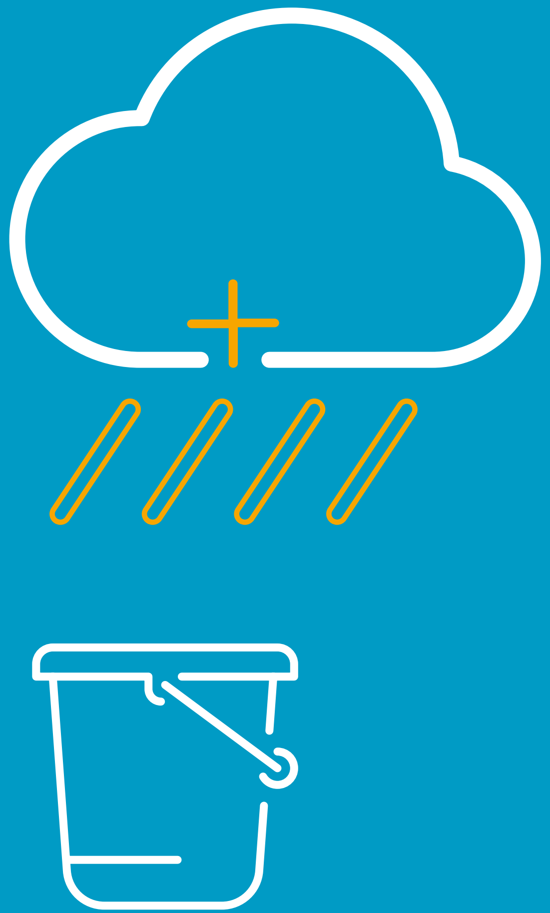
LCP INSIGHT CLARITY ADVICE

VISTA

Our investment view

Issue 8. **Summer 2018**



OPPORTUNITIES COME INFREQUENTLY. WHEN IT RAINS GOLD, PUT OUT THE BUCKET, NOT THE THIMBLE

Warren Buffett

IN THIS ISSUE

A NOTE FROM THE EDITOR

+ *Matt Gibson*
Matt.Gibson@lcp.uk.com

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

Opportunities come infrequently. When it rains gold, put out the bucket, not the thimble.

Warren Buffett

Truly new investment ideas are very rare, but sometimes changes in regulation or market practice throw up opportunities that are worth detailed consideration.

Nikki Matthews and Matt Selfe discuss two such **new ideas** that are outside of the mainstream for many institutional investors: Trade Finance and Litigation Finance.

Innovative ideas don't need to be in new asset classes. Steve Hodder argues that it's a good time to consider another idea that has been around for some time, but is worth looking at with fresh eyes. An allocation to a manager that can take an opportunistic approach to investing in struggling companies could be interesting at this stage of the economic cycle.

And Andy Jacobson considers an approach to investing in the UK property market that reduces the reliance on any one manager's performance.

We also have a section on **governance**. How can institutional investors and their advisers engage with members and with each other to achieve their investment goals? Claire Jones deliberates on how we can engage younger savers in the link between their investments and climate change, whilst I discuss why trust is the fundamental difference between fiduciary management and investment consulting.

Nigel Dunn questions how trustees can set an investment strategy to deal with members of **defined contribution** schemes retiring at the 'wrong age'.

We also look at the needs of **maturing defined benefit pension schemes**. Charlie Finch looks at the path a DB scheme takes to its endgame, and asks if your scheme is possibly closer to buy-out than you might think. Finally, Laasya Shekaran talks through an interesting way to increase interest rate exposure using US treasuries, in place of UK gilts, to take advantage of higher yields.

I hope you find the articles interesting and thought provoking. Please do get in touch with the authors or your usual LCP contact, if you would like to discuss any of them.

CONTENTS

Issue 8. **Summer 2018**

Follow the conversation on Twitter #LCPVista

OPPORTUNISTIC INVESTING: EVERYTHING HAS A PRICE

Steve Hodder
Partner

+

I specialise in advising schemes in challenging situations, requiring a clear, coherent plan to deliver members' benefits in full. Often this requires a fresh perspective, and a willingness to construct bespoke investment and funding approaches consistent with the scheme's situation and available sponsor support.

As well as helping my clients, I research diversifying investment approaches, including absolute return funds, private lending markets and "opportunistic" managers.

+44 (0)1962 672 929
steve.hodder@lcp.uk.com

What is "opportunistic" investing?

Most investors systematically avoid struggling businesses – their publicly traded bonds and equity drop out of passive indices, and active managers typically lack the skills, resources or simply appetite to take on managing them. But opportunistic investing is a strategy characterised by targeting under-performing and/or under-managed businesses.

I know what you're thinking: there is a good reason to avoid investing in struggling businesses – they are struggling! But hear me out...

The key is price

Assets of these businesses trade cheaply, presenting the opportunity for very strong returns. Remember how most investors systematically avoid these markets? Well that helps too, creating an "inefficient" market with lots of forced sellers and not many skilled buyers.

Opportunistic managers specialise in finding the right opportunities in these markets, picking the companies which are trading more cheaply than they should be.

The most typical approach is to buy bonds issued by these businesses, at a deeply discounted price. From there, either the company recovers, and can pay-off its debt in full, or it fails and the assets are sold to pay back bond holders.

This is, though, the most wide-ranging of our asset class categories, and the funds themselves are flexible in where they make their investments, depending on where opportunities arise. Each manager has its own particular niches and specialisms, and aims for different levels of risk and return.

The way we see it, opportunistic managers have at least the following characteristics in common:

- **High conviction**
  Building portfolios of relatively few, carefully selected investments
- **Fundamental approach**
  Investments are assessed with a detailed analysis of the company's prospects and value
- **Unconstrained**
  Cash-plus targets, not pegged to wider market performance
- **Flexible**
  Managers have wide discretion as to where to invest
- **Downside protection**
  Considerable focus on underlying security to control losses

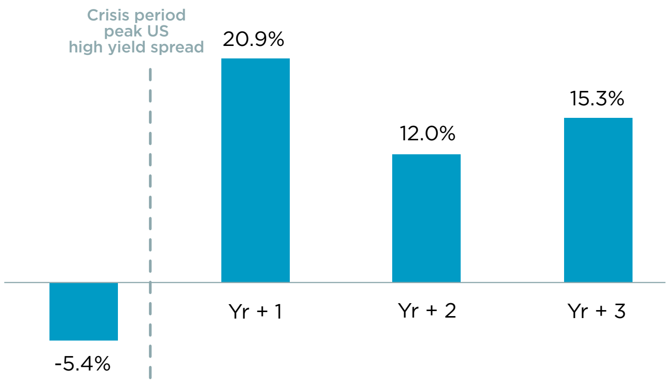
As part of the process of considering this type of investment, it is important to consider a range of managers and to find the right ones for your circumstances.

When do these managers perform best?

History suggests that these managers perform strongly when money is invested in challenging economic environments. Given it is so important for these managers to be picky, the more struggling businesses there are to choose from, the better.

The chart below shows the average performance of this strategy one year before and three years after each of the seven credit crises since 1990. Managers typically find ample opportunities after these periods and subsequently deliver strong returns.

For close to a decade now, markets have largely enjoyed a gradual recovery with little in the way of volatility. Should we see a substantial correction over the coming years, opportunistic managers should be well-positioned to take advantage.



Performance of this strategy after periods of credit crisis

What are the risks?

It won't surprise you that investing in struggling businesses does involve some risk.

