LCP INSIGHT CLARITY ADVICE

VISTA

SUMMER 2019

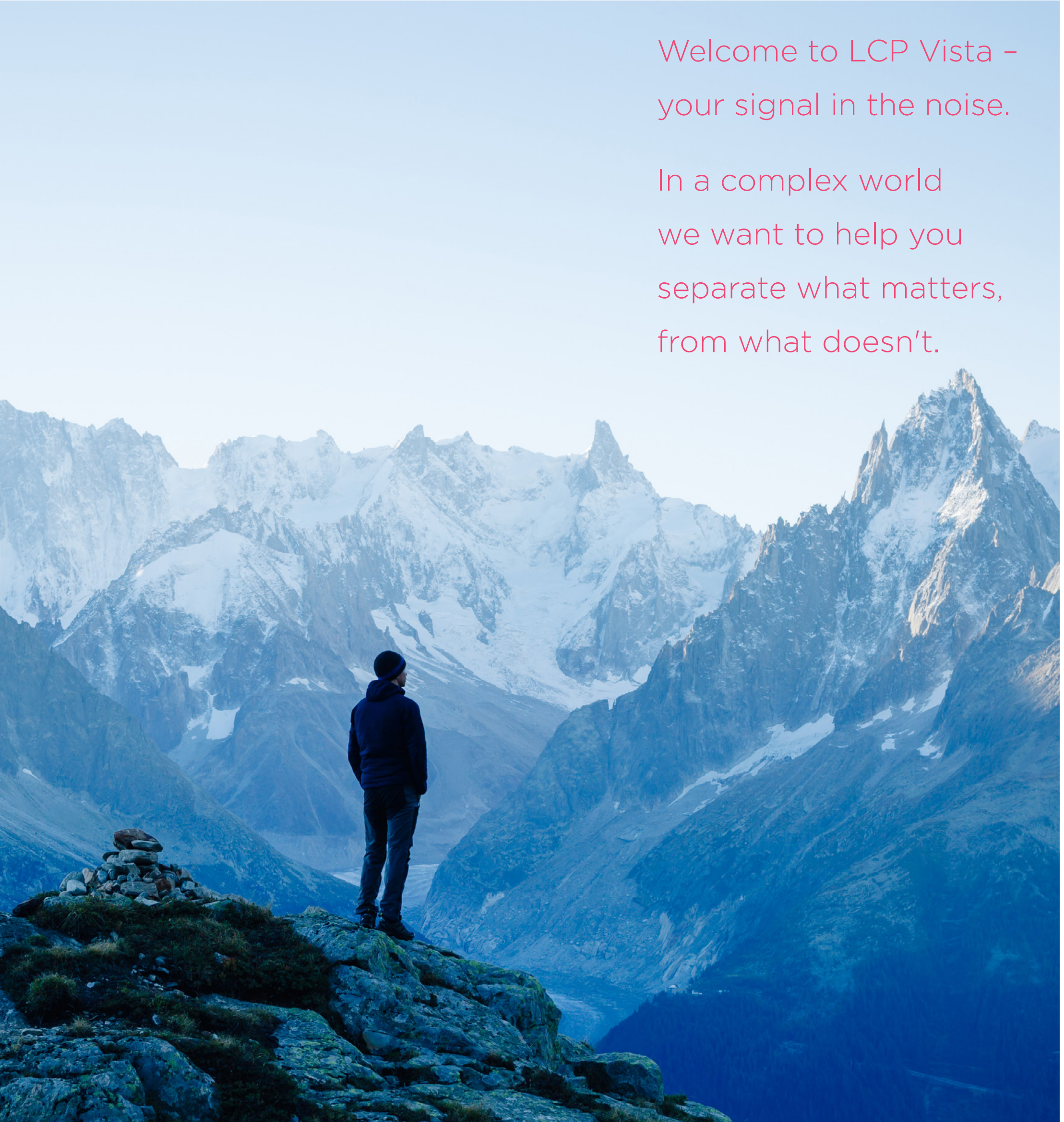
Driving your investments forward

ALSO INSIDE THIS ISSUE

- *Optimising the growth engine*
- *Asset-backed securities*
- *Long-term good, short-term bad?*
- *Curb your behaviour*

Shhhhh

It's noisy out there isn't it?



Welcome to LCP Vista – your signal in the noise.

