INFLATION-LINKED BONDS:
ARE INFLATION-LINKED BONDS THE MOST UNDERAPPRECIATED ASSET CLASS?

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Rashaad worked at Prescient Investment Management for seven years, rising to the position of senior portfolio manager. He joined Aeon Investment Management in January 2009 as a portfolio manager and director, where he launched and managed a range of multi asset products. Rashaad moved to ABAX in April 2012 in order to expand their capabilities into the fixed income and multi asset space. He brought across the Diversified Income, Absolute Return and Balanced funds to ABAX and helped grow these products to R43bn during the 9 years he was there. Rashaad joined Foord in 2022. Rashaad holds a Bachelor of Business Science (Honours) (Finance) and is CFA charter holder.

Farzana worked at Prescient Investment Management between 2003 and 2018, where she was an executive director and senior portfolio manager responsible for all cash, money market, income and global income portfolio management, managing more than R60bn. In 2018, she was a founding member of Ngwedi Investment Managers where she served as the Chief Investment Officer and managed a range of fixed income and multi asset funds. She helped grow the business to R10bn assets under management before it was acquired by Taquanta Asset Managers in 2021. Farzana joined Foord in 2022. Farzana holds a Bachelor of Business Science (Honours) (Actuarial) and is a CFA charter holder.

WHAT ARE INFLATION-LINKED BONDS (ILB'S)?

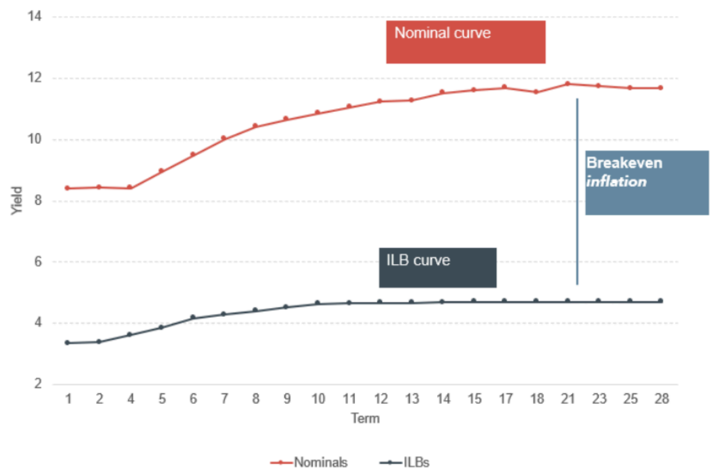
Nominal bonds pay a fixed return for a fixed period. They have existed for millennia and are the largest component of the $133 trillion global bond market. Inflation-linked bonds (ILB's) are a much newer and much smaller fraction of the market at around $3 trillion. The British government was the first to issue ILB's in 1981. The United States started issuing Treasury Inflation-Protected Securities (TIPS) in 1997 and South Africa issued its first ILB in 2000. ILB's are currently issued by a range of both developed and developing markets.

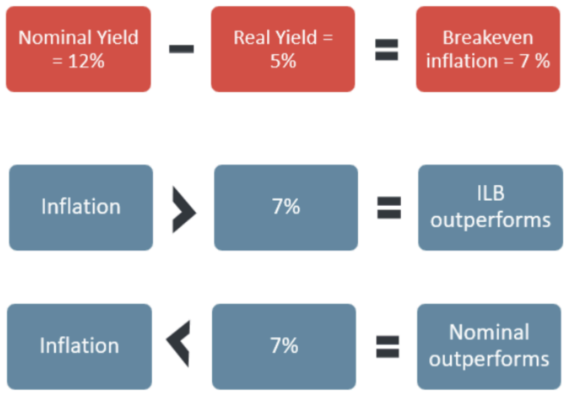
The capital and coupon of an Inflation Linked Bond increases in line with inflation, in contrast with a nominal bond where the capital and coupon remain fixed over the life of the bond.
Inflation-linked bonds are therefore a distinct asset class in that they provide a guaranteed return on capital in *real* terms, thus preserving the real value of capital. Such a return was unavailable prior to the advent of ILB's. They act as a constraint on governments as they are a form of debt which can't be inflated away.

