



Stephen Hart examines the rising cost of living and ways to protect clients against a rise in both the consumer price index (CPI) and its volatility.

Households are already feeling the pinch with higher petrol and utility prices. If these factors feed through to higher inflation, investors without a direct hedge against inflation risk will be experiencing a marked deterioration in their ability to meet future expense streams. Specifically, an elevation in inflation remains a serious risk for investors.

As outlined in my recent articles, inflation-linked bonds (ILBs) are the best available direct hedge against inflation with current returns rivalling equity returns. If prices of necessary household items continue to rise, investors can expect an elevation in the consumer price index (CPI) and an increase in the volatility of the CPI.

Household expenses

The pressure on household budgets has already been highlighted in a recent Westpac/Melbourne Institute Consumer Confidence survey. It revealed one component of the index expectations of family finances has deteriorated sharply over the past 12 months. Importantly, this component is now approaching low, possibly recessionary, levels. As Westpac chief economist Bill Evans remarked in a report titled *Consumer sentiment edges lower*, 18 May 2011:

"We saw some disturbing movements in the components of the Index ... we note that the Family Finances Index is at its lowest level since July 2008 and there has only been one other read of the Index (June 2008) which has been lower since the early 1990s when families struggled in the aftermath of Australia's last recession."

Petrol and utility charges, being two important components of household spending, have risen substantially over the past 12 months. Utility charges have risen because of the long-overdue re-investment in underlying infrastructure. Petrol costs have risen because of perceptions over future global demand. Neither of these components is directly controllable



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by the Reserve Bank of Australia (RBA).

The longer petrol prices are elevated, the more likely the price of oil will impact upon the broader price indices, including the CPI. On top of these rises the RBA has increased interest rates substantially over the past year. While expenses have risen, incomes have not risen sufficiently to compensate consumers and the household budget is being squeezed.

Investors who rely on fixed income streams need to plan for periods of higher inflation, especially in products and services that are needed for day-to-day living. ILBs with coupons tied to the CPI provide a solution.

Household income

Investors need a cash flow that is protected against increases in the CPI, or their expenses will outstrip investment income. Unlike investments in other asset classes, ILBs provide a direct solution. Equity returns suffer in high inflation environments and do not provide an

effective inflation hedge in the short or medium term. Investing in Commonwealth and State Government ILBs can reduce your overall risk by around half while cutting investment return by approximately 1.5 per cent (see figure 1).

Investors can achieve higher returns if they are willing to consider corporate ILBs. For example, Sydney Airport Finance ILBs bought in the secondary market in parcels from \$50,000 can achieve 5.4 percentage points real return over CPI. Meaning, if CPI is 3 per cent, the total return would be 8.4 per cent. While the volatility of return will be higher from an investment in Sydney Airport Finance in comparison with the UBS Government Index, the higher return compensates the investor for the additional volatility.

Investors are therefore presented with an opportunity to buy an effective hedge against inflation that does not dilute equity returns and substantially dampens the overall volatility of return across a portfolio.

CPI and volatility

Not only are we facing the prospect of further rises in inflation due to an elevation in commodity pricing (beyond the control of the RBA) the volatility of the CPI may also rise. Its volatility has been

falling steadily since 1969 as shown in figure 2.

These results have also been shown in figure 3. Although this graph shows a trend of increasingly lower CPIs and lower CPI volatility, it can be argued that over the investment period of the next 20 years, the change in this trend since 1969 may well begin to reverse. If input prices such as fuel and utilities continue to rise, the upside risk to inflation outside the control of the RBA will increase. This possibility alone confirms the underlying rationale for investing in ILBs.

Conclusion

While figure 3 might normally lull investors into a state of complacency, recent experience with increasing expenses is sounding alarm bells – the effects of which are starting to have an impact upon household balance sheets. The trend in the level and volatility of inflation has been one way for 30 years. Elevation in utility prices and petrol prices is not something the RBA can adequately control which may mean a change in trend. This suggests that ILBs should be preferred to other investments.

Stephen Hart is head of planner services at FIIG Securities.

Figure 1 Inflation-linked bonds versus equities – 10-year period

Attribute	UBS Gov ILB	ASX All ords acc	50% UBS Gov ILB/50% ASX All Ords	Risk Drop vs 100% Equities	Return Drop vs. 100% Equities
Start	30/04/01	30/04/01	30/04/01	30/04/01	30/04/01
Finish	29/04/11	29/04/11	29/04/11	29/04/11	29/04/11
Return An.	6.65%	10.00%	8.32	-	1.68
Risk An.	3.62%	19.17%	9.48	-	9.69
Ret/Risk	1.84	0.52	0.88	-	-

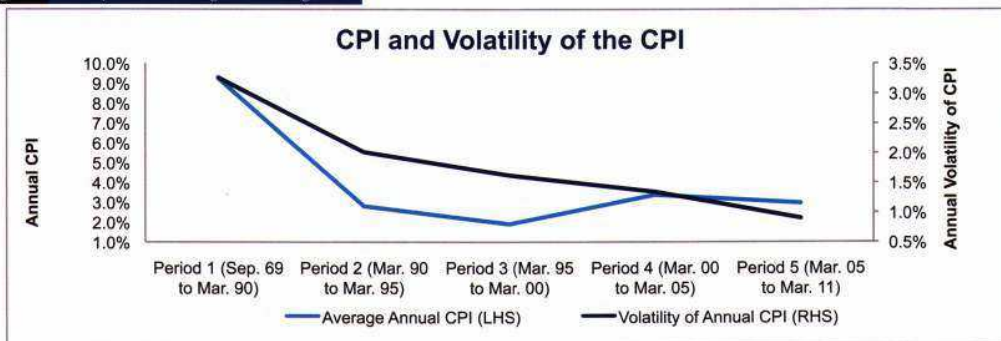
Source: FIIG Securities, UBS, Bancap

Figure 2 Australian annual CPI and annual volatility of CPI

Start	End	Period	Average Annual CPI (LHS)	Volatility of Annual CPI(RHS)
September 1969	March 1990	Period 1	9.26%	3.26%
March 1990	March 1995	Period 2	2.81%	2.01%
March 1995	March 2000	Period 3	1.91%	1.62%
March 2000	March 2005	Period 4	3.38%	1.34%
March 2005	March 2011	Period 5	2.97%	0.90%

Source: FIIG Securities, RBA

Figure 3 Recent performance of global banking stocks



Source: FIIG Securities, RBA

Note: LHS refers to the left hand axis in figure 2, and RHS refers to the right hand axis.