In a complex world we want to help you separate what matters, from what doesn't.

This edition of Vista contains five short articles, hand-picked content from our internal experts covering a range of themes across strategy, objectives and asset classes that we think will be most relevant to you. You can always count on our pieces to be independent – we say what we really think because we have no links to asset management products. In a world with too much complexity we always look to boil difficult issues down to their key components and help you focus on what really matters.

We hope you enjoy this new issue of Vista. Please do tweet or send us feedback or ideas for future editions. We would love to hear what you think.

Enjoy,

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Here's how this issue breaks down:

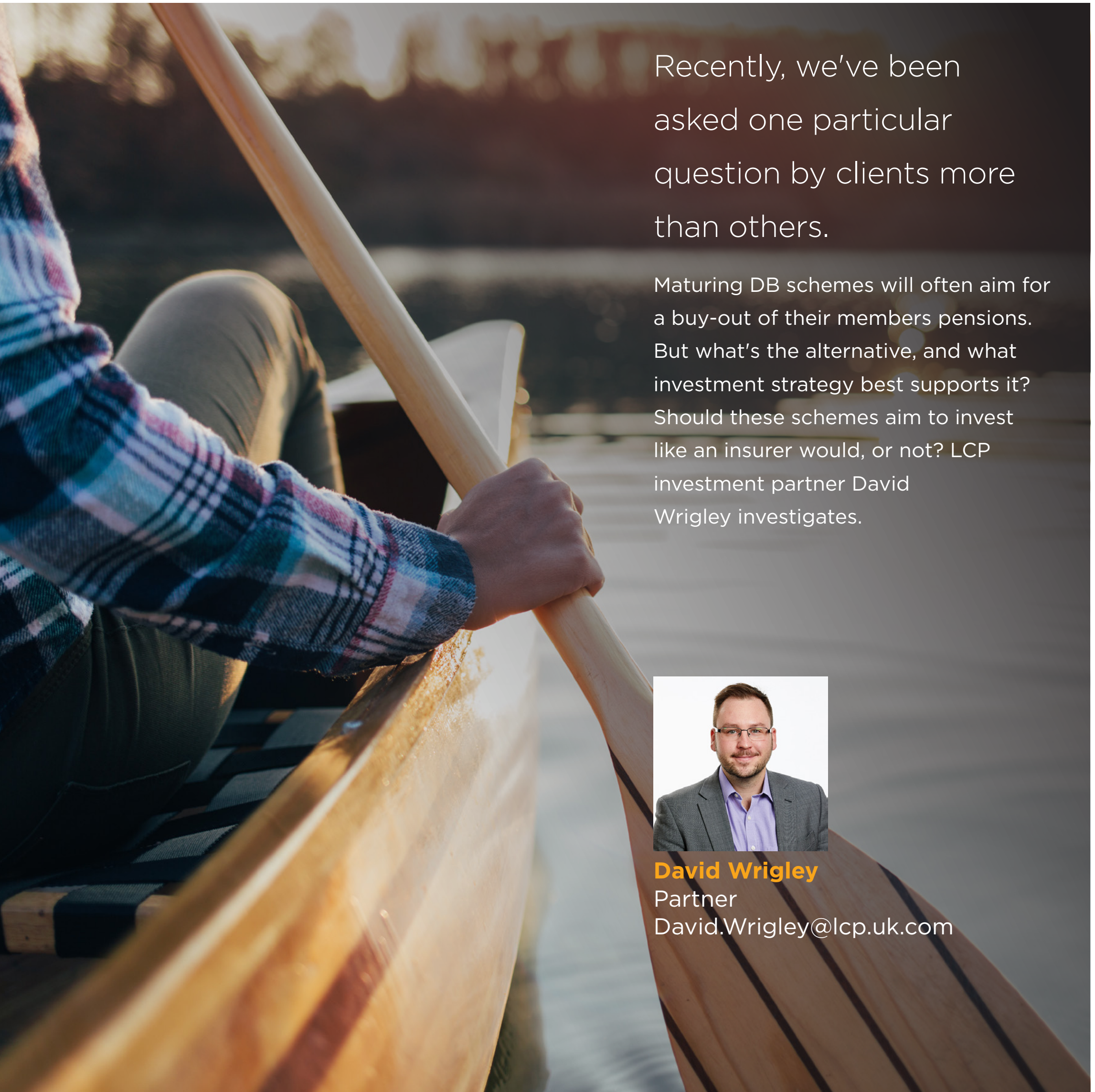
Strategy shorts
David Wrigley discusses whether or not DB schemes should invest like an insurer.