CHOOSING BETWEEN NOMINAL AND INFLATION-LINKED BONDS

Nominal bonds a pay a fixed rate of return. Inflation-linked bonds pay a real rate of return PLUS Inflation. The gap between Nominals and ILB's is the breakeven rate of inflation. If inflation materialises at higher than the breakeven rate, the return on ILB's will be higher than nominal bonds. If inflation materialises at lower than the breakeven rate, then the return on nominal bonds will be higher than the return on ILB's. The following chart shows the yield of nominal bonds and ILB's across the curve.

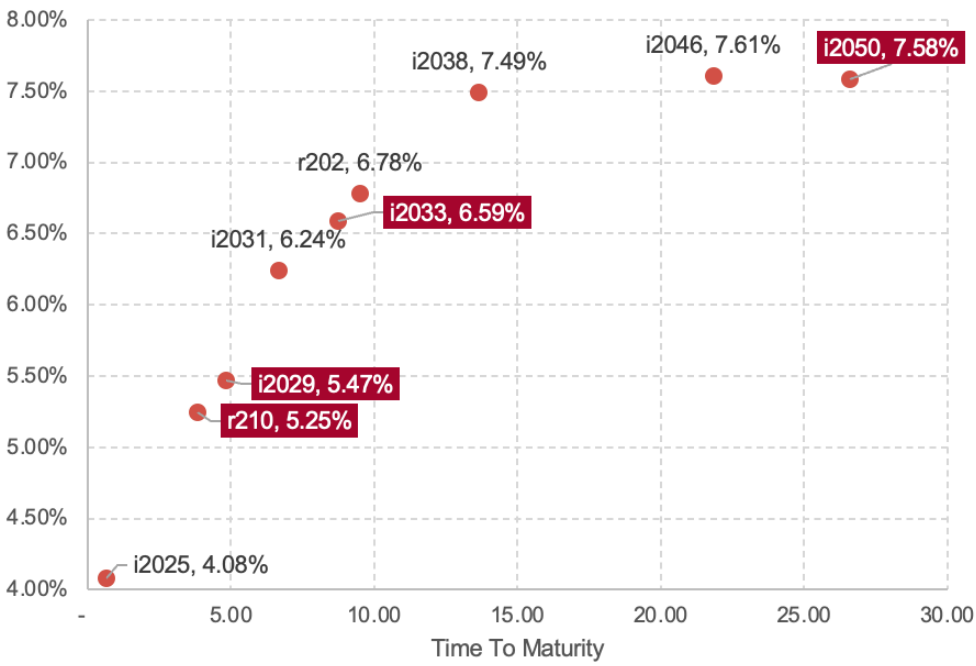
NOMINAL YIELD CURVE ILB YIELD CURVE





The following chart shows the breakeven inflation for South Africa across the curve. It ranges from around 5% at the short end, to 6.5% in the belly and around 7.5% at the long end of the curve. Depending on your term of investment, the inflation rate needs to turn out to be higher than the breakeven inflation rate in order for ILB's to outperform nominal bonds.

