Rising interest rates will have diverse effects: Cerulli

By Editorial Staff *Thu, Feb 10, 2022*

The impact of higher inflation, and higher discount rates, will be less severe on insurance company general accounts than on endowments and foundations, which benefit from low rates, the consulting firm said.

Different types of institutional investors face dramatically different effects from a trend toward higher inflation and lower capital market returns, according to a new Cerulli Associates report, *North American Institutional Markets 2021: Inflation's Impact on Return and Liability-Oriented Investors.*

That's important to understand, because this year institutional investors may need to choose whether to incorporate higher inflation assumptions into their portfolios or to position their portfolios for a return to low inflation and low interest rates, Cerulli said.

Cerulli estimates the US institutional market at $29 trillion. The market grew at a rate of 7.9% in 2020. Corporate and public defined benefit (DB) and defined contribution (DC) plans accounted for about 68% while insurance general accounts made up about 25%. Nonprofits (endowments and foundations) make up only 7% of institutional assets.

For nonprofits—return-oriented investors—inflation works as a tax on nominal returns, forcing them to target higher returns to offset an expected loss of purchasing power. "Low interest rates have been positive for absolute return, risk-oriented investors such as endowments and foundations," said James Tamposi, associate director, in the report.

"As inflation increases, however, these investors will have to increase their required returns to incorporate an expected loss of purchasing power. If incremental returns do not offset inflation, these investors will rely more on long-term endowment funds [i.e., principal] to support normal operations," he added.

The impact of higher inflation, and higher discount rates, will be less severe on insurance company general accounts. Insurers surveyed prior to inflationary pressure expressed three great concerns: generating return/yield (81%), selecting appropriate investments from a risk-based capital perspective (47%), and asset/liability matching (33%).

"The low-rate environment has presented obstacles for insurers on the asset side. Low yields mean they have had to move up the risk spectrum to match liabilities," said Tamposi.

Institutional investors have experienced a low-rate, low-inflation environment for over a decade. Following the recent spate of high inflation levels, those investors will need to consider potential consequences for their existing portfolios as well as strategic adjustments they will need to make if this trend continues.

"While both expected and unexpected inflation hamper investors' returns, investors are able to reposition their portfolios more effectively in cases where inflation is expected," concluded Tamposi.