Asset class corner
Rory Sturrock discusses various approaches to building a growth portfolio and Luc Pascal provides a (re) introduction to Asset-Backed Securities, illustrates how it could be helpful for DB schemes now and dispels some myths around it.

Alternative viewpoints
In this section Matt Gibson asks where are all those 'short-term' investors that commentators rail against, and Nikki Matthews ponders whether behavioural risk should be the 'first risk' you consider.

Driving your investments forward

An insight into investment strategies



Recently, we've been asked one particular question by clients more than others.

Maturing DB schemes will often aim for a buy-out of their members pensions. But what's the alternative, and what investment strategy best supports it? Should these schemes aim to invest like an insurer would, or not? LCP investment partner David Wrigley investigates.

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How are DB schemes maturing and changing?

As pension schemes mature they start to look more and more like an insurance annuity book. From my perspective, pension schemes are increasingly moving from the left-hand-side towards the right-hand-side of the graphic below:

It's no surprise then that pension schemes are looking to the insurance industry for how to approach 'end game' investing.

Traditional pension scheme landscape	→	Typical insurer annuity book
Open to future accrual		*No accrual*
Mostly non-pensioners		*Mostly pensioners*
Long time horizon		*Shorter time horizon*
Cashflow positive		*Cashflow negative*
High allocations to equity/growth assets		*High allocations to credit and cashflow matching asset*
Gilt based discounting with prudent outperformance assumptions for growth assets and reinvestment risks		*Discounting based on yield on assets less allowance for defaults (matching adjustment)*

Cashflow Driven Investment (CDI) a concept borrowed from the insurance industry

1

CDI gives schemes a framework for investing all of a scheme's assets, largely copied from how insurers invest and grounded in the straightforward model of asset cashflows matching liability cashflows. CDI (or 'invest like an insurer') came with the following benefits:

- A low-risk investment strategy, typically focusing on investment grade credits, and therefore a high degree of certainty of investment returns given the historical and expected very low rate of default.
- A perceived 'simple approach', evidenced by intuitive pictures showing the projected liability cashflows coloured in with asset cashflows.
- Comfort that the pension scheme is following a strategy similar to the experience and expertise of an insurance company.
- Similar to the 'matching adjustment' aspects of the insurance regime, CDI provides the scope for using the actual yield on the assets to discount the liabilities, providing a far more stable funding position when compared to a 'gilts-plus' approach.

2

But there are drawbacks of using CDI, some generally better understood than others:

- Certainty of investment return isn't necessarily that helpful if the liability cashflows are so uncertain. People don't tend to retire/die when you expect them to. Many members take transfers.
- And even if you did know with certainty when each member is going to retire/die, whether they'd leave a spouse behind and how long the spouse would live for etc, then it's still not practical (for most schemes) to match the precise inflation linkages of pension scheme payments – there will always be a mismatch that is not evident in the cashflow pictures often used in the marketing of such strategies.
- Pension schemes are not insurers. Insurance regulation is one of the key factors affecting an insurer's investment strategy. It isn't efficient for insurance companies to, say, take credit re-investment risk or invest in equities. Insurance companies invest in contractual, investment grade cashflows because they are incentivised by regulation to do so.
- And all insurers are incentivised in the same way – this means these types of assets are in high demand (read expensive).
- Furthermore, CDI strategies typically focus on one area of the market – long-dated (predominately sterling) investment grade credit. We all know it's better to diversify investments, and when you look in detail at the long end of the sterling credit market, it looks anything but diversified.
- For pension schemes, that are subject to different regulation, re-investment risk can be an opportunity as well as a risk. Personally, I'd rather lend to someone for a short time period at a higher return and repeat, than lend to someone for a very long time at a historically low level of interest.
  If re-investment risk can be properly understood, we can assess whether or not it is rewarded, and make a more informed choice around our strategy.
- CDI strategies are generally long term in nature (or buy-and-maintain) and not well-suited to responding to changing circumstances (eg de-risking as prudence unwinds or opportunities arise, changes in covenant etc).

