

VISTA

MAGAZINE

OUR INVESTMENT VIEW

ISSUE 3 DECEMBER 2015

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Vista is designed to keep you abreast of our latest investment thinking. #LCPVista



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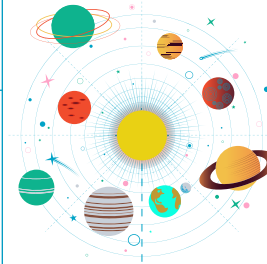
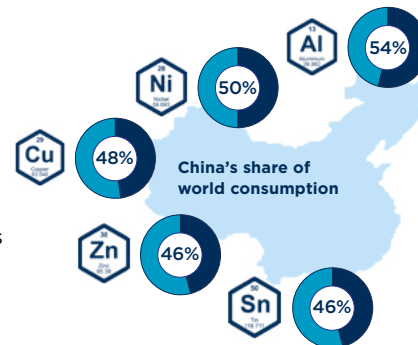


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China and the outlook for Emerging Markets

Thomas Donohoe – Investment Consultant

We are now at a point where different markets are growing at markedly different rates. Thomas takes us through the key factors behind the recent pressure on emerging market assets.



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Absolute Return: a universe of opportunity

Steve Hodder – Investment Consultant

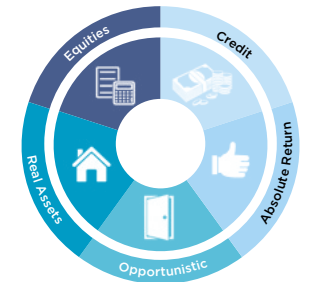
Steve compares the expansion in the ways pension schemes can seek “absolute” returns to the big bang theory and outlines the key to constructing a robust portfolio.

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Using investment toolkits better in today's challenging markets

Hishendhra Ravindra – Senior Investment Consultant

It's important for investors to ensure that they are using the full toolkit to enhance returns whilst still managing risk. Hishendhra considers a framework for getting the best from your assets.



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Make a home for residential property

Andrew Jacobson – Senior Investment Consultant

Andrew explores why pension schemes hardly own any UK residential property, when it's been one of the strongest performing sectors over the last 10 years, outperforming both commercial property and equities.



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Enhancing yield with swaptions

Gavin Orpin - Partner

Interest rate options, known as swaptions, have seen more favourable pricing over the past year. Gavin takes us through a case study where a client used swaptions to enhance yield.

A Note from the Editor

ACCESS to all the latest investment THINKING



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Ian helps his clients to develop better investment strategies by helping them diversify and hedge risks. As well as advising clients with assets between £50m and £3bn, he leads our research into new asset classes and is a key member of our LDI and derivatives research team.

The eagle-eyed reader may have noticed that the cover image of this edition of LCP Vista is Shanghai in early morning rush hour. This is rather apt as the slowdown in China over recent months has really impacted markets, and therefore pension schemes' funding levels. Not only has the Chinese slowdown reduced the value of Chinese assets, it has had knock-on effects in almost all markets; equity markets around the world suffered as the Chinese slowdown transformed into fears of a global slowdown; commodity prices fell further (particularly base metals); and government bond yields continued downwards, as hopes of an interest rate rise soon were dashed once more.

So, once again, investors are left wondering how to navigate all this volatility, and the question of how to seek out good returns in a world of low yields is more relevant than it ever was.

In such an environment we think it's important for schemes to have access to all the latest investment thinking. LCP Vista is just one way that we aim to deliver that to you.

In this edition

Thomas Donohue looks at what's been happening in China, and re-examines the case for investing in Emerging Markets. We also share a couple of topical investment ideas – with Andrew Jacobson looking at residential property, whilst James Trask tells us why distressed debt is the place to be in the next few years.

Steve Hodder investigates a somewhat overused term, “Absolute Return Funds”. These days most pension schemes have an “absolute return” strategy of some description - perhaps you call yours a diversified growth fund, a cash plus or a hedge fund strategy? However, Steve points out that these are very broad terms, as they disguise a whole universe of different strategies and approaches. He encourages you to look more deeply at what these funds actually do, and to

consider what mix of these funds would best achieve your objectives.

