Ros Altmann: Rethinking pensions for a post-QE world

By **Ros Altmann** | 12th June 2023 11:00 am

Last year was dreadful for many pension investors. Traditional assumptions about investment risk and prudent investing failed.

The conventional advice that 'low risk' investors, especially those nearing pension age, should hold mostly bonds or gilts to avoid large losses let many with defined contribution pensions down, particularly those in workplace default funds.

Being switched out of equities or other supposedly riskier investments resulted in huge losses.

The year saw gilts fall 20% and index-linked gilts down more than 30%, while the FTSE All Share and FTSE 100 rose 1% (or 4.7% including dividends). Yes, the FTSE 250 lost nearly 20% but, overall, supposedly lowest risk assets proved riskier than ever imagined.

Are there lessons for advisers from this experience?

> Nobody knows what investment risk means in a post-QE world of higher inflation

The root cause of the bond market problems stems from the ongoing policy response to the 2008 financial crisis.

Quantitative easing (QE) saw all major central banks create massive amounts of new money to purchase fixed income securities. The aim was to force down long-term interest rates to avoid deflation and bolster growth by increasing asset values.

This massive monetary experiment was meant to be temporary but proved such a boon for governments (who could spend more despite rising deficits), as well as inflating asset markets (benefiting the wealthiest groups and financial firms), that it continued.

Further QE during Covid facilitated furlough affordability, but creating huge amounts of new money while the economy was almost shut down, with people having less chance to spend, resulted in too much money chasing too few goods – the classic definition of inflation.

Coupled with the Ukraine War and Brexit trade disruptions, this resulted in soaring inflation.

> Standard risk models may now be unreliable, not just temporarily but for the longer-term

QE theory held that central bank bond purchases would be unwound once the economic emergency had passed. This has not yet happened.

As the deflationary fears following the banking crisis are long gone, central banks should start the process of quantitative tightening (QT) by selling the bonds they hold. This would make bonds riskier than before, as the official underpin is removed, with significant implications for markets.

Financial advisers and pension investors must be careful assessing risk appetite and supposedly ‘safe’ assets. Standard risk models may now be unreliable, not just temporarily but for the longer-term, as QE ends and QT looms on the horizon.

So, unlike recent years, pension investors cannot rely on a natural buyer to underpin bond markets, especially with negative real rates, as inflation remains above nominal yields.

> The usual emphasis on holding large amounts of fixed income, axiomatic in auto-enrolment, may continue to let investors down

Bonds have become a relatively unattractive proposition and if the economy remains resilient, real assets such as equities and supposedly ‘higher risk’ investments may offer safer investment opportunities. We cannot be sure as there is no lived experience of unwinding QE.

Effectively, QE undermines traditional risk models. Post-QE markets could see previously lower-risk assets far riskier, while assets that were considered to offer ‘higher expected returns’ with greater risk may now be lower risk relative to traditional low-risk investments.

In truth, nobody knows what investment risk means in a post-QE world of higher inflation.

Capitalism and capital asset pricing models assume government bonds are lowest risk or ‘safe’ assets. But as the artificial depression of interest rates is being unwound, we cannot reliably predict which assets will be more volatile, which have lower expected returns and what their relative risk characteristics are.

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A broadly diversified portfolio, comprising assets seeking to capture more than one type of risk premium, may offer a lower risk, better return structure.

Exposure to equity risk, illiquidity risk, property, infrastructure and private markets could be more appropriate for people approaching pension age, especially if they still wish to benefit from market upside and pension death benefit tax advantages, with no intention of buying an annuity.

The usual emphasis on holding large amounts of fixed income, which is axiomatic in auto-enrolment workplace default funds such as lifestyle or target-date funds, may continue to let investors down.

It is time for a fundamental rethink on pension investment.

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