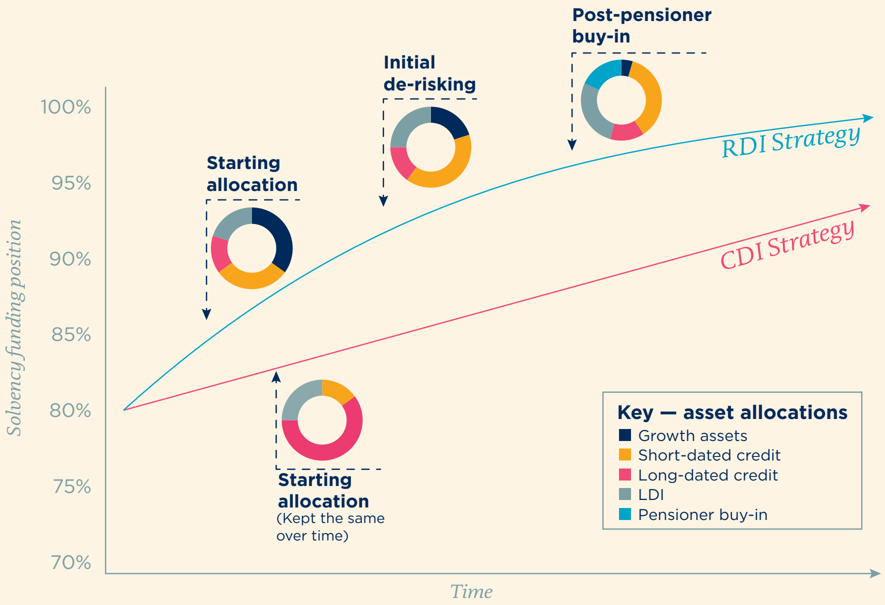
Return Driven Investment (RDI) an alternative approach that bridges the gap

3

An RDI strategy:

- Focuses on delivering the return required to maximise the chances of all members receiving their benefits in full, importantly taking account of scheme maturity and covenant strength.
- Is cashflow aware rather than cashflow driven - in particular, it recognises the uncertainties underlying the liability cashflows.
- Typically targets higher investment returns than a CDI strategy. There is a delicate balance here between risk and return. Our long-term modelling shows that in many cases, higher returns are, in the round, often better for member security when viewed over a full time horizon (giving a greater buffer against adverse experience), improving expected funding positions and can offer a better outcome for sponsoring employers. However this will not necessarily be the case for every scheme and we recommend doing a full integrated analysis including the covenant perspective to get a handle on this important question.
- Incorporates a diversified investment strategy that invests in a broad range of assets and strategies – each allocation appropriately sized - can be put together in a way that limits exposure to any single risk and keeps overall risk pretty low. Equities are good long-term investments when accessed and sized in the right way.
- Provides a ready-made de-risking framework based around three pillars:
- Delivering the required investment returns.
  - Keeping a reasonable proportion of the assets in liquid investments, to respond to challenges (eg paying transfer values, degrading covenant) and investment opportunities.
  - An informed perspective on re-investment risk, that enables a trade off between re-investment risk for higher returns available on shorter-dated assets or equities.

Components of an RDI Strategy



The diagram shows how member security can be improved through an RDI strategy and how the components can change over time as a scheme's circumstances change.

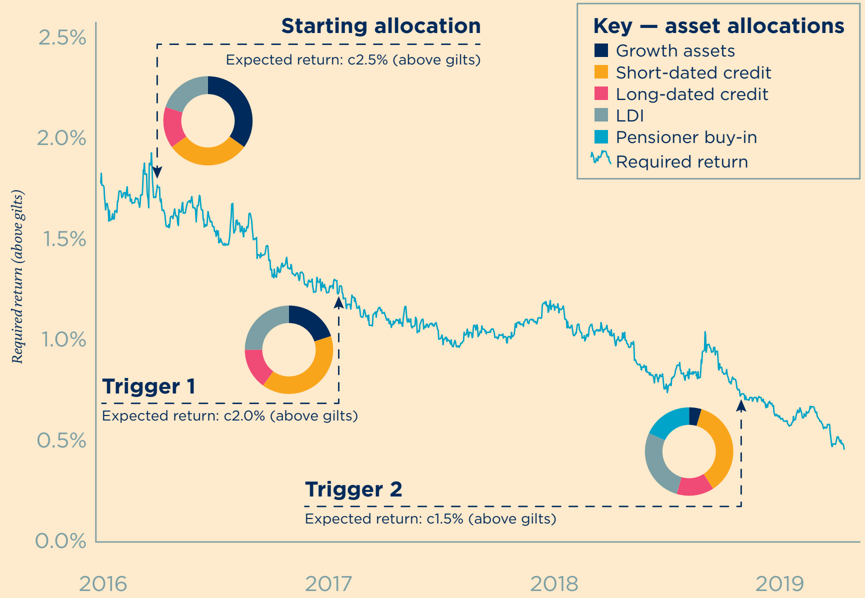
As can be seen from the above, the components of an RDI strategy can include:

