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HERMES: NO SILVER BULLET FOR INFLATION

With UK inflation hitting its lowest rate in 14 years, inflation risk can easily be overlooked. Even in a disinflationary environment the persistent corrosive nature of inflation can meaningfully erode the real value of investors' portfolios. The purchase power of £1 has declined by 15% in the last 5 years. Preserving and enhancing the purchase power remains the key objective.

The latest white paper from the Hermes Multi Asset team, *Inflation – tracking the spectre stalking your portfolio*, argues that there is no simple solution to inflation-matching, and history provides no easy solutions. As the causes of inflation vary overtime, different assets respond differently to different inflationary environments. In short, there is no silver bullet.

Seven years after the start of the global financial crisis the future remains uncertain, despite the low-growth and moderate-inflation environment. Policy measures such as quantitative easing have created an environment that begs the question not just of how we return to normal, but what normal.

Tommaso Mancuso, Head of Hermes Multi Asset, said: "There is no simple solution to inflation matching, and history provides no easy over the counter solution. Upon a closer look, it is clear that traditional hedging tools such as gold, real assets or inflation-linked bonds are either poor inflation hedges or may only deliver in very specific scenarios. Policy reactions to the global financial crisis, not least quantitative easing, have created investment conditions that are novel, fluid and therefore potentially treacherous."

Implied inflation
Most inflation-targeting portfolios start with an estimation of future inflation rates, then the blending of a portfolio of assets that are expected to match or exceed this with an acceptable level of volatility. However, the problem remains this is premised on a series of market expectations and therefore is vulnerable to the interaction of estimation errors between various assets' returns and inflation.

Mancuso continues: "In the end, it comes down to guesswork, irrespective of how sophisticated the deductive reasoning behind it may be. Market participants have proven themselves rather poor at predicting the future level of inflation, e.g. implied inflation, which is the market-driven expectation for future inflation as priced in the breakeven spreads of linkers, is not a reliable forecast of future realised inflation."

Single strategy solutions
If inflation was an investible asset, then it would have an enviable return per unit of risk having generated an average 3% return p.a. with 1% volatility. Building an inflation-matching portfolio with a low tracking error therefore is – literally – a rewarding but challenging task. Single strategy solutions such as linkers are fraught with problems. The more specific the inflation solution, the more vulnerable it will be to asset class risk, and the less protection from diverse external shocks it will provide.

An obvious irony is that inflation-proofing assets are themselves prone to inflationary pressures and precisely at the time when investors need them most. Demand is most likely to exceed supply for inflation assets when inflationary threats are seen to be at their greatest. And in general, potential demand far exceeds supply for inflation-linked assets – some three-fold with regard to UK linkers – so in order to avoid over-paying, investors who seek inflation protection need alternative solutions.

Diversifying to match and exceed inflation: The case for multi asset
Given that no single asset class can consistently match, let alone exceed, inflation, there is a need for a diversified, dynamic solution – a flexible investment approach focused on delivering real returns with a low tracking error to inflation.

By decomposing the drivers of inflation, and understanding the relationship between different assets and different inflation scenarios allows us to identify and classify the broad universe of assets and risk factors into matching assets and enhancing assets. Consistency of returns and low tracking error are the result of building the entire investment process – asset selection, portfolio construction, risk management - around inflation. .

Mancuso concludes: "Because no asset shows a stable relationship with inflation, monitoring the portfolio and rebalancing the weights is necessary on a monthly basis. This ensures the strategy stays on target, with controlled levels of risk. In doing so, it further ensures that the portfolio's volatility stays in sync with the environment, thereby delivering a low tracking error."

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Notes to Editors:

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Hermes manages assets on behalf of more than 200 clients* across equities, fixed income, alternatives and real estate, with £28.6 billion* assets under management. In Hermes EOS, we have the industry's leading engagement resource, advising on more than £134.0 billion* of assets.

We believe in **Excellence**, **Responsibility** and **Innovation**

- **Excellence:** We aspire to excellence in everything we do. This manifests itself most visibly in our investment performance. We will only offer products to our clients where we believe there is a strong investment thesis and where we can deliver sustainable alpha.

- **Responsibility:** We believe it is our responsibility to lead discussion and debate about the fiduciary responsibilities of fund managers to our clients, their stakeholders and, ultimately, society at large. We have always sought positive engagement with the firms in which we invest.

- **Innovation**: We have the entrepreneurial culture to identify forward-looking products that meet those needs, along with the resources and speed-to-market mentality to develop them rapidly.

Our structure gives clients globally the benefit of access to a broad range of specialist, high conviction investment teams operating within an established and robust operating platform.

Hermes' investment solutions include:

- **Equities**: Global, Emerging Markets, Small & Mid Cap, Europe, Asia Ex Japan, Greater China
- **Fixed Income**: Inflation-Linked, Government Bonds, Investment Grade, High Yield
- **Real Estate**: Segregated, Unitised, Debt, UK, US Residential, European, UK PRS
- **Alternatives**: Multi Asset, Infrastructure, Private Equity

*Please note the total AuM figure includes £3.7bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 December 2014.