SA BREAKEVEN INFLATION

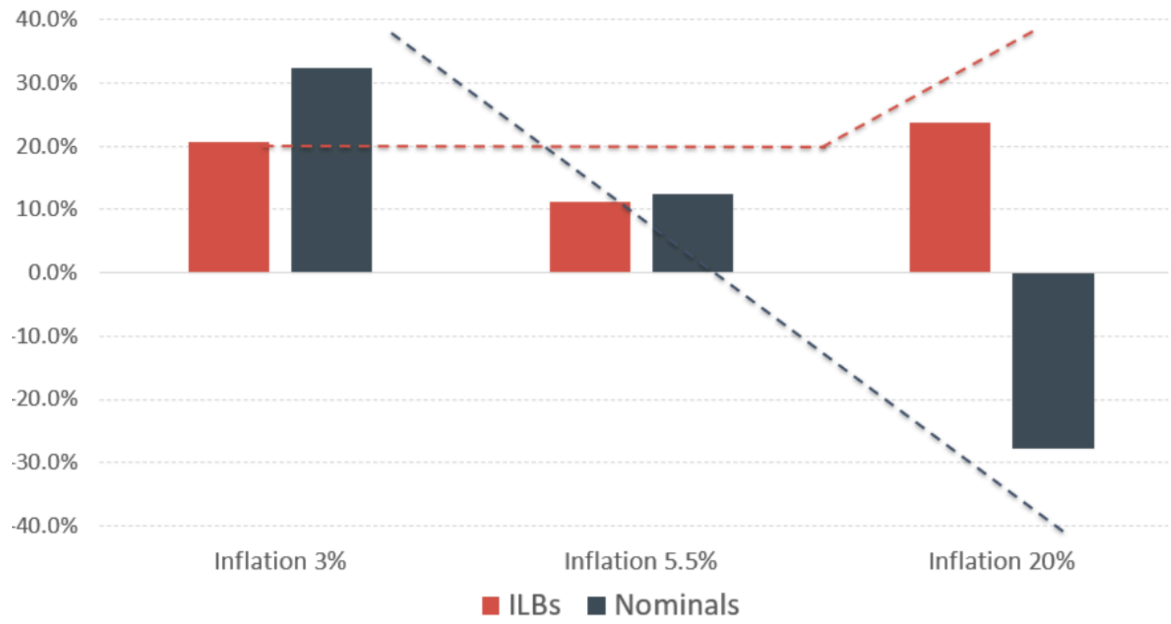


WHY HOLD ILB'S?

Inflation-linked bonds (ILB's/linkers) are an unappreciated and underutilized asset class. Investors generally understand the mechanics of fixed rate bonds better and therefore invest largely in that space – they are also far more familiar with nominal government bonds given that linkers are also a newer asset class. We think there is room for both nominal and linkers in any multi asset fund as they both play a different role in portfolio construction and in particular, in risk management.

ILB's provide investors with full inflation protection regardless of what happens to inflation - provided the real yield doesn't rise materially. The table below shows how linkers and nominal bonds will perform over a 1-year time frame under various inflationary scenarios: (Please note: These are scenarios and do not reflect Foord's house view).

RETURN ON ILB VS NOMINALS UNDER DIFFERENT INFLATION SCENARIOS



- In an environment of flat inflation, linkers and nominals provide a similar return.
- In an environment of high inflation, linkers significantly outperform nominals and nominals can have large drawdowns in this scenario.
- In a low inflation environment (a scenario most investors fear with linkers), linkers underperform nominals. However, on an absolute basis, they still deliver a reasonable return. If inflation is 3% and the real yield is 5%, an investor in linkers will earn 8%, which is in line with a cash return. But in that scenario, the South African Reserve Bank (SARB) is likely to cut interest rates, meaning real yields will fall. The fall in real yields would also mean a positive capital impact which would also further contribute to linker returns. Thus, an investor holding linkers could do better than holding cash - even in a low inflation environment.

From a risk/return perspective, linkers offer minimum downside risk across various inflation scenarios vs nominals which can massively underperform in a high inflationary environment. Therefore, linkers are one of the few asset classes that offer an asymmetric payoff profile: In an environment of high inflation, they tend to perform very well and provide diversification benefits, while in a low inflationary environment, the downside equates with similar returns to cash. On the other hand, nominal government bonds have a linear payoff profile with both unlimited upside and downside risks. As such, linkers and nominals behave very differently in different inflation environment with linkers providing more downside protection.