- Investments that would typically form part of a CDI or insurer portfolio, such as long-dated credit and LDI.
- Equities and other growth strategies (see later article on the growth portfolio for more details).
- Asset-Backed-Securities (see page 9 for more details on this asset) and secured finance.
- Private credit and other forms of illiquid but short-dated lending.
- Buy-ins (eg as a stepping-stone to securing all members benefits, but only after considering the return and liquidity requirements).

Adapting strategy:

Here's the thing, you can spend a lot of time setting up a beautiful looking strategy but markets tend to do funny things. You will always need to react to movements, buy or sell things to rebalance and add or reduce risk to stay on track for your goal and react to unexpected news. Here is where RDI works really well because it is more adaptable.

For example, we have lots of clients with required return triggers: where they plan in-advance to reduce return in the portfolio when the future returns needed fall below certain thresholds. These are usually triggered following an unexpected good run of investment performance or reduction in expected liability payments. This works really well within the RDI framework, as assets can be efficiently moved and re-allocated to adapt as needed. With up-to-date funding and investment systems, monitored daily, this gives clients unparalleled ability to respond to opportunities immediately and can add huge value over the run-off of a scheme.



Optimising the growth engine

Recently, the investment consulting industry has been focused on derisking. However, there are many DB schemes still underfunded on technical provisions and others striving to reach full buy-out funding. They still need growth assets.

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For these schemes (as well as other investors, such as DC schemes, private investors and sovereign wealth funds), growth asset investing remains a key question and the focus of their investment thinking.

Data from LCP's Sonar platform shows that around 35% of DB schemes are below 70% funded on a gilts basis, needing returns of around gilts +3% or more (for more detail see our Chart Your Own Course). Today, investors have more choice than ever on the strategies, assets and managers to include in growth portfolios. In this piece we set out our thoughts on constructing the best growth portfolios.

Jet fuel

We believe that there are three primary sources of investment return;

1. Market beta (for example equity markets)
2. Contractual income – visible streams of cashflows payable to the investor, whereby the primary risk is cashflow default (for example long-lease property)
3. Manager skill or alpha.

We prefer to construct growth engines on 1 and 2, limiting reliance on 3, as we believe these have the highest probability of achieving attractive investment returns.

Our research has found that the majority of multi-asset funds' returns are not driven by alpha. Furthermore, identifying managers who do possess genuine skill which translate to future investment returns is no simple task for trustees.

We believe that it is suitable to pay for active management in order to access different asset classes where necessary (such as infrastructure) and due diligence on the quality of the underlying assets (for example assessing the likelihood of default on underlying loans).

However, we believe that growth investment returns should be primarily driven by market beta and contractual income first and foremost, not by manager skill, as these are the most likely to deliver the returns that schemes require.

A balanced flight

We break down asset classes into four broad buckets; equities, real assets, absolute return and credit, all of which have sub-categories (illustrated below).

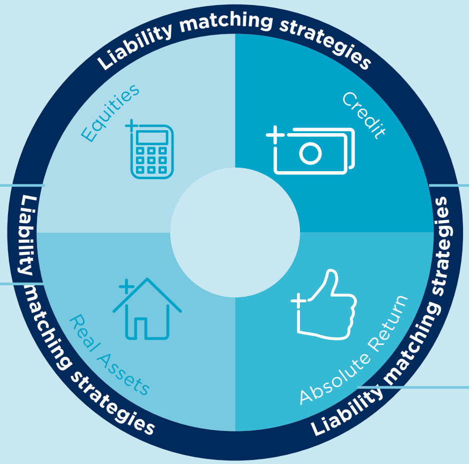
In terms of how you allocate between the buckets, we advocate allocating such that the growth portfolio's risk distribution is not dominated by any asset class. For example, as equities are (in our view) the riskiest asset class, a 25% allocation to equities could lead to equities accounting for 40% of the growth portfolio's risk distribution, which is too high. A good end point is a broadly equal risk distribution, as this means the portfolio is less likely to be hit by a single event to any of the buckets.

