



Analyst

Liang Shibin

+6565311516

liangsb@phillip.com.sg

Inflation and Fund Investing – 5 Key Ideas

Executive Summary

- **The presence of high inflation remains an inherent risk for many investors. With a structurally higher inflation to come, there are investment opportunities investors can look out for.**
- **Inflation Linked Bonds – Bonds which are designed to hedge against the domestic inflation risk. The principal and coupons will increase proportionally with inflation.**
- **Commodity Companies and Countries – Price inflation through rise in commodity prices tend to benefit common stocks of commodity producers (countries and companies).**

This Inflation is “Transitory”?

Rising global inflation is having profound effects on the macroeconomic environment today and investments for individuals. The question remains whether the presence of today's inflation is going to persist over the next few quarters or fizzle out in the near term.

The Federal Reserve (Fed) Chairman Ben Bernanke has labeled the current increase in inflation in the U.S. to be “transitory”. He blamed the recent spike in commodity prices for the rise in inflation in the U.S. and said it was not likely to last. Others are disagreeing

Some economists suggested that the recent inflation spike will persist. This is backed by a sustained increase in supply of paper currencies. Large scale of quantitative easing from the Fed have resulted in a surge in supply of the paper currencies in the form of U.S. dollar. From this angle, the purchasing power and value of the paper currencies (primarily the U.S. dollar) with respect to hard assets are poised to decline over the long term.

Whether today's inflation by itself is transitory or persistent remains debatable. The presence of high inflation remains an inherent risk for many investors. As a guide, nominal fixed income and cash generally do not offer the best protection against inflation. In this report, we will highlight 5 funds which may be potentially good investment candidates for investors who foresee structurally higher inflation to come.

Inflation At Home

Singapore's inflation last stood at 5 percent in March as housing and transportation costs continue to climb. The recent year-on-year gain in consumer prices matches the gain reported previously for February. Prices rose 0.1 percent from February, without adjusting for seasonal factors.

The Monetary Authority of Singapore said on April 14 that it would allow further tightening of monetary policy for the third time in a year. Inflation remains above the central bank's 3-4 percent forecast range this year.

Regionally, with Australia taking the lead, central banks in China and India are moving aggressively to curb price pressures as oil and food costs rise.



Inflation Linked Bonds – Hedging Inflation Risk in Developed Nations

Typically, inflation erodes the real value of nominal debt, particularly for those with fixed coupons. Rising inflation, together with rising yields, will make traditional bond investment less than attractive.

However, some bonds are designed to hedge against the domestic inflation risk. Inflation-linked bonds are bonds where the principal and coupons will increase proportionally with inflation. Therefore, inflation-linked bonds will outperform conventional bonds in periods of low economic growth and high inflation.

Inflation-linked bonds are gaining attention among the private and institutional investors. These investors need to be certain that their investments will retain their real value over the medium to long term. They could be saving for retirement or to match their investment income with long-term future inflation-linked liabilities.

In terms of liquidity, the market value for inflation-protected debt last stood at US\$1.7 trillion, with the US Treasury making up more than half of the market share. The main issuers of inflation-linked bonds are governments from developed nations. Issuances from governments of developed economies include:

- Treasury Inflation Protected Securities (TIPS) in the United States
- Index-linked Gilts in the United Kingdom
- Real Return Bonds in Canada

It is important to note that the abovementioned issuances do not offer any exposure to inflation in the emerging world. In particular, an inflation-linked bond fund may also utilize sophisticated financial instruments such as derivatives and interest-rate swaps contracts for hedging or speculative purposes.

Funds in focus: [Fidelity Global Inflation-Linked Bond Fund](#)

Chart 1: Fidelity Global Inflation-Linked Bond Fund Performance

Performance of Fidelity Global Inflation-Linked Bond Fund (since inception)



In an inflationary environment, inflation-linked bonds will outperform relative to comparable nominal bonds.

Source: Bloomberg, based on last price on 06 May 2011



Commodity Companies and Countries – Profiting From Inflation Risk

Energy prices and many other commodity prices have risen rapidly over the past few months. At the moment, the run-up in commodity prices looks to have stalled and we feel that attractive investment opportunities are rare in the physical commodity space. Nevertheless, high commodity prices may bring about several opportunities which investors can look to tap on.

Commodity Countries: Price inflation through rise in commodity prices tend to benefit common stocks from countries that are large commodity producers. Though not a direct exposure to a commodity based product, non-commodity related companies in countries such as Australia and Brazil will benefit from economic growth brought along by the higher country's revenues. As such, the wealth of resources in Australia and Brazil, together with respective political stability will point to a strong economic performance in an inflationary environment.

Funds in focus: [LionGlobal Australia Fund](#) and [BNP Paribas Parvest Equity Brazil](#)

Commodity Companies: Alternatively, investors can look to companies engaging in the extraction and sale of natural resources as well as the production process. This sector is commonly identified as the global resources sector. Resources companies are boosting new records for unit sales and revenues. Overall, the sector also boosted impressive profits in the most recent fiscal year, helped by rising commodity prices over the last 24 months.