But having access to the best investment ideas is only half the battle; investors also need the right frameworks in place to implement them. Hish Ravindra has been doing a lot of thinking about how pension scheme investment strategies can be redesigned so that the schemes can be opportunistic and nimble, to ensure that the maximum value possible is earned from the latest ideas. Gavin Orpin then outlines exactly how one of his clients extracted significant value from an opportunity in the derivatives markets, in what was almost a win-win situation.

If any of the topics discussed in this edition are of interest, then please do get in touch with me, your usual LCP contact, or any of the authors themselves. I'd also be really interested to hear any feedback you have on LCP Vista itself; we're always striving to improve it.

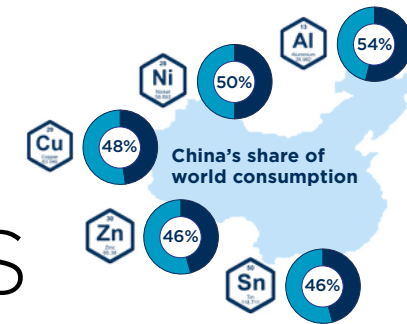
The question of how to seek out good returns in a world of low yields is more relevant than it ever was.



A short video outlining the topics covered in this issue of LCP Vista

The macro-economic outlook

+ CHINA and the outlook for EMERGING MARKETS

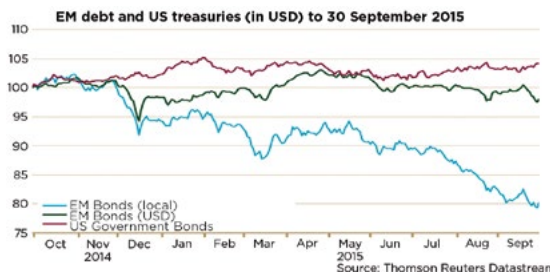


Over recent years many pension schemes have made investments into emerging markets (EMs). Whilst they should have been prepared for a bumpy ride, recent returns have been disappointing to say the least. Many schemes are now reappraising the strategic case for EM investment.

Emerging markets have been viewed for some time as a



group of economies under the same economic influences, for good or bad. High future growth across EMs has been the dominant investor narrative – driven by the emergence, industrialisation and urbanisation of these economies, particularly China. But we are now at a point where different markets are growing at markedly different rates; investors



should no longer view Emerging Markets as a homogenous (or in some ways even similar) collection of economies. Pressure on EM assets has been building in recent years with equity and bond markets declining due to three key factors:

1. China's slowing growth

The 1.4 billion Chinese people account for 20% of the world's population and for about 13% of the world's economic output. Over the last two decades, Chinese economic growth has been a perhaps overly relied upon but still very significant element of total global growth. As a result, once China's growth rate began to wane, as now appears to be officially admitted even by the Chinese authorities themselves, the economic and markets effects have been significant. The lower

growth rate is part of a structural economic transition from Beijing's previous economic model, which relied on investment in industries and infrastructure, to a more consumer-driven economy, led by China's new middle class.

2. Falling commodity prices

The impact of a slowdown in China has not only affected Chinese assets themselves but has also impacted other emerging markets that export to China. Commodities prices in particular have reacted negatively. China consumes an astonishing amount of raw materials. A China that slows down to growing by "only" 3% to 4% pa is a China that buys materially less resources from around the world. This is the central reason why China's slowing growth is causing problems for commodity producing nations.

3. Declining EM exchange rates

Currencies of many commodity-producing nations have plummeted over the last twelve months as prices for their output have collapsed with the lower pace of growth in China. The decline in EM foreign exchange rates has been exacerbated by developed nations' monetary policy since 2008. Expectations of higher future interest rates in the developed world have caused EM exchange rates to depreciate significantly against strengthening developed market currencies (and in particular the US Dollar). Some foreign exchange rates of emerging markets are looking historically cheap at the moment.

The case for investing in emerging markets

In my view the case for investing in emerging markets is certainly not broken. However, whilst further volatility and currency depreciation is a distinct possibility in the short term, investors should continue to find attractive longer-term return potential across specific markets.

