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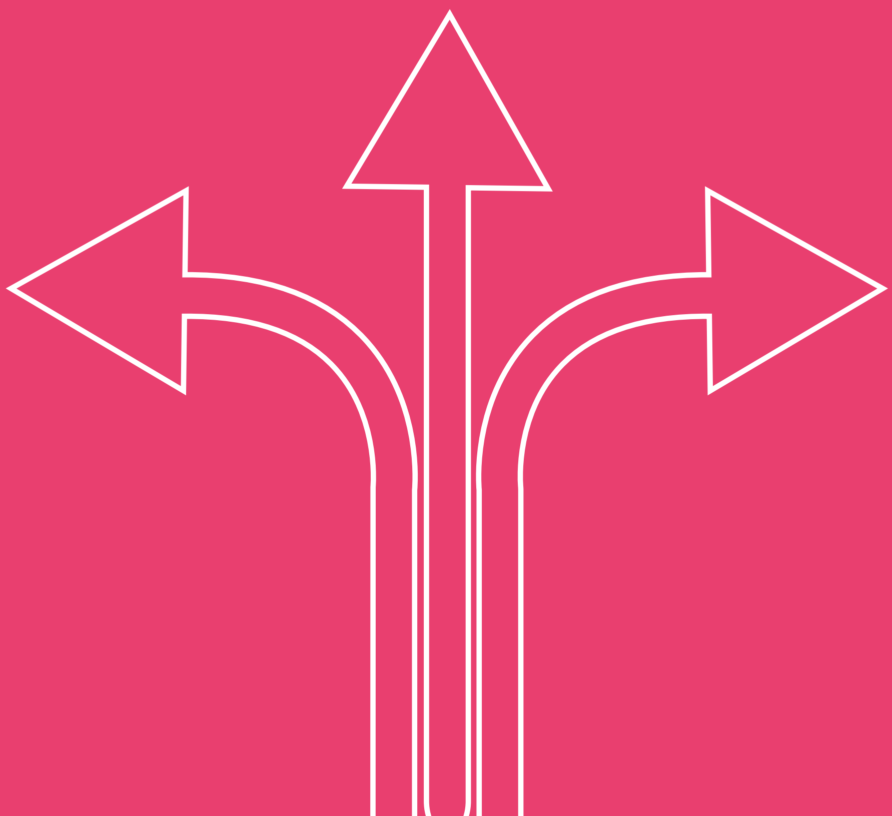
Our investment view

Issue 9. **Winter 2019**



DO NOT REPEAT THE TACTICS WHICH HAVE GAINED YOU ONE VICTORY, BUT LET YOUR METHODS BE REGULATED BY THE INFINITE VARIETY OF CIRCUMSTANCES

Sun Tzu, The Art of War

IN THIS ISSUE

A NOTE FROM THE EDITOR

+ Sophie Carter
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Welcome to the latest edition of Vista, LCP's investment magazine. We have lots of fascinating articles in this edition covering a wide range of topics including the latest innovative investment ideas.

Do not repeat the tactics which have gained you one victory, but let your methods be regulated by the infinite variety of circumstances

Sun Tzu, The Art of War

2018 ended up being rather more challenging than most investors had anticipated. With some headwinds for the global economy and investment markets, investors can't really have any confidence that 2019 is going to be a whole lot better.

What they can do however is ensure that they are holding a resilient portfolio. For some this might point to dialling down the risk and adopting the brace position, but for others, an overly defensive portfolio could undermine their long-term goals. Opportunities present themselves during periods of uncertainty and where appropriate, it makes sense to take advantage of them.

Here at LCP we recognise that each client's circumstances and objectives are different: each investment strategy should therefore be tailored to those needs. It's this approach to strategy which is the theme of this edition of Vista. We hope you enjoy it and don't forget to have a go at a new addition to Vista – the Cryptic Crossword which can be found on page 26!

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LCP'S INVESTMENT STRATEGY FRAMEWORK

David Wrigley
Partner

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I am a partner in the investment team. I work alongside a range of trustees, sponsors and in-house teams in setting and implementing investment strategies.

I help my clients focus on the bigger picture and set a clear journey plan to achieving their objectives. Whether that's buying out smaller schemes, buying-in pensioners, hitting de-risking triggers, implementing cashflow matching strategies or working collaboratively with the trustee and sponsor to set up an LDI strategy.

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Setting an appropriate investment strategy is the most financially important part of an institutional investor's role.

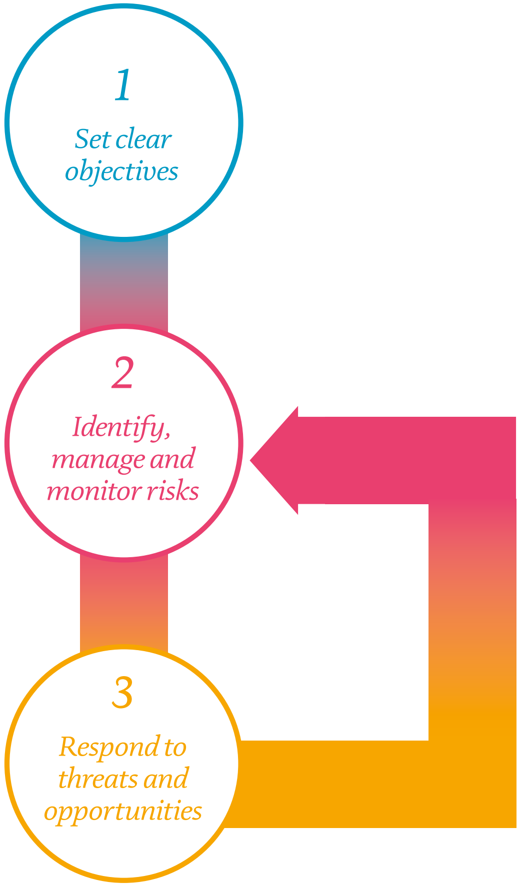
At LCP, we guide our clients through the process in a straightforward, simple way that focuses on the key factors to consider and the decisions that need to be taken.

Our approach has three clear principles running through it:

1. **Set your objectives carefully (both short and long term) – be clear in what you want to achieve, by when and why.** These will be specific to your circumstances and take into account the strength of any sponsors you have behind you.
2. **Identify, manage and monitor risks:**
   - minimise risks that are not expected to be well-rewarded;
   - for risks that are expected to be rewarded, diversify your sources of return.
3. **Respond to threats and opportunities.** Things change so take advantage of opportunities and keep an eye out for risks materialising in unexpected places.

Each client's circumstances and objectives are different, so each investment strategy will be different. We do not over-complicate investment strategies, to ensure that costs (both explicit and implicit, eg monitoring time) are kept down. By following this framework we ensure clients have the best strategy for their particular situation.

The framework



Investment strategy for defined benefit pension schemes

1 Set clear long-term objectives

Have clear long-term objectives that you are working towards and think carefully about the journey plan to get there. This should be considered in light of both the desired 'end game' and the tolerances for risk along the way.

Regularly review the objective to ensure that it remains appropriate.

Once you have the objective, you can start to consider how to achieve it and judge all investment decisions against whether it helps you to meet it.

2 Identify, manage and monitor risks

All significant risks should be identified and monitored. As far as possible, only take a risk if you expect it to be well rewarded. Other risks should be removed, reduced or mitigated, where possible.

For many pension schemes and other institutional investors subject to funding measures, the decision on the level of hedging for interest rate and inflation risks is key.

Asset allocation is the main driver of asset returns. Invest in a wide-range of different asset classes to diversify your risks.

Focus your time and thought on getting the asset allocation right to achieve your objectives with an appropriate amount of risk. Manager selection is important too, but has much less effect on achieving your objective.

Liquidity needs particular consideration. Make sure you have sufficient liquidity to pay expected outflows without distorting your overall investment strategy and have the flexibility to take advantage of opportunities when they occur.

However, if you can take a long-term view and invest in illiquid assets, you should expect to achieve better returns.

Monitoring many different investments takes time. If you do not have the resources, keep it simple and use investments that are already diversified, such as multi-asset funds.

The generation of long-term sustainable investment returns depends upon stable, well-functioning and well-governed environmental, social and economic systems. These ESG issues should be considered throughout the investment chain.

3 Respond to threats and opportunities

Know what you will do if things go to plan and if things don't go to plan. If you are well on track to meeting your initial objective, review your strategy to see if it's possible to reduce risk. Opportunities may also present themselves which will accelerate the attainment of the end goal.

This may also involve re-framing the original objective.

Review 'new' asset classes and look to enter when they are attractive.

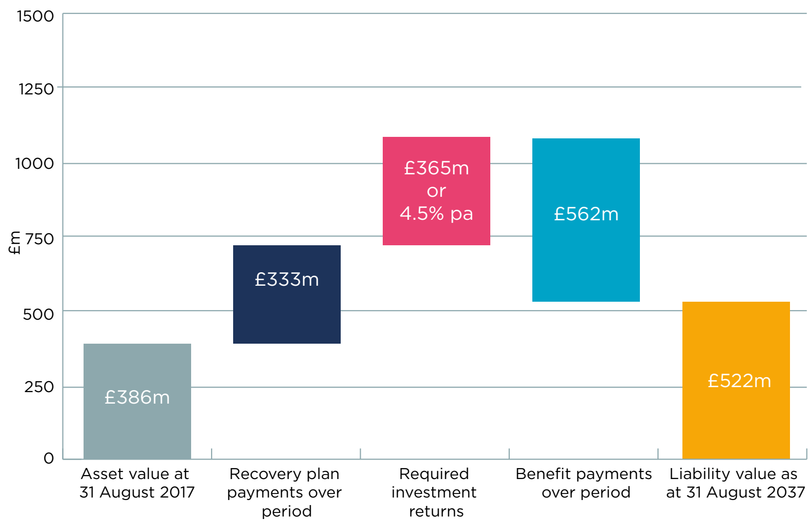
Deal with risks and opportunities from events – such as Brexit.

