus on central banks is nevertheless unusual. With tapering a term determines the headlines, which is not well understood. Even experts cannot agree whether a reduction in bond purchases will impact the economy or whether the Fed’s ballooning balance sheet is in fact more important.

Whatever the direct effects of tapering may be, it is important to bear in mind that the central banks will do their level best not to put the upturn at risk. Inflation, which has actually been falling in recent months, shows no signs of posing a danger.

Rising interest rates a sign of recovery

The markets now rightly believe that tapering is not the same thing as a hike in benchmark rates. That is still a long way off for the Fed, to say nothing of the ECB, SNB or BoJ. That does not mean that yields on longer-dated bonds cannot continue to head north, so these instruments still hold little appeal. On the other hand, we do not see long yields skyrocketing.

The public sector and private households are still too fragile to be able to cope with a sharp upward move in rates.

A scenario of moderate rate increases is a good starting point for the asset class that is our favorite on strategic grounds – equities. The biggest price driver in recent years – the correction of the undervaluation – has once again in 2014, namely equities. The monetary environment is undoubtedlycharted waters.

Globally-oriented model portfolio for Swiss pension funds*

<table>
<thead>
<tr>
<th>CHF</th>
<th>EUR</th>
<th>GBP</th>
<th>CAD</th>
<th>JPY</th>
<th>Em. Markets</th>
<th>Commodities</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>11.9%</td>
<td>0.0%</td>
<td>0.8%</td>
<td>0.1%</td>
<td>0.2%</td>
<td>0.0%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Bonds</td>
<td>51.4%</td>
<td>3.4%</td>
<td>0.0%</td>
<td>2.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>56.1%</td>
</tr>
<tr>
<td>Equities</td>
<td>9.7%</td>
<td>4.4%</td>
<td>1.6%</td>
<td>7.5%</td>
<td>2.5%</td>
<td>4.3%</td>
<td>36.0%</td>
</tr>
<tr>
<td>Total</td>
<td>73.0%</td>
<td>7.9%</td>
<td>2.4%</td>
<td>9.8%</td>
<td>2.8%</td>
<td>4.3%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>


Youthful equities have still put in an outstanding performance. The public sector and private households are still too fragile to be able to cope with a sharp upward move in rates.

Temporary setbacks

Investors have to realize that the flip side of a higher valuation is more potential for a setback. After a long period when the news has been almost all good, any disappointments could see a sharp reaction. The Fed’s adroit announcement that it is to start measured tapering from January removed a major uncertainty. We have therefore increased our equity allocation once again and are focusing in particular on the considerable catch-up potential for European and Japanese earnings. Given strained sentiment indicators, a temporary correction seems likely, but we would use it as an opportunity to further top up equity holdings.

Outlook

17.12.2013  |  Estimate 12 months  | Expected return in local currency (%)  | Expected return in CHF (%)  
--- | --- | --- | --- |
**Equity market**  |  |  |  |
USA (S&P500) | 1,787 | 1,960 | 9.1% | 19.6%  |
Germany (DAX) | 9,085 | 10,000 | 10.1% | 12.5%  |
Netherlands (AEX) | 378 | 420 | 11.1% | 13.6%  |
UK (FTSE 100) | 6,486 | 7,300 | 12.5% | 15.0%  |
France (CAC 40) | 4,086 | 4,500 | 10.1% | 12.7%  |
Italy (MIBTEL) | 17,905 | 20,000 | 11.6% | 14.3%  |
Spain (IBEX 35) | 9,343 | 10,500 | 12.4% | 15.0%  |
Switzerland (SMI) | 7,881 | 8,800 | 12.4% | 26.1%  |
Japan (TOPX) | 1,292 | 1,450 | 17.7% | 26.1%  |
**Capital market (10-year government bonds)**  |  |  |  |
USD | 2.85 | 3.10 | 0.9% | 10.5%  |
CAD | 2.64 | 3.10 | –0.9% | 8.7%  |
AUD | 4.23 | 4.30 | 3.7% | 15.0%  |
JPY | 0.67 | 0.90 | –1.3% | 5.7%  |
EUR | 1.83 | 2.10 | –0.4% | 1.9%  |
GBP | 2.91 | 3.20 | 0.7% | 2.9%  |
CHF | 1.02 | 1.40 | –2.2% | –2.2%  |
**Money market (3-month LIBOR)**  |  |  |  |
USD | 0.24 | 0.30 | 0.3% | 9.9%  |
CAD | 1.27 | 1.20 | 1.2% | 11.1%  |
AUD | 2.60 | 2.60 | 2.6% | 13.7%  |
JPY | 0.15 | 0.20 | 0.2% | 7.4%  |
EUR | 0.27 | 0.20 | 0.2% | 2.6%  |
GBP | 0.53 | 0.60 | 0.6% | 3.7%  |
CHF | 0.02 | 0.10 | 0.1% | 0.1%  |
**Currencies against CHF**  |  |  |  |
USD | 0.88 | 0.97 | –9.6% | 9.9%  |
CAD | 0.83 | 0.92 | –9.7% | 9.7%  |
AUD | 0.79 | 0.87 | –10.9% | 10.9%  |
JPY | 0.86 | 0.92 | –10.9% | 7.2%  |
EUR | 1.22 | 1.25 | –2.3% | 2.2%  |
GBP | 1.46 | 1.48 | –2.2% | –2.2%  |
**Gold**  |  |  |  |
USD/oz | 1,231 | 1,150 | –6.6% | 2.4%  |


