

LMM COMPASS



Dear readers,

We hope, you had a good start into the new Year 2017! This year as well we will assist you with regard to the management of your assets and to keep you on track. How do bond-portfolios react on a sudden rise in inflation expectations? Do inflation-linked bonds offer protection? If yes, under which circumstances? More details as well as some important comments you will find in this issue.



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THEMES



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- Markets and strategies



Topic

- Bonds with protection against inflation



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MARKETS AND STRATEGIES

The 4th quarter 2016 has led to a number of shifts within the asset classes. Primarily share prices increased further and the US markets and Emerging markets closed the year with an increase of more than 10%. On the other hand, interest rates went up towards the end of the year after having reached

a low in July. This resulted in price falls on bonds and other income-producing investments (such as real estate). Along with the increased investor confidence, the demand for gold has waned and the price dropped in the 4th quarter.

		Value	% QTD	% YTD	Currency	Index
Currencies	EUR/CHF	1.0721	-1.78	-1.48		
	EUR/USD	1.0517	-6.39	-3.18		
	USD/CHF	1.019	+4.90	+1.69		
	USD/JPY	116.96	+15.40	-2.71		
Bonds	Switzerland	136.23	-2.34	+1.32	CHF	SBI Total AAA-BBB
	Europe	247.01	-2.42	+3.32	EUR	Barclays Cap. Euro-Aggr.
	USA	1976.37	-2.98	+2.65	USD	Barclays Cap U.S. Aggr.
	EMMA	366.98	-3.27	+9.00	USD	Barclays EM Hard Currency Agg TR Unhedged USD
	Inflation linked	316.27	-5.35	+3.91	USD	Barclays Global Inflation-Linked TR Unhedged USD
	High Yield	1186.09	-0.19	+14.27	USD	Barclays Global High Yield TR Unhedged USD
	World	451.35	-7.07	+2.09	USD	Barclays Cap GA
Equities	Switzerland	2295.47	+0.80	-3.42	CHF	MSCI Switzerland Net
	Europe	196.34	+6.12	+2.58	EUR	MSCI Europe Net
	North America	5786.23	+3.38	+10.89	USD	MSCI USA Net
	Pacific	5218.96	-1.03	+4.18	USD	MSCI Pacific Net
	EMMA	379.84	-4.16	+11.19	USD	MSCI EM Net
	World	198.58	+1.19	+7.87	USD	MSCI AC World Net
Alternatives	Real Estate	3623.05	-5.39	+4.99	USD	FTSE EPRA/NAREIT Glb TR USD
	Raw materials	87.51	+2.54	+11.39	USD	Bloomberg Commodity Index
	Gold	1152.27	-12.42	+8.56	USD	Gold (1 ounce)
	Private Equity	2095.08	+2.34	+8.76	USD	LPX 50 Index
	Hedge Fonds	1203.46	+1.15	+2.50	USD	HFRX Global HF Index USD

Values in local currencies. Source Bloomberg, reference date 31.12.2016

The investment year 2016 closed on a positive note. Investment strategies with high weightings in US- and Emerging markets equities were the most compelling ones. The investment environment was

generally positive as well on the interest-rate side, especially in the case of riskier high yield- and emerging markets bonds.

Investment strategies in EUR

■ QTD ■ YTD

		4.25%	6.30%	EUR Growth
		2.50%	5.51%	EUR Balanced
		0.22%	4.51%	EUR Yield
		-2.11%	3.33%	EUR Fixed Income

Investment strategies in CHF

■ QTD ■ YTD

		2.27%	3.61%	CHF Growth
		1.19%	3.18%	CHF Balanced
		-0.26%	2.53%	CHF Yield
		-1.80%	1.62%	CHF Fixed Income

Calculation LMM, Period 01.01.-31.12.2016 (before costs)

BONDS WITH PROTECTION AGAINST INFLATION

During the months November and December 2016 interest rates have started to point upward and commodity prices had a strong upward trend as well. Many investors were surprised by the fast movement and they ask themselves whether this is a change in trend in interest rate markets and whether inflation, expected by the central banks, returns. The past has shown, that with a high probability, stocks, real estate and commodities can provide a hedge against inflation in the long-term. Bonds, however, would become under pressure in an environ-

ment of rising inflation and interest rates. Bonds protected against inflation ("Inflation-Linked-Bonds" or "ILB's") contain a price index clause, with which one tries to hedge the inflation risk. The face value of these bonds will be adjusted periodically according to the development of a price index (mostly consumer prices). This means that the repayment amount is aligned to the change of inflation rates, i.e. rising inflation leads as well to a higher repayment amount. In return, ILB's pay a lower coupon.