Equity assets

- Emerging market multi-asset
- Equities – emerging market
- Equities – global developed markets
- Equities – small cap
- Equities – UK
- Private equity

Real assets

- Listed Infrastructure
- Long-lease property
- Unlisted Infrastructure
- Commodities (active)
- Property – European
- Property – UK commercial
- Property – UK residential



Credit assets

- Opportunistic credit
- Absolute return bonds
- Asset-backed securities
- Emerging market bonds
- Lifetime mortgages
- Short duration buy & maintain credit
- Corporate bonds
- High yield debt
- Multi-asset credit
- Private credit
- Secured loans

Absolute return

- Alternative risk premia
- Diversified growth funds
- Insurance-linked securities
- Protection strategies
- Fund of hedge funds

Beyond the horizon

We believe that there is an illiquidity premium – ie investors are compensated for investing in less liquid investments with superior risk-adjusted returns. Therefore, we encourage our clients to take advantage of these asset classes, particularly those with long time horizons. However, clients should be mindful of when they may require liquidity when allocating to these assets.

Resilience to turbulence

Investors should consider how their portfolio would perform in a market shock. We recommend stress-tests of the growth portfolio. One way of protecting the portfolio is maintaining some overseas currency as a tail risk diversifier. Another is using equity protection strategies, which are effectively insurance policies against market downturns.

Over a long timeframe, we would not expect equity protection strategies to outperform a traditional equity strategy. However, with schemes still needing equity-like returns, but having shorter timeframes to achieve these returns (and therefore less time to claw back losses made due to any market turbulence), we think protection strategies could have merit in our clients' portfolios in some circumstances.

Asset-backed securities

A relic of the financial crisis or worthy of a place in your portfolio?

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For some investors, the mere mention of asset-backed securities (ABS) triggers flashbacks of the US subprime mortgage crisis and the global recession that followed.

A decade has now passed since the global financial crisis. Is this negative reputation still deserved? Was it warranted in the first place?

What are asset-backed securities?

ABS are bonds backed by a diversified pool of assets (debt obligations), rather than by a company or a government. Cashflows generated by the asset pool (which might contain residential mortgages for example) are passed through the bond to the ABS investors.

When compared to traditional bonds, there are two differences worth highlighting:

- ABS investors can effectively choose how much risk they want to take (and therefore the return they expect to earn) as the securities are tranched: cut into slices according to risk level.
- Typically, ABS are floating rate instruments, meaning they carry very little in the way of interest rate risk.

So, is the reputation for ABS deserved?

We don't think the whole ABS universe should be painted with the same brush. Yes, there are parts of the market that have performed poorly, but there are large parts of the market that have performed strongly, with very low loss rates (in some cases no losses).

To help illustrate the differences between ABS issues across geographies and vintages, let's look at three items:

Origination

In the US prior to the financial crisis, third-parties were prevalent in the origination phase (when new loans are created), but once mortgages were packaged and sold off, the originators had no stake in how those loans performed.

This so called 'originate to distribute' model resulted in a focus on quantity not quality, and loans were made to borrowers with very poor credit profiles.

In Europe, banks originated most loans; the majority to prime borrowers.

Recourse

Recourse is essentially the amount of power given to a lender to recoup the outstanding debt in the event of default.

The US market is a non-recourse market. In the event of default, a borrower can simply walk away from an obligation.

In Europe, this is not the case.

Risk retention

After the financial crisis, ABS originators/issuers were obliged to hold a portion of any newly issued security to help create an alignment of interests between all parties involved.

In Europe, this is still the case, but rules in the US have been loosened again recently.

All ABS are not created equally. Some parts of the market may again perform badly. Others have been very resilient (such as Europe). Through careful due diligence and monitoring, we believe investment managers can create robust portfolios of ABS that are worthy of consideration.

Why include them in a portfolio?

We believe that high grade, European focused ABS mandates fit well within a client's matching portfolio as part of a collateral waterfall for LDI portfolios. Why?