drivenbytheCentralBanks-Outlook-10.02.14-kart

*This is an indicative asset allocation, which may change over time. Estimated performance indications and financial market scenarios are no guarantee of current or future performance. Source: Credit Suisse.
Over the past years, central banks have reacted strongly and with unconventional measures to counter the global financial crisis and the ensuing recession. Interest rates fell to zero and central banks bought large amounts of bonds, foreign currencies and even equities. While these policies were designed to counter deflation risks following the significant shocks to the financial system and steep declines in economic activity, the concern for investors and the wider public for several years has been that central banks’ money printing efforts will ultimately cause significant inflation. We assess some channels that could lead to such a development, and discuss historical occurrences and the outlook for inflation.

Some theory and some history

From a longer-term historical perspective, persistent inflation is a phenomenon that only really emerged in the 20th century (see Figure 1). One key reason was the strong rise of “fiat money” creation and the fact that – contrary to the current situation – central banks were not independent from political influences. With central banks now still explicitly or implicitly much more committed to medium-term price stability, three aspects are most crucial to assess when thinking about the medium-term outlook: economic slack, monetary activity, and in particular, credit developments, and inflation expectations. All three suggest limited risks at this point in most advanced economies. Over the past years, significant short-term swings have resulted from changes in commodity prices, exchange rate adjustment or administered prices, but these short-term changes appear to have limited lasting effects.

The real economy angle: economic slack and inflation

After significant declines in economic activity, inflation usually takes a long time to increase meaningfully and has historically been a “late-cycle” development. The reason for this is that after an economic shock, the amount of slack is great and price pressure from high capacity utilization or wages is unlikely. Despite improvements in economic activity since the depths of the global recession, “slack” appears to remain high in many advanced economies, with a significant share of the labor force still unemployed. The longer high unemployment persists, the less likely it is that workers can easily be re-employed. In such a situation, the available pool of idle workers might be smaller than unemployment rates suggest.

The monetarist angle: credit booms and busts and effects on inflation/deflation

As mentioned above, the rise of “fiat money” contributed to strong money growth in several episodes in the 20th century before monetarist assessment of inflation/deflation. Inflation appears to have generally become less sensitive to the business cycle and to short-term shocks like oil price swings over the past decades. One reason is probably an increased commitment on the part of central banks to prevent inflation and improve their credibility. Apart from a more active management of the inflation risks, significantly improved stability of inflation expectations has certainly been beneficial. As central banks’ credibility anchors inflation expectations and to control it. To some extent, the risk of overestimating the amount of slack is also present today, but at an unemployment rate of 7% in the US, and measures of capacity utilization or the output relative to potential still indicating significant slack, these risks appear to be limited in most advanced economies for now. Importantly, central banks’ credibility appears to remain high.

Outlook still for low inflation but market expectations already very low

Contrary to many investors’ expectations, inflation in most major economies has actually fallen substantially over the past months. Much of the decline was due to lower energy and food price pressures. In principle, this can be viewed as supportive for disposable income growth and corporate profitability. However, core inflation, (i.e. excluding the price of energy and food), has also declined to low levels, perhaps indicating a more fun-
Alternative Investments

Impact of Alternative Fixed-income Strategies in Response to Emerging Changes in Economic Conditions

Damaris Reiser, Alternative Investments Advisory

To correctly position the fixed-income portfolio in order to meet changing market conditions, a suitable solution should include fixed income relative value strategies. Their earnings drivers differ significantly from those of traditional fixed-income investments and can therefore help diversify fixed-income risks, as the following article illustrates.

Current fixed-income market environment

The fixed-income market has been marked by regulatory intervention in recent years. This has not only had an impact on pricing—which is now largely unaffected by supply and demand—but also on the behavior of market participants. Investor behavior is currently based primarily on expectations of central banks’ further regulatory invention. The central banks have been using quantitative easing to try to boost the credit markets and to stimulate aggregate demand. They achieve this by purchasing bonds. In the past few years, the US Treasury has bought hundreds of billions of dollars in Treasury bonds, while holding down interest rates at virtually 0%.

Implications for investors

Given such conditions, fixed-income investors, on their hunt for returns, no longer have many options open to them. As short-term rates produce almost no returns, higher interest-rate and/or credit risks must be taken on to achieve even a modest return. Interest rates and credit spreads are at historically low levels. Government intervention in the markets has made investors more willing to take on higher risks for a lower premium. In other words, investor appetite for risk has risen. As a result, bond prices are relatively stable. A short-term widening in interest or credit spreads (on par with a fall in investor risk appetite) could only be observed in the past if the wording used by central banks hinted that there would soon be a shift in monetary policy.

Long-term portfolio considerations

For a long-term fixed-income portfolio strategy, investors should price in an end to this monetary policy. A portfolio with high duration, but also elevated credit risk, could negatively affect the portfolio’s performance. With the Japanese experience of a protracted feedback loop from economic weakness to falling prices in mind, monetary policymakers are unwilling to tolerate inflation at very low levels. The combination of low inflation and moderate growth, especially in the eurozone, raises the risk that a negative economic shock might drive economic developments more towards “genuine” deflation.