Investors should make a point of considering how they access emerging markets within their investment strategy in the near future.

I think the best approach is to employ a manager that can dynamically switch between the various sub-sectors of the market; into different geographies, different asset classes and different currencies.



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Thomas helps his clients implement dynamic changes to their investment strategies over time. Thomas assists his clients in understanding the important factors that are influencing their Scheme's funding level as well as analysing changes to investment managers' portfolios.

+ Residential property

Make a HOME for RESIDENTIAL PROPERTY



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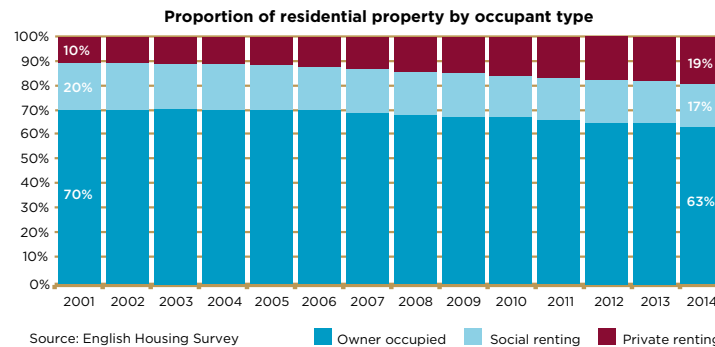
Andrew advises a range of pension funds and is an implementation specialist. He also is a senior researcher on the real assets team, driving LCP's view on UK real estate and alternative inflation opportunities.

Residential property investments have long been part of the national psyche, but have traditionally been considered too specialist for pension schemes. This perception is changing, with the rapidly growing Private Rented Sector (PRS) providing exciting opportunities for early movers.

The simple truth is that the UK is not building enough new homes. Initiatives like David Cameron's new starter homes policy may address this issue over time. However, high house prices and difficulty accessing mortgages are breeding a new generation of renters – often urban, socially mobile professionals in the 25-35 age bracket – who want (and are prepared to pay for) high-quality, purpose built rental accommodation with all the mod cons.

Private renters are a fast growing group - with a two-fold increase since 2001 - and now account for 19% of households in the UK.

In recent years financial institutions have been encouraged to inject capital into the private rented market, with initiatives like the 2013 "Build to Rent Fund" spurring on new PRS developments – often purpose-built multi-unit apartment blocks in locations with great transport links and amenities. In turn, real estate managers are launching a number of open-ended pooled fund vehicles which, like their commercial property equivalents, provide pension schemes with easy access to the market.



STOP PRESS: STAMP DUTY CHANGES IN THE 2015 AUTUMN STATEMENT DO NOT APPEAR TO IMPACT INSTITUTIONAL INVESTORS

Undoubtedly the rise in house prices has been a key driver of performance – however PRS has several other potential attractions for pension schemes:

- Favourable market growth** - residential dwarfs commercial property in the UK, yet accounts for less than 1% of institutional portfolios.
- Strong rental demand** – rental growth in London, for example, has averaged 4.4% pa since 2011 with a 40% premium on rents for new builds.
- Inflation hedging characteristics** – with short-hold tenancy agreements, rents tend to rise with wage inflation.
- Diversification benefits** - residential property has traditionally exhibited low correlations to commercial property, and to other growth assets.

Investing in this new market does have risks. House price growth has been very strong in recent years, so PRS could be susceptible if there is a sharp correction. There is also the political dimension – changes in government policy could impact the market either positively or negatively. Finally, the choice of real estate manager is essential – experience in managing development projects and establishing trust with tenants is key to success.

I think adding PRS to a well-diversified real assets portfolio therefore makes plenty of sense, with favourable demographics, the structural supply-and-demand imbalance, and attractive rental growth potential all underpinning this new opportunity.

So perhaps including residential property in your portfolio is closer to home than you think.



+ Distressed debt

When the GOING gets tough - opportunities for the NIMBLE INVESTOR



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The world would not function without credit. Indeed the Latin "credere" meaning "to trust" gave rise to the word credit. Nowadays lenders rely on detailed analysis of the borrower, rather than simply trust, to ensure they get their money back. And with banks shrinking their balance sheets, long-term owners of capital such as pension funds can lend money at attractive rates, with conditions and security attached.