We advise each client to build a bespoke investment strategy to fit their unique circumstances. We use a common framework for all clients, to ensure that our key principles are applied. The next two articles are written by the LCP consultants advising two very different clients. They illustrate how this framework was used to develop two very different investment strategies.

CREATING A JOURNEY TO BETTER INVESTMENT

Building a strategy for a poorly funded scheme in a challenging industry.

We started advising this scheme in late 2016. The scheme's funding level was poor and their sponsor was small compared to the size of their liabilities, however, the journey plan was heavily reliant on sponsor contributions. These factors made this a more complicated situation than most, requiring a different solution to most other schemes.



1 Set clear long-term objectives

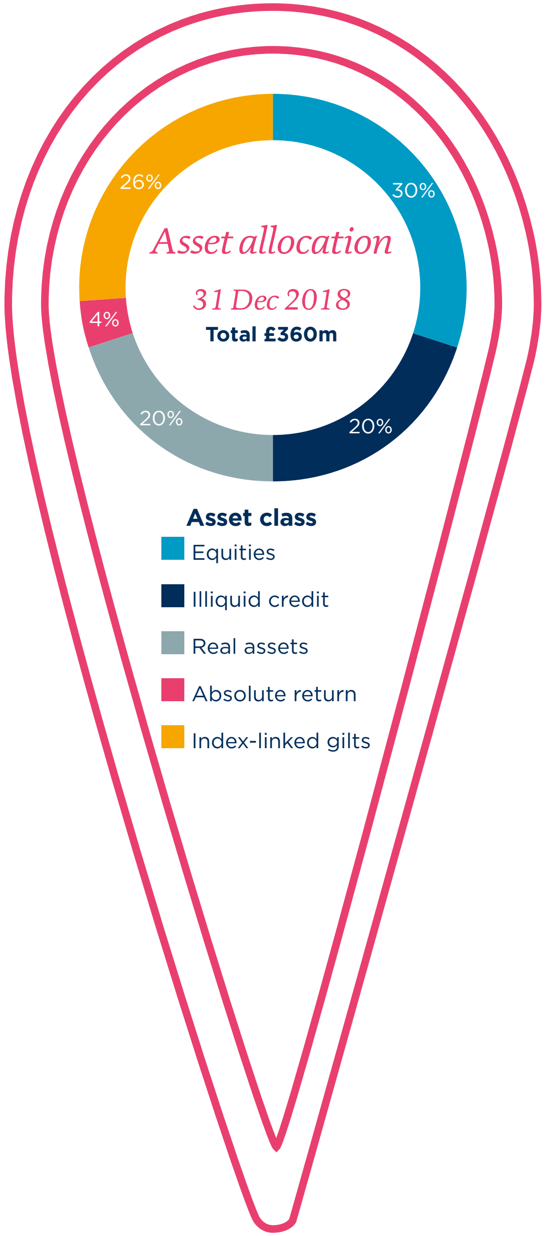
This scheme couldn't afford to adopt the objective of targeting a high funding level in the medium-term.

It needed instead to focus on achieving healthy returns, generating income to pay current benefits and maintaining the stability of the value of its assets.

By establishing this objective, we set a more balanced journey plan and created a coherent framework for monitoring progress against the ultimate objective of paying members.

2 Identify, manage and monitor risks

Key risk	Description
Sponsor health	The most-important consideration was sponsor health. Our client is dependent on significant contributions from the sponsor for the years to come. It was important to recognise this within our investment thinking.
Liquidity	We identified attractive investment opportunities, including private-market credit, infrastructure and global property. These all offered an attractive combination of income and security. However, the illiquid nature of these assets created potential problems with the scheme's need for liquidity over the shorter term. The solution to this was to develop an integrated cashflow management framework, to facilitate a rolling investment programme to access illiquid asset classes.
Investment risk and funding level volatility	A final key risk was that the typical actuarial approach of measuring liabilities against changes in gilt yields would potentially lead to excessive funding level volatility. This risk would normally force the scheme to invest in leveraged, volatile gilt investments simply to match the way the actuarial basis had been constructed. Given the need for healthy investment returns and asset stability, in this instance, leveraged gilt investments were a potentially dangerous investment over the shorter-term. This scheme had a clear long-term target investment strategy not particularly focussed on gilt investments, which enabled consistency between the scheme actuary's funding target and the coherent investment journey plan best matched to the scheme's needs.
Risk progression over the scheme's lifetime	We also needed to consider the balance of risks over the scheme's lifetime. The usual approach of taking enough risk now to target a very low risk strategy later risked undermining the viability of the scheme. To achieve this, the scheme would need to take excessive risk now in order to have any reasonable chance of reducing it later. In this case, risk needed to be spread out, and it's likely that some will have to be taken even when the scheme is quite mature.



3 Respond to threats and opportunities

Establishing a clear, investment-led journey plan allowed the scheme to focus on managing its transition towards a more secure investment strategy.

The current strategy and target strategy share many common components, with the transition through time focussed on reducing equity exposure and increasing allocations to safer credit investments.

We have planned the strategy such that the transition away from the most cyclical asset classes, such as equities, can be managed carefully, to avoid becoming forced sellers when markets are performing badly. We have also introduced a framework for monitoring the attractiveness of safer credit investments – if opportunities arise to build up that allocation ahead of time, the scheme will be ready to act quickly.

Outcome

These changes have increased the expected return on the strategy by circa 1% pa, whilst reducing asset and funding-level volatility. But most of all, this restructuring of the investment approach has paved the way for a clear and achievable path towards meeting the scheme's objective.

AN ENGINEERED STRATEGY THAT TURNED A SCHEMES' FORTUNE

Contemplating my highlights of the past four years this scheme is a story of overwhelming success.

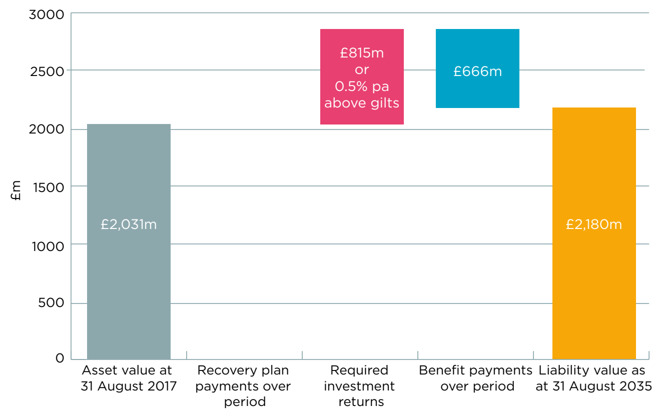
In 2011, the scheme was around 73% funded with assets of around £1.2bn. Fast-forward to today and it's now 100% funded with well over £2bn of assets. How did the trustees achieve this and are there lessons that can be applied to help others?

The answer of course is rather more complex than the question implies, but a carefully engineered and well-implemented investment strategy undoubtedly played a pivotal role.

At the start of this review, our work on the scheme brought it to a position where it was well funded and had interest rate and inflation hedge ratios in place to 100%. It also had a strong covenant from a large international organisation.

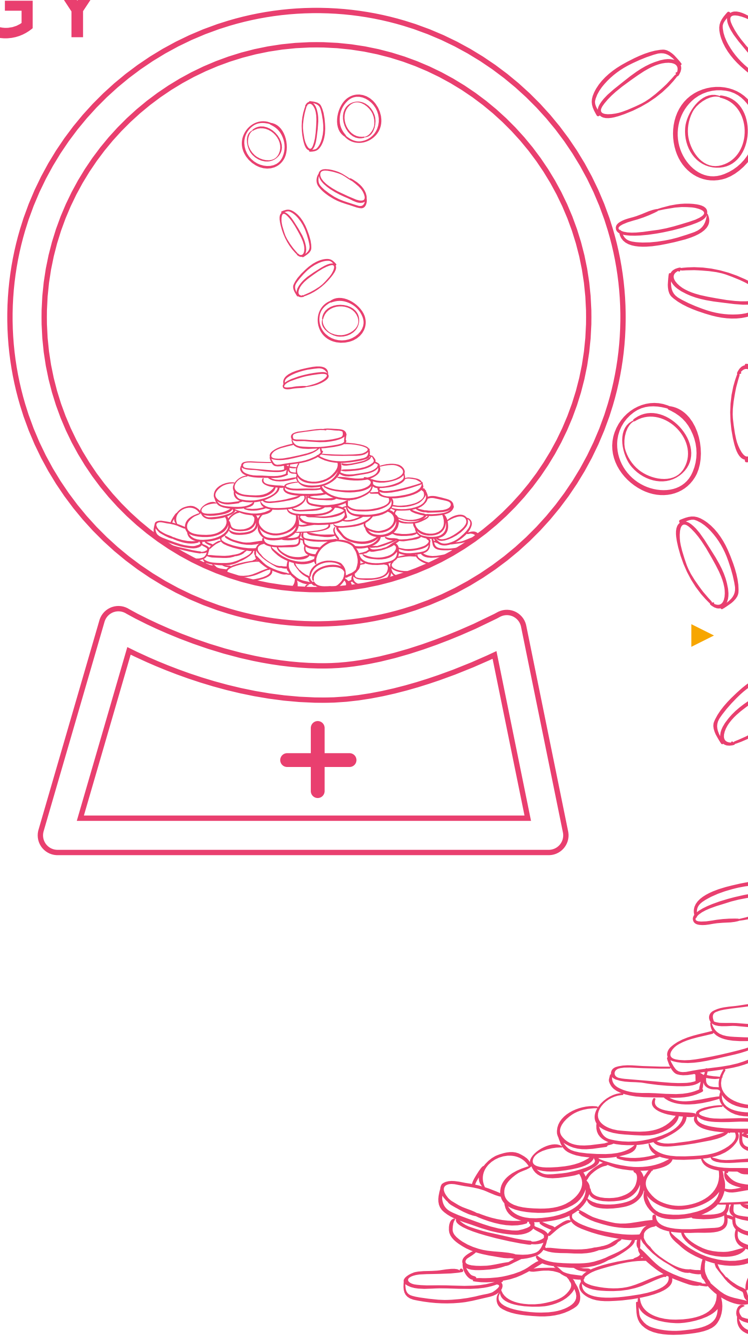
1 Set clear long-term objectives

Against this backdrop, we considered the scheme's long-term objectives. The trustees decided they wanted to target paying the scheme's benefits with as much certainty as possible, without significant risk that they would need to ask the sponsor for more money. They planned to continue running the scheme for many years, but would like to keep the option open of securing a buy-in transaction from an insurance company. As shown below there are no scheduled contributions and the required investment return is low.