The key risk is that managers won't get every decision right, and lose money when businesses do not recover. Suitably experienced and resourced managers mitigate this by conducting thorough assessments of the company's creditworthiness, developing a full understanding of a business's assets, revenues and the potential outcomes.

Managers also have the legal expertise to understand and enforce their ownership rights over the business's assets, should it come to that.

All of this is time-consuming, complicated and specialist work, so managers tend to charge relatively high fees. Investors will also have to be prepared to lock money away in a closed fund structure for a number of years.

Clearly these risks warrant close consideration. However, I believe that for many investors they can be appropriately managed as part of a balanced overall portfolio.

And let's not forget the second part of the "risk vs reward" relationship – in today's low yield environment, the potential reward on offer from opportunistic managers may more than offset the different risks that they bring.

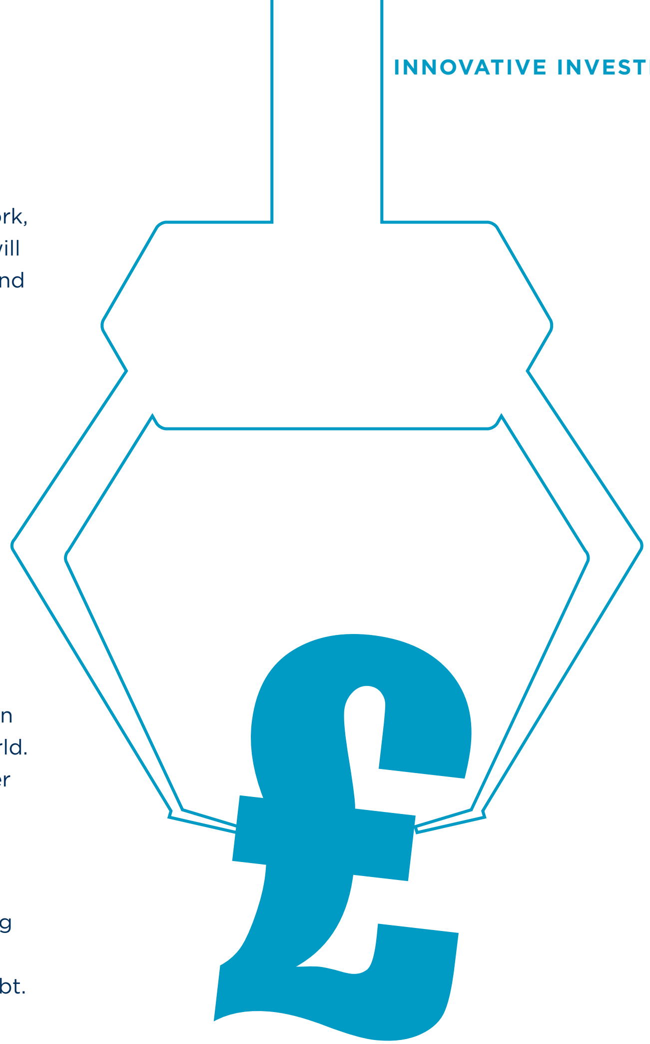
Conclusion

Most traditional asset classes have delivered very strong returns over the past few years. In these environments, it can be easy to sit back, relax and assume all is well with the world. Perhaps Gordon Brown was right all along, and we will never again see the "boom and bust" cycle...

But the events of 2008/09 suggest he wasn't. Since then, the extended recovery across all asset classes has been supported by unprecedented central bank support, pumping money into the markets, driving up prices and allowing struggling businesses to prop themselves up with cheap debt.

Surely this cannot continue forever. We are already seeing central banks start to move away from these policies, and the impact on inflated markets could be severe. Given bonds and equities have marched up in price together, I question whether relying on "diversification" between bonds and equities will work this time around.

Overall, I believe that opportunistic managers can add genuine diversification to investors' portfolios, which may prove very valuable over the coming years.



DON'T PUT ALL YOUR PROPERTY EGGS IN ONE BASKET

Andrew Jacobson
Principal

+

I lead LCP's Real Assets team and have 15 years' experience of conducting real assets research. My role is to find property and infrastructure ideas with attractive return characteristics that help LCP's clients reduce risk and diversify their investment portfolios.

I am also an implementation expert, and I use my experience to help pension schemes save time and money when they make changes to their investment strategies.

+44 (0)20 7432 6714
Andrew.Jacobson@lcp.uk.com

Andrew Jacobson explores some of the challenges of investing in traditional open-ended UK property funds and sets out his thoughts on how schemes can use a specialist property multi-manager to reduce risk

Open-ended UK property funds have long been a staple for many pension schemes. They offer exposure to a range of different properties, low levels of gearing and regular liquidity (in theory – more on this later).

While many investors simply want a property market return to diversify equity exposure, it's important to remember that ALL open-ended funds are managed on an active basis. It is hard to find an open-ended fund that consistently outperforms its peers.

Performance ups and downs

Did you know that:

- over the last 10 years, all but two of the 15 largest open-ended funds popular with pension schemes have experienced at least one prolonged period (ie three years or more) of underperformance?
- size doesn't matter? The three most popular funds have all underperformed the market consistently over the last 5 years!

Many investors only invest in one open-ended fund, happy that this should provide sufficient market diversification. History tells us though that, with this approach, investors should not be surprised by a period of prolonged underperformance in the future.

> *Additional fees of a multi-manager approach can be less than 0.2% pa*

Based on my experience, clients will often tolerate some underperformance if the UK property market as a whole is performing well, particularly as high transaction costs (eg stamp duty) are a barrier to changing funds. In more challenging markets however, disappointing performance can trigger change, and expose the illiquidity of open-ended funds. In a falling market, property can be hard to sell. In the last property crisis (2007-9), redemption pressure forced several managers to sell at distressed prices, and led some to impose a gate on funds, suspending redemption requests. This often exacerbated underperformance for schemes that remained invested.

The difference between the best and the worst performing fund over this two-year period was 41%. In subsequent years, five funds that were previously popular with pension schemes closed permanently or underwent significant (and costly) restructures.

Fund specific risk can be significant for investors if things do go wrong.

So why raise this now? Well, I see some headwinds for UK property on the horizon, so I believe it's important for investors to understand this risk and, if possible, take steps to mitigate it. This can be easier to do than you think.

Multi-managers can spread the risk

A specialist property multi-manager can reorganise a single-fund holding into several bite-size chunks across a range of different open-ended funds.

This is a simple way to spread the risk. With this approach the underperformance or collapse of any one fund would have much less of an impact on your portfolio. A collection of funds is also more likely to track the property market index. I believe that many schemes would prefer this to the ups and downs of one actively-managed fund.

Transitioning into a multi-manager product from your existing property portfolio may not be as expensive as you think. Multi-managers widely use secondary market property brokers which can significantly reduce the transaction costs involved. Brokers match buyers and sellers of open-ended funds. Sometimes (although not always) it's possible to purchase funds at a discount to NAV, or sell funds at a premium. We've seen examples of a multi-manager reduce reorganisation costs of an underperforming fund by 70%, reducing the transaction cost from 7% to just over 2% – so for a fund underperforming by 1% each year, the pay-back is only two years.

For some outperforming funds, multi-managers may be able to sell at a price above NAV locking in an extra premium.

Additional fees of a multi-manager approach can be less than 0.2% pa - relatively modest considering the reduction in risks. And I think that using a multi-manager helps future-proof the strategy. Many schemes will want to rein back their property allocation as they de-risk - with a mix of funds and efficient use of brokers to provide liquidity, the chances of a bad outcome for schemes selling in a troubled market, or being stuck in a gated fund, reduce materially.