But not all lending is good lending. Or put another way, not all borrowing is sensible borrowing. As an example, we are starting to see the consequences in the energy sector with the collapse in oil and commodity prices. Those businesses that were over-leveraged on the basis of \$100+ oil are finding their business plans unsustainable with \$40 oil. But it isn't just the energy sector where over-borrowing may lead to problems. We are now seven years on from the greatest recession of modern times, so we are surely now closer to the next recession than the last. And this time we will be entering it with abnormally low interest rates, even if the Fed and the Bank of England manage to get rates up to 2-3% first. So the central banks won't have the usual scale of rate cutting to apply to help those in distress.

And businesses can get into distress for all sorts of reasons:

- Inappropriate capital structures (borrowing too much without enough thought as to what could go wrong)
- Cyclical effects (every business cycle yields casualties)
- Industry effects (eg will the VW emissions scandal lead to a wholesale move away from diesel fuel?)
- Technological changes (look at what digital photography did for Kodak)

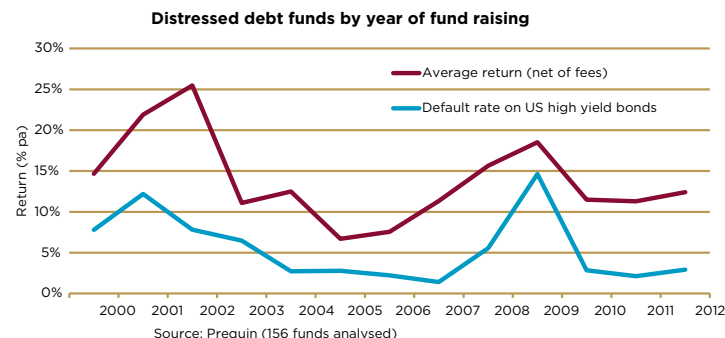
We are surely now closer to the next recession than the last.

In some cases, distress is the beginning of the end, and you should stay well clear. But in others, there is opportunity. There may be a perfectly viable business generating cash, but with an inappropriate capital structure so that cash income is simply paying debt interest. Distressed credit managers buy into distressed businesses at low prices, and have a say in restructuring the debt. The end result can be an ongoing business with a viable structure, and the opportunistic investor can end up with significant capital gains.

This is not for the faint hearted - the fund manager won't get every decision right, and you must be prepared to lock up your money for up to a decade in a closed fund structure

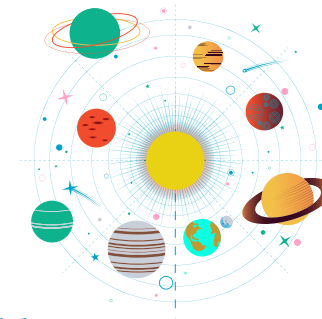
with high fees. But history shows that capital deployed when the default cycle hits its peak yields the highest returns. (See chart)

Looking at the lack of growth around the world, alongside the need for interest rates to start to normalise, something will have to give: we have a recipe for a big increase in corporate defaults in the coming years. This would no doubt have negative consequences for traditional equity and credit investments, so distressed debt investing may provide a genuinely counter-cyclical investment opportunity, and I think it's going to start getting interesting soon.



Absolute returns

Absolute Return: a UNIVERSE of opportunity



The range of absolute return funds has expanded vastly over recent years – are you making the best of the opportunities available?

According to Stephen Hawking, when our universe exploded into life around 14 billion years ago it initially doubled in size 90 times within its first second. More recently, expansion of the “universe” of ways pension schemes can seek absolute returns has felt just as rapid!

Absolute return funds have proved hugely popular with investors over recent years, offering a new way of protecting against volatile equity markets. In my view, this trend will only strengthen as trustees and corporates look to reduce downside risk associated with closed pension schemes.

Global equity markets sold off dramatically over the third quarter of 2015, providing a good “test environment” for absolute return funds. The chart classifies absolute return funds we research into different “shades” and explores whether they genuinely offered something different over a tricky quarter for investors.