Return of 0.5% pa above gilts required to meet Gilts flat (-0.75% from 1 March 2018 as at 31/12/2038)

Our focus now turned to targeting an appropriate level of investment risk to meet those objectives. At the time, growth assets accounted for around 60% of the scheme and were expected to return 1.8% pa over gilts. Working collaboratively with the scheme actuary, we established that the scheme only required a return of around 0.5% pa over gilts to meet its objectives.

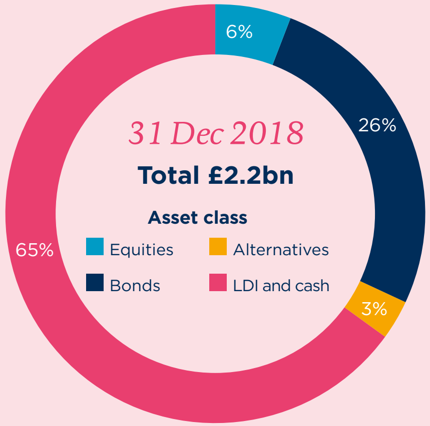


2 Identify, manage and monitor risks

Key risk	Description
Sponsor health	No significant risk. The sponsor is a large, international organisation and financially strong.
Liquidity	The cash requirements to pay benefits currently are not large compared to the size of the scheme. The proposed asset allocation was predominantly in highly liquid investments.
Investment risk and funding level volatility	Our newly proposed strategy for the scheme focused on reducing the investment risk in the portfolio. The most notable change in asset allocation was decreasing the allocation to growth assets from 60% to 30%. As a reminder, the scheme already hedged 100% of the inflation and interest rate risks so, funding level moves from changes in interest rates and inflation were already well mitigated. The trustees invested the majority of the growth assets into investment grade bonds managed on a buy-and-maintain basis. The remainder of the assets were invested in relatively low risk growth assets such as a small allocation to equities.
Risk progression over the scheme's lifetime	The objectives of the trustees were to reduce the investment risk and funding level volatility. We advised that the scheme should reduce the risk now and expect to maintain it at a reasonably constant level for the foreseeable future. The alternative of keeping a relatively high level of risk now with the expectation that risk could be reduced later was rejected.

Asset allocation

The additional cash released from reducing the growth assets could have been held in low risk bonds to support the leveraged LDI portfolio. Instead we worked with the LDI manager to restructure the hedging portfolio composition to use more physical assets such as gilts. The benefits included reduced governance and fees (which fell by around 60%) and addressed other real risks, such as roll risk, collateral exhaustion and counterparty risk.



3 Respond to threats and opportunities

Given the scheme's strong position, we are currently working with the trustees to plan the end-game and have begun buy-in discussions with a number of insurance companies. In the meantime, we remain vigilant on investment risks and continually aim to opportunistically remove these, including recently reducing property exposure given a market opportunity to sell a property fund at an attractive price.

A diligently constructed portfolio also facilitates our proactive approach, including corporate bond mandates designed to release cash over time rather than be re-invested. This provides a regular, healthy source of income (useful for cashflow in a maturing scheme), while avoiding being a forced seller of assets.

Outcome

Our advice and the trustees' decisions have brought this scheme to the point where both trustees and sponsor see the risks as well contained and affordable. All parties remain alert for emerging threats, but this scheme looks like a success story for defined benefit pension promises.

DO YOU KNOW WHAT YOU'RE HEDGING?

Jacob Shah
Associate Investment Consultant

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I've been helping my clients since 2015 to understand risk, improve their investment returns and reach their long-term goals by providing clear, tailored advice. My clients range in size from around £30m to £1bn and I advise on a whole spectrum of investment issues including strategy, manager selection, asset transfers and performance measurement.

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In this article, we take a step back to remind ourselves of our aims when hedging liability risks, cover some of the considerations when doing so and provide a cautionary warning on hedging.

If you forget, for a minute, about the somewhat artificial constraints your actuary's assessment of your scheme's funding level imposes, would you still choose to hedge the scheme's liability risks with government bonds? I would.

The job of the pension scheme is to pay people's pensions. With sufficient assets, government bonds give the best possible match to paying these benefits and eliminate nearly all of the investment risk. Even if you don't have sufficient assets, a matching portfolio is still a really useful reference point for measuring and reducing risk, and stabilising the level of returns needed from your investments.

But what should this portfolio look like when the pension scheme is underfunded?

Which liabilities should you hedge?

Before even thinking about how much of your liability risk you should be hedging, it is worth taking a step back and reflecting on what it is you're actually trying to hedge. There are several different measures of a pension scheme's liabilities, and which one is most applicable will depend on the trustees' objectives. Each of these measures places a different pound value on the liabilities and therefore might require a different approach to hedging.

It is also worthwhile making a cautionary warning about hedging too precisely. There are many known-unknowns in valuing liabilities and what you think you're hedging may be wildly different in practice. For example, a scheme may experience much larger transfer values out than expected and/or only update for actual membership changes infrequently. Spending a significant amount of time getting a perfect liability hedge only yields a marginal benefit when the liabilities you're hedging are approximate anyway!

What hedging measure should you use?

We typically consider two different targets for hedging risk: either hedging the percentage funding level ratio or hedging the pound-value of the deficit (the asset value relative to the liability value).

Trustees might be more concerned with the funding level – focusing on how well members' benefits are covered, looking to protect that ratio from falling, or considering say the solvency ratio (depending on the strength of the sponsor covenant).

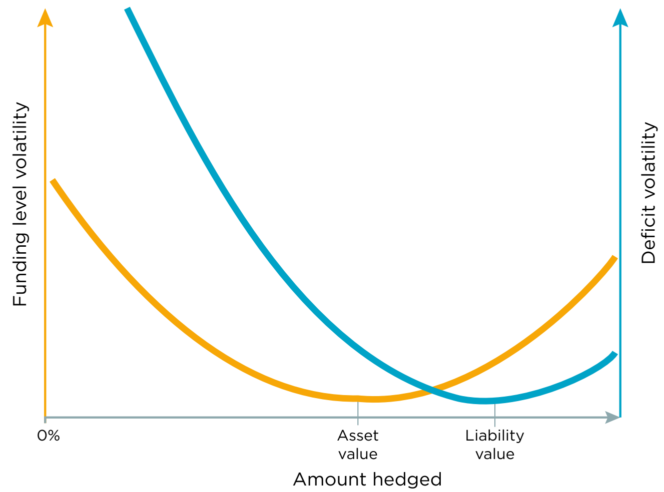
Sponsors might be more concerned with the pound-value deficit number, with recovery contribution expressed in pound-values too, with this reflecting how much the sponsor may need to contribute to fully fund the scheme. This can also be important when assessing the size of the deficit compared to key financial metrics of the sponsor.

How much risk should you hedge?

For most schemes, we generally advocate high hedge ratios as we view other investments as offering more attractive risk / reward trade-offs than those available from the speculation on the future direction of government bonds. Even if you believe that government bonds are over-priced today it may be wise to bet only a relatively small amount of the scheme's money that you are right.

But how high is high? In the chart to the right we illustrate how deficit and funding level volatility typically vary as the hedge ratio increases for an underfunded scheme.

Impact of hedge ratio on volatility



The funding level volatility is minimised when the amount hedged is equal to value of the assets, whilst the deficit volatility is minimised when the amount hedged is equal to the value of the liabilities. We suggest it is important for both trustees and sponsors to understand the impact on their hedging ratio – to avoid those difficult "why has the deficit increased, when I thought we were 100% hedged?" conversations.

However, there are two principal drawbacks to hedging:

- **Opportunity cost** – By buying bonds, you forego the potentially greater returns that can be experienced by investing in riskier assets.
- **Locked into existing rates** – If government bond yields rise, the scheme won't fully benefit from the fall in liabilities as the asset value will also fall.

The opportunity cost can be largely mitigated using leverage. This allows pension schemes to hedge their liability risks, while still maintaining a sizeable allocation to growth assets.

In addition, for trustees or sponsors concerned about locking into current bond yields, they can consider innovative strategies, such as swaptions, that can help address these concerns. These strategies help limit the downside impact of falling yields, whilst retaining the upside benefit of rising yields.

In our experience, hedging the funding level is the most common target amongst pension schemes, but this means the deficit, expressed in pounds, is still exposed to changes in interest rates.

To hedge the deficit requires a greater investment in matching assets, or more leverage, than hedging the funding level. As a result, due to leverage constraints or required return targets, many pension schemes hedge ratios are less than, or equal to, the funding level.

> The average LCP client hedges around 65% of their interest rate and inflation rate liability risks (on a Technical Provisions basis). This equates to around 70% of the value of the assets!

