



## Inflation

*What it is, why it's here, why it's staying, and how to deal with it*

UK money supply (M4) trillions (1982 £0.15 trillion - 2010 £2.2 trillion)



Source: Bloomberg



**Dr. Ana Armstrong , Chairman Distinction Asset Management**

*“Consistent and persistent inflation is the inevitable outcome from the suffocating level of debt owed by the West”*



**Patrick Armstrong, CFA , Fund Manager Distinction Asset Management**

*“Inflation is the most important issue investors will need to deal with over the next decade”*

The UK has gross debt equal to 75% of its GDP and the US is at 100%. Both countries are running massive fiscal deficits and the IMF expects debt to continue to rise at a faster rate than economic growth over the next three years.

From Ancient Rome to post-World War I Germany, many empires and countries have debased their currencies when faced with massive debt or other obligations. We believe this strategy is part of the end game for most of the West.

UK M4 (money supply) has risen from £150 billion in 1982 to £2.2 trillion today. The money supply has grown at 10% per annum, which is more than 7% per annum faster growth than the economic growth over that period.

Short-term interest rates have been near zero % since 2008.

Inflation has been above the Bank of England's target rate in 52 of the past 61 months (to May 2011).

We expect the Bank of England and US Federal reserves to keep interest rates near zero for the next year.

Previously disinflationary forces from emerging markets are now inflationary forces in the West.

We expect UK inflation will average at least 4% per annum over the next 10 years and will have periods where it spikes considerable higher.

We expect UK RPI will move past 6% and UK CPI will move past 5% by Q4 2011.

Bonds are delivering negative real yields and broad-based equity exposure is not an effective hedge vs. inflation when inflation moves past 5% per annum.

A diversified approach with allocations to a range of assets and strategies is the most robust method to grow capital at rates higher than inflation.

## **Distinction Real Return**

**Funds:** Distinction Asset Management offers a range of multi-asset real return funds managed by Armstrong Investment Managers. These funds invest across a wide range of regions and asset classes and employ a wide range of strategies to target consistent real returns above inflation.

Current allocations include: agricultural commodities, precious metals, inflation-linked bonds, short duration high yield bonds, dividends swaps, Asian currencies, branded consumer goods companies, high yielding equities, Canadian and Brazilian equities.

We believe investors must position their portfolios for an inflationary environment. Cautious investors who have been drawn to the safety of cash and Government bonds are destroying the real value of their wealth.

***Most funds target returns vs. a benchmark or peer group while investors need to target returns in excess of inflation to grow the real value of their wealth.***

## What causes inflation

A growth in the amount of money available or debasing one's currency inevitably causes inflation. The *History of inflation* section will show many examples of this. In times when a government has significant obligations and these obligations are growing faster than revenues and tax receipts, governments have often attempted to monetise their debt – essentially in times when gross debt and annual deficits were not manageable through growth in the economy. Quite often these instances of increasing obligations are the result of a great crisis, often revolving around war.

### *The theory of inflation*

There are two main schools of economists. The first camp, known as Monetarists, say there is a fixed amount of goods and the supply of money determines the price paid for those goods. Another branch of economists, called Keynesians and neo-Keynesians, believe there are two types of inflation, one stemming from demand pulling inflation higher or from costs pushing inflation higher.

Most economists and central banks policies favour/target a low and steady rate of inflation. A small regular increase in prices allows the economy the flexibility to reduce the severity of economic recessions by enabling the labour market to adjust more quickly in a downturn. Generally wages are hard to reduce, but an element of inflation allows real wages to fall while nominal wages stay fixed.

Factors determining the rate of inflation during extended periods of low to moderate rates of inflation are often attributed to fluctuations in real demand for goods and services, or changes in available supply.

However, the consensus view is that a long sustained period of above moderate inflation is almost always caused by money supply growing faster than the rate of economic growth.

**Deflation:** Reduction of the general level of prices in an economy.

**Inflation:** A general increase in prices and fall in the purchasing value of money.

**Stagflation:** Persistent high inflation combined with high unemployment and stagnant demand in a country's economy

**Cost push inflation:** type of inflation caused by substantial increases in the cost of important goods or services where no suitable alternative is available.

**Demand pull inflation:** type of inflation caused by increased total demand for goods and services exceeding their total supply.

**Monetarists:** Economists who believe that variations in the rate of inflation are usually caused by changes in the supply of money.

**Keynesians:** Economists who believe changes in aggregate demand lead to changes in the price level. Inflation comes from rising demand for goods or higher costs for producers.

**Monetisation:** A strategy where a Government prints new money to pay back old debt

## Roman Empire

The silver denarius was introduced by Augustus, the first Roman Emperor, at the end of the 1st century BC. At this time the coin was about 95% silver. The denarius was used for 200 years as the basic medium of exchange in the empire. However, beginning with Trajan in 117 AD, successive emperors replaced the percentage of the silver in the denarius with base metals such as bronze or copper and prices of goods rose dramatically in response. By then, the denarius was diluted to about 85% silver and during the age of Marcus Aurelius in 180 AD it was down to about 75%.

In Septimius Severus's time at the beginning of the 3<sup>rd</sup> century AD it had dropped to 60%, and his son and successor Caracalla evened it off at 50/50. But the real crisis came after Caracalla, between 258 and 275 AD, in a period of intense civil war and foreign invasions. The emperors simply abandoned, for all practical purposes, a silver coinage. By 268 AD there was only 0.5% silver in the denarius. Prices in this period rose in most parts of the empire by nearly 1,000%.

The situation did not change even when in 301 AD Emperor Diocletian attributed the rapid inflation to the greed of his people. He threatened death against any merchant who charged more than official limits he created. He fixed the price at 50,000 denarii for one pound of gold. Ten years later it had risen to 120,000 denarii and he finally abandoned the silvered coinage, which by this time was simply a bronze coin dipped in silver rather quickly. In 324 AD, it was 300,000 denarii for a pound of gold. In 337 AD, the year of Constantine's death, a pound of gold bought 20,000,000 denarii.

Despite the threat of death, inflation continued for another century until a gold coin known the bezant was introduced. As currency fell in purchasing power, the equivalent purchasing power of gold had remained stable whereas all this other coinage just became increasingly worthless.

The economy moved towards a barter economy where salaries were paid in food and taxes were also paid in kind. This had a negative impact on the potential for growth in the economy and the Emperor could not pay soldiers as efficiently as he had in the past. Many previous landholders left their land as they could not pay taxes and a significant decline in the Roman economy followed.

Early currencies were minted with precious metals, to give them intrinsic value as well as a medium of exchange

In times of economic hardship or periods where large obligations had been amassed by the state the amount of precious metal in each coin has been reduced

Debasement of a currency was once a literal event. The term is continued to be used figuratively when central banks attempt to devalue their currency through increasing money supply.



Debasement of the denarius

Emperor	Year	% Silver
Nero	54	<b>94</b>
Domitian	81	92
Vitellius	86	81
Trajan	98	93
Hadrian	117	87
Antonius Pius	138	75
Marcus Aurelius	161	68
Septimus Severus	193	50
Elagenbalus	218	43
Alexander Severus	222	35
Gordian	244	28
Philip	244	0.5
Claudius Gothicus	268	<b>0.2</b>

Source: Nomura, Pivotal Events

## UK History of Inflation

### 12<sup>th</sup> century

The Norman kings of England took steps to maintain the quality of their coinage, not so much with a view to controlling inflation but to stem the flow of silver out of the currency and into the pockets of those that operated the mints (moneymen). The minting of money was the sovereign's privilege and the king was able to earn revenue from the process by instructing the minting of coins with a small percentage of other alloys mixed in to the silver or gold. This was known as seigniorage. However, under Henry I the quality of England's silver coins fell dramatically. In 1124, 94 of these moneymen were called to account for debasing the currency and had their right hands and one testicle removed. The quality subsequently improved.