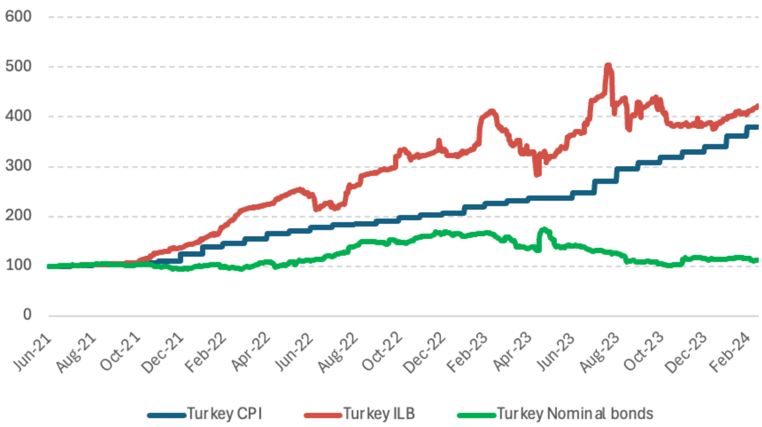
WHAT HAPPENS IN AN INFLATIONARY PARADIGM: TURKEY CASE STUDY

As a case study, we considered Turkey, which has experienced very elevated inflation of 70-80% p.a over the past few years, in order to ascertain whether linkers provided inflation protection. We also compared the outcome of being invested in linkers against this backdrop, in comparison to nominal bonds.

The chart below shows the total return of Turkey ILB's vs nominals from mid-2021 to date.
Over this period, nominal bonds delivered a return of 15% in an environment where inflation was 280%. Hence in real terms, an investor would have lost 70% of their principal per annum. In contrast, linker returns kept pace with inflation over this period, delivering a nominal return of 305% and a real return of 7% per annum.

This demonstrates that investments in nominal bonds proved a disaster in Turkey over a period of very high inflation. Had you held this asset class, you would have wiped out a large part of the real value of your capital. Linkers however did their job in protecting the real value of an investor's capital. This highlights the critical role linkers could potentially play – in a way few other assets can – in protecting investors capital during disaster.

TOTAL RETURN OF ILB'S VS NOMINALS IN TURKEY FROM MID-2021 TO DATE



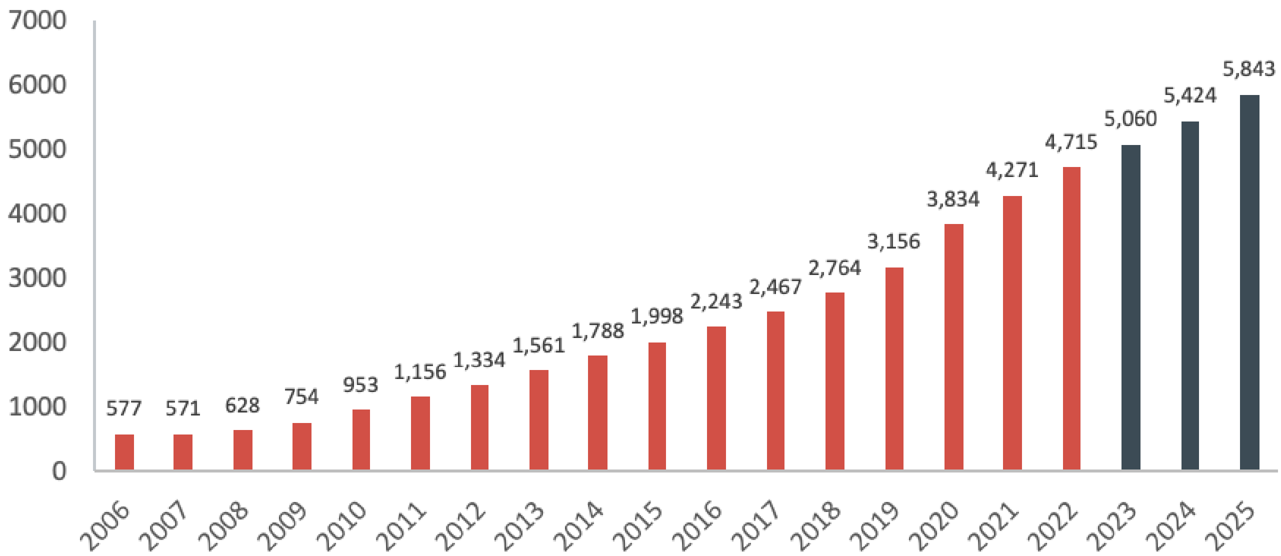
	Return	Real Return
Nominal bond	15.6%	-69%
ILB	305.8%	7.0%
Inflation	278.8%	