Summary

Liability hedging is all about managing risk. For the same overall level of risk, hedging interest rate and inflation risk allows schemes to focus on other more attractive risk / reward trade-offs. It also allows trustees and sponsors to then focus on stabilising the level of returns needed to fund the scheme and pay members' benefits. With an appropriate level of leverage, these risks can be managed without significantly reducing the expected returns on the assets.

From the trustees' perspective, there is a strong rationale to set the first hedging milestone of being hedged equal to the value of the scheme's assets. However, it is always important to bear in mind what you're hedging, and the risks associated with being too precise in your liability hedging programme!

THE CMA'S RECIPE FOR SUCCESSFULLY APPOINTING A FIDUCIARY MANAGER

Harriet Salmon
Investment Analyst

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I work as an analyst within LCP's investment department, having joined as a graduate over a year ago. I advise a range of DB advisory and fully-delegated clients with assets of between £50m and £6bn, where I help clients meet their strategic, long-term objectives in a practical and accessible way.

My additional responsibilities extend to fiduciary management research, where LCP provide independent procurement and oversight advice. I also sit on LCP's PPF team, where I help manage our response to the latest guidance.

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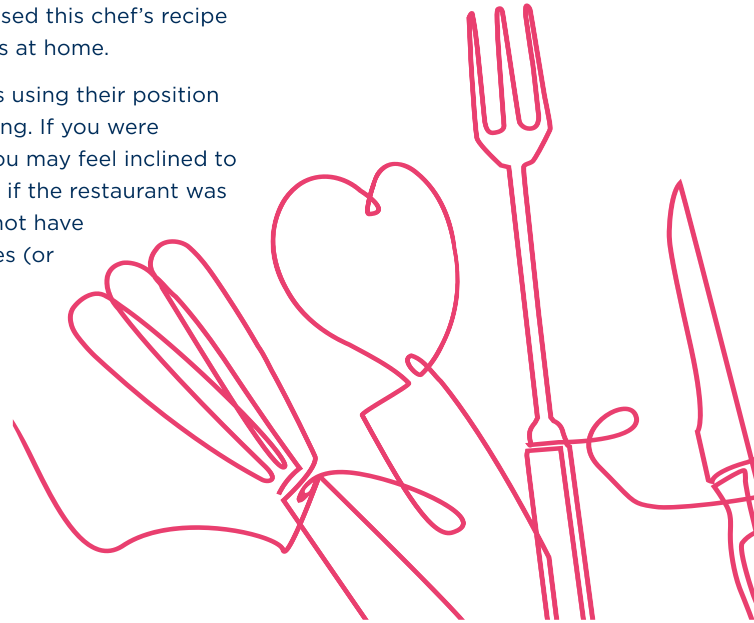
The CMA has published its proposals for fiduciary managers.

The UK's competition watchdog, the Competition and Markets Authority (CMA), published its final report in December on the supply and acquisition of investment consultancy and fiduciary management services in the UK. It underlines concerns with low levels of trustee engagement and opaque fee structures in the fiduciary management industry.

To make this a bit clearer, as a trustee, suppose your fiduciary manager was a chef in a restaurant that just opened up down the street – sounds somewhat far-fetched but bear with me! You may have previously used this chef's recipe book (your investment consultant) when preparing meals at home.

The CMA has cited concerns with investment consultants using their position to encourage trustees to switch into their fiduciary offering. If you were impressed with the recipes you had tried out at home, you may feel inclined to spend a lot of money in the chef's restaurant particularly if the restaurant was heavily marketed in the recipe book. However, you may not have considered restaurants that are more suited to your tastes (or you may be better off sticking with your current arrangement, ie home cooking).



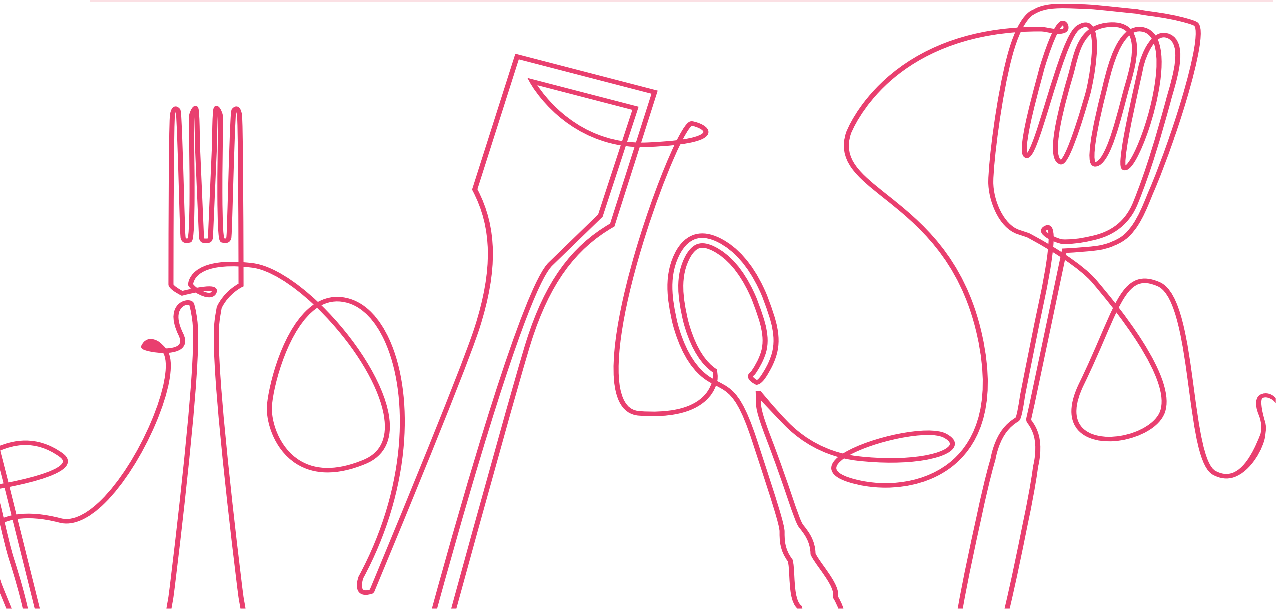
Although fiduciary management and investment consultancy can produce similar outcomes, they are fundamentally different services in three key ways:

1. **Investment consultancy is advisory only**. With consultancy, you as the trustee are fully involved in choosing and following the recipe so the decision-making process and any instructions (or strategy changes) can be followed or ignored by you. Importantly, you can buy your ingredients (appoint a new manager) from wherever you want.

   With fiduciary management, your chef has free reign to follow any method (design a journey plan) or use any ingredient (appoint a new manager) he or she chooses – as long as the end result is what you expected! Reducing the amount of time spent cooking clearly comes with its merits for clients who don't have the scale to do it efficiently themselves. You would, of course, want to ensure that your chef is suitably trained and licensed before letting him/her cook a meal on your behalf.

2. **Fiduciary management total costs can be complicated.** The chef needs to be compensated for the additional responsibilities placed on him/her: in the unlikely event that you suffer food poisoning , the chef would be held accountable. However, the ingredients may be cheaper when purchased by a bulk-buyer. Understanding the total costs, who is receiving them and judging whether they are offering good value for money may not be straightforward.

3. **Barriers to entering and exiting fiduciary arrangements** are much higher than in investment consultancy. It can be costly and challenging to set-up and (even more so to) unwind often complex investments.



The CMA is proposing mandatory tendering on first purchase of a fiduciary management service, if it represents more than 20% of assets. It is also making retendering existing appointments mandatory, if the existing mandate was awarded without a tender.

This is encouraging as it levels the playing field and discourages the largest consultancies from using their position to steer clients into their own fiduciary management services. To follow through with the example: you would have to shop around a bit before deciding upon your chosen restaurant, and chefs would have to be clearer when promoting their restaurant in their recipe book. According to recent analysis provided by the CMA, tendering for fiduciary management could lead to fee savings for clients of between 19% and 22%.

So where can LCP fit into all of this? LCP, as the largest, independent, UK consultancy not to offer fiduciary management, can provide regular monitoring of a client's fiduciary manager and can help trustees navigate the tender process. You may think of us as a fiduciary management comparison site; we are well-placed to assess fee rates, including any 'hidden' charges that trustees might not otherwise be aware of. We firmly believe that independent oversight should not be seen as an optional extra, but necessary to ensure your fiduciary manager is acting in your members' best interests.

For the most part, fiduciary clients are happy with their arrangements. However, ensuring your fiduciary manager is performing in line with expectations (we believe) is the right call and can help you assess whether value for money is being achieved. Fiduciary management is a huge responsibility and having the right governance framework in place can give you some much needed assurance.

After all, you wouldn't go to an expensive restaurant without first reading the reviews.

PROTECTING YOUR EQUITY PORTFOLIO WHEN THE GOOD TIMES END

Matt Selfe
Senior Consultant

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I'm a consultant within LCP's Investment team and am a qualified actuary. I help my clietns meet their investment objectives by providing clear and straightforward advice. Alongside my client responsibilities, I also actively research investment funds. My objective is to find the best investments for our clients. I have a particular focus on researching specialised alternative investments.