- ABS offer an attractive yield premium above comparably rated investment grade credit due to favourable supply/demand dynamics.
- ABS offer diversification into consumer debt, lending mostly to prime borrowers.
- Default and loss rates in the European market have been very low.
- The floating rate nature of these securities means they are likely to hold their value in a rising interest rate environment.

Whilst there are risks associated with this asset class, which have only been hinted at here, our view is that investors should look past the negative reputation to what we consider a very compelling investment case.

Long-term good, short-term bad?

Not so fast says Matt Gibson

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There's a widely held view that investors, investment managers and company management pay too much attention to short-term profits to the detriment of both longer-term returns and the economy more widely.

This view has driven some recent regulation that aims to get both investment managers and institutional investors to focus on the long-term sustainability of companies they invest in. It has also created a broader industry narrative championing the long-term over the short-term.

Taking some of the statements and headlines at face value you could be forgiven for thinking that asset management must be built almost entirely on a short-term focus with just a small band of genuine long-term thinkers swimming against an impossible tide of short-termism. Not so at all.

Here are two possibly controversial but important views:

- Acting for the long-term future of a company is NOT necessarily appropriate, or desirable, all of the time.
- Short-term thinking is NOT endemic in asset management, despite what some would have us think.

Why do I say this?

The thrust of recent regulations from the Financial Conduct Authority is that investment managers and insurance companies should justify how they are taking into account the longer-term sustainability of each company they invest in. In turn, regulations from the Department of Work and Pensions encourages pension fund trustees to guide their investment managers to take a long-term view of investing. This approach seems intuitively correct: when investing in a company, you want it to continue to make money long into the future. It is, clearly, appropriate most of the time.

The exceptions matter

However, it's not appropriate all the time and these regulations do not recognise the exceptions. There are situations when a company or even a whole industry no longer meets the needs of its customers, or cannot meet them profitably, and it does not have a long-term future. These regulations risk encouraging both investment managers and company management in these situations to make unprofitable decisions and, in some cases, make bad situations worse.

To be clear, this is not an argument against responsible investment. I do believe companies should be run responsibly. Businesses that cause undue environmental damage or are socially irresponsible, are not only morally questionable, but are likely to suffer financial penalties when their poor behaviour catches up with them.

Don't throw good money after bad

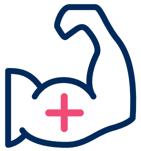
When a company goes into decline, at some point, the rational thing to do is stop investing more money in it and even to wind things down. Persuading company management to close parts of their business and return money to shareholders may be the right thing to do financially. Taking a long-term approach to investing in this company is irrational – it has no long-term future. Trying to prop up a dying company because of a mantra of long-term sustainability is merely throwing good money after bad. Investment managers should help company management recognise reality and execute an orderly reduction in the size of the business.

This is not a situation only applicable to a small number of companies. Management teams find themselves in this position all the time.

Deutsche Bank recently announced it was pulling out of large parts of the investment banking industry; Carillon went into administration because it wrote unprofitable business.

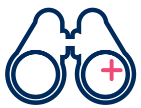
In both cases, shareholders could have saved themselves a lot of pain if company management had recognised earlier that they could not profitably compete in their respective business areas.

Tough decisions often need to be made



Our financial system relies on those with capital to invest making rational decisions about the best place to put it to work. That may mean taking capital away from some areas to invest in others. The consequences of this reallocation could include job losses, and responsible investors would wish to act to minimise the disruption on employees as far as possible. In most cases, the disruption can be minimised by recognising the reality of the situation and managing it accordingly; not pretending otherwise until near bankruptcy when a crisis situation develops.

Long-term outcomes



Institutional investors clearly want investment managers to produce good long-term investment performance, but that does not mean that all decisions by the manager also have to be long term – a good track record over an extended period could be produced by a series of short-term decisions about how to manage companies in decline.

In my experience, when considering profitable companies that do have a long-term future, asset managers rarely target short-term gains - the regulation is fighting a 'straw man'.

Of the 500 or so fundamental equity managers I estimate I've researched in my career, there have been only a handful that explicitly stated they were looking at the companies' next quarterly earnings figures as their key measure. The vast majority of managers use long-term forecasts of cashflows or company performance to value companies. Yes, some may lose patience too quickly and sell 'too early', but in most cases this will be an error in their judgement of long-term value, it's not due to a focus on the short term.

I believe investors should not dogmatically guide their investment managers to take a long-term view of investing in every company, but give them freedom to take short-term decisions when needed.