RISK OF HIGHER INFLATION IN SA

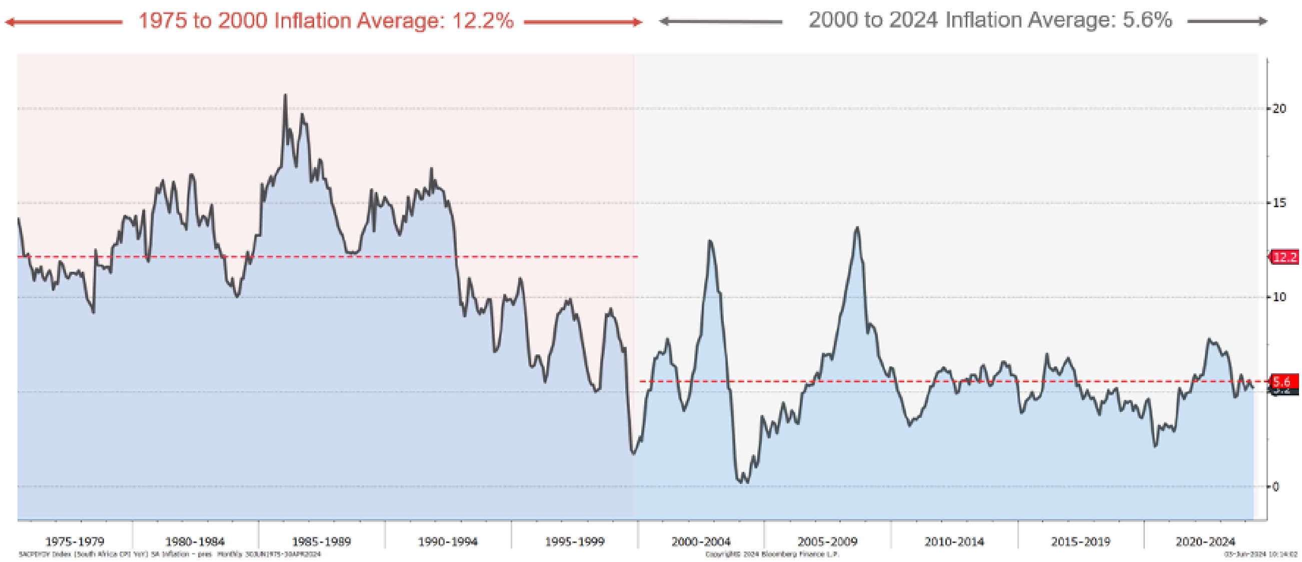
With the SARB having done a good job of targeting inflation, and even talk of lowering the inflation target further, it is difficult for many to imagine a scenario of higher inflation in SA. While inflation has been well-contained over the past decade, the risk of higher inflation has increased given government's rising debt levels. SA government debt has gone from under R1 trillion in 2010 to over R5 trillion in 2023, with no sign of it abating as we continue running a large fiscal deficit and funding this by borrowing at increasingly higher yields. Given the unsustainability of our government debt levels, we have two options to stabilise debt: 1) Economic growth or 2) Higher inflation. With SA having grown at less than 1% per year in real terms over the past decade and no signs of meaningful structural reforms in the near to medium term, growth is unfortunately likely to continue on the same trajectory.

This means that the easiest option to stabilize our debt would be to allow higher inflation. This is clearly not thinking the current SARB team subscribe to. But South Africa faces significant political uncertainty over the coming years. The president appoints both the SARB governor and deputy governors, and in time a new president could appoint an entirely new SARB team – one that may be more amenable to running with higher inflation in the interest of stabilising debt levels. (Remembering that government debt is usually measured as a percentage of nominal GDP – and with higher inflation, the denominator rises – causing this measure to fall.)