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Equities have had a fantastic run. Returns for equities since the crash in 2008 have been over 10% per annum (that's the unhedged FTSE All World for those interested). In other words, if you had put £100 into equities after the crisis, you would have over £300* today.*

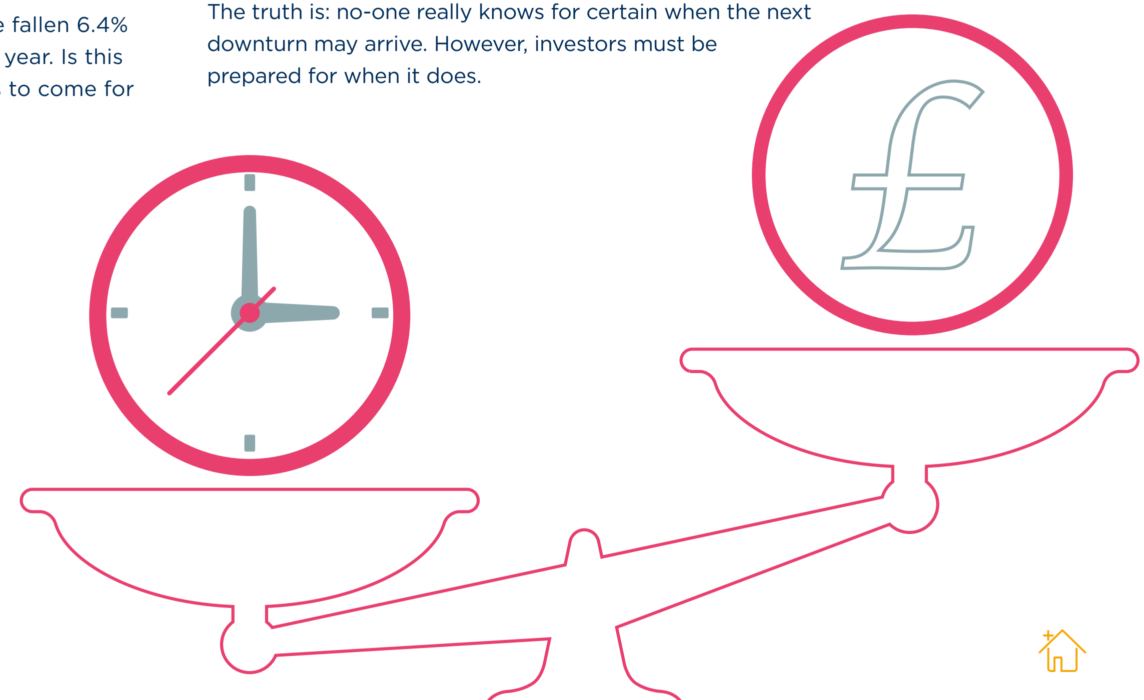
To January 2019, equities have fallen 6.4% from their peak in August last year. Is this an indication of tougher times to come for equity markets?

The good times can't go on forever.

The question that is often asked is: "When will the good times stop?". Many investment commentators will cite the length of previous similar runs (eg seven years between 2001 and 2008, or the ten years from 1990 to 2000) and deduce that, as we're now ten years since the last crash, the next one must be 'soon'. Others will undertake various statistical tests and compare the results to historical values, which imply that equities are now 'too expensive'.

My own view is that equities have become artificially inflated due to loose monetary policy in recent years. This has caused more money to swill around the financial system, pushing equity (and bond) prices through the roof. Equity prices are now at significant risk as central banks turn the money taps off.

The truth is: no-one really knows for certain when the next downturn may arrive. However, investors must be prepared for when it does.



*Statistics taken from Bloomberg

How should investors protect themselves against equity falls?

Investors should be ready to protect the gains achieved by equity markets over the past few years. I've outlined some of the key ways that you could do this.

1. **Switch into 'safe haven' assets**
   This is by far the most straightforward approach. It is sometimes forgotten by those looking for more complicated solutions. If you are worried about equity falls, just don't hold them (or at least trim your allocation).

   The main issue here is that the risk goes both ways; you also forgo the benefits if you are wrong and equities continue to perform well. Many investors also need to keep some exposure to growth assets to keep on track to meet their future liabilities. Not all can afford to simply sell down and sit on a pile of 'safe' assets. If you can, this is definitely worth consideration.

   It's also worth checking whether any more complicated protection strategy is significantly better than simply selling equities. The extra complication may turn out to add only marginal gains.

2. **Diversify your growth assets**
   This option is ideal for investors who want to maintain some scope for growth in their portfolio but who may be highly exposed to equity markets.

   There are a plethora of alternative growth assets out there for investors willing to look at something a little different. The trick is to find the right ones, particularly those that may not be significantly impacted in the event of an equity crash.

3. **Put a protection strategy in place**
   A third option is make use of protection strategies. These can allow investors to take advantage of rising equity markets, but dampen the impact of a crash.

   Protection includes investments such as options. These are similar to an insurance policy; investors can effectively pay a premium for a contract that will pay out in the event of a crash. There are other, more complicated strategies out there too. For example, there are some investments that pay out when equity volatility spikes (as happens when there is a crash).

   The drawback to this option is that it is more complicated and often requires investors to meet a 'minimum investment size'. Investors should bear this in mind before considering this option.

A quick word for pension schemes…

Many pension schemes have witnessed vast improvements to their funding levels since the aftermath of the last crisis. In 2008, we saw gilt yields fall significantly and growth assets fall at the same time. This proved to be a toxic cocktail for pension schemes to take.

Pension schemes shouldn't easily give up their improved position now. Equities, which have fuelled the recovery over the past ten years, could easily take this away. We must be better protected against a crash this time around.

Summary

Despite recent falls, the last few years have been a good time to be in equity markets. There have certainly been jitters along the way, but overall equities have performed terrifically for brave investors. We are reaching a point now where the outlook is less certain, and it may be time to lock in some of the good times that we have enjoyed.

EMERGING MARKETS - PROBLEMS IN 2018, BUT LONG-TERM PROSPECTS ARE STILL POSITIVE

Anais Caldwell-Jones
Associate Investment Consultant

I'm an associate investment consultant within LCP's Investment team and a CFA charter holder. My client responsibilities center around providing clients with clear strategy advice to help them meet their investment objectives.

Alongside client responsibilities, I am also a key member of LCP's macroeconomic research team, helping formulate long-term views of various asset classes given the macroeconomic environment. I am also a key member of LCP's equity research team, involved in researching global, UK and emerging market equities alongside emerging-market multi-asset funds.

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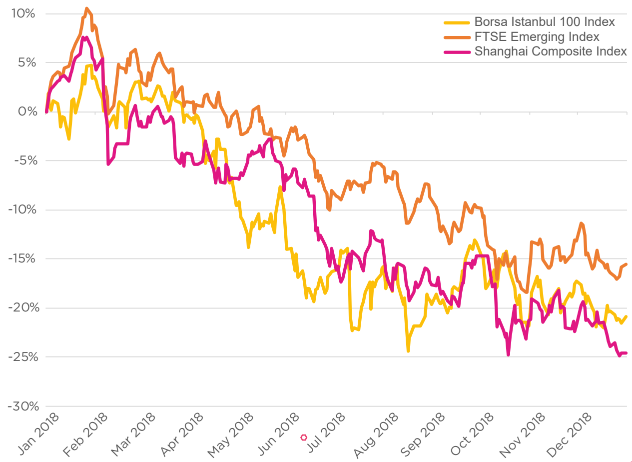
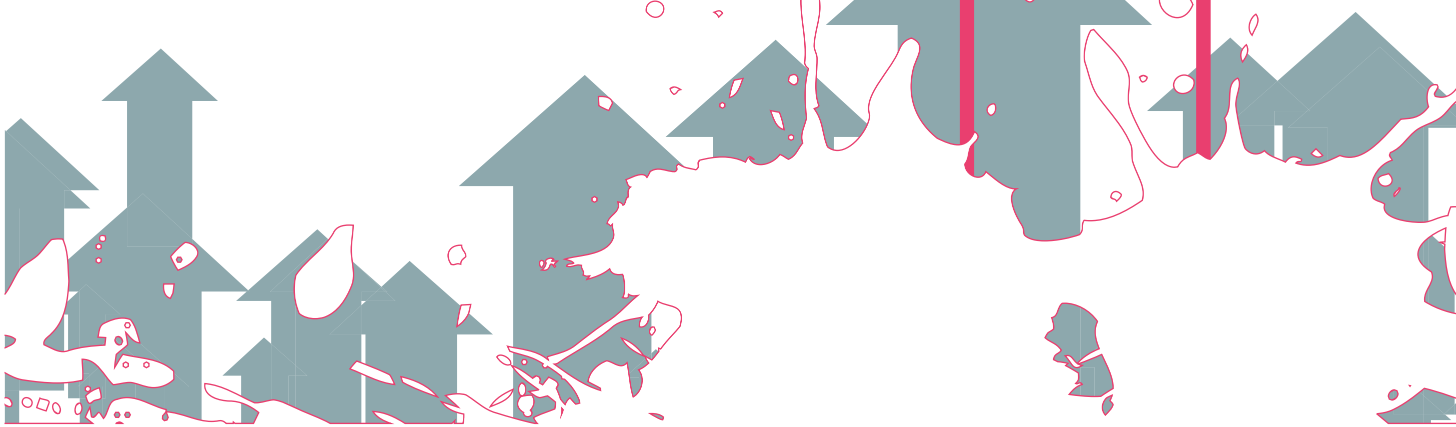
Emerging market performance was disappointing over 2018.



The weakness can be attributed to three main factors: the increasing strength of the US dollar, ongoing US / China trade tensions and country-specific difficulties. Whilst the short-term outlook for emerging markets remains mixed, emerging markets still merit a place in investment portfolios over the long term.



Why was emerging market performance weak in 2018?

Fluctuations in the US dollar
One of the factors contributing to the poor performance of emerging markets in 2018 was the strength of the US dollar. A rise in the value of the dollar is bad news for emerging markets governments that have to pay back debts denominated in dollars. This impacts different emerging market countries to different extents, but investor sentiment tends to affect emerging markets as group.