### 1470-1620

Western Europe experienced a major inflationary cycle known as the 'price revolution' during the fifteenth, sixteenth and seventeenth centuries. This was attributed to two causes: a population boom following years of plague and Black Death; and the influx of gold and silver from the New World. The former put pressure on food prices as agricultural production had contracted sharply as the population was decimated by disease. In the latter case, the increased supply of precious metals meant that the relative value of the gold and silver coins decreased. Providers of goods and services therefore required more coins by way of compensation.

### 1542-1551

The Great Debasement occurred under the reigns of Henry VIII and Edward VI. In 1542 the value of the silver content of English coinage averaged 75% of its face value. By 1551 this had fallen to 25% of face value. The inflationary effect of this policy was compounded by 'Gresham's law' which dictates that bad (or overvalued) currency drives out good currency. In other words, households and businesses tend to hoard the good currency, taking it out of circulation, and pay debts with the bad currency.

### 1793-1815

Britain was at war with France. In 1797 the country suspended the Gold Standard, as there was not enough gold to match the money being printed to finance the war. In 1800 prices jumped by 36%, which is the highest inflation the country has ever experienced based on massive Government spending on arms. In 1821, the Gold Standard was re-introduced and price stability returned.

English kings had the right of seigniorage, which was a form of tax for issuing the currency. In essence a small amount of other alloys were included in freshly minted coins, which the king keeping the substituted weight in gold/silver.

If the currency become debased, Gresham's law states that 'bad' (i.e. impure) currency drives out 'good' currency as people rationally use the debased coins to settle their debts and hoard the higher quality coins

Source: Bank of England, Bloomberg, AIM

## 1854-1856

The Crimean War caused prices to rise by more than 15% in 1854.

## 1914-1918

The First World War saw the UK end the currency's link to gold. The war effort necessitated the printing of money and the accumulation of massive debt. During the war prices doubled versus pre-war prices.

## 1921-1933

The post-war depression saw deflation for over a decade. In 1925 Winston Churchill returned the link between the pound and gold. Despite the link, the following six years saw prices fall. The deflationary spiral reduced economic growth, as people continually deferred purchases believing prices would fall as they waited. In 1931 the UK departed from the Gold Standard again and unemployment rose to 22% in 1932. The 12-year period saw prices fall by almost 40%.

## 1939-1945

The Second World War saw the return of massive government spending and inflationary pressures returned. Prices rose by over 50% during the War. The value of the pound was fixed against the US dollar at a rate of \$2.80.

## 1967-1988

In 1967 the pound devalued by 14% to \$2.40 to boost economic growth by making British exports more competitive, but this stoked inflation as imports became more expensive. On October 17, 1973 the Organization of the Petroleum Exporting Countries (OPEC) made decision to stop fuel supply to the US, Japan, and Western Europe in response to America's support of Israel in the Yom Kippur War. Oil prices reached \$5.11 per barrel, and \$12 in mid 1974. Stocks listed in London, as measured by the FT30 index, fell in value by 73% during this period. Inflation averaged 13% per annum in the 70s, peaking at 25% in 1975.

In 1979 on the back of the revolution in Iran, oil prices moved from \$15.85 to \$39.5 per barrel. During the following recession oil fell back below \$10 per barrel on decreased demand.

Inflation remained high throughout most of the 80s and goods costing £10 in 1969 cost £61.38 in 1988, as measured by RPI. (10% per annum growth)

Linking a currency to gold has been used for thousands of years to give credibility to currency.

This link often ends when the government needs to print currency to meet obligations. Wars are often the cause of runaway debts.

Source: Bank of England, Bloomberg, AIM

## 1992-2010

In 1992 the Bank of England (BoE) set its first official inflation target of 2.5% per annum (RPI ex mortgage costs). In 1997 the BoE was given independence and the Monetary Policy Committee was given power to set interest rates. In 2004 the new target for inflation became 2% per annum as measured by CPI. The period saw inflation stabilise at levels near the MPC's targets.

In 2007, the oil price escalated to roughly \$140. Property bubbles and the monetary policy of America led to a financial crisis in the middle of 2007. In October 2008, it expanded worldwide and became the worst financial downturn since Great Depression (1929-33). Western central banks lowered interest rates to near 0% and the US and UK embarked on quantitative easing programmes purchasing hundreds of billions of their treasuries. In 2009 S&P lowered the outlook for the UK's AAA status to negative.

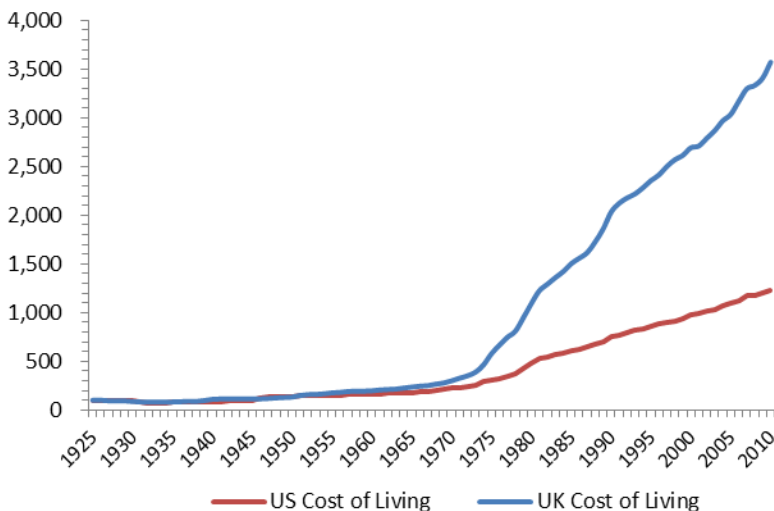
## 2011

Uprisings and unrest in the Middle East and North Africa, in particular in major oil producer Libya, have recently sent the oil price over \$100 per barrel. Uncertainty over the duration of the crisis in Libya or the outcome are likely to ensure that production from the country remains on hold as foreign workers stay away. Meanwhile, real fears remain about unrest spreading to other oil producing nations. The UK has been unable to meet its inflation target and is running a double digit deficit. The US has seen inflation rise to 3.6% and its gross debt has risen to a level equalling its annual economic output.

Rising commodity prices are responsible for a large proportion of the inflation we experience. This can be felt directly in such things as fuel and food prices or indirectly through manufactured goods or commodity intensive services such as transport.

Central banks aim to control inflation mainly through domestic monetary policy – increasing or cutting interest rates – but many price pressures are imported.

## The rising cost of living



Source: Barclays Equity Gilt Study 2011

Source: Bank of England, Bloomberg, AIM



We manage a range of funds which are designed to consistently beat inflation using a very flexible investment approach. My first experience at beating inflation came during my years as a student at the university of Belgrade in 1993-1994.

I grew up and did my undergraduate degree in Belgrade, in the former Federal Republic of Yugoslavia. Civil war led to massive deficits and pressures from a huge expansion in the money supply led to inflation spiralling out of control. In January 1994 inflation peaked at 331,000,000%.