As the old adage goes don't put your (property) eggs in one basket. Or as a good bricklayer would say (apparently) don't put all your bricks and mortar in one hod!

ARE MEMBERS RETIRING AT THE RIGHT AGE?

Nigel Dunn
Senior Consultant

I am a senior investment consultant in the Defined Contribution team and I have been helping DC schemes for over 10 years navigate the ever changing landscape of the pensions market.

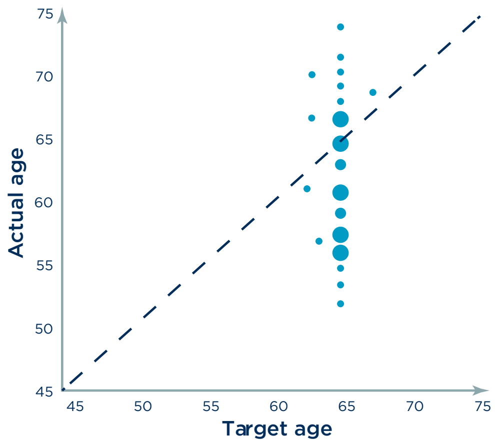
Most recently I have helped clients to implement innovative default strategies that take into account the impact Freedom and Choice has had on retirement outcomes.

+44 (0)20 7432 7793
Nigel.Dunn@lcp.uk.com

Members of DC schemes do not all retire at the normal retirement age. How can trustees set investment strategy to deal with members retiring at the 'wrong' age?

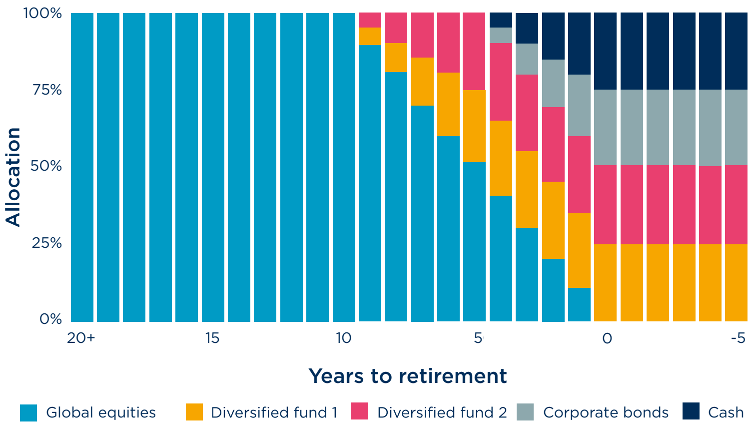
Generally, it's accepted that the age at which people are leaving the workforce is increasing. Should schemes be increasing their normal retirement age to allow for this? Many schemes and providers talk about increasing the normal retirement age with increases in the state pension age.

What's often not considered is the age at which members are actually taking their benefits from the scheme and the spread between their age and their target retirement age (TRA). I've taken a look at the data available for one of my clients to analyse what their members actually did, and the impact of a market shock on the lifestyle strategy.

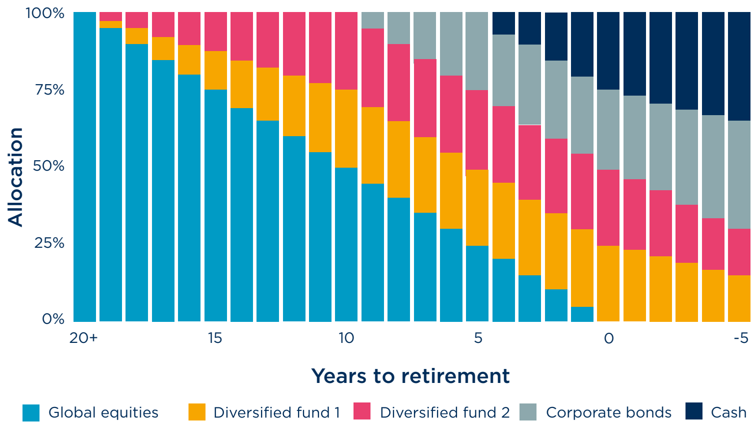


The spread of ages at which members are taking their retirement benefits

The chart shown on the left shows the variability in the age at which members took their benefits. We can see that anyone below the diagonal line has taken their benefits before their expected retirement age, and those above have taken their benefits after. The majority of these members were in the default investment strategy shown in the chart on page 9 and, because they took their benefits at different times, they were in a different place in the de-risking phase of the investment strategy at the point at which they took their benefits.



A typical DC default investment strategy



A DC default investment strategy with earlier de-risking

The first quarter of this year, particularly February, was a good reminder that markets do not always go up. We saw falls of around 3.5% in the FTSE All Share index and falls of around 1% in gilts.

So, what would happen if our members withdrew their benefits in February this year? Or further still, what would happen if they withdrew their benefits following a more significant market crash?

For my client, the analysis showed that if a one-in-twenty event occurred at the point of retirement, a member who retired ten years early could expect to lose almost £20,000 (about a quarter of the member's pot). We could increase the volume of communications in the run up to retirement, but is there more that the investment strategy could do to protect members?

For schemes like this, where many people are taking their benefit before their TRA, I believe we should start the de-risking journey much earlier, say from 20 years before TRA, as illustrated above right. Moving members out of 100% global equities and into lower risk assets such as diversified growth funds and corporate bonds can reduce risk by up to 30%.

Of course, whilst moving to the new strategy has the benefit of reducing the absolute loss that members experience, we can expect members on average to retire with a slightly smaller pot due to fact they are taking less risk at a crucial phase of their DC saving. There are ways to overcome this, such as taking more risk in the early stages of the glide path, through an allocation to riskier assets when there is time to make up for any potential shortfalls.

Three years on from Freedom and Choice, I expect many schemes will be undertaking another review of default strategy over the coming year. You will want to ensure the default strategy is suitable and takes account of all the risks the members could face.

Here are my three simple steps to consider as part of your review:

- In the short term - request data on when members are taking their benefits, this is likely to be held by the provider or administrator but your HR department will also have data on active members.
- In the medium term – build up a picture of how this compares to their TRA and the risks that members may be taking as a result.
- Over the longer term - use the data when reviewing the appropriateness of the default strategy.

Do this now, and ensure your members are protected, whatever age they decide to take their benefits.

People love working with LCP.

Clients tell us they value the trusted relationships we build and quality, bespoke advice we give.

"I always enjoy working with LCP, they deliver what I need when I need it."

Independent Chair of Trustees
May 2018

"LCP's client care programme, LCP CARES, regularly seeks client feedback and then uses it to improve service"

Pension and Investment Provider Awards
Judges quote for Actuarial Consultant of the year

Celebrating Investment Consultancy of the Year for a second year running

UK Pensions Awards 2018

We are delighted to have won this prestigious UK Pensions Award for the second year in a row. It is wonderful that our consistent first-rate innovation, performance and client service have been recognised again.

From the judges:

“LCP’s reporting technology and dashboards are helping clients demystify their pensions challenge.

A firm that constantly strives to save its scheme clients’ time and money, demonstrates consistently good performance to clients and has a comprehensive and consistently rewarding offering.”

PROFESSIONAL PENSIONS
UK PENSIONS AWARDS 2018
WINNER
Investment Consultancy of the Year

LITIGATION FINANCE: TRUE DIVERSIFICATION

Nikki Matthews
Associate Consultant

+

I advise our DB pension scheme clients on a number of investment issues including strategy, implementation, and monitoring.

