Is your pension fund at risk of blowing up your savings?

As the yield on government bonds have dropped, pension funds assumed new risks in complicated structured and highly illiquid investments.

Many areas of the asset management industry today look the other way than to the implications should inflation stay with us for longer. That is to say, the risk of being caught between rising financing cost, falling assets prices and no way out.

LIABILITIES **ASSETS**	Fixed rate	Variable rate
Liquid	I	II
Illiquid	IV	Double whammy

As the discount rate of future cashflows has dropped for the past some 40 years, asset prices automatically have increased. This bit of financial math has been the single most important driver of capital gains in for instance stocks, bonds and home prices.

As real interest rates over the 2008 financial and 2020 CoVID19 crisis fell below zero, asset prices accelerated higher. This started a frenzy hunt for long-term yields, particularly for pensions funds hit by another secular factor, the increased life expectancy of the retirees.

The hunt for yields

Little surprise then, that the search for yield has led many institutional investors in the direction of complicated structures of real estate, private equity, private debt, corporate debt structuring (eg. CLOs), infrastructure and sustainability projects. High net individuals have followed suit.

Providers of such products have been more than happy to meet the demand of yield hungry investors. Not least because these products have the added benefit of locking up client assets, often for decades.

Traditionally such investments offer a higher yield than good old long term government bonds. This yield premium is supposed to compensate for the liquidity risk of not being able to sell.

We estimate that allocation to such illiquid investments is on an all-time-high and institutional investment managers are only looking to increase that share further.

Selling what you can, not what you should

However, risk premia on many long-term investments have fallen below a point where investors are paid for the illiquidity of the assets. Inflation has increased to 5% since it became clear that the CoVID19 pandemic would be possible to control. As bond yields then started to rise, so did the discount factors used in calculating today's value of any long-term investment. When a higher discount factor is applied, the value of such investments falls.

Illiquid asset prices are not marked-to-market on a daily basis, but in a rather opaque and often infrequent manner, sometimes only once a year. Add that many of such asset are particularly sensitive to rising interest rates as they are based on high leverage. There is a near certain risk that today's prices (which prices) no longer accurately reflect the risk to investors.

In the pension fund industry, such risk will broadly be ignored until it becomes necessary to recalibrate portfolio risk. Some high net individuals could find themselves in an urgent need of liquidity. Both types of long-term investors would then find themselves in the same situation of being forced to sell liquid assets instead.

How come that so few long-term investors appear worried? Our best guess is that a) most market participants today have no real experience with inflation b) some participants are not really bothered since they just follow what their peers do c) you rarely gain any friends pointing towards an inconvenient fact.

Yet many find that there is really no reason to worry. Just in case they are wrong, the results will not become immediately visible. They will end where most bad investments often do; in your pension account (9 minutes watch, but worth it).

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