We can see that these funds delivered a huge range of outcomes over this quarter, which isn’t at all surprising when you consider the huge range of approaches being taken. Funds in this space are often forced into broad categories such as “Diversified Growth” or “Hedge Funds”, but I believe this can discourage investors from understanding the true breadth of approaches available.

Some funds offer fairly balanced portfolios of traditional asset classes. Others look to dynamically adjust their position to improve returns. Whilst funds of this nature can work well, they may not offer significant diversification from existing equity and bond allocations, given they generally seek returns in similar markets.

Moving further into the universe, we find managers looking to steer clear of traditional market returns altogether. Some construct a blend of relative value opportunities (ie expressing a view that one asset will outperform another) or focus on discretionary trading (ie good old-fashioned expressing an opinion).

Others access “exotic” asset classes or seek out alternative risk premia (in the hope that these are independent to broader markets). Some even target opportunistic investments in distressed companies. These approaches can be very effective at complementing more traditional asset classes.

Of course there are downsides to consider with these less-traditional approaches: they can be harder to understand and are often more expensive, reflecting greater complexity and resourcing. However, I think it is worth taking on these hurdles given the potential benefits. I believe that the key steps to constructing a robust portfolio are as follows:

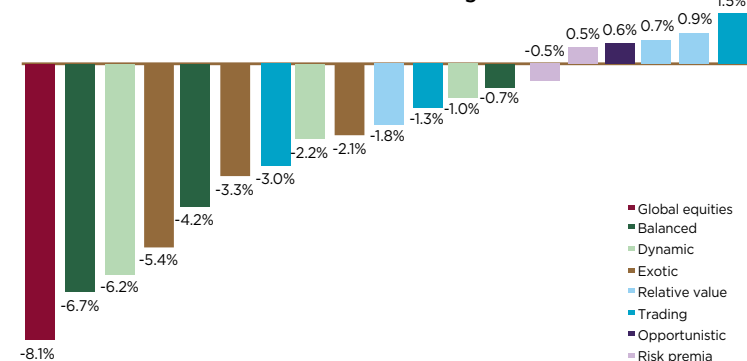
1. Establish clear risk tolerances and corresponding return Objectives.
2. Design a strategy incorporating a complementary range of return sources in order to achieve true diversification and risk control.
3. Use efficient managers to harvest easier returns and identify skilful managers to access returns which are harder to come by.

In my view, absolute return approaches can offer something powerful to investors as part of this process: true diversification.

By accessing returns from completely different sources, less-traditional approaches can help protect investors’ portfolios. It is easy to appreciate the value of an investment which simply shrugs its shoulders while others are falling, rather than being dragged down with the ship.

Overall, our “universe” of absolute return fund is just that: a huge, diverse and rapidly expanding space. Investors should aim to understand the breadth of opportunities available and employ a range of approaches to build truly robust portfolios. As these kinds of strategies become more and more popular, I think investors – particularly those making additional allocations in this area – should take a step back and think about what combination of absolute return funds will best suit their needs.

Net returns for various absolute return managers over Q3 2015



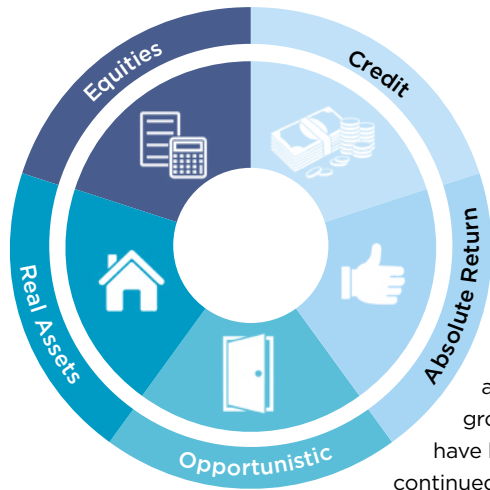
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Steve helps his clients establish investment strategies consistent with their long-term objectives, for portfolios ranging from £20m to £3bn. He is also a member of LCP’s alternatives research team, specialising in researching funds which provide access to complementary sources of returns to those provided by more traditional asset classes.