I am a key member of LCP's Alternatives research team where I lead research into several asset classes and look into new ideas that could benefit client portfolios. I am also part of LCP's Fiduciary Management research team, involved in strategic oversight and monitoring as well as manager selections for clients.

+44 (0)20 7432 612
Nikki.Matthews@lcp.uk.com

Nikki Matthews introduces an asset class that is still fairly new to the UK - litigation finance. One to watch!

What is it?

Litigation finance is the funding of civil lawsuits in exchange for a share in a successful award. This is a fairly new investment in the UK and one that is currently quite difficult to access. Its truly diversifying characteristics make it an interesting idea to keep an eye on as the industry develops.

In the mid-1990's Erin Brokovich successfully sued the Pacific Gas and Electric Company for pollution in California, despite having no formal legal training. Her case was made into a popular film in 2000, starring Julia Roberts. Brokovich won her case, but there may be many similar cases that never get off the ground because the claimants cannot afford access to legal advice or to the courts.

Litigation finance is used to fund cases that litigants could not otherwise afford to pursue.

Litigation finance has been around for a while, but has only really taken off in the UK after common law prohibitions against third parties backing cases were relaxed.

In the UK, typically, a specialist litigation finance firm acts as the third party (though hedge funds have also invested in cases) providing finance for a claimant's legal fees (lawyers, expert witnesses, court fees etc) in return for a percentage of the award if the case succeeds.

Where is the demand?

Of course not all cases are uplifting stories of David vs Goliath like Brokovich's one.

The majority of cases funded by specialist firms in the UK focus on intellectual property. Many cases are brought by small, often start-up, firms claiming larger companies have infringed their intellectual capital. In these start-up companies low cash flow is common and any increased cost is definitely an issue.

As the value of intellectual property is only likely to expand with technology becoming an ever increasing part of the economy, it is likely that demand for litigation finance will grow along with it.

Demand for litigation finance also comes from consumers taking class action lawsuit against corporations. Litigation funders are supporting a few cases related to data security, where the consumers are suing large corporations for failures to protect individuals' data. For example, a recent case was funded against Google for alleged bypassing of the default privacy settings on Apple iPhones, which was used to track users' online behaviour.

£10bn
size of available finance for litigation finance in the UK

And the market is growing

New commitments in 2017 for one litigation firm were $1.3bn, 3 times the 2016 level and over 30 times the 2013 level! This illustrates exponential growth in usage by law firms (7% in 2013 versus 36% in 2017 used litigation finance) and more 'mainstream acceptance' of the asset class. A survey of law firms and corporates found 72% agreed that litigation finance is growing and increasingly important.

The investment case

This is an asset class that is genuinely uncorrelated to traditional markets. Performance will be largely unaffected by the stage of the business cycle. In a time where traditional asset valuations appear stretched across the board, pricing looks quite attractive here.

Litigation finance could therefore be a great diversifier for investors' portfolios and could also enhance returns: 15-30% pa return is a common return target, though there is a wide range.

Cash is distributed to investors on an ongoing basis as cases are resolved – beneficial for investors with cashflow needs.

Considerations

Whilst some cases may take years to resolve, many do not even go to trial as settlement is reached. Risk is eliminated earlier in cases that settle, whereas the outcome is uncertain and binary if the case proceeds to court. It is important to have a diversified fund containing cases with both types of expected route – successful court wins have generated the highest pay off but settlements provide stability and less fluctuation in returns.

Litigation finance firms are increasingly investing in a pool of a law firm's claims instead of just single cases. This gives the investor exposure to a diversified pool of cases by client, industry, country and duration of case. The well established relationships that funders have with law firms are essential in providing access to the best cases. High barriers to entry means that competition by litigation finance firms is unlikely to erode returns over time.

The majority of cases backed are in the US but also in the UK, Australia, Canada and Singapore, therefore largely confined to developed markets where more robust legal systems are in place.

On the downside?

Litigation finance could be accused of funding spurious cases. I believe this is likely to be a small minority as firms exercise thorough due diligence to select the strongest cases that are most likely to succeed.

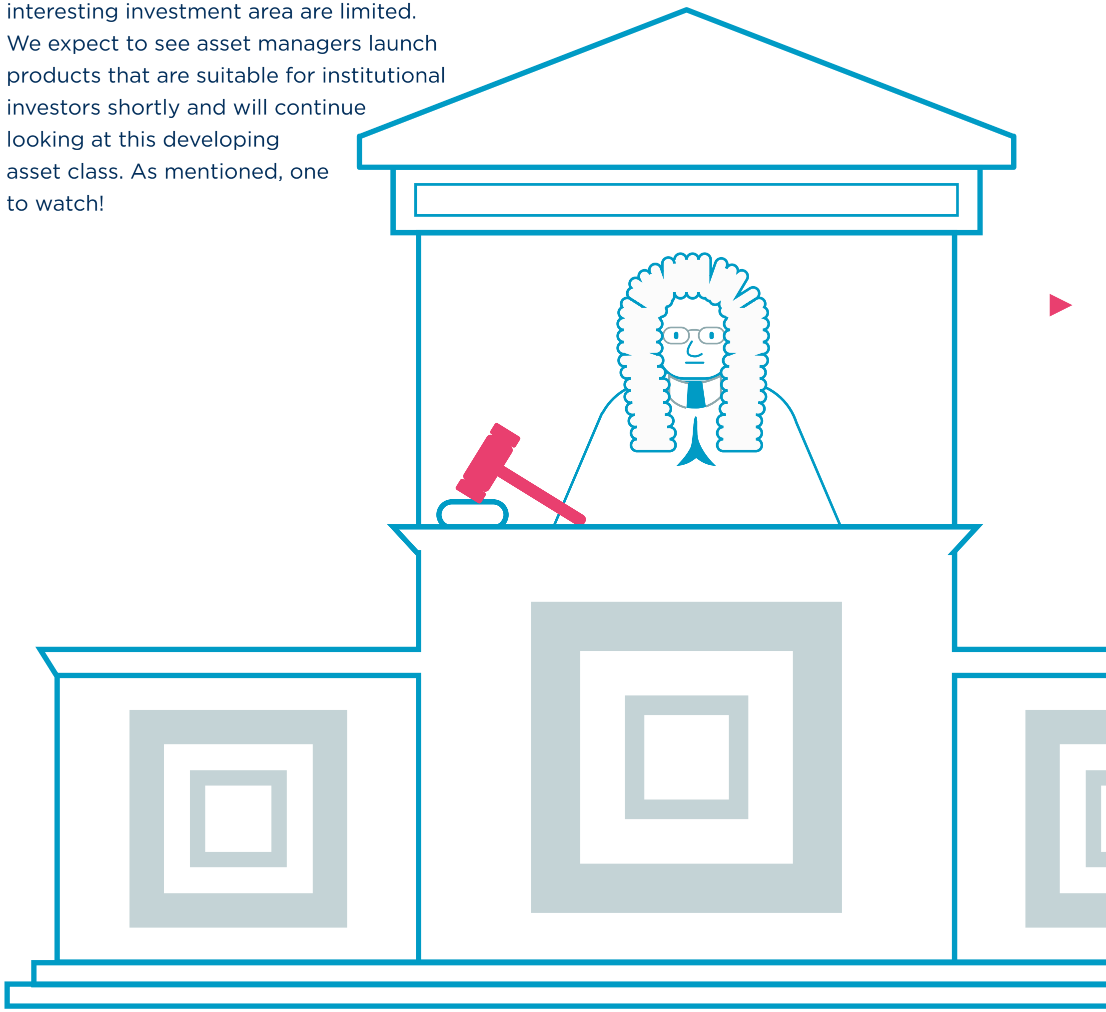
Of course, as with any investment – without risk there is no reward. What happens in the event a claim is not successful? The funder would take a hit on their investment. However, in a well-diversified portfolio, typically constructed to include hundreds of cases managed by many different law firms, losses should be limited. Firms will generally only commit a limited amount to each case or to any one firm, if backing a pool of cases. Therefore the maximum potential loss on a particular case is known and can be managed so that it is a very small percentage of the fund.