The following example illustrates the payout profile:

	1. Year	2. Year	3. Year	4. Year
Price index +/- in %	2 %	4 %	-1 %	2 %
Price index clause	$1.02 \times 1000 = 1020.0$	$1.02 \times 1.04 \times 1000 = 1060.8$	$1.02 \times 1.04 \times 0.99 = 1050.2$	$1.02 \times 1.04 \times 0.99 \times 1.02 = 1071.2$
Coupon payment	20.4	21.2	21.0	21.4
TOTAL Return flows	$20.4 + 21.2 + 21.0 + 21.4 + 1071.2 = 1155.2$			

Example: Face Value 1000, Coupons 2% p.a., Duration 4 years, Adjustment to price index ann.

It is obvious, that the price index clause protects the investor from (real) losses in times with strongly increasing prices. In the reverse case, i.e. during a period of negative inflation, bonds with a nominal value should be preferred.

IN PRACTICE

- **What speaks in favour of this asset class?**

ILB's can contribute an important part, when it comes to preserving the purchasing power and to be protected against an unexpected rise in inflation.

- **What is the best economic environment?**

The best environment is stagflation, this means inflation and falling interest rates.

- **What is the worst economic environment?**

In a rising interest rate environment without inflation, the inflation protection is not effective.

- **How can this asset class being implemented?**

Due to the complexity the use of investment funds is recommended. It is important to make

sure, that the indirect costs of the funds chosen are in relation with respect to the added-value of the asset class.

- **What are the challenges with ILB's?**

Quite often it is difficult to understand the pricing together with a lack of transparency. For the protection against inflation, the investor pays a premium in the form of a lower coupon. The indirect costs of the bond have to be checked before the purchase.

- **Are those bonds having an interest rate risk?**

Yes, ILB's as well can suffer losses if interest rates rise. They are however diminished by the indexing of the coupons and the nominal value.



LMM WINS AWARD IN DUBAI

On 1 November 2016, LMM has won the Award in the category "Wealth Management – Innovative client solution". The Award was presented on the occasion of the Wealth Briefing GCC Region Awards,

which was held by ClearView Financial Medit., London. We are delighted to receive this award and we are convinced that this will strengthen further our brand in the middle east region.

INSTITUTIONAL PENSION PROVISION DIALOGUE FALL 2016

Barbara Bertolini staged the Institutional Pension Provision Fall Dialogue with the friendly support of LMM Investment Controlling under the motto "Pension Provision at the Turning Point". Around 60 experts from Austria, Germany, Switzerland and Norway, managing assets of more than EUR 320 Billion, followed the invitation to come to Vienna in order to discuss with economists and high-ranking representatives of the EU, as well as with the supervisory authority. Industry experts such as Dr. Wolfgang Huber, Board member of BONUS Pensionskasse and

Vorsorgekasse, agreed that there will be an increased focus again on the costs for the asset management.

Cost transparency at all levels of the management, is in our experience, one of the prerequisites for an efficient implementation of the investment strategy.

Not only the cost structure of pension funds can be optimised with an independent cost audit, but it can also be demonstrated externally with the "LMM cost transparency seal of approval."

Publications

In the current issue 6/2016 of the magazine "Aufsichtsrat aktuell" (Linde Verlag), our branch managers Switzerland and Austria, Markus Häni and Stefan Kargl, are highlighting the requirements for the internal control system of a foundation. Their conclusion

is, that the functions of the Investment Controlling cover the most important areas of the internal control system of a foundation.

The entire article is available for download on our homepage.



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