Indicators to track

Inflation is a “complex beast” with many influencing factors whose importance varies over time. Given the channels described above, some indicators might give an earlier signal for inflation concerns. They include wage developments, credit dynamics and inflation expectations. For the US, the picture is not clear-cut: some indicators, such as average weekly pay, have begun to show a pick-up in recent months, while others have changed little. In the eurozone, wage declines are still occurring in many peripheral countries, weakening demand and creating pressure on the overall price level. Inflation expectations of both consumer and financial markets have so far been stable, both in the US and the eurozone. Most measures of economic slack, like output relative to potential or unemployment rates, remain high in advanced economies. This should limit upside risks for consumer price inflation, as opposed to asset price inflation. This suggests that major central banks can remain very expansionary in 2014. Nevertheless, market expectations for inflation are currently very low and even slightly higher inflation could bring a surprise and could impact the pricing of rate expectations.

Figure 1: Rolling 12-month correlation of FI RV strategies with other asset classes, January 2011 – August 2013

Source: Credit Suisse.

To calculate the correlation, a Credit Suisse investment fund using this strategy was chosen as a proxy for FI RV strategies. The bonds are represented by the JPM Global Aggregate Bond Index, the equities by the MSCI World Index and hedge funds by the HFRX Index.

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Volatility of US equities

Alternative fixed-income strategies
Interest rates have only a very limited effect on beta-independent strategies. The market dynamics of demand and supply only have a marginal impact as well. Two examples of beta-independent strategies are residential mortgage-backed securities (RMBS) and fixed income relative value (FI RV).

FI RV strategies generate returns by betting that at some point there will be a correction in inefficiencies in pricing on the yield curve or between different markets. The associated risks are mainly specific to the position and not systemic. Thus compared with long-only strategies, there is very little correlation between strategies and interest-rate or credit risks in the fixed-income market (see Figure 1 on the previous page).

Opportunities for relative-value managers in the event of a shift in current monetary policy
FI RV managers have several strategies open to them, such as bond arbitrage, yield curve arbitrage, volatility trading, inter-market spread trading, and money market spread trading.

Performance analyses show that these strategies can be very successful when market volatility is high. Currently, however, volatility is being suppressed by central banks’ intervention (see Figure 2).

As mentioned, intervention artificially increases bond prices, creating a permanently bullish climate. In this environment, market participants mostly follow a buy and hold strategy, which results in low market activity. In the past, every time central banks announced they were intervening, volatility could be seen to drop markedly.

A further source of returns for FI RV strategies—structural price anomalies and irrational relative price differences—is not available in the current environment. This is because price differences are few and far between. Structural price anomalies are not being corrected through the market as they usually are, but are remaining intact due to external intervention.

Given the current market environment and potential earnings drivers, it is clear that FI RV managers can act only with the “foot on the brake” at present. A trend reversal is, however, on the horizon. In fact, the US Federal Reserve gave the first specific indication regarding this shift when it announced that tapering would begin in January 2014. Therefore, for tactical reasons, it makes sense now to “stock up” the fixed-income portfolio with beta-independent strategies to be in a stronger position when more turbulent market phases return.

Beta-independent fixed-income strategies at Credit Suisse
Credit Suisse’s APS (Alternative Funds Solution) team has carried out detailed research on the impact of quantitative easing and its implications for fixed income relative value strategies, and recently published a white paper (source: see pages 31 and 32 of this publication). The white paper shows that beta-independent strategies in a normal market environment (i.e. one with no major government intervention) are characterized by stable returns, even under crisis conditions (see Figure 3).

Figure 2: Quantitative easing impacts the volatility of various investment segments

Figure 3: Returns and volatility by asset class and strategy, 1.1.2005 – 31.8.2013

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Annualized Return</th>
<th>Annualized Volatility</th>
<th>Sharpe Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays Arb trade</td>
<td>11.3%</td>
<td>4.6%</td>
<td>2.5</td>
</tr>
<tr>
<td>Barclays US Aggregate Bond Index</td>
<td>4.7%</td>
<td>3.3%</td>
<td>1.4</td>
</tr>
<tr>
<td>Citigroup World Government Bond Index</td>
<td>3.2%</td>
<td>7.0%</td>
<td>0.5</td>
</tr>
<tr>
<td>MSCI World Index</td>
<td>4.2%</td>
<td>16.8%</td>
<td>0.2</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>5.3%</td>
<td>14.1%</td>
<td>0.4</td>
</tr>
</tbody>
</table>

*Based on a basket of 17 funds. Sources: Credit Suisse, Barclays, Bloomberg. Historical performance data and financial market scenarios are no guarantee of current or future performance.
Equities will remain the preferred asset class for many investors in 2014. With interest rates as low as they are this comes as no surprise since alternatives are few and far between. But it can make sense to take a careful look at things. The equity universe offers interesting market niches in sectors such as security, protection and prevention. Global security industry is enjoying long-term structural trends and attractive growth rates. In the following interview, Patrick Kolb provides some insights into the industry and explains the key drivers behind this growth. With over seven years of investment experience, he is a proven expert in security stocks.