SA DEBT PROFILE

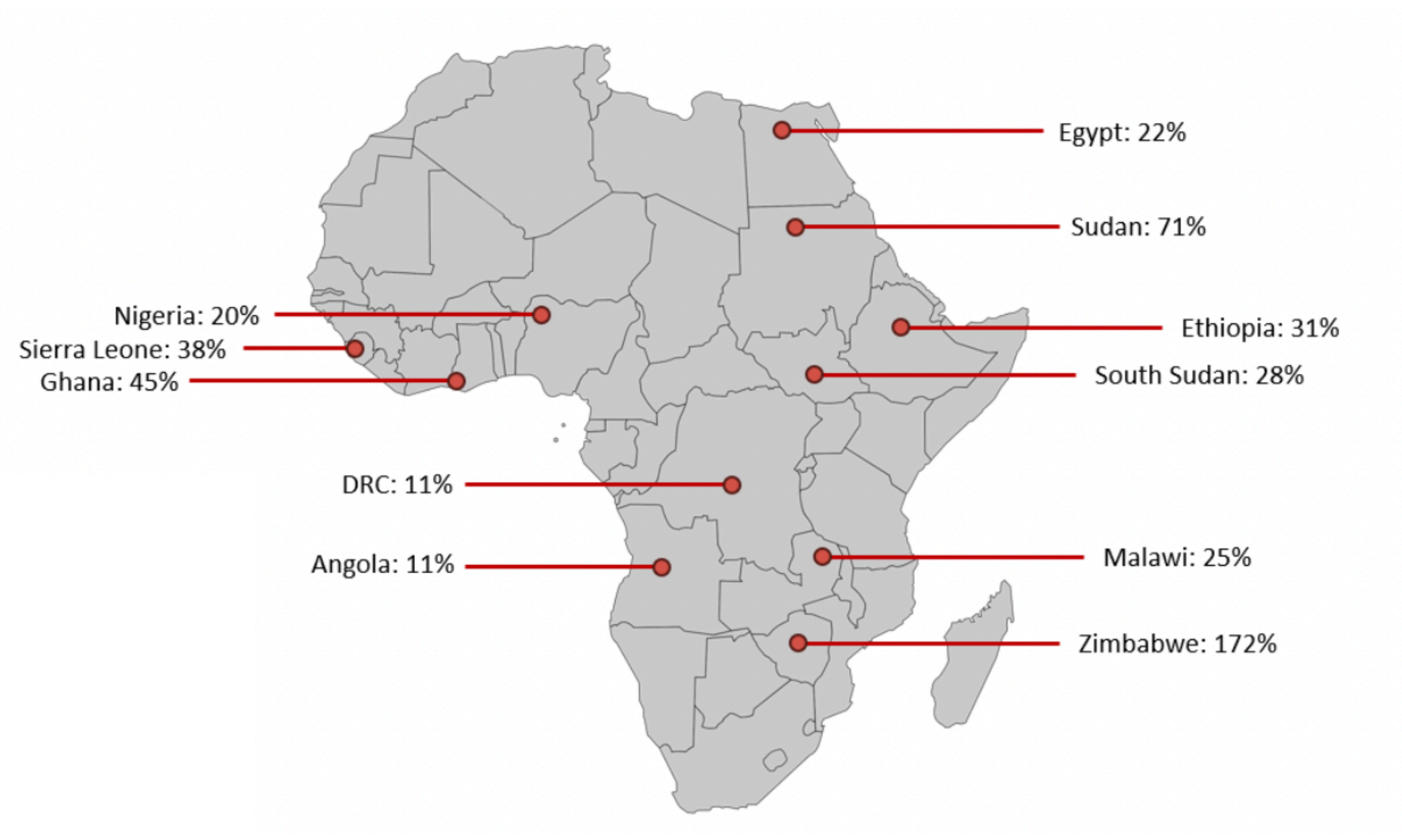


> *While inflation has been reasonably well-contained in SA since 2000, prior to 2000 inflation was running at much higher levels of over 12%. Therefore, contrary to recent history, a higher inflationary environment is not something SA has not suffered before.*