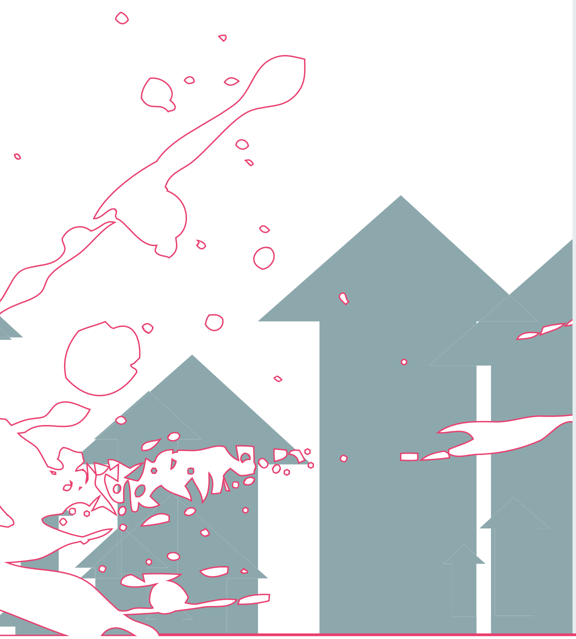
US / China trade tensions
The ongoing US / China trade tensions over 2018 were a contributing factor in China's equity market falling 25% over the year. The negative sentiment resulting from the trade conflict also affected emerging markets as a whole. Many emerging markets are heavily dependent upon both the US and China for investment that could be affected by the dispute.

In addition, a further slowdown in Chinese growth resulting from the trade wars will decrease China's need for commodities – which it tends to buy from other emerging market exporters.

A warming of relations between the US and China may calm investor sentiment and provide a more stable platform for emerging market securities.

Country-specific difficulties
In 2018, emerging market performance was impacted by idiosyncratic issues affecting specific nations. Turkey's was hit by concerns of inflation and growing political uncertainty.

In Brazil, where stocks reached record highs after the election of populist President Jair Bolsonaro, there were now concerns whether the President will be able to implement promised economic reforms. Evidence that the new government can implement an effective economic policy could support a recovery in growth and provide a further boost to Brazilian equities.



Emerging market outlook in 2019

So what should we expect in the year ahead? While trade tensions and country-specific concerns remain, some commentators are suggesting that the dollar may fall in value over 2019, bringing some much-needed good news for these debt-burdened emerging market countries. Coupled with this, emerging market valuations already look favourable compared to those of developed markets, with suggestions that the risks faced by emerging markets over 2019 are already mostly priced in.

The long-term case for emerging markets

Although the short-term outlook for emerging market economies looks muddled – the long-term economic thesis for investing in emerging markets remains.

One of the main arguments in support of emerging market investment relates to the changing demographics. Developed market economies are under increasing pressure from ageing populations, whilst emerging markets are characterised by young and growing workforces. A growing labour force contributes to economic prosperity and a growing middle-class population. With a larger middle-class population comes increased disposable income and spending which is often associated with rising equity markets (as consumer spending pushes up stock prices).

For those investors able to tolerate volatility over the short term, emerging markets may act as a valuable addition to investment portfolios over the long term.

A TOUGHER TIME FOR CORPORATE BONDS?

Peter Abrahams
Investment Consultant

+

I work as an investment consultant within LCP's investment department, having worked at LCP for over five years. I advise a range of DB clients where I help clients meet their investment goals, by providing clear tailored advice.

Alongside client responsibilities, I am also a key member of LCP's high-grade liquid bond research team, researching a wide range of solutions for clients including corporate bonds and absolute-return bonds.

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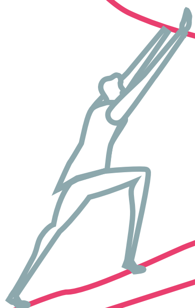
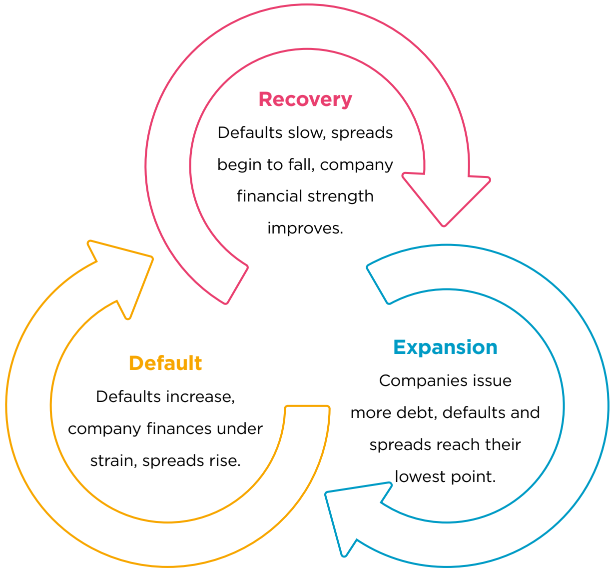
The last ten years have been a great time to be invested in non-government bonds, but could we be seeing the end of this period of easy returns?

In 2018, UK corporate bonds posted negative returns when credit spreads – the additional yield available on corporate bonds above less risk government bonds - widened. This reversed the trend of the past ten years when central bank policies have helped corporate bonds perform well.

A note on terminology here – I'll be using the word spread a fair bit throughout this article, so if you're unfamiliar with this term wherever you see spread just read additional expected return.



Credit markets (borrowing by anyone who isn't a government) operate on a cycle, with three distinct phases.



I meet with many corporate bond investment managers and, as a group, they have been getting more cautious on credit markets over the past few months. If the majority are right, I'm concerned about the impact on investors when the current credit cycle turns.

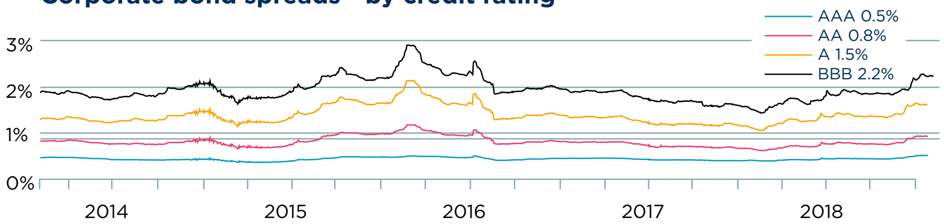
Here are some of the key reasons why I'm particularly worried about credit markets and strategies I'm discussing with my clients to help protect themselves against any downturn.

Credit spreads

Credit spreads have reduced substantially since 2008. This has been great news for investors – as spreads narrow, the value of corporate bonds increases – but it now means that investors are being paid little in the way of yield when compared to the risk of the asset they are invested in.

Credit spreads - difference between investment grade and high yield

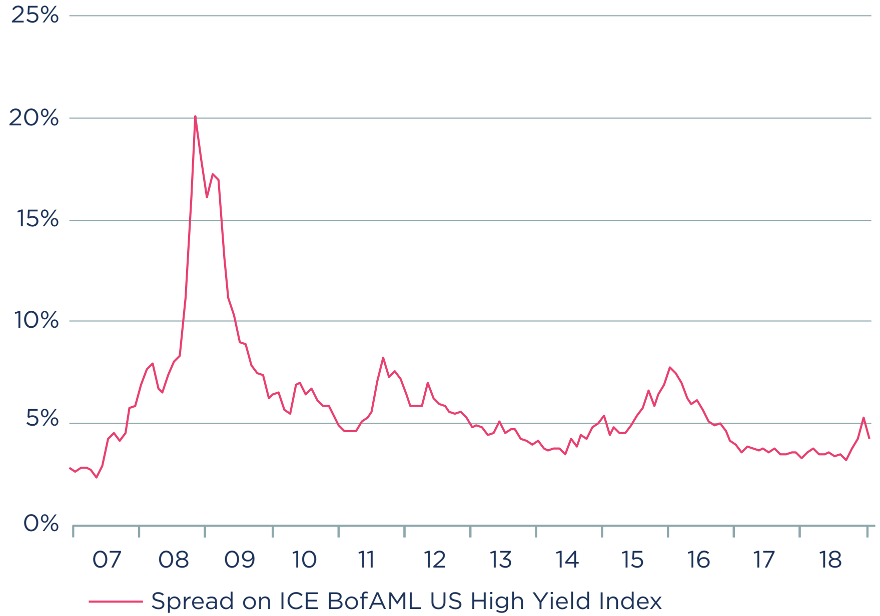
Corporate bond spreads - by credit rating



Source: Thomson Reuters Datastream

This is particularly true for high yield bonds, where the spread on these bonds reached historic lows in 2017. Despite some increase in spreads at the end of 2018, they remain low by historic standards.

Spreads on high yield bonds



Source: Thomson Reuters Datastream

Market liquidity

The reducing yields available on higher grade corporate bonds have led investors to make allocations to high yield bonds in order to get the additional yield.

High yield bonds are less widely traded than investment grade bonds, and in the event of market stress, investors selling these bonds may find it difficult to find buyers or may have to accept a much lower price than they expect to achieve.

Increased levels of corporate debt

From the borrowing companies' perspective, the lower yields on bonds is an opportunity to lock into low interest rate borrowing. And they have been taking advantage of it. From 2013, UK corporate bond issuance has risen from £1.0bn pa to almost £4.0bn pa in 2018.

The average term (length of bond payment schedule in years) of UK corporate bonds has also increased substantially, which increases the length of time a bond is exposed to default risk.

As the yields available have come down, issuance has increased and corporate bonds have a longer term, it could certainly be argued investors are being paid less and less for higher levels of risk.

Central Bank policy

With the Fed increasing interest rates four times in 2018, the ECB's bond-buying programme coming to an end and the Bank of England increasing the base rate (although only to 0.75%), the previous decade of accommodative monetary policy seems to be coming to an end. The question is "what will happen when the money taps are turned off?"

My fear is that increasing interest rates could stretch companies' finances increasing the risk of holding corporate bonds.