Patrick, why do people attach so much importance to security?

Security is an essential human need. This was recognized, for example, by the American psychologist Abraham Maslow. He put human needs into five categories in what is known as the Maslow’s Hierarchy of Needs pyramid (see Figure 1). At the bottom of the hierarchy there are the physiological needs such as sleep, breathing and food. The next level up is the need for security. Maslow believes that these two lowest levels represent the needs that are vital to survival. Only then can a person live within regularized structures and turn their attention to higher needs, namely social contact, esteem and self-actualization.

With security being a basic need, issues related to it have always been important. However, we only perceive this need selectively, generally when we are personally involved. Take a holiday flight as an example. What happens at the airport is always the same for all passengers; checking in, going through security control, getting on the aircraft. But almost no one is aware of the many different levels of security involved. The only security-related factor we, as passengers, notice is when we go through the scanner. X-raying the baggage, the aircraft pre-flight safety tests and the air traffic control from takeoff to landing are all things we take for granted rather than notice directly.

"Security industry" is a very abstract term. What exactly does it mean and how do you define your investment universe?

We have deliberately chosen a broad definition. For us, the industry covers all companies involved in security, protection and prevention. What these companies have in common is the overarching objective of offering products that help to make the world a safer, as well as a cleaner and healthier, place. We have identified five sub-themes we use as an investment focus: IT security, healthcare, environmental protection, transport safety and crime prevention. What matters for us is that the companies have significant activities in the security industry. So we have set a revenue criterion. The investment universe only includes companies that generate at least 50% of their revenues from security, protection or prevention. Defense companies are excluded automatically.

Experts particularly point out the structural growth trend in security. What factors are driving this?

Estimates assume the global security solutions market is growing at around 3% to 7% annually. This gives investors the chance to put their money in a sustainable growth market. The industry growth is being driven by various factors, primarily technological innovation, increasing liberalization in the movement of goods, capital and people, and tougher regulations. Let me explain this briefly.

In the last ten years, technological innovation has changed the world dramatically. At the same time, new security-related needs have emerged. For example, I think e-banking has been one of the most important developments in the financial services industry. This innovation would have had little chance of being accepted if it had not been accompanied by protection such as access authorization controls.

Or take the increasing liberalization in the movement of goods, capital and people as a result of globalization. One result is that manufacturers can source inputs globally, but they have to rely on certain quality standards such as certification.

For a cotton supplier, for example, certification guarantees that production is organic and no environmentally harmful pesticides have been used. Providers of such certification are profiting from this structural trend.

The third key factor is ever tougher regulation. It is just under a year since a case emerged of horse meat being falsely declared as beef in ready meals. That example clearly shows how vulnerable our food chain is. I assume that in the future authorities will tighten up food controls, testing and hygiene standards. The beneficiaries will be companies providing such services to food manufacturers.

There are now a host of companies in the security industry. What should investors look out for?

The sustained high growth rates in the industry have attracted a large number of providers. There are now around 200 companies listed worldwide, covering a broad range of security solutions (see Figure 2 on the next page). In general, it is fair to say that there is a very large number of small and medium-sized companies active in the security, protection and prevention sector. These are often small and mid caps, not well known to the general public and poorly covered by analysts, if at all. So pricing mechanisms are not always efficient. For us, as active investors, this offers an opportunity to generate additional value for clients, which could be considerably higher than in the case of large caps. Security, protection and prevention companies are often leaders in their particular niche market or technology. Anyone looking to invest directly in the segment needs to have the necessary market knowledge and take a hard look at the annual and quarterly financial statements. I think that a portfolio approach is the best solution, for reasons of risk.

Why are there so many small and mid cap security companies?

Innovative solutions and applications often begin in small start-ups. But as their businesses develop, they desperately need capital. So many owners aim for an IPO to ensure they can continue to take their ideas and products forward. They are often acquired by large companies, especially if they have pioneering new business ideas.

Growth markets often see a great deal of consolidation. Is this the case for the security sector, and if so, what are the opportunities?

There have been many examples in the past of small niche companies from the security, protection and prevention business areas being taken over by conglomerates at very high prices. For instance, Cisco has recently paid USD 2.7 billion for SourceFire, representing a takeover premium of 33%. As a matter of principle, we recommend clients take a broad portfolio approach on risk/return grounds. This increases the likelihood of profiting from such events.

**Figure 1: Maslow’s Hierarchy of Needs pyramid**

<table>
<thead>
<tr>
<th>Maslow’s Hierarchy of Needs pyramid</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Physiological</strong></td>
</tr>
<tr>
<td><strong>Safety</strong></td>
</tr>
<tr>
<td><strong>Love/belonging</strong></td>
</tr>
<tr>
<td><strong>Esteem</strong></td>
</tr>
<tr>
<td><strong>Self-actualization</strong></td>
</tr>
</tbody>
</table>

The hierarchy of needs is a theory that psychologist Abraham Maslow proposed in his “A Theory of Human Motivation” published in 1943 and subsequently expanded upon. Maslow argued that humans first fulfill their basic needs before gradually moving on to "higher" needs, which are satisfied according to a certain hierarchy.