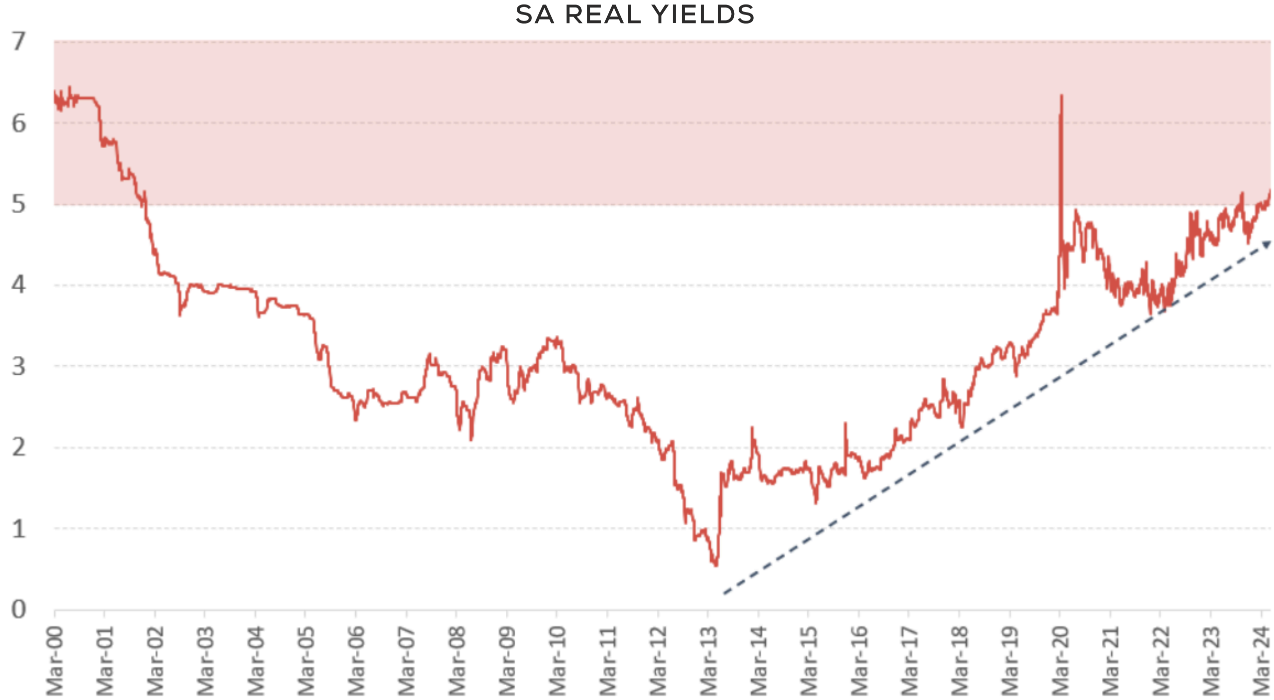


Looking across at our neighbouring countries, many are already running with double digit inflation:

COUNTRIES WITH INFLATION RATES OF 10%+ IN AFRICA



IS THERE VALUE IN ILB'S IN SA?



The above chart shows the historical real yield in South Africa since ILB's were launched in 2000. Real yields in South Africa have been rising for the past 10 years, leaving investors disillusioned with linkers as an asset class. However, with real yields having increased significantly from 0.5% to over 5%, they are now close to the highest levels that we've seen in the past two decades. This provides a very attractive entry point, with limited downside risk and very favourable prospects for this asset class going forward.

CONCLUSION

Foord's investment philosophy centres around the concept of "safety first" and preserving investors' capital first and foremost. In deciding whether to include an instrument in our portfolios, we carefully consider the role the instrument would serve in our overall portfolio construction, as well as the risk/return characteristics of the asset. We place a strong focus on risk-adjusted returns (the highest prospect for returns at the lowest levels of risk) and have a preference for assets that offer an asymmetric return profile with attractive upside and limited drawdowns.

We believe linkers are an asset class that meets the above objectives very well. Inflation-linked bonds are unique in their ability to provide a guaranteed real return and protect against extreme inflation events. Over and above this, they offer investors extremely attractive risk-adjusted returns across a diverse range of inflation scenarios. In doing so, they provide an asymmetric payoff profile that sets them apart from other asset classes. With such distinct risk/return characteristics, we have very high levels of conviction that this asset class will prove to be critical in protecting investors' capital against the corrosive impact of higher inflation.