As a typical poor student, many luxuries were not possible. However myself and several friends managed to use the rapid inflation to our advantage. We would meet for coffee and dinner at the nicest hotel in the city and enjoy quite lavish evening. The bill would come, and we paid by cheque including a very nice tip for the staff.

By the time the cheque cleared from my bank account it was essentially a meaningless amount of money.

*Dr Ana Armstrong*

## Recent hyper-Inflation

**Germany, 1923** Wholesale prices increased by 85,000,000,000% in a year.

**Russia, 1923** Inflation reached 60,804,000% following the Russian Revolution.

**Greece, 1944** The Government printed money to pay for expenditures rather than collecting taxes. Inflation peaked at 130,000%. A single drachma note was typically changed hands more than 6 times per day in 1944.

**Hungary, 1946** Prices quadrupled every day.

**China, 1945-48** 80% of Government spending was on the military during the civil war in 1948. Inflation peaked at 2,372%

**Argentina, 1980's** Massive fiscal deficits led to a decade long period of hyper-inflation. Inflation grew at 750% per annum for the 80's.

**Yugoslavia, 1994** Inflation peaks at 331,000,000% in January 1994 following civil war

Source: Bank of England, Bloomberg, AIM

## Savers punished

Inflation can cause a reduction in the real value of savings – especially if real interest rates are negative (where inflation is above cash and bond rates). On the other hand, borrowers see the real value of their debt diminish. Inflation, therefore, favours borrowers at the expense of savers especially in periods of unexpected inflation, or when interest rates are below the cost of inflation.

People on fixed incomes lose out. Many pensioners have pensions linked to inflation, but the CPI and RPI baskets are not representative of pensioners' spending habits (see page 11, 'Is inflation the same for everyone?'). This has often been negative for pensioners as their cost of living has risen more than the national average over the past decade.

## Economic volatility

High inflationary growth is often followed by a recession. Inflation may magnify the swings in the economy as high economic growth in very inflationary periods is unsustainable. Most governments and central banks target a positive but low and steady rate of inflation because of this.

As inflation rises corporations and people have more difficulty in planning their budgets. When inflation is high firms are often less willing to make investments because of the uncertainty about the future costs. This uncertainty can lead to lower rates of economic growth over the long term.

## Higher taxes

The lower and middle class are often hardest hit by inflation. The amount of tax people pay increases if there is inflation. As wages rise more people will slip into the top income tax brackets.

## International competitiveness suffers

A sustained period of inflation leads to rising wages. This can make a country or region less competitive, leading to rises in imports and fall in exports. In the long term this is usually offset by a decline in the exchange rate, but in the short term the loss of competitiveness may be magnified through rising interest rates, which further hurt competitiveness and rising interest rates often push a currency higher.

## UK Bonds

A UK 10 year government bond is currently yielding 3.4% (30/06/11). UK RPI has been 5.2% (05/11) over the past year.

Should inflation stay at 5.2% per annum, a tax-exempt investor who buys a £1000 10 year UK bond and reinvests coupons will have £1370 after 10 years. A tax payer with a 40% income tax rate will have £1207 after ten years.

Goods which cost £1000 will cost £1660 in 10 years. The tax exempt investor will only be able to purchase 82% of what he could have purchased initially. If the investor pays 40% income tax, he will only be able to purchase 75% of the initial basket.

**Table:** Price of a basket of goods in future with varied inflation assumptions

£1000	Current				
	2%	4.5%	5.2%	6%	8%
10yrs	1,219	1,553	1,660	1,791	2,159
20yrs	1,486	2,412	2,756	3,207	4,661
30yrs	1,811	3,745	4,576	5,743	10,063

Source: AIM, May 2011

## Impact on asset classes

Not only does inflation eat into the real value of savings and investment returns it also has significant impact on pricing of different asset classes.

Almost all investors aim to increase their long-term purchasing power.

Inflation can adversely affect *fixed income* investments. Rising inflation will generally lead to rising nominal interest rates to preserve the real rate from bonds. Given the inverse relationship of yields to prices, investors will also see a fall in the capital value of their investments.

*Equities* have often been a good investment relative to inflation over the very long term and have beaten inflation by about 5% per annum since 1899, according to the Barclays Equity Gilt Study.

Companies can raise prices for their products when their costs increase in an inflationary environment and higher prices may lead to higher earnings. However, over shorter time periods, stocks often fall in times of rising inflation. When inflation rises beyond a band or level the central bank is comfortable with, interest rate rises may follow which dampen the potential for economic growth. In times of sharp or unexpectedly high inflation, it may create uncertainty about the economy, as well as higher risk aversion and lower equity prices.

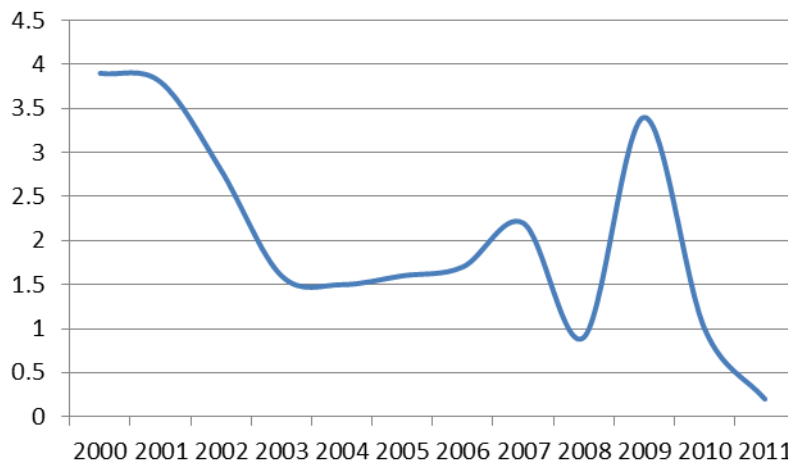
## Bonds

Most bonds pay a fixed level of income. If inflation is rising the real value of these coupons becomes less attractive. Some governments and companies issue index linked bonds. The coupons paid by these bonds are linked the level of inflation.

## Equities

Equities can provide a form of protection against inflation as companies' earnings tend to rise in line with higher prices. However, historically, if inflation rises above 5% price/earnings multiples tend to fall and this more than offsets higher nominal earnings in the short term.

Global Real Yields



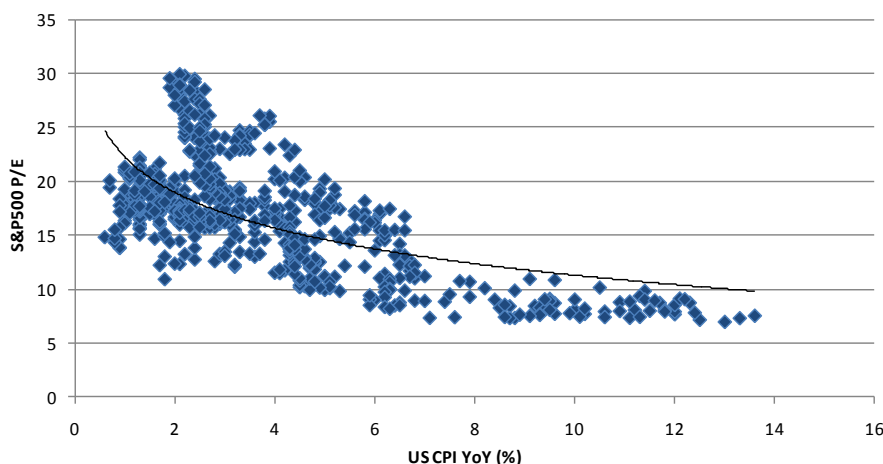
Source: Barclays, Bloomberg.