**Figure 2**

- **IT security**
- **Healthcare**
- **Environmental protection**
- **Transport safety**
- **Crime prevention**

*Source: Credit Suisse, estimate as of end-June 2013.*
Many security companies are based in the US. Why is the industry so heavily represented there? What other countries are important?

Most security, protection and prevention firms are indeed based in Silicon Valley. The area south of San Francisco is one of a kind, with a unique environment for innovative companies. Israel is also important. The country is very advanced in IT security, and has been underestimated by many investors and analysts. Here too, we have invested in promising smaller companies.

For which investors is investing in the security sector best suited?

The sector is an ideal addition to a broadly diversified overall portfolio. Investors should have an investment horizon of at least 7 to 10 years. We are investing in long-term structural trends that are often not apparent on a short view and only emerge over the course of several years.

Let’s go back to e-banking by way of illustration. When it was launched, clients were identified simply with a log-in and password. For security reasons very soon strike lists were added as an additional form of identification. A few years after that, multi-factor authentication came in, and this is currently the standard. I can well imagine that in the future new and more sophisticated methods will become established, for example with biometric data such as finger prints, iris recognition and voice recognition. Technological progress is crucial for user authentication. You need to invest in the companies at the cutting edge.

The sector has already performed very well in recent years. How do you think it will do from here?

As long-term investors, given the structural growth opportunities we have been discussing, we feel the economic environment for investing in the security, protection and prevention sector will remain attractive. Until I see a slowdown, I remain optimistic. There may be short-term market volatility, but there is nothing you can do about that. You have to keep a cool head in such situations and grasp any opportunities that arise.

What criteria are used to select the stocks? Are there any areas you favor right now?

Our stock selection uses a disciplined bottom-up approach. We analyze our global investment universe using qualitative, quantitative and growth criteria. The focus is on a company’s products and services, the key financial data and management quality. We generally have a concentrated portfolio of 40 to 60 stocks. Right now we are especially keen on IT security, so we have an overweight position in the segment. We only invest in companies with strong market positions that are able to sustain or increase margins and boost profits.
Protection against Inflation Risk

Inflation-Linked Bonds – Preserving Real Purchasing Power and Diversifying Risk

Dr. Samuel Huber, portfolio manager in the Overlay and Inflation-Linked Solutions team

Inflation means that money gradually loses its purchasing power. It affects us not only as consumers, but also as savers and investors. Inflation-linked bonds are a means of preserving real purchasing power in periods of substantial inflation. The following article looks at the characteristics of inflation-linked bonds and how they work. It also suggests ways for investors to use them to protect themselves from the undesirable consequences of an unexpected rise in inflation. In addition, taking Switzerland as an example, it shows how protection against inflation can be created synthetically for countries that do not have their own market for inflation-linked bonds.

A brief introduction

Inflation-linked bonds are securities whose coupons and/or nominal value are tied to a consumer price index. In the event of an unexpected spike in inflation, they protect investors by generating additional returns. In other words, they preserve real purchasing power.

Inflation-linked bonds are the only asset class to offer sustained protection against inflation, enabling investors to obtain a real yield that protects purchasing power even when inflation is high. Since inflation-linked bonds have a low correlation with nominal bonds and stocks, they also help to enhance the diversification of a traditional portfolio and thus improve the risk/return profile.

Real estate and precious metals: No true protection against inflation

In discussions about investments that protect against inflation, real estate and precious metals are often mentioned because these are "real assets." However, contrary to popular opinion, these two asset classes seldom offer reliable protection against inflation.

In the case of real estate, rental income is fixed at a nominal value for the short to medium term, so rent cannot be adjusted immediately to the new general price level.

Moreover, a pickup in inflation increases borrowing costs, which counters a flight from cash to property and thus hinders real estate prices from rising. Given this two-fold effect, real estate offers only limited protection against inflation. The same applies to precious metals and commodities in general. Rising inflation reduces consumers’ real purchasing power and erodes companies’ revenues and profits. This, in turn, reduces demand for commodities and thus depresses their prices.

An asset class is deemed suitable for hedging purposes if the asset value keeps pace with inflation. If inflation picks up, the asset value should increase accordingly. Conversely, after adjustments for inflation, the prices of asset classes suitable for use as inflation protection should increase linearly. Figure 1 shows the evolution of the real value of gold between 1975 and 2013 (in Swiss francs). The volatile performance indicates that gold has not provided Swiss investors with good protection against inflation over the last four decades.

Evolution of the market

Dating back more than 230 years, the market for inflation-linked bonds is older than many people think. During the American War of Independence (1775 to 1783), the US’s fledging government financed the war effort by substantially increasing the supply of Continental dollars in circulation, which had only just been introduced as the national currency in 1776. This quickly resulted in annual inflation rates of up to 30%. Against this backdrop, the state of Massachusetts issued the world’s first inflation-linked bond in 1780, with the cash flows of this bond linked to the prices for a representative basket of consumer goods.

More recently, in 1981 the UK became the first industrialized nation to issue inflation-linked bonds (called index-linked gilts). The US followed suit in 1997 (with Treasury inflation-protected securities, or TIPS). Germany saw its first issues take place in 2006, after which the eurozone also developed into an important marketplace for inflation-linked bonds. Today, 13 of the world’s 20 largest economies (based on gross domestic product) are active on the inflation-linked bond market. The total market value of all inflation-linked bonds issued worldwide currently amounts to around USD 2.4 trillion (see Figure 2).