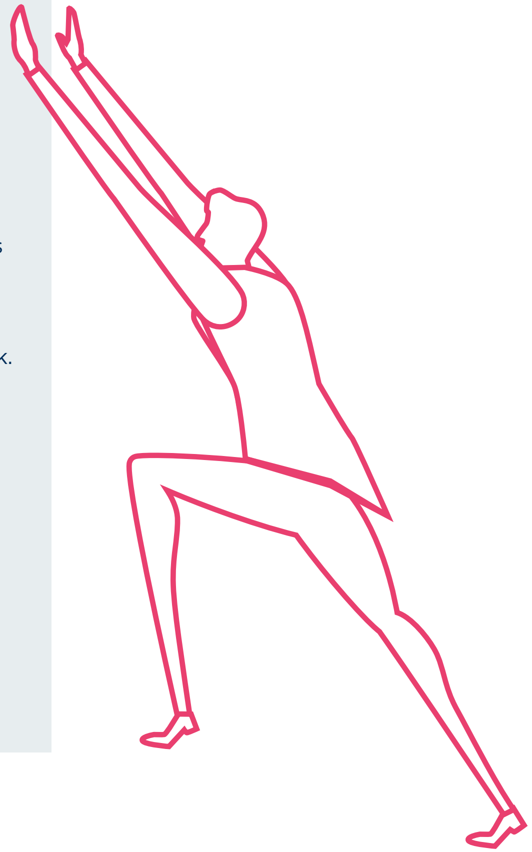
How can pension schemes protect themselves?

This is obviously only one scenario (and a pretty pessimistic one at that). But how can investors protect themselves against this?

Clients can make their credit portfolios more robust by taking the following actions:

- Focus on higher-rated investment grade corporate bonds. Perhaps through a buy and maintain mandate where managers aim to avoid defaults and downgrades as a priority;
- Consider active bond mandates where the manager has greater discretion to take less credit and interest rate risk. For example, absolute return bonds; and
- Be prepared to take advantage of the opportunities a credit market downturn brings, such as opportunistic credit/distressed debt mandates.

Ultimately, the credit market goes in cycles and this bull run cannot continue uninterrupted forever. However, I believe that credit is a suitable asset for many UK pension schemes over the long term and there are a number of actions trustees can take if they are concerned about performance in the short to medium term.



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Knowing me Knowing you

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INVESTMENT RISKS AND OPPORTUNITIES ARISING FROM BREXIT

Max Nastasi-Grace
Associate Investment Consultant

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I'm an associate investment consultant within LCP's Investment team, currently working towards my CFA qualification. I help pension scheme and charity trustees meet their investment objectives by providing clear and straightforward advice. Alongside my client responsibilities, I am also a key member of LCP's fiduciary management research team, involved in strategic oversight and monitoring as well as manager selections for clients.

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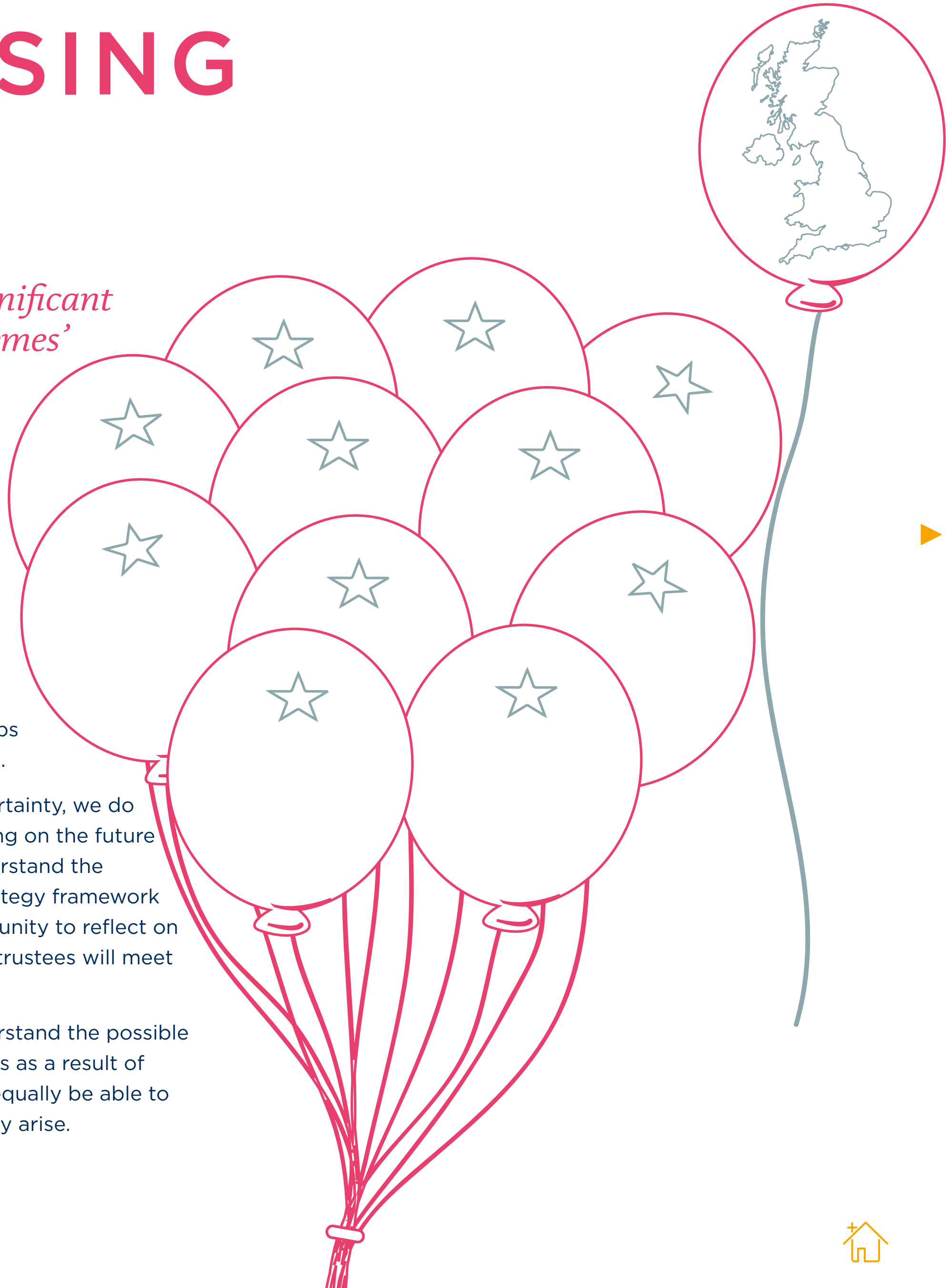
Brexit is likely to have a significant impact on UK pension schemes' investment strategies and funding positions.

With 'exit day' - 29 March 2019 - fast approaching what can trustees do to prepare?

Two and a half years have passed since the momentous EU referendum decision and the UK has been trying to get to grips with the implications of Brexit ever since.

As the UK is facing unprecedented uncertainty, we do not believe trustees should be speculating on the future direction of markets but looking to understand the possible risks. Under our investment strategy framework (outlined on page 4), Brexit is an opportunity to reflect on whether it is more or less likely that the trustees will meet their original objective.

We want to help trustees to better understand the possible impact of upside and downside scenarios as a result of Brexit, how to mitigate these risks, and equally be able to take advantage of opportunities that may arise.



An unfavourable Brexit

If an unfavourable Brexit scenario were to materialise, it is expected that Sterling would weaken further leading to a more bearish outlook for the UK economy, in particular domestically focussed businesses. Unsurprisingly UK property might also take a hit as foreign investors withdraw capital, however subsequent Sterling weakness may well tempt others to invest.

We believe weaker Sterling would result in gains for unhedged global equity assets when translated back to Sterling.

We also anticipate a modest increase in market breakeven inflation rates and the Bank of England to maintain accommodative monetary policy to support the economy, causing gilt yields to fall and liabilities to increase. As a result, many UK pension schemes may see a deterioration in their funding positions, unless fully hedged.

A favourable Brexit

A more favourable Brexit may enable an improvement in economic growth and could increase the pace of tightening monetary policy, strengthen Sterling, push up gilt yields and subsequently improve the funding positions of many UK pension schemes (to the extent that they aren't fully hedged).

	Unfavourable Brexit	*Favourable Brexit*
Gilt yields	↓	↑
Inflation expectations	↑	↓
Overseas currency	↑	↓
UK equities	Limited change	Limited change
Overseas unhedged equities	↑	↓
Other growth assets	↓	↑

What are the immediate next steps for trustees?

Trustees and sponsors should be well prepared ahead of exit day, considering potential options and developing a contingency plan. As such, we suggest that you consider taking the following actions before 29 March 2019:

Step 1 - Consider whether the current level of interest rate and inflation hedging remains appropriate
If your hedge ratios are significantly less than your funding level, we recommend reviewing the size of your liability hedging programme to mitigate the impact of an unfavourable Brexit outcome. If you are concerned about the current levels of yields, you may wish to consider innovative strategies such as swaptions to hedge liability risks.

Step 2 - Review the level of currency exposure
Consider whether the current level of currency hedging remains appropriate. Unless your scheme is well funded or you follow a low risk investment strategy, you may wish to consider an overseas currency exposure as part of your investment strategy.

Step 3 - Consider advancing any planned sale of property exposure
If you anticipate selling your property allocation in the next few years, we recommend reviewing whether to bring that sale forward to before March 2019. This would allow you to lock-in gains experienced to date and avoid possible downturns from an unfavourable Brexit.

Step 4 - Consider delaying prospective illiquid credit investments
Given the possible downside risks, we recommend deferring any new commitments to illiquid investments, including private credit. However, we believe a negative Brexit outcome could create attractive opportunities for clients to invest in distressed debt.