*Investors are no longer receiving a premium vs. inflation in most Government bonds*

In the short term the most important factor affecting equities is the market multiple.

The chart below shows that if annual inflation exceeds 5% then equity multiples (price times earnings) tend to contract, which in most cases means falling equity markets.

## US historic P/E and CPI (1958-2010 Monthly)



Source: Bloomberg. Annual Historic Price to Earnings and CPI

Prices for *commodities* generally rise with inflation and are often the cause of inflation

*Property* is considered to be a good inflation hedge and property prices in many Western countries have raced ahead of the cost of living in recent decades. This was mainly fuelled by strong demand due to the easy availability of finance, and limited supply. While property yields may begin to look unattractive in the face of higher-than-expected inflation, upwards only rent reviews in the UK and inflation linked rents in Continental Europe can mitigate this negative impact.

### Commodities

There is a very strong relationship between commodity prices and inflation, given that raw material and fuel prices have a direct and indirect bearing on CPI and RPI readings.

### Property

Property prices in the UK have far outstripped the cost of living over the past two decades and living costs are part of the RPI calculation.

### Alternatives:

Inflation linked bonds and inflation swaps are ways more sophisticated investors can hedge against inflation. Dividend from equities have tended to rise in line with economic growth and inflation. Swaps on dividends from equities are another alternative way to gain exposure to an asset which tends to nominally rise with inflation.

## Is inflation the same for everyone?

Broad measures of inflation such as the consumer price index or retail price index are designed to reflect the aggregate inflation level in the general economy. No summary inflation measure for a large population group will precisely account for the experience of each member of that group. Different individuals and subgroups may have very different individual inflation baskets.

Because there is substantial variation in inflation rates among individuals and between different groups of individuals, any single measure of inflation is going to over – or under – state the inflation actually experienced by many.

The Alliance Trust Research Centre tracks monthly UK inflation data and analyses how it impacts different age groups. The following table shows how spending weights in some of the key sub-baskets vary depending on your age.

### Spending weights in CPI basket (%) for each age group

Age group	Food	Electricity	Gas	Petrol	Clothing
Under 30	9.6	2.2	1.9	4.1	4.9
30-49	11.8	2.4	2.2	5.2	6.2
50-64	12.5	2.6	2.5	5.6	5.6
65-74	15.5	3.4	3.2	5	4.2
75+	17	4.4	4.4	3.1	3.4

Source: The Family Spending Survey: 2010 and Alliance Trust

For most of the past 20 years the Western world has been importing deflation from low cost manufacturing bases such as China. For example, the Clothing and Footwear sub-basket in the CPI calculation has roughly halved in value since 1988 (a long-term average of -3.1% per annum) compared to the overall CPI index which has doubled in that time (see chart on next page). The other area to have actually fallen in value since 1988 is Communication.

So while younger people have been benefiting disproportionately from goods and services that have been falling in price (clothing, online goods and services), older people have been suffering disproportionately from higher inflation in the areas where most of their income is spent (food and fuel).

Rates of inflation vary between socio-economic and age groups

Older people currently suffer from higher rates of inflation than the young

## Varying rates of inflation



Source: Office for National Statistics. CPI baskets rebased to 100 in 1988.

Using its own age group weights Alliance Trust calculates an inflation rate for each age group. Data from the past six months show that inflation consistently runs at a higher rate for older people than it does for younger generations.

## Annual inflation rates (%) for each age group

Age group	May '11	Apr '11	Mar '11	Feb '11	Jan'11	Dec'10
<b>Under 30</b>	4.8	4.8	4.6	4.7	4.4	3.6
<b>30-49</b>	5	5	4.9	5	4.6	4
<b>50-64</b>	5.1	5.1	5.1	5.2	4.8	4.1
<b>65-74</b>	5.2	5.2	5	5.2	4.8	4
<b>75+</b>	4.9	4.8	4.7	4.9	4.4	3.8

Source: The Family Spending Survey: 2010 and Alliance Trust

Also, according to Age UK, a charity, since the beginning of 2008, the over 55s have experienced price rises almost 2% greater than that suggested by the official RPI measures – and this gap widens as people age.

Older people are not only hit by higher inflation, but are penalised by the negative real yields on cash and on bonds as those people have a disproportionate amount of their income coming from savings, which have been affected by record low interest rates.

Clothing and footwear prices have halved since 1988 while transport costs have increased 2.5 times

Those close to or in retirement have consistently suffered from higher than average inflation

## Rising interest rates & government intervention

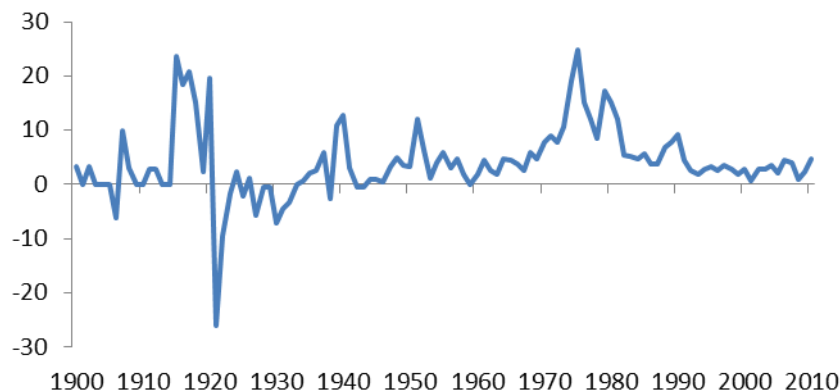
As high inflation is deemed unacceptable governments may take steps to reduce it. Higher interest rates are a normal response from a central bank facing inflationary pressures and governments often reduce spending and investment to cool an economy which is suffering demand pull inflation. This reduction in aggregate demand will lead to a decline in economic growth and lower employment.

Low inflation is often seen as harmless or even beneficial because it allows prices to adjust more easily and is viewed as conducive for economic growth.

Central banks in most developed markets are independent of their governments

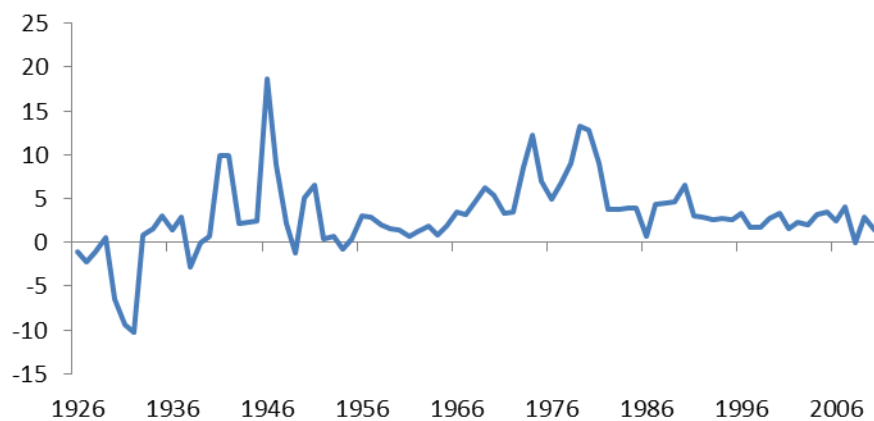
However, governments may use other tools such as changes to fiscal policy to influence inflation