In terms of the market value of issued paper, the US leads the way, followed by the UK. Brazil is in third place, accounting for a market value equivalent to around USD 280 billion. The South American giant issued its first-ever inflation-linked bond back in 1984.

Figure 1: Evolution of the real value of gold in Swiss francs

Figure 2: How the market for inflation-linked bonds has grown
The inflation-linked bond segment is dominated by sovereign issuers. But why do countries issue inflation-linked bonds? After all, doing so means that they are obliged to pay a real return that they cannot simply “inflate away.” One of the reasons cited the most often is that the absence of an inflation risk premium means lower costs (see also the section titled “Return differences between nominal and inflation-linked bonds” on this page). Inflation-linked bonds therefore reduce expected refinancing costs. Yet over the last nine years, the inflation risk premium has been extremely low anyway in domestic inflation by using inflation-linked bonds from foreign issuers.

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Credit Suisse has developed an ideal concept for doing just that. In 2003, Credit Suisse became the first financial institution to offer synthetic inflation protection for Swiss investors and today manages more than CHF 2 billion for private and institutional clients in this strategy. The model employed can be applied to other countries and can even be used, for example, to implement inflation protection for emerging-market investments.

The basic underlying concept is simple: the combination of foreign inflation indices that best replicates inflation in Switzerland also provides the best basis for inflation protection for Swiss investors.

In this section we will examine the relationship between inflation in Switzerland and inflation in Europe and the US. There are inflation-linked bonds for these two markets as well as a highly developed derivatives market. Figure 7 shows how the regression coefficients $\beta_{\text{US}}$ and $\beta_{\text{Euro}}$ changed over the period between January 1998 and July 2013, with $\beta_{\text{Swiss}}$ representing the regression coefficient of the log change in Swiss inflation and $\beta_{\text{US}}$ the corresponding coefficient for the US. It can be seen that both coefficients were largely stable throughout the period examined.

The model enables Swiss inflation to be closely replicated and, by using an inflation swap overlay, enables synthetic inflation protection to be created for a portfolio invested in nominal Swiss franc bonds. Synthetic implementation ensures that the portfolio is always invested in Switzerland’s real interest rate curve and not in a foreign curve, as would be the case with physical implementation using inflation-linked bonds from foreign issuers.

In addition, the portfolio manager can invest in the much broader investment universe of nominal bonds, thus enhancing portfolio diversification. Thirdly, the portfolio can be custom-adjusted to the investor’s wishes with regard to duration, credit rating allocation and market allocation. Fourthly, with a synthetic implementation, the foreign currency risk is limited to the cash flows of the inflation swaps and does not encompass the entire bond portfolio, as is the case with a physical implementation. This leads to lower currency hedging costs.

Return performance of inflation-linked bonds versus nominal bonds

While the value of nominal bonds is determined by changes in real interest rates and inflation expectations, the value of inflation-linked bonds changes only when real interest rates fluctuate. If inflation expectations remain constant, the returns generated by nominal and inflation-linked bonds are therefore identical and depend only on the real interest-rate level. This means that any differences in the returns of the two bond classes are caused solely by changes in inflation expectations. If inflation expectations rise, inflation-linked bonds outperform nominal bonds. Conversely, they perform less well when expected inflation falls (see Figure 8 on page 23).

Portfolio management

Inflation-linked bonds can be actively managed in a portfolio in various different ways. Minimum-variance optimization (MVO) seeks the same degree of protection against inflation risk in a nominal bond portfolio that retrospectively would have minimized the variance, or risk, of the portfolio. To illustrate the strategy, we have calculated the MVO of a portfolio of nominal US government bonds hedged with inflation swaps. Figure 9 on page 23 displays the resulting curve along the risk/return frontier, which shows that for the period examined, a hedge ratio of around 45% would have improved the risk/return profile of a nominal government bond portfolio.

Why are inflation-linked bonds of interest right now?

Inflation is not headline news at the moment. Instead – in Europe in any case – it is deflationary risks that are the real hot topic. Consequently, protection against inflation is very expensive right now. As soon as signs of rising inflation emerge, the market will price these in, and hedging against inflation will become more expensive as a result. It is entirely conceivable that inflation will become an issue again sooner or later. In the US, for instance, the average rate of inflation over the past century has been 3.3%1. In November 2013, annualized inflation was running at just 1.2%. Taking the average for the last hundred years as a long-term guideline, there is certainly potential for an increase.

However, while it matters to get the timing right when protecting against inflation, the benefits for portfolio construction are even more important. Since inflation-linked securities have a low correlation with nominal bonds, they can significantly reduce overall risk in a mixed portfolio. Moreover, in recent years – in an environment of declining inflation expectations and falling realized inflation – returns on inflation-linked bonds have only been marginally lower than those on normal bonds.

Summary

Inflation-linked bonds are the only asset class to offer sustained protection against inflation. They enable a real return to be...
generated that preserves purchasing power, even when inflation rates are high. Inflation protection can be obtained either physically, via inflation-linked bonds, or synthetically via nominal bonds in combination with an inflation swap overlay.