Step 5 - Consider how to meet cash flow needs in a stressed scenario
Consider how the scheme's cash flow needs are likely to develop in light of its maturity profile and volume of transfer value payments. Consider holding a pool of liquid capital to avoid becoming a forced seller of growth assets in a stressed market environment.

Step 6 - Identify and prepare for post-Brexit opportunities
Uncertainty may result in further opportunities to lock-in any improvement in the funding position through de-risking. We recommend trustees prepare for these opportunities now to enable quick implementation.

CRYPTIC CROSSWORD

Give your brain a and solve our cryptic crossword

For those not familiar with cryptic crosswords, a cryptic clue gives you two chances to get the answer: a definition found either at the beginning or the end, and some wordplay. Using 1 across as an example, “found in” tells you the answer is hidden in “pantry”. You can see in “p**ant**ry” the answer, ANT, which is a “small insect”.

You can find the answers on page 25

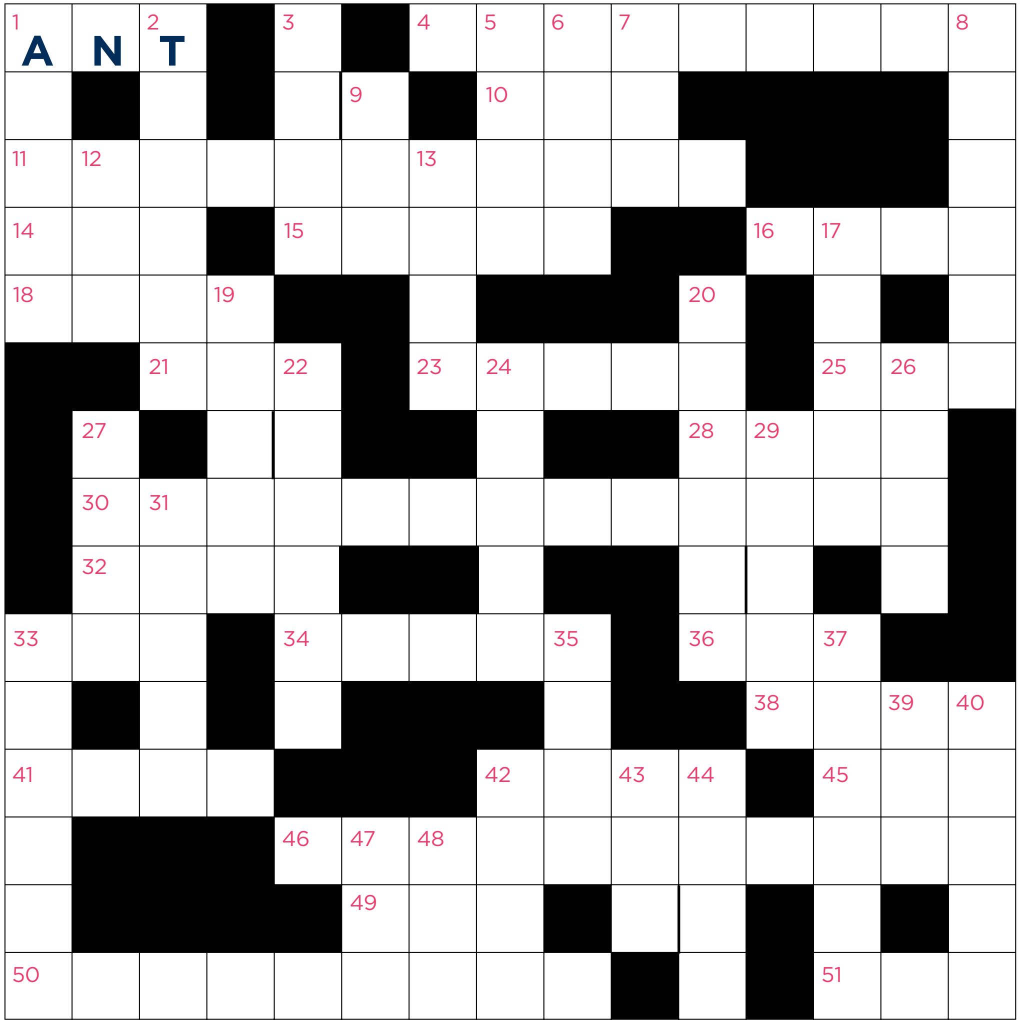
Across

1 Small insect found in pantry (3)
4 Argon induces a small piece of anger - Risk-free profit (9)
10 Long time period ruined neo (3)
11 Act for each class, given the cane, badly (11)
14 Witch mercury hides adenine (3)
15 Put up invoiced, by the sound of it (5)
16 Centres, pivots (4)
18 Zone inside square always (4)
21 Travel firm existing in perpetuity (3)
23 Mode of transport found in icy clearing (5)
25 A hooligan turned into young man (3)
28 Matching concealed by market window (4)
30 Army junior shares profits from venture (7,6)
32 Fill up fresh teas (4)
33 Garland of flowers as seen in a kaleidoscope (3)
34 Skid opposite of north west, encircling cap (5)
36 Network computer board starts to net interest cost (1,1,1)
38 Band of special forces soldiers heading home (4)
41 It may be planted in the street (4)
42 Compressed image file format hides the compiler (4)
45 Retrograde creep concealing urine (3)
46 Damaged fire divides many (11)
49 Sibling. Nazi special police force caught me (3)
50 To final in volatile expansion (9)
51 Period covering last 37.5% of a home loan (3)

Down

1 First Greek of importance (5)
2 Pitch to achieve your aim (6)
3 Mistake in either direction (4)
5 Actual Shakespearean king got mixed up (4)
6 Promise 007 (4)
7 Corporation initially lacking zinc (3)
8 Share leave in audit firm (6)
9 French vineyard oddly lacking a circus (3)
12 Listener found in arrears (3)
13 Various things picking the odds in mail sack (4)
17 Circular path, a sphere and a small portion? (5)
19 Review German car against the back of lot (5)
20 Turner unscrambled turn around (6)
22 Put money in thermal undergarment (6)
24 Give up produce (5)
26 Black stone on man’s genetics, backwards (4)
27 Recess is well over before start of exams (4)
29 New Zealenders get confused over collaborative websites (5)
31 Modify Aries for more pay (5)
33 Chinese fruit discovered in split China wall (6)
35 Untangle a sticky situation for Arabian ruler (4)
37 Each person sent the illuminati packing skyward. Not entirely (6)
39 Look! Sir Edward Elgar’s leads (3)
40 Protect garden boundary (5)
42 Juggled unfinished poser with money (4)
43 Government savings firm caused chaos after omitting first digit from ISIN (1,1,1)
44 Risk-off asset sounds like a shame (4)
47 Suffix for personal nouns, starts, I should think (3)
48 Roman calculates 70 ÷ 10 (1,1,1)

Theme: Investment



Click to reveal the answers

Be prepared, changes are ahead

Trustees of both DB and DC plans will have to state their policies on financially material considerations – including ESG factors such as climate change – non-financial factors and engagement. You need to do this by updating your statement of investment principles (SIP) by 1 October 2019.

Help is at hand. We have produced guides for both DB and DC schemes.

You can read more here:

[How can you incorporate responsible investment into your DB pension scheme?]

[How can you incorporate responsible investment into your DC pension scheme?]

Visit our resource hub to find out more.
www.lcp.uk.com/pensions-benefits/responsible-investment

Reinvigorating our trustees' approach to risk management: LCP Sonar

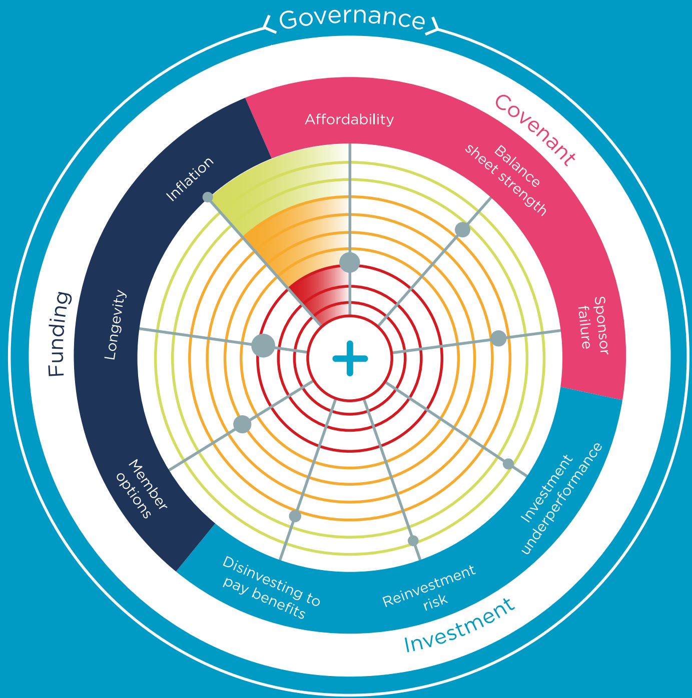
Chris Martin, Executive Chairman, Independent Trustee Services Ltd

"I'm really impressed with LCP Sonar, which is a great way of starting risk management discussions with the right focus. It's one of the more intuitive and engaging examples I've seen in the market and really helps trustees to focus their time and efforts on the risks most relevant to them. I'm looking forward to seeing more of my schemes use this framework to manage their risks effectively."

LCP INSIGHT CLARITY ADVICE

LCP Sonar is a bespoke risk profiling tool that makes risk management more accessible, intuitive and engaging.

It benchmarks your scheme against a peer group of data, covering covenant, funding and investment risks. You can quickly see how your scheme's risk profile compares to others and think about the key risks for you – helping you prioritise and manage your risks more effectively.



To find out more about LCP Sonar visit www.lcp.uk.com/technology-innovation/lcp-sonar or contact Jill Ampleford, Mary Spencer or Francesca Bailey.

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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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