### UK Cost of Living



Source: Barclays Equity Gilt Study 2001

### US Cost of Living



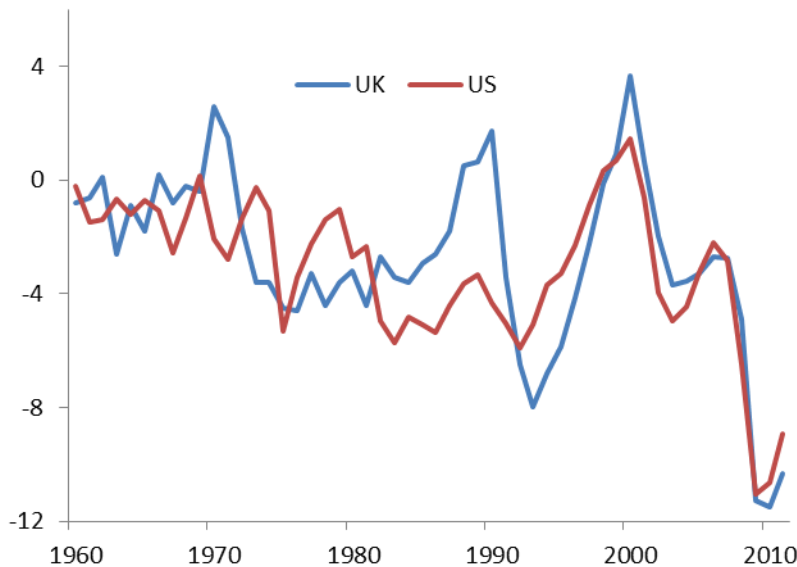
Source: Barclays Equity Gilt Study 2001

## Current environment

Massive debts and fiscal deficits in advanced economies have been accompanied by loose monetary policy since the financial crisis in 2008. We believe the current environment can be described by Friedman's "liquidity effect", where an increase in money supply leads to an increase in demand for securities, increasing their price and lowering interest rates.

An increase in money supply will have an expansionary effect on real incomes and price levels, which will then tend to lead to increased interest rates. However, in the short run an increase in the money level will increase expectations of inflation. Higher anticipated inflation will increase nominal interest rates. This "price anticipation effect" could even have a stronger impact than low interest rates, which is consistent with empirical studies of countries with high inflation where interest rates are also the highest.

### US and UK Fiscal deficit as % of GDP



Source: Bloomberg, OECD

"Inflation is the one form of taxation that can be imposed without legislation"

Milton Friedman

### CPI targets and current readings

UK target: 2%  
Actual: 4.5%

Euro-zone target: <2%  
Actual: 2.7%

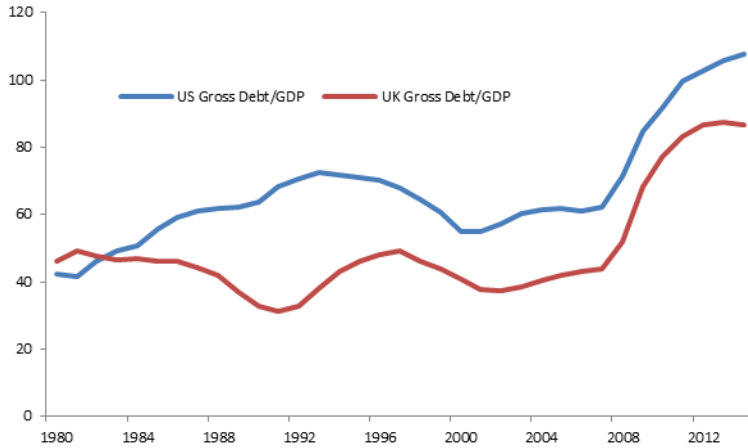
US Target: 1.5-2.0%  
Actual: 3.6%

Source: Bloomberg. Data for May 2011

## Current environment

The effects of zero interest polices, quantitative easing, the printing of money and rapidly rising energy and food prices are all inflationary forces which need to be dealt with.

### IMF Estimates of US and UK Gross debt to GDP

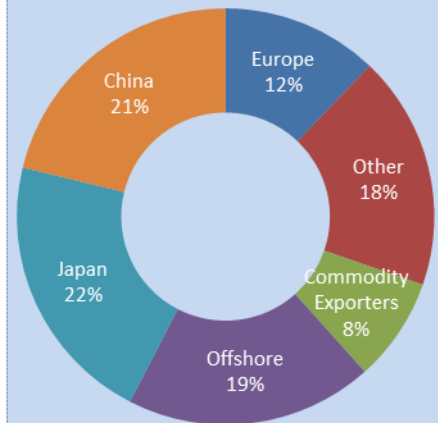


Source: Bloomberg, 1980-2014

Unfortunately most major Western Governments are struggling with massive fiscal deficits and ballooning national debts. If you put yourself in the shoes of a politician it is very easy to understand why inflation will continue to be very sticky on the upside.

China and Japan now own over 20% of the US debt. Because of large foreign ownership we believe its it far more likely the US will monetise its debt.

### Foreign ownership of US treasuries



Source: ING, Bloomberg

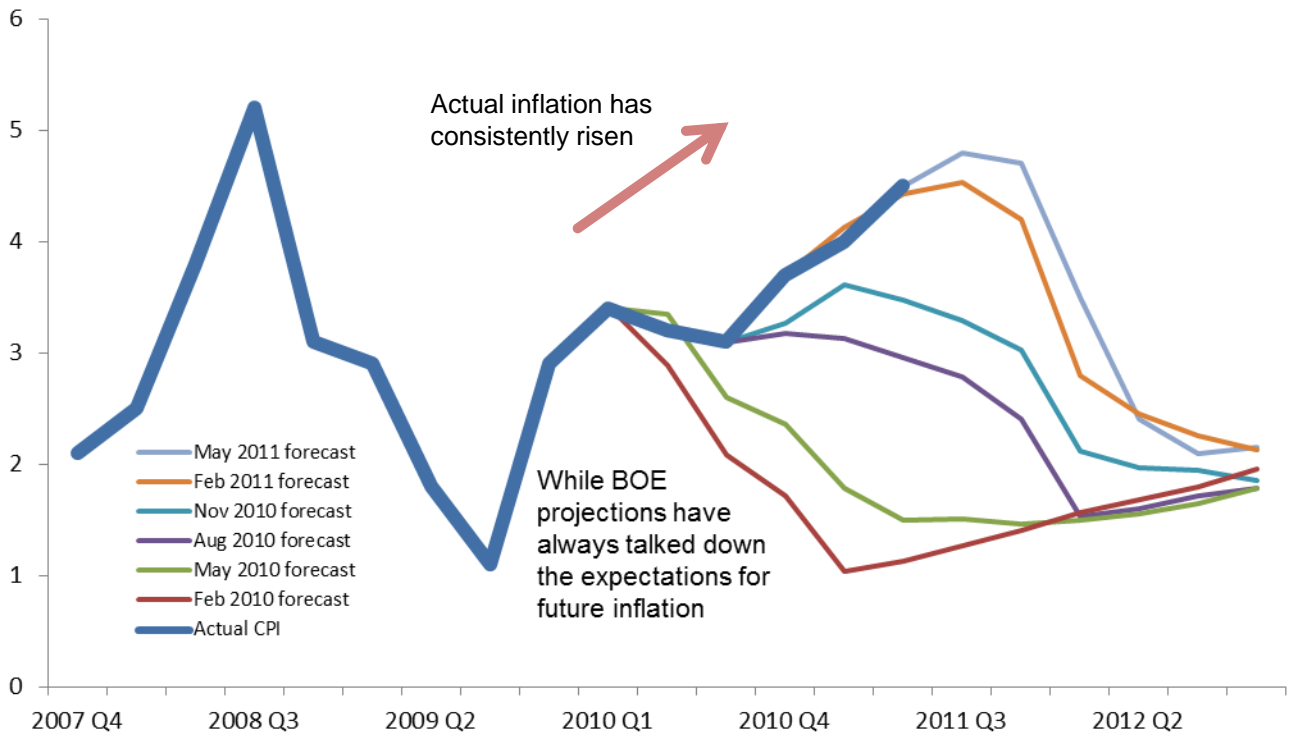
The US is in a scenario where they are completely incentivised to destroy the purchasing power of their currency to reduce the real value of their debt

The Bank of England (BoE) has consistently underestimated future inflation. The chart below shows that in its February 2010 Inflation Report the BoE projected that annual CPI inflation would be just over 1% in the first half of 2011. The actual readings in both April and May 2011 have been 4.5%.