Since inflation-linked bonds have a low correlation with traditional asset classes, they are a good means of lowering the overall volatility of a portfolio.

This article is an excerpt from the recently published white paper titled "Inflation-Linked Bonds – Preserving Real Purchasing Power and Diversifying Risk." If you are interested in this topic, you can request a copy. You will find the contact details on pages 31 and 32 of this publication.

Sources: Credit Suisse, Bloomberg.
Historical performance data and financial market scenarios are no guarantee of current or future performance.
The issue of sustainability has found its way into many aspects of our daily lives, and even into modern asset management, due to increased social awareness. Over the last seven years, the sustainable investment market has grown by around 23% per year on average in Switzerland, Germany and Austria. Today there are thus many opportunities and ways to incorporate sustainability into institutional asset management. Investors are significantly helped here by solutions that do not require a complete change in investment philosophy, but are simply a pragmatic extension of investing from a sustainable angle.

What do we mean by sustainable investing?
Credit Suisse offers a wide range of sustainable investment solutions that, in addition to providing a financial return, also take ecological and social issues into account. The investment possibilities here are based on a three-pillar concept and include products and services in the areas of philanthropy, impact investments and sustainable investments (see Figure 1).

For investors, the social objective is the focus of philanthropy, whereas in impact investments, the financial return, besides being important too, is important too. For institutional investors, sustainable investing mainly comes into question because of their financial responsibilities toward third parties (pension fund beneficiaries, trusts, etc.) who place achieving financial returns under compliance with sustainability criteria at the forefront.

What criteria are normally used?
Credit Suisse uses ESG criteria (see Figure 2 on the next page) to assess the sustainability of an investment in securities from a private- or public-sector issuer. These criteria cover environmental, social and corporate governance (ESG) issues and are currently standard criteria in sustainability research.

What sustainability approaches are there?
Today there are a number of sustainability approaches that can be used, either individually or in combination with each other, to assess the investment universe. Based on the definition by the European Sustainable Investment Forum (Eurisif), sustainability strategies can be grouped as follows (see Figure 3 on page 26):

Exclusion of companies with controversial business activities
Exclusion screening enables the targeted exclusion of companies with business practices or products that are considered to be immoral or unethical. It is primarily based on individual concepts of values. Business activities considered by most investors to be unsustainable include armaments, firearms and “sin securities” (tobacco, alcohol, pornography and gambling). Credit Suisse rules out all companies involved in serious controversies are excluded.

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Norm-based screening
Norm-based screening means using ESG criteria to examine whether a company is involved in ongoing controversies (labor rights issues, involvement in sensitive countries, corporate scandals) that constitute material reputational risk. The results of the screening are displayed using a “traffic light system” and a corresponding allocation of the companies into red, yellow, and green groups. Companies involved in serious controversies are excluded.

Best-in-class screening
Best-in-class screening identifies the companies in a specific sector with the best grades from an ESG perspective. An analysis is conducted to determine how well the company’s management deals with ESG issues. For instance, can the company lower emissions, retain talented employees or ensure workplace safety? The individual factors can vary a lot from one industry to another. The best-in-class approach is based on a relative rating system that measures a company’s ESG risks and opportunities and assigns grades ranging from AAA (the best) to CCC (the worst). This strategy aims to lower the financial risks that can arise from ESG reputational risks.

Figure 1: Philanthropy, impact investments and sustainable investments

<table>
<thead>
<tr>
<th>Philanthropy</th>
<th>Impact investments</th>
<th>Sustainable investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donations (social objective)</td>
<td>An investment strategy that not only delivers a financial return, but also makes a social and/or environmental contribution.</td>
<td>Investments that focus on optimizing risk and return while taking environmental, social and corporate governance criteria into account.</td>
</tr>
</tbody>
</table>

Definition

Figure 2: ESG criteria cover three subject areas

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental issues include: Climate change, Toxic waste, Resource scarcity</td>
<td>Social issues include: Diversity, Human rights, Consumer protection, Animal protection</td>
<td>Corporate governance issues include: Management structure, Labor relations, Management compensation</td>
</tr>
</tbody>
</table>

Source: Credit Suisse.
the universe is even further reduced. The approach described will exclude a total of around one-third of the 2,400 companies composing the original universe. But investors will still enjoy broad diversification across regions and sectors in the remaining equity universe. Sustainable investing can therefore be considered safe from a risk perspective.

Which asset classes are especially suitable?

Unfortunately, sustainable investment implementation cannot be offered across all asset classes at present. Well-known research providers like MSCI ESG evaluating companies in the MSCI All Country Index and some local stock indices and more than 90% of the issuers in the Barclays Global Aggregate bond index. The asset classes described above are especially suited to sustainable investing. However, coverage of small and midsize enterprises is much sparser, so there are only limited opportunities to invest sustainably in SMEs through specialized investment funds. Although opportunities exist for sustainable investing in real estate depending on the focus, sustainable investments in other alternative asset classes like private equity, commodities or hedge funds cannot be implemented under the scope of an asset management mandate yet.

What are the challenges of sustainable investing?