Another risk is that change in regulation could impact litigation finance – though this is true for most industries!

Lastly, reputational risk could be an issue ie the funding of controversial cases. It is important to note that litigation finance has helped cases that achieve socially and environmentally beneficial outcomes to proceed, eg supporting fishermen in Indonesia that are claiming compensation for alleged damages caused by an oil spill (action is being taken against an Australian company).

It may be the case that dedicated environmental litigation funds are developed in the future or that an investor can choose to support only specific cases. This could make it more appealing to schemes that consider environmental, social and governance factors as a key part of their process.

At the moment the routes to access this interesting investment area are limited. We expect to see asset managers launch products that are suitable for institutional investors shortly and will continue looking at this developing asset class. As mentioned, one to watch!



TRADE FINANCE: A LIQUID ALTERNATIVE TO PRIVATE CREDIT?

Matt Selfe
Consultant

I'm a Consultant within LCP's Investment team and am a qualified actuary. I help pension scheme trustees 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.

+44 (0)20 7432 7793
Matt.Selfe@lcp.uk.com

Private credit is compelling

Over the past couple of years, many investors have turned to private credit as an alternative source of returns. Banks have been moving their businesses away from lending to mid-size borrowers due to more onerous regulatory requirements. The investment case for institutional investors to step in and take the banks' place was, and remains, strong.

However, some investors are put off private credit by its lack of liquidity. Investments are often locked up for years at a time, which can be particularly problematic for pension schemes that want to de-risk over a relatively short time frame.

Trade finance could provide an alternative without the illiquidity

Similar to private credit, investors in trade finance are again benefiting from banks moving out of the space due to stricter regulation. However, such investments are much more liquid, with investors often able to redeem monies on a monthly basis.

What is trade finance?

Trade finance involves providing short-term private debt financing to buyers and sellers of commodity and industrial goods. Borrowers use this type of financing to bridge the trade cycle funding gap between:

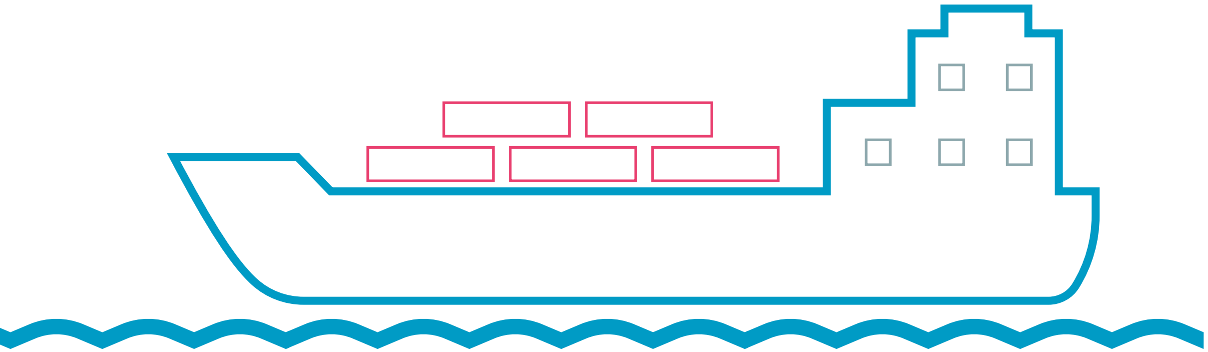
- buyers who want to make payment only once the goods have been received; and
- sellers who want upfront payment before shipping goods to manage working capital.

Why would you invest?

Trade finance could fit in the growth section of a portfolio, given it:

- aims to achieve set return targets, irrespective of wider market conditions. The funds generally target around cash + 4-6% pa;
- is uncorrelated to traditional asset classes, such as equities or bonds. The movements of the equity or longer-dated bond markets are expected to have little impact on returns; and
- has historically low default rates. Trade transaction cycles are relatively short-term, and companies are typically stable. In addition, many arrangements have security over an asset if the borrower were to default.

Banks haven't just reduced their long-term loans to private companies but their short-term loans too; this creates opportunities for other investors.



What are the key risks?

The key risks are that the buyer or seller does not honour their obligations. Depending on the exact structure of the loan, this could be either:

- the buyer defaults on the payment; or
- the seller defaults on the delivery of goods.

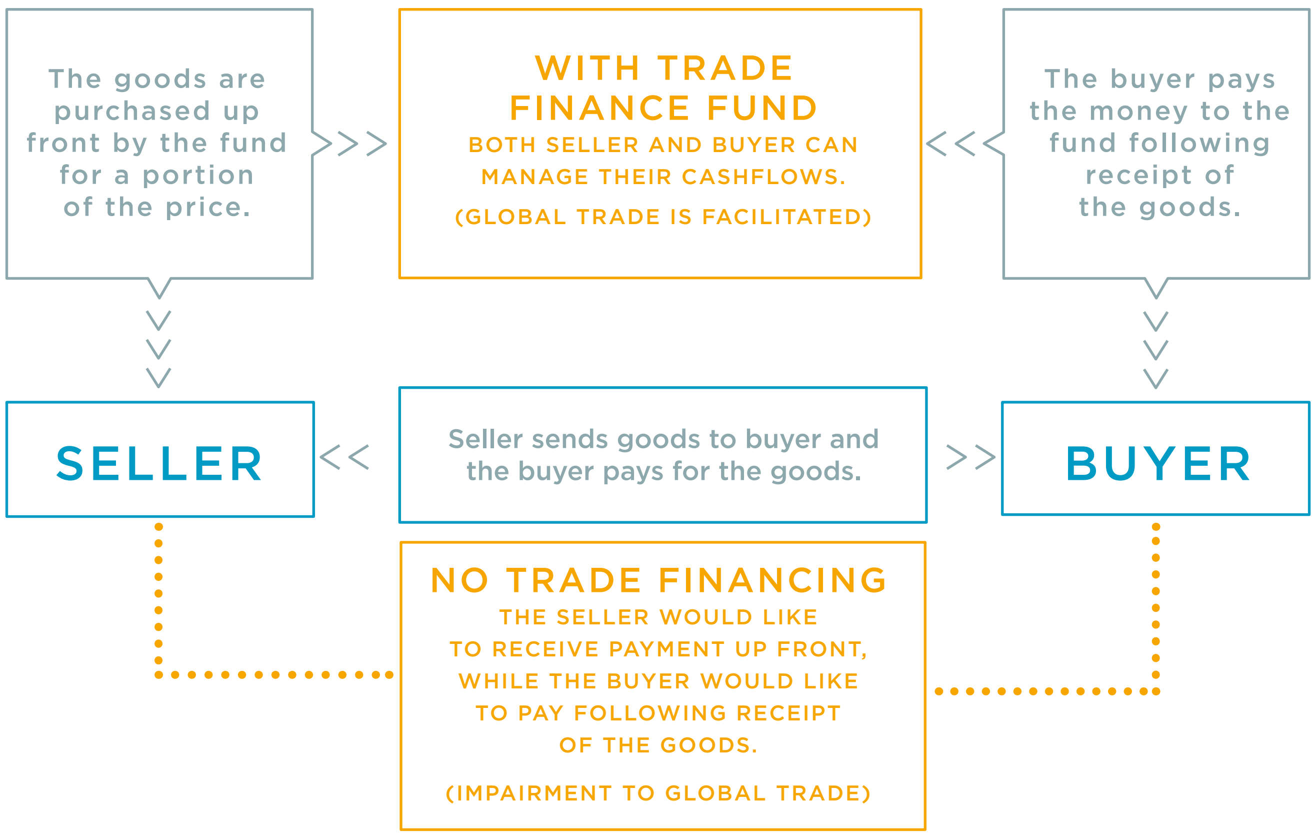
In both cases, the investor may not receive the repayment of their loan. However, these risks are often mitigated as:

- portfolios are well diversified, with many underlying loans;
- transactions are protected by collateral and/or insured; and
- managers carry out rigorous due diligence on their investments.

Overall, trade finance could provide a good investment solution for investors

The investment case is compelling, with expected returns of around 4-6%, creating an opportunity for investors to take advantage of an area being vacated by banks. Furthermore, the absolute return target, low correlation to traditional asset classes, and liquidity makes trade finance a really interesting area.

An example of a trade finance deal



THE INFINITE LINE OF ADVISERS – CURTAILED

Matt Gibson
Partner

I have 20 years' experience analysing and selecting investment managers across all asset classes. I am responsible for LCP's manager research and delivering clear advice to LCP's clients on their investment management arrangements.

My role is to ensure LCP's consultants are receiving appropriate information, analysis and opinion so they can provide advice about investment managers that is tailored to their clients' requirements.

+44 (0)20 3824 7255
Matt.Gibson@lcp.uk.com

*The Competition and Markets Authority (CMA) investigation into investment consultants has reached some provisional conclusions. It seems to me that at the heart of many of the issues raised in the investigation is the difference between **delegation** and **advice**.*

What do you want from your investment consultant? That's easy, right? You want great recommendations for asset allocation and managers that deliver better returns than the picks from other consultants.

But if that's all you want from your consultant, then you may as well let them implement the recommendations for you and use a full fiduciary management service. That may be ideal for some people, but... you're then left with another problem. Who monitors the performance of that fiduciary manager / investment consultant?

Professor John Kay, in his excellent review of the UK investment market, made an insightful comment about advisers:

"Outsourcing of functions based on... specialist skills... is to be welcomed. But in an environment in which trust and confidence are lacking...the process of hiring advisers to review the work of other advisers can multiply indefinitely. The addition of successive layers of oversight and accountability not only adds to cost but... creates additional possibilities of misalignment of incentives"

Professor Kay forsees an infinite line of advisers: you employ an investment consultant to select and monitor your asset managers, you employ someone else to select and monitor your investment consultant; and someone else to monitor the performance of that adviser... and so on.

The CMA is currently investigating the market for investment consultants and has suggested that a possible remedy is to force consultants to publish the performance of their manager selection advice. Now, we are very happy to provide this narrow set of information to any client, but it doesn't really capture what we, or any good adviser, should be doing.

As I see it, an investment consultant has a much wider role, one that breaks the infinite line of advisers that Professor Kay talks about.

I see our role as helping you make the decision that best suits your circumstances. That involves applying our specialist experience; communicating clear rationale behind advice; providing firm recommendations when appropriate; and setting out the consequences of taking different courses of action. That process is much more than just providing you with a recommended course of action. Done right, it becomes integral to your decision making process and builds the trust that Kay's review found to be lacking in UK finance.

An investment consultant has a much wider role, one that breaks the infinite line of advisers

Trust in partnership is hard to gain and you don't abandon it lightly: Don Quixote would never switch advisers, he knows Sancho Panza has his back; Batman isn't going to put Robin's role out to tender anytime soon; who could replace Robert Duvall as Marlon Brando's Consigliere in the Godfather?

Some investment consultants offer both advisory and fiduciary management services. They argue there's a spectrum of services between the two that makes one a natural extension of the other. I won't comment on the perceived conflicts of this arrangement here, but I do see these as fundamentally different services. Once your adviser has discretionary control and does not have to refer back to you to buy and sell your assets, they've crossed a line. It's more than just the regulator viewing these services differently, it's truly a fundamental difference. They are no longer bringing you along with them in their view of how the assets should be invested. They are just doing it! This might be a valuable service and what some clients need, but it does mean you need to monitor closely that they're doing it well.

The distinction between these services is similar to the difference between driving yourself with a navigator alongside, and taking a taxi. Navigating is like the provision of investment consulting services. The navigator provides advice on the destination, the route, appropriate speed and points out hazards along the way, which the driver (the client) can accept or ignore. In a taxi (fiduciary management), you instruct on the destination, but it is clear that the taxi driver is in control of the vehicle.

As an industry, investment consultants have been successful in gaining and retaining this position of trust. The CMA found that pension fund trustees rarely change their investment consultant. Three quarters have not changed adviser in the last five years. This is of no surprise to me. That's not an indication of a failure in the market or clients not being engaged enough to review their consultants – it's an indication of the industry's success. Trust in a partnership is hard to gain and you don't abandon it lightly – Don Quixote would never switch advisers, he knows Sancho Panza has his back; Batman isn't going to put Robin's role out to tender anytime soon; who could replace Robert Duvall as Marlon Brando's Consigliere in the Godfather?

Our aim is to gain and retain your trust to the point that you are not just taking our views at face-value, but making our advice integral to your decision-making process. We don't underestimate the challenges in gaining that trust, nor how fragile it can be, but the long term rewards to all parties in this sort of partnership are substantial.

JOINING THE DOTS ON PENSIONS AND CLIMATE CHANGE FOR MILLENNIALS

Claire Jones
Senior Consultant

+

I am an actuary with over 15 years' experience spanning pensions, investment and sustainability. I help LCP's clients to include environmental, social and governance considerations in their investment processes, with the aim of delivering sustainable long-term financial returns.

+44 (0)1962 873373
Claire.Jones@lcp.uk.com

Making the link between pensions and action on climate change could be a turning point for engaging socially conscious millennials on retirement savings issues.

We have a generation of socially-conscious millennials, who care passionately about climate change and sustainability. We also have a generation of future pensioners who are not engaging with retirement savings issues.

So how can we 'join the dots'?

Anecdotally, we know that young people today are, by and large, a passionate bunch – particularly when it comes to sustainability and environmental, social and governance (ESG) issues. In fact, according to the World Economic Forum's 2017 Global Shapers Survey, young people around the world consider climate change to be the world's most serious problem, bar none.