Resources companies are also expanding production to take advantage of generational boom in demand and pricing for commodities. According to the Financial Times, global mining expenditure is set to hit a record US\$115 billion to US\$120 billion this year, above the peak of US\$110 billion set in 2008.

Funds in focus: [First State Global Resources](#) and [UOB United Global Resources](#)

Table 1: Performance of Commodity Related Equity Funds (in Local Currency)

	Currency	1 Yr Return %	3 Yr Return %	1 Yr Max Drawdown %	Expense Ratio
Lion Global Australia	SGD	15.15	1.42	-12.42	0.99
BNP Paribas Parvest Equity Brazil C	USD	22.24	-1.60	-9.90	2.12
First State Global Resources	SGD	21.67	-5.91	-11.11	1.75
UOB United Global Resources	SGD	14.14	-3.15	-12.24	2.21

Commodity producers (countries and companies) are benefiting from rise in revenues on increasing sales volume.

Source: Financial Express, based on last price on 06 May 2011



Risks in Equity Investments

There are two key risks that investors should take note of in the above equity fund investments.

Single country or sector funds concentrate their investments in a specific country and industry. As such, the recommended funds may be subject to greater risks and fluctuations than a portfolio representing a broader range of equities from different industries.

We would also wish to highlight that the basic assumption in the report is that global inflation does not get out of control. High inflation will devalue corporate earnings and depress stock prices as a result. In particular, resources companies may suffer from higher exploration and operating costs without being able to pass along price increases to end users in a timely manner.

Conclusion

To conclude, inflation can cause uncertainty about future prices, interest rates and exchange rates, dampening the general business environment. Thereby, this report offers relevant fund investment ideas for investors looking to play out the inflationary environment and/or hedging the inflation risk.

For investors looking to hedge the inflation risk, Fidelity Global Inflation-Linked Bond Fund will be a conservative choice. On the other hand, investors looking to profit substantially along with the rising inflation can look to commodity producers (countries or companies). The other 4 recommended funds include LionGlobal Australia Fund, BNP Paribas Parvest Equity Brazil, First State Global Resources and UOB United Global Resources.



GENERAL DISCLAIMER

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities Pte Ltd shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

This publication is solely for general information and should not be construed as an offer or solicitation for the subscription, purchase or sale of the securities, and specifically funds, mentioned herein. It does not have any regard to your specific investment objectives, financial situation and any of your particular needs. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of any person or group of persons acting on such information and advice. Unit Trusts distributed by Phillip Securities Pte Ltd are not obligations of, deposits in, or guaranteed by, Phillip Securities Pte Ltd or any of its affiliates. No action should be taken without first viewing the details in a fund's prospectus. A copy of the prospectus can be obtained from Phillip Securities Pte Ltd or online at www.eunittrust.com.sg. Past performance is not necessarily indicative of future returns. Investments in unit trusts are subject to investment risks, including the possible loss of the principal amount invested. Investors should note that the value of the units and income from the fund may rise as well as decline. Investors should also note that there are limitations whenever performance is stated or comparison is made to another unit trust or index for any specific period as no funds or indices are directly comparable.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any investment product described in this material is suitable or appropriate for the recipient. Recipients should be aware that the investment products described in this publication may involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Whilst we have taken all reasonable care to ensure that the information contained in this publication is accurate, we do not guarantee the accuracy or completeness of this publication. Any advice contained in this publication is made only on a general basis and is subject to change without notice. We have not given any consideration to and have not made any investigation of the investment objectives, financial situation or particular needs of any specific person or group of persons as we are not in possession of any such information. You may wish to seek advice from a financial adviser before making a commitment to purchase the investment products mentioned. In the event you choose not to seek advice from a financial adviser, you should consider whether the investment product is suitable for you. Any unit trusts mentioned in this publication is not intended for U.S. citizens.

DISCLOSURE OF INTEREST

Statement pursuant to section 36 of the Financial Advisers Act - Phillip Securities Pte Ltd, its directors and employees may have interest in the securities recommended herein from time to time, and its associates and connected persons may also have positions from time to time. Opinions and views expressed in this report are subject to change without notice.

PhillipCapital is a group of companies who together offer a full range of quality and innovative financial services to retail, corporate and institutional customers. Member companies in Singapore include Phillip Securities Pte Ltd, Phillip Securities Research Pte Ltd, Phillip Financial Pte Ltd, Phillip Futures Pte Ltd, Phillip Trading Pte Ltd, Phillip Capital Management (S) Ltd, CyberQuote Pte Ltd, International Factors (Singapore) Ltd and ECICS Ltd.

Information on any and all independent PhillipCapital members and the respective financial services they offer can be obtained through the following website – www.phillip.com.sg. Members can otherwise be identified by their authorised use of PhillipCapital brand name along with their own name in their documentation and literature.