The issue of sustainability is playing an ever greater role in the investment reasoning of institutional investors in Switzerland, and pension funds in particular. A rather pragmatic approach is frequently adopted here, i.e. it is generally not discussed whether assets that have previously been managed using traditional methods should be managed using a pure sustainability approach, but rather in which form and to what extent sustainability considerations should be taken into account. Many institutional investors are faced with various challenges here:

Management of third-party funds

Institutional investors manage other people’s money. They therefore bear greater responsibility than private investors. The institutional investor must answer to the asset owners. This also makes well-founded and transparent decisions on the investment strategy and on sustainability necessary.

Definition of sustainability

Sustainability criteria should derive from the client’s guiding principles. The criteria should be measurable and assessable so that their implementation is clear and comprehensible.

Investment strategy

The investment strategy should ensure that it is highly likely that the economic objectives will be achieved. The sustainability filter implemented should not adversely interfere with the defined risk/return profile.

Costs under the spotlight

For institutional investors, the costs of a mandate play an important role. The costs of an investment solution in the area of sustainability are comparable to those of a traditional mandate.

Legal framework

The legal framework (e.g. regulations governing pension assets pursuant to the Swiss Federal Law on Occupational Retirement, Survivors’ and Disability Pension Plans) must be adhered to.

How will this theme further develop?

Sustainable investing is often based on moral and/or ethical considerations. In institutional asset management, however, emphasis is still placed on earning an adequate financial return. It is therefore important to employ solutions that can achieve a competitive return. As is the case in the traditional investment environment, each individual investor’s investment strategy must be defined on the basis of the investor’s specific risk/return profile, though a pragmatic approach can definitely be chosen to implement the strategy. This means that frequently only selected asset classes such as equities and bonds are implemented sustainably.

Environmental incidents such as the oil spill in the Gulf of Mexico have once again significantly increased public awareness of environmentally and socially responsible conduct. Given this altered situation, it comes as no surprise that the product range for sustainable investment solutions has also undergone continual development in recent years. We believe that this trend toward greater market penetration will continue. Institutional investors in particular are increasingly seeing the opportunity to enhance their current investment strategies by adding in sustainability criteria.
Real Estate
Foreign Real Estate – Smart Diversification is Half the Battle
Ulrich Braun, Head of Real Estate Strategy and Advice, and Francisca Faríña Fischer, Fund Manager

Investors looking to optimize their investments have to ensure they are well diversified. International real estate can be an excellent way to improve a portfolio’s risk/reward profile.

Investing in Swiss real estate has been very rewarding over the last 15 years. Swiss real estate funds have provided very stable returns and seen net asset values and prices rise over an extended period. Adding some real estate to an equity and bond portfolio increases the risk only marginally, but boosts the overall return significantly. That is why many insurance companies and pension funds have built up large positions in real estate - sometimes to as much as 20% of their portfolios.

Attractive investments abroad
Swiss real estate prices have been rising, with minor interruptions, for 15 years now. Many foreign markets, by contrast, have not yet got over the sharp correction that followed the financial crisis, and offer attractive opportunities to get on board. Anyone looking for a solid cash flow from real estate over the next few years should be looking internationally. Geneva and Zurich might be pricey now, but what about Vancouver, New York, London and Sydney? International real estate is offering higher total returns than currently available in Switzerland and other economically important countries in Europe. This is mainly being driven by above-average economic growth, thanks to demographic trends and transformation in Asia and South America. Whenever a broad middle class gets wealthier and GDP and productivity go up, demand for real estate - offices, retail space and residential properties - rises. A large number of countries are seeing strong real estate markets, among them China, Brazil and Chile, but also New Zealand and Australia.

Demand for offices has also risen sharply in the US and parts of Canada recently.

Diversification – but how?
One simple argument in favor of real estate is that net rental yields are currently above bond yields almost everywhere. Investing in foreign real estate offers not just the prospect of good cash flow, which is very attractive in the current period of low interest rates, but also a chance for capital gains, for instance if land values rise for prime sites.

One possible reason why there is not much international real estate in many Swiss investment portfolios may be that there are not many products that allow investors to participate directly in the international real estate markets. At present, there are two Swiss real estate funds active in this segment, and two consortia of investment foundations.

By contrast, even experienced experts who opt for a listed real estate company find it hard to keep track of the 3,800 or so individual stocks listed around the world. It is important to note that real estate stocks and real estate investment trusts (REITs) are exposed to both standard real estate risk and also the risk of stock market movements. The volatility of international real estate investments is largely equivalent to that of equity investments.

Generating stable cash flows
Several things need to be borne in mind if real estate investments are to provide the desired diversification:

- It is worth investing in several countries over longer periods to smooth out the different cycles and risks in the countries concerned.
- Directly owned properties are preferable to listed investments to achieve the greatest diversification effect. In the US, for example, direct investments are offering a total return of 7% p.a. This is only slightly less than the expectations from listed equities. The volatility of directly owned US property is only a fraction of that from exchange-traded instruments.
- Real estate funds are an efficient solution for investing in foreign real estate markets.
- Ultimately, Swiss investors are interested in steady cash flow in Swiss francs. Two Credit Suisse real estate funds invest directly in attractive locations in various parts of the world and hedge most of their currency exposure.

Conclusion
Investing in foreign real estate is an excellent way to generate stable and above-average returns while simultaneously improving a portfolio’s risk/reward profile.
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