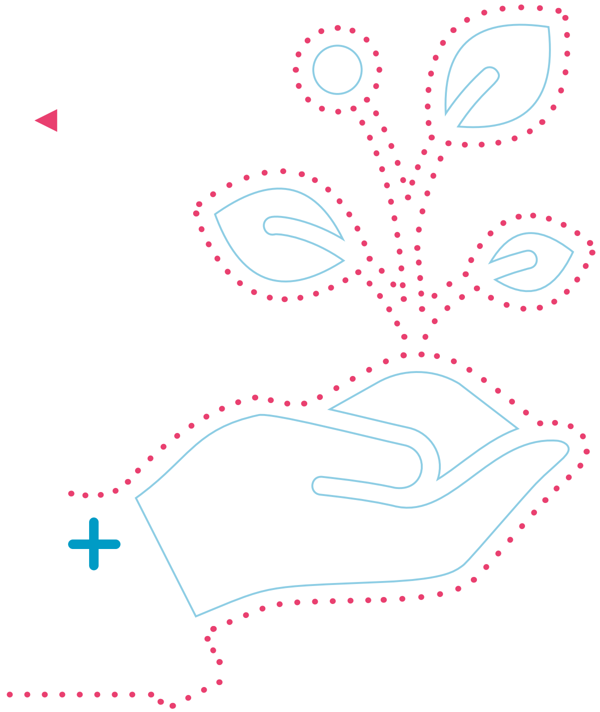
LCP's Future Pensioner campaign seeks to look at ways the industry can encourage younger generations to save for pensions that are "fit for the future" but the "uncomfortable truth" is that there needs to be a future worth saving for. ShareAction has recently explored similar themes and the more voices joining this debate, the better.

The challenge facing the pensions industry is to bridge the gap between the socially conscious younger generation, and their engagement in retirement saving. There are natural links between retirement savings and responsible investment strategies, but none of these are communicated to young savers.

As the PLSA's Luke Hildyard points out, "climate change is not just an ethical issue for pension fund governance bodies, but a major threat to financial stability".

Climate factors affect investment performance. A study from Cambridge Institute for Sustainability Leadership revealed that "even in the short term, climate risks pose a significant threat to investment portfolio performance" and "investors cannot entirely shield themselves from the exposure to climate change".

Largely viewed as a longer-term issue, the more immediate risk to pension fund investments cannot be overlooked. The Cambridge study showed, for instance, how equity portfolios could lose up to 45% of their value in the short-term due to market participants reassessing the significance of climate risks.



Such stark warnings come as the UK government is also turning its attention to responsible investment. In March, Mary Creagh MP, chairwoman of the parliamentary Environmental Audit Committee, wrote to the top 25 UK pension funds – which have a combined £555 billion in assets under management – to explore how these funds are protecting people's pensions from the financial risks associated with climate change.

The companies in an investment portfolio could be affected drastically and quickly, with new energy sources giving rise to new disruptive companies, that impact the value of existing companies (fossil fuel companies may lose value as low-carbon energy methods surge, for example).

Governance bodies, investment managers and consultants need to consider their approach to the financial risks associated with climate change, and not misinterpret their fiduciary duty as simply 'maximising short-term returns'. This is also an opportunity to catalyse engagement in retirement and savings issues.

The whole industry must now reach out to the untapped potential of passionate millennials, harness their fervour, and fully engage them in not just saving **for** the future, but also saving their future.

LCP Responsible Investment Survey 2018

Behind the scenes: Are investment managers delivering on their responsible investment claims?

ESG considerations and stewardship have risen up the agenda in recent years, but are investment managers doing all they can in this area?

120 investment managers, including nearly all the major institutional investment managers in the UK, responded to our survey on responsible investment.

Download your copy from our website.

ARE YOU CLOSER TO BUY-OUT THAN YOU THINK?

Charlie Finch
Partner

+

I joined LCP in 2000 and provide pensions advice to both companies and pension plan trustees with particular focus on strategic advice and longevity de-risking.

I jointly set up LCP's award-winning buy-in, buy-out and longevity swap practice in 2006 and have since helped many clients to design and implement buy-ins and buy-outs to reduce longevity risk.

+44 (0)20 7432 0625
Charlie.Finch@lcp.uk.com

Our latest ***de-risking report*** *outlined the favourable conditions in the buy-in, buy-out and longevity swap market.*

At the end of 2017, around 1 in 5 of the UK defined benefit pension plans of FTSE100 companies were more than 80% funded relative to the cost of buy-out, up from 1 in 8 last year.

So, on the back of the improved funding and current attractive pricing, we are anticipating a marked increase in demand from pension plans to de-risk. Anecdotal evidence is already supporting this, with insurers reporting a large increase in pipelines this year.

Given the big stride forward schemes have made over the last year, I have set out below five key questions I think you should be asking yourself about your de-risking strategy.

1. Where would you like to get to?
2. How far away is your goal?
3. How will you get there?
4. How do you keep on track?
5. What upfront work do you need to do?

Where would you like to get to?

The way we see it, there are three potential ultimate goals for every pension plan:

- Firstly, you may wish to run the plan on, with the ultimate goal being self-sufficiency. Under this strategy, the ultimate objective is to be well funded with a low risk strategy, with limited risk of future contributions being required.
- Alternatively, the ultimate goal may be to buy-out the pension plan with an insurer, as soon as it is affordable to do so. This is often driven by a sponsor desire to remove the plan completely from the company balance sheet in the short term.
- Or perhaps you may take the view that, although the ultimate objective is to fully buy out the pension plan, this is best done by hedging longevity risk for pensioners (eg through buy-ins) as members retire, and to benefit from profits as non-pensioners exercise member options over time, and you are comfortable maintaining a reasonable level of risk on that journey.

Buy-ins and longevity swaps can be appropriate for all three strategies. The first longevity swaps have now been converted to buy-ins demonstrating their viability for schemes targeting full buy-out. Buy-ins are gaining increasingly widespread recognition as an attractive low risk asset class that can be held as part of a long-term self-sufficiency strategy.

Of course, the recent launch of DB consolidation vehicles provide an alternative ultimate goal for some schemes, but that is for a separate article!

How far away is your goal?

Given the improvements in buy-out funding for the FTSE100, we would be surprised if the funding position of your plan on a buy-out basis is not markedly higher since the last actuarial valuation. Obtain an up-to-date estimate (through your online valuation platform, such as LCP Visualise, or by asking your advisers). Consider any deficit contributions already committed and what the additional cash cost would be to plug the buy-out shortfall.

How will you get there?

If the shortfall on buy-out remains unaffordable, consider how else it could be closed. For example, a phased buy-in strategy steadily insuring liabilities over time can achieve meaningful savings relative to the "standard" full buy-out cost – we estimate the ICI Pension Fund has saved over £100m through phased de-risking. This approach has now become well established with nearly half of all buy-ins over £100m in the past two years being a repeat transaction for the pension plan. In addition, add in expected investment returns and expected gains from member options and you may find that the buy-out shortfall will close much faster than you think.

How do you keep on track?

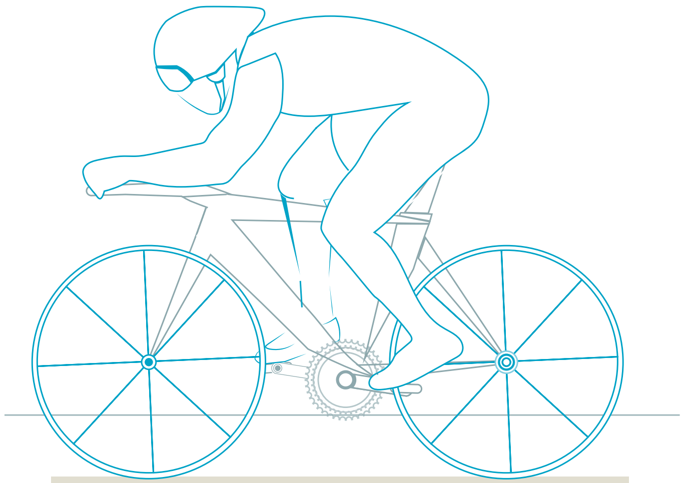
There is a wide range of risks that can blow a pension plan off course, such as investments underperforming, inflation or longevity. These risks can be monitored and managed by trustees and sponsors through tools such as LCP Visualise, and action taken to prioritise and tackle them.