In February 2010 the BoE predicted that CPI inflation would be 1% in May 2011. The actual reading was 4.5%.

The most recent Inflation Report published in May 2011 forecasts inflation peaking at 4.8% in the third quarter of 2011 before falling rapidly to just above the 2% target rate a year later. This rapid fall in inflation estimates is predicated on the removal of base effects such as the VAT rise at the start of 2011 and higher commodity prices.

## BoE inflation projections vs. realised CPI inflation



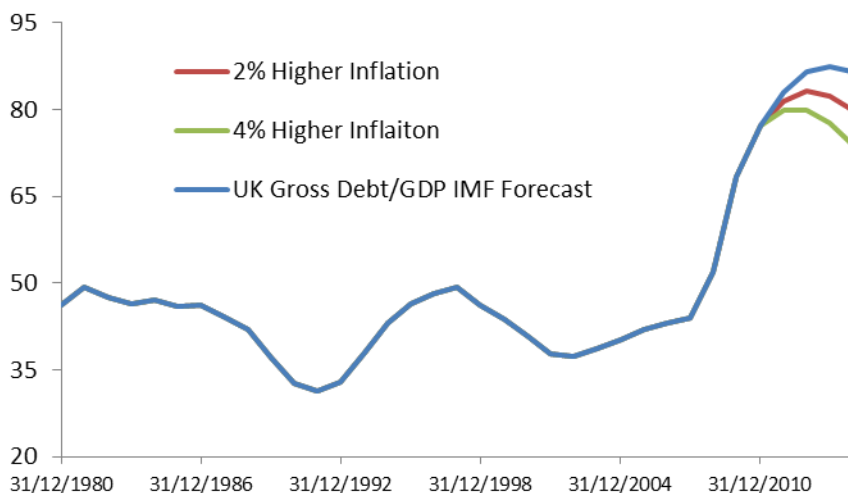
Source: Bank of England Inflation Reports

We believe the BoE will help the UK shave about one percentage point off its debt-to-gross domestic product (GDP) ratio this year by keeping interest rates low even as inflation surges ahead.

Gross debt will rise to 83% of GDP this year according to International Monetary Fund projections based on an inflation rate of 4.2%.

We do not believe central bankers have underestimated the effects of the trillions of dollars of quantitative easing, printing of money, and low interest rates. We believe they understand the consequences of this, but they also view this as a solution to the West's debt. The most effective way to deal with massive debt is to create higher nominal economic growth. This is ideally done through real economic growth, but is very difficult in a deleveraging economy with high unemployment. The other way is to create nominal economic growth through inflation, without real growth

### The impact of above-target inflation on debt/GDP



Source: IMF, Bloomberg, AIM

The Bank of England has allowed the UK to manage its debt. High inflation means higher nominal GDP growth. Normally this forces interest rates to rise. However, Mervyn King and other central bankers have effectively talked down inflation expectations by stating that current high levels of inflation are transitory, while often bringing up the ongoing risks of deflation. This strategy combined with the purchases of £200bn of government bonds through quantitative easing has allowed bond yields to stay low. This strategy allows a reduction in a country's debt/GDP ratio without the need for any real economic growth.

This strategy results in a stealth tax through inflation, but it is the only way of addressing the debt mountain of the West, so we are not overly critical on the central banks employing this strategy.

Higher than expected inflation reduced a country's debt to GDP ratio as nominal GDP is boosted by rising prices but the level of debt remains the same.

The BoE is aware of this beneficial impact but must seek to play down inflation expectations so that investors are willing to carry on buying government bonds which offer very low yields.

The UK and the US have put themselves in situations where they have been running double-digit fiscal deficits and their national debt is approaching the level of annual GDP. The US is in a scenario where it is completely incentivised to destroy the purchasing power of its currency to reduce the real value of its debt. Foreigners now own more than 40% of all US treasuries and a plummeting US dollar is a wealth transfer to the US economy. Any elected official considering cutting costs to reduce the fiscal deficit risks infuriating the people who elected him and will err to the side of inflation.

In 1982 the UK M4 (a broad measure of money supply used by Bank of England) was £0.15 trillion. By 2001 it had risen to £0.8 trillion and at the end of 2010 it was £2.2 trillion (9.5% per annum growth). We expect inflation will be used by public policymakers to cope with a rising real debt burden.

UK money supply (M4) trillions  
(1982 £0.15 trillion - 2010 £2.2 trillion)



Source: Bloomberg

Import prices have been largely unchanged over the past decade.

We believe disinflationary forces from emerging markets have suppressed inflationary forces from developed markets last decade.

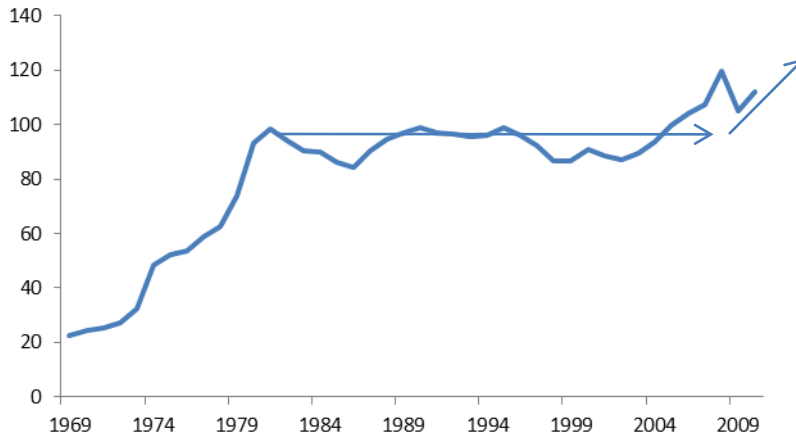
We expect emerging markets will now begin to export inflation to the West.

Monetarists believe that any growth in the money supply at a level greater than economic growth is inflationary.

UK M4 has grown at almost 10% per annum since 1982

We believe inflation has been masked by low cost production and outsourcing to emerging markets over the past decade. The price deflator for US imported goods has risen by 4% per annum. However from 1981 until 2005 it was essentially unchanged (implying that there was no imported inflation).

**US Import Price Deflator**



Source: Bloomberg, 1969-2010 (2005=100)

Cheaper goods manufactured in and imported from low cost emerging markets, as well as gains in productivity, masked the inflationary pressures of a ballooning money supply during this period. We believe this is now changing as emerging markets have to deal with their own rapidly rising inflation.