Sometimes it can be 'long-term bad; short-term good.'

Curb your behaviour

How can your behaviour affect your investment and what can you do about it?

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Have you ever been winning all day at the races, feel like you are immune, taken another bet and wiped out all your gains? Conversely have you ever began losing – panicked and instead of coolly calling it quits, proceed to continue in the hope you can make it all back with one risky bet – nope, wipe out!

I'm sure if you are reading this you have heard of terms like 'market risk', 'credit risk' and 'stock-specific risk' Have you though considered behavioural risk? Perhaps this should be the first risk you consider. There is an old saying 'financial markets are driven by two powerful emotions – greed and fear'. Though the saying has long been around, the study of behavioural impacts on finance is newer, beginning in 2002 when Daniel Kahneman (an award winning psychologist) was awarded the Nobel prize for economics.

It is hard for us humans to admit our faults, and so we do frequently make the same mistake twice (I refer you to repeated economic crisis, debt crises, corporate failures). Behavioural risk continues to loom large, even though it does not fit neatly into any of our conventional economic models of risk and return.

Now back to managing a pension scheme - thankfully there is regulation, and the trustee model in place to curb the worst behavioural tendencies and prevent wipe out. A well funded scheme can afford to de-risk and protect capital whilst ensuring their assets are generating enough returns to meet liabilities. For the weakest schemes there are safe guards in place and the PPF.

However, there are always efficiencies that can be gained by properly considering behavioural risks, and situations with bad behavioural dynamics can result in a lot of wasted time and sub-par decisions. For example, have you ever hired a manager with stellar performance only to have them underperform for the next few years. Or have you ever fired a manager, or divested from an asset class then painfully watched as performance recovered?

There are sometimes good reasons to replace managers, but these should be driven by fundamentals, I'm sure you've all seen the disclaimer 'past performance is not a guarantee of future return'. It is important trustees understand the asset classes and managers they invest in and potential ups and downs to avoid selling an asset class/manager at exactly the wrong time. For example, if you are an emerging market investor you should expect some potentially outsized gains and losses at times and a solid return over say a ten year horizon. You should also expect returns to differ markedly from a global developed portfolio – emerging markets routinely go through periods of returning below a developed market index.

Have you participated in long and tortured debates on currency hedging, interest rate hedging or rebalancing where it became less and less clear what you should do? We've certainly seen all of these behaviours play out over the years. For example, some schemes have not implemented LDI due to the low rate environment in the hope that rates rise, reducing the scheme's liabilities. In recent years, the most important determinant of how well a scheme is currently funded has been how much LDI they've had in place. The rational view to take is that interest rate risk is unrewarded therefore should be mitigated.

How can we help? Here are a few ideas:

1. Checklists. Yes, the humble checklist, beloved of the airline industry, can help us here by forcing us to think systematically through a number of steps, which can help avoid getting overly influenced by only one factor and keep our emotions in check.
2. The pre-mortem. Whenever you invest in something first go through the exercise of imagining you are analysing its bad performance a year later (not where anyone wants to be, but always perfectly possible, however good for the investment).
3. The decision log. Clearly recording the key reasons you made an important decision for the scheme and monitoring these over time to ensure they still remain valid, or whether a change is needed. After all, nothing is forever except change.

Studies have shown informed groups can make better decisions (than an individual) in certain environments – however it is critical that each member voices their opinion, and more often than not that doesn't happen, which can make groups worse. If you have a group that is dominated by one or two very engaged individuals you may end up with a strategy that only reflects the beliefs of a couple of people. This could be, for example, riskier than needed if the person has an appetite for risk. It is therefore important to encourage open debate so that decisions are reached by consensus, factoring in everyone's opinion and the specific information that they hold and others might not.

Ways to counter these group biases:

1. Write down individual opinions on a matter, read out all opinions and discuss each one.
2. If a member of the group is not voicing an opinion, ask them!
3. Ensure the group has diverse perspectives, ie not all from the same company's division, town or educational background, so that they can bring a different view point to the table. Studies have show that firms with diversified boards: by gender, culture and ethnicity have outperformed their peers.

A big part of our role as investment consultants is to help minimise behavioural bias and ensure decisions are taken as objectively as possible.

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Take a moment to **let us know your preferences**, and in return we will try our best to only send you the things that matter to you.

At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and employee benefits.

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