There are of course other risks, that are less easy to measure. For example, insurer pricing risk, the risk that insurer pricing deteriorates in the future, pushing up the cost of buy-out. This is a risk that schemes and sponsors are becoming increasingly aware of, with the dynamic currently shifting between pension scheme demand and insurer supply. After all, many schemes are targeting buy-out over a similar timeframe and if they all get there at around the same time, insurer capacity is likely to be quickly exhausted, with obvious implications for pricing.

What upfront work do you need to do?

This is all about having a realistic plan and prioritising the work required to achieve it. When approaching the market, insurers will assess your commitment and likelihood of a transaction proceeding. Having a clear plan which you can explain to the insurers and realistic expectations can make a big difference to insurer engagement and therefore the pricing achieved.

*To get more detail around your de-risking options and these five key questions, watch our recent **webinar** or take a look at our buy-in, buy-out and longevity swap **case studies** to see how others have tackled their de-risking journey.*



TIME TO INVEST IN US GOVERNMENT BONDS?

Laasya Shekaran
Investment Analyst

+

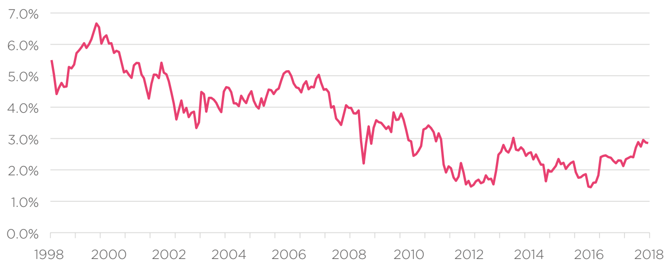
I am an investment analyst at LCP. I joined LCP as a graduate in September 2017 and I am currently working towards my CFA qualification.

In addition to advising clients, I am involved with some of LCP's research teams. I am also part of the modelling team at LCP, which is responsible for regularly updating our modelling assumptions underlying the tools we use, such as LCP Visualise.

+44 (0)1962 67 2950
Laasya.Shekaran@lcp.uk.com

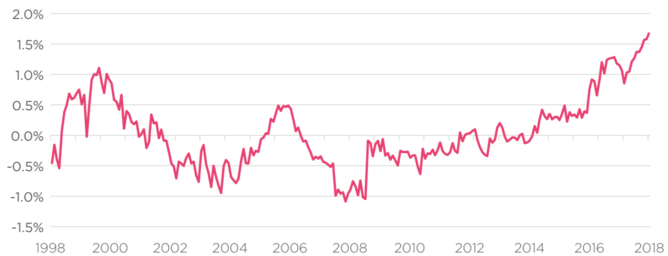
US government bond yields have risen

Yields on 10 year government bonds from the US rose above 3% pa at the middle of May, for the first time since 2014.



10 year US government nominal bond yields (%)
Source: Thomson Reuters Datastream

3% pa doesn't sound much but it's broadly double the yield on equivalent UK gilts – in fact the difference in yields is now close to a 20 year high.



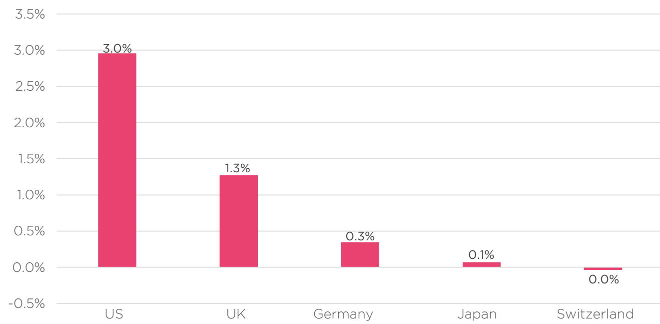
Excess yield of 10 year US government bonds over 10 year gilts
Source: Thomson Reuters Datastream

I wonder at what point would UK pension schemes consider US government bonds as an alternative to their lower yielding UK equivalents? Have we reached it?

The case for US government bonds

I think there are three good reasons why UK pension schemes might want to consider a position in US government bonds: the return, the liability matching characteristics and the diversification benefit.

US government bonds are offering nearly double the yield of UK gilts. They are now one of the highest yielding, developed government bond markets as shown in the chart below.



10 year government bond yields in select developed markets
Source: Thomson Reuters Datastream

With many UK pension schemes de-risking and no longer requiring high returns to meet all the pensions promised, a 3% pa return would be a significant contribution to the overall return they need.

With the backing of the US government, they are of course virtually free of any credit risk.

US government bonds and UK gilts also have a reasonably high correlation and the price tends to react in a similar way to economic news. After all, it's a global economy so the factors causing price changes have a similar effect on all developed bond markets. So while US government bonds don't have the precision of UK gilts for matching the value of pension scheme liabilities, they offer some matching characteristics.

Furthermore, to the extent schemes require higher returns and need to maintain an allocation to riskier growth assets, US government bonds are often good protective assets and diversifiers. When global equity markets have gone through turbulent, negative periods, the US bond market has tended to rally. Some of these protective characteristics come from investing in US dollars, which also tend to do well when equities fall, boosting returns for a UK based investor.

Cons

While this sounds like an amazing opportunity – why wouldn't you choose to have yields of 3% vs 1.5%? Of course, there's a catch! Any gain that you get from the greater yield on US Treasuries might be wiped out by depreciation of the US dollar against the pound. If that did happen, on the plus side, it'd be cheap holidays in the US.

You could, of course, hedge this currency risk, but the total cost of hedging is about the same as the excess yield.

But could the unhedged dollar exposure act as a further boost to investment returns? Since the end of 2016 the dollar has depreciated by 7% against sterling. So there's some protection that you're already buying a depreciated dollar.

Conclusion

In my view, there must be a point when UK pension schemes would consider US government bonds as an alternative to (at least some of) their UK gilt holding. Is double the return at a 1.5% pa pick-up enough for everyone? I doubt it. But surely it must be attractive enough to consider a smaller allocation if and when a scheme is increasing its hedge ratio? And if adding some dollar exposure across your portfolio helps to reduce risk... then win-win!

LCP INSIGHT CLARITY ADVICE

The long and the short of it

LCP's Annual Pensions Conference

18 September 2018 8:30AM

Hilton Park Lane, 22 Park Lane, London, W1K 1BE

Registrations are now open for our Annual Pensions Conference on Tuesday 18 September 2018.

Reserve your seat to hear our expert views on the key current issues facing pension scheme trustees, sponsors and managers.

Professional and interesting with the right mix of topical subjects to get you thinking and keeping you informed.

Register now at
www.lcp.uk.com/events

#LCPAPconf

Follow us

Insights and opinions on our blog at **www.lcp.uk.com**

News and conversation on Twitter: **@LCP_actuaries #LCPVista**

Updates from our experts on LinkedIn

Meet our people at one of our regular events www.lcp.uk.com/events

It's all about you!

It's important to us that we deliver what you want, and don't clog up your inbox with things you don't care about.

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.

Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands B.V.
(operating under licence)
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com