Import prices have been largely unchanged over the past decade.

We believe disinflationary forces from emerging markets have suppressed inflationary forces from developed markets last decade.

We expect emerging markets will now begin to export inflation to the West.

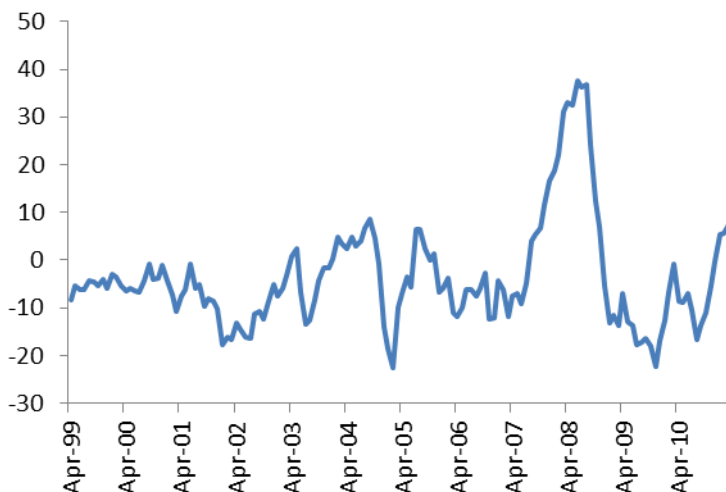
## Impact of emerging markets

Inflation is now rising rapidly in emerging markets meaning that the developed world will start importing inflation from these manufacturing bases. As well as rising food and energy prices emerging markets are experiencing more fundamental upward price pressure in the form of wage inflation.

The Chinese authorities are particularly keen to avoid further unrest or strikes based on higher wage demands. This was most clearly illustrated by electronics firm Foxconn's agreement to a 30% increase in pay for staff, while the minimum wage in Shanghai rose 10% in April this year and Beijing's municipal government raised minimum wages by 21% in January.

These recent pay hikes come after Chinese workers received real wage rises averaging 12.6% a year from 2000 to 2009, compared with 1.5% in Indonesia and zero in Thailand, according to the International Labour Organisation. However, this is offset to a certain extent by productivity growth and there is also scope to move production inland, away from the more expensive eastern seaboard, or to countries that are cheaper still such as Vietnam or Indonesia.

### Citi EM Inflation surprise index



There are also concerns that many emerging market countries that supply the developed world with commodities and manufactured goods have got behind the curve in terms of tightening monetary policy. This could mean a period of uncomfortably high inflation.

It is likely that the West will no longer benefit from imported deflation from the developing world.

Rising wage pressures are beginning to be seen in imported goods from previously lower cost manufacturing bases in the East

China's latest five year plan focuses on repositioning the economy away from exports and increasing the emphasis on consumption. Higher wages and a rising Chinese currency are required to underpin this transition.

In June the Bank for International Settlements argued monetary authorities were collectively underestimating global inflationary pressures and that a tighter global monetary stance was needed to keep inflation under control.



Investors have turned to stocks and bonds as a way to build long-term wealth because these asset classes have historically delivered inflation beating returns. Equities have delivered the largest nominal return and largest historic risk premia versus inflation. The chart on the next page shows equities have delivered approximately 5% more than inflation per annum since 1900. The above-average returns have come with much higher volatility than bonds.

Both government bonds and corporate bonds have also beaten inflation, and done it with a lot less volatility. Many cautious investors are drawn to the lower volatility of government bonds. Unfortunately we believe many of these investors are at the greatest risk of losing ground to inflation in the coming years.

At the time of writing this article UK 10 year gilts are yielding 3.4% (30/06/11), source: Bloomberg), which is less than the most recent annual CPI figure of 4.5% (05/11). This clearly shows one of the problems of looking at historic returns to determine asset allocations for portfolios which need to deliver a real return for clients to meet their objectives.

Given our expectations for the coming inflationary environment and the negative real yield on government bonds from many Western countries, we believe this shows the flaw in statically allocating to traditional asset classes with the hope of generating positive real returns.

The investment industry offers investors many types of products which are benchmarked versus traditional asset classes, such as equities and bonds or combinations of the two. Fund managers often speak with pride that they have beaten a peer group over various periods, but often have failed to deliver either a positive nominal or real return for clients.

New balanced portfolios or diversified growth strategies have been growing in popularity recently. This type of multi-asset approach also includes assets such as property, commodities, and possibly other alternative investment strategies. The attractions of this approach are clear. A more diverse set of assets can lead to a less volatile portfolio, and it is an improvement on the two asset class portfolio, but it is still often designed with the objective to match or beat the return of a benchmark or peer group.

Investors and savers who require income have traditionally allocated most of their capital to fixed income investments. Unfortunately many of these instruments offer a negative real yield.

Many investment products have objectives to deliver a relative return versus a benchmark or peer group rather than aiming to generate a positive or real return.

# Appendix:

IM Distinction Diversified Real Return Fund\*:

Targets a capital return in excess of inflation (UK RPI) +4% per annum over a 7 year market cycle.

The broad opportunity set and dynamic flexibility of this fund creates the potential for much better risk adjusted returns than traditional investments. The fund is diversified across a range of Global investment themes as well as a diverse range of regions, asset classes and investment strategies.

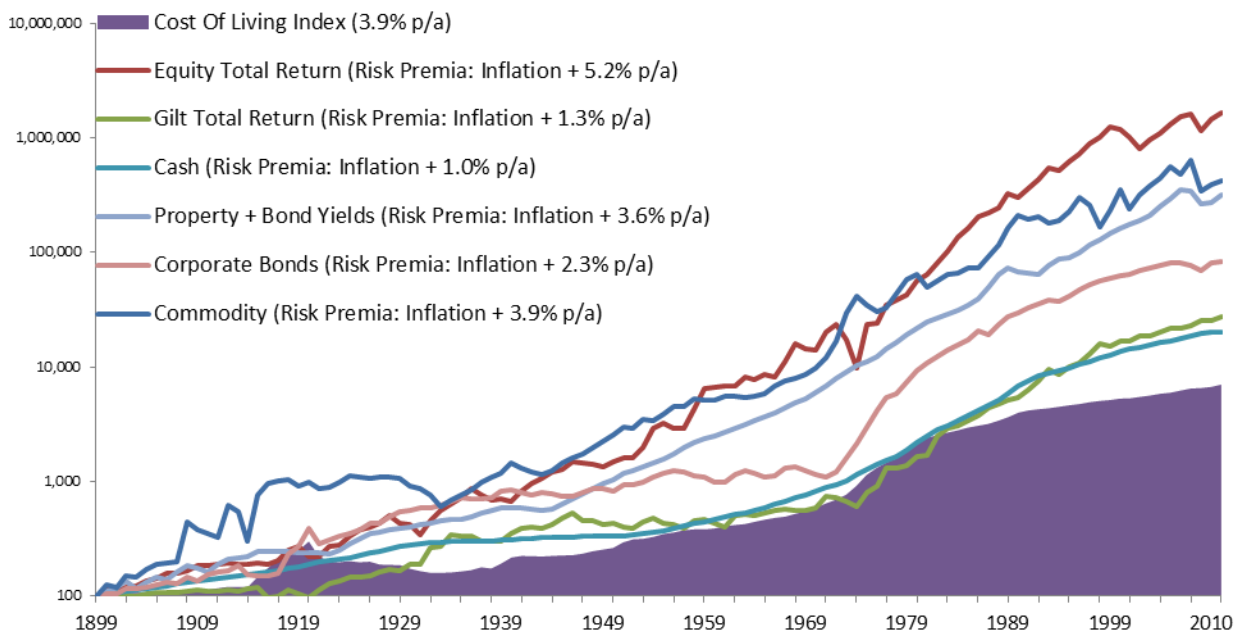
## How we manage portfolios to beat inflation

### Investment beliefs:

1. Real diversification is the most effective method to control portfolio volatility
2. Asset allocation is responsible for the majority of investment portfolio returns and risk
3. Real asset classes provide investors a risk premium vs. inflation and cash over time
4. Markets are not efficient (benchmarks can be beaten)
5. Inflation is the ultimate destroyer of purchasing power

***Generating real returns above inflation is the most suitable investment objective for most investors***

## Historical annual asset class returns: 1899 - 2010



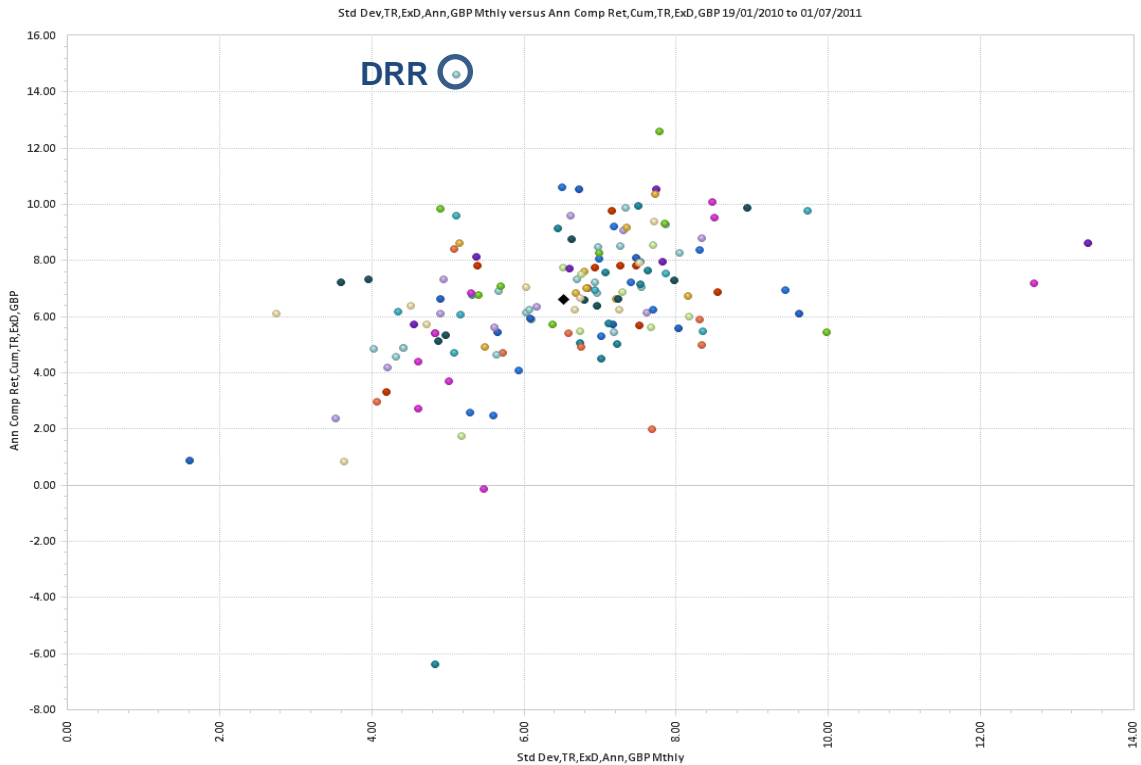
Source: AIM, Barclays Capital, Deutsche Bank, Case Shiller .



	<i>Long</i>	<i>Short</i>
<b>Equities</b>	Global Water Western Telecoms Pharmaceuticals Utilities Canada Brazil Consumer Basket (Pricing Power)	Small Cap US Stocks EUR Banks
<b>Bonds</b>	US Short Duration High Yield Australian Inflation Linked	US, German, UK Government Bonds
<b>Real Estate</b>	Swiss Listed Property	Call Options Asian Property
<b>Currency</b>	Singapore \$ Chinese Yuan Renmimbi Korean Won Canadian \$	US \$ Euro GBP Japanese Yen
<b>Commodities</b>	Agricultural commodities (3 months forward) Gold Copper Oil (6 months and 12 Months forward)	US Natural Gas SP GSCI Oil (Front Month)
<b>Alternatives</b>	Euro 50 Dividend Futures	Volatility

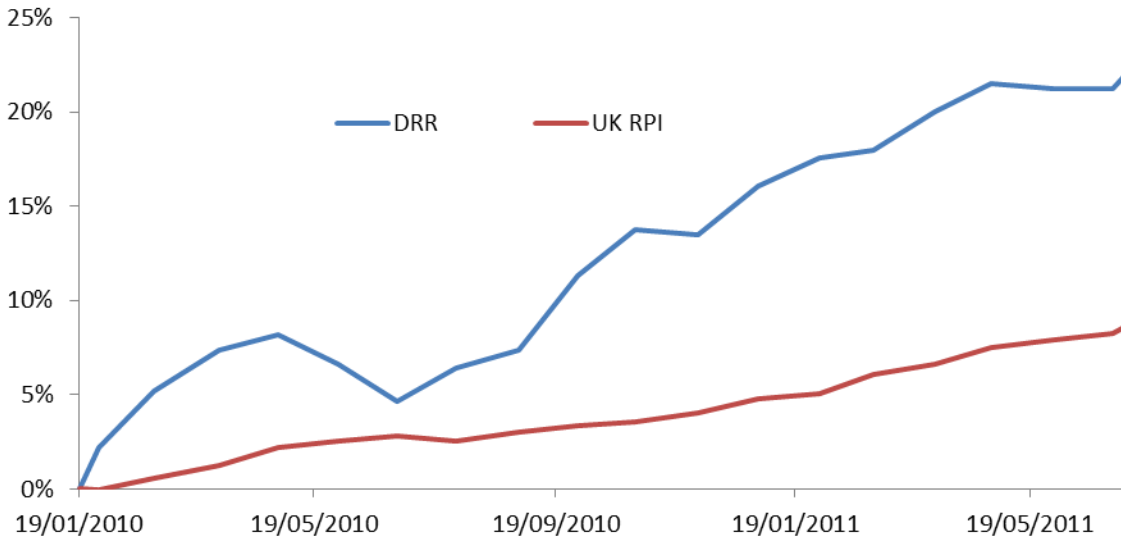


## Return/Volatility of all funds in IMA Cautious Managed Sector



Source: Lipper. January 19 2010 (Launch of DRR) – July 1 20011. Each dot represents a fund in the IMA Cautious Sector. Y Axis: Annualized Return. X Axis annualised standard deviation

## DRR vs. UK RPI estimate



Source: Bloomberg, AIM. 19/01/10-30/06/11

IFDS Managers Ltd is the Authorised Corporate Director (ACD) of IM Distinction Multi-Asset Funds and is authorised and regulated by the Financial Services Authority. Registered office: IFDS House, St Nicholas Lane, Basildon, Essex, SS15 5FS

Contact:

Email:

aim@multi-asset.co.uk  
info@distinctionfunds.co.uk

Phone: +44 (0)20 3440 5060

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