+ Investment toolkit

Using INVESTMENT TOOLKITS better in today's CHALLENGING MARKETS



Pension schemes have always been looking at ways to enhance their investment strategy by improving returns and managing risk. Indeed, the Pensions Regulator has placed an increasing importance on managing risk as part of a scheme's journey plan. Over the years, this has led to many schemes adopting liability driven investment approaches and investing in diversified growth funds. These schemes will have benefited greatly as gilt yields have continued falling and market volatility has returned more recently.

Looking forward, I think that the wait for gilt yields to rise will continue as low inflation expectations and doubts about the global economic recovery have left our central bankers uncertain as to when to increase rates. In today's market, where 20 year gilts are yielding less than 2.5%, earning consistent positive returns is becoming more and more challenging.

That is why I think it is important for investors to ensure that they are using the full toolkit to enhance returns whilst still managing risk. The graphic in the top left illustrates the wide range of return-seeking assets available to pension schemes. Whilst some of these areas will be familiar, there are two in particular that I think many schemes have not focussed enough on:

- using their illiquidity budget in real assets; and
- having a specific allocation set aside for opportunistic investments

Accessing the illiquidity premium

Having an allocation to real assets such as property and infrastructure can help schemes boost returns. This is because the right exposures will provide access to an illiquidity premium that most other investors cannot exploit. For pension schemes working towards a long-term target, that are unlikely to need liquidity from all their assets in the short term, an appropriately sized allocation to these asset classes can help diversify and boost returns.

Opportunism

It is also just as important to take advantage of any opportunities in markets as and when they arise, but many pension schemes are just not set-up to take advantage of the best ideas. We have seen from experience that markets aren't always efficient and there are opportunities that come and go, so it's important to get this right.

I think one way pension schemes can position themselves to take advantage of these opportunities is by having a specific allocation set out to 'opportunistic' strategies and also earmarking a liquid portfolio where the assets will remain invested until these opportunities arise (eg multi-asset funds). This would allow them to react more quickly to the latest ideas, and hopefully to maximise their impact.

Of course, an investment strategy is not complete without assessing a journey plan and knowing what to work towards. But understanding the investment toolkit options available and using the right ones at the right time should help pension schemes reach their target more quickly.

Having an allocation to real assets such as property and infrastructure can help schemes.



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Hishendhra helps his clients improve their funding position by advising them on all aspects of their investment strategy.

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Swaptions

ENHANCING yield with SWAPTIONS

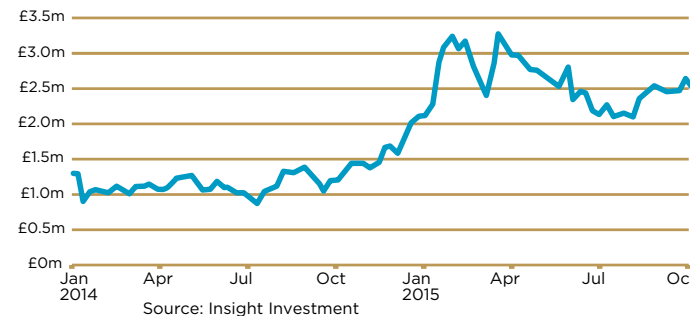


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Gavin advises the pension schemes of several high profile companies on all aspects of their investment arrangements, including setting strategy and selecting fund managers. Gavin's specialist area is advising on innovative risk management solutions using interest rate and equity derivatives which have successfully helped protect schemes over the long term.

An ongoing aspect of LCP's research is to monitor the relative attractiveness of hedging assets such as gilts and swaps, and many of our clients have benefitted from this. One instrument that has seen more favourable pricing over the past year (as shown in the chart below) is interest rate options, known as swaptions. The premium received from selling a 5-year option¹ has increased from around 1.0% in 2014 to around 2.5% in September 2015. Put another way, if an investor was to sell such an option, they would receive £2.5m today (for £100m exposure), compared to only £1m last year.



Case study

However, swaptions are not straightforward instruments, so we have designed a simple approach to exploit this opportunity, to ensure that our clients can be fully comfortable with the risks involved.

After a detailed review, in mid-September 2015, one of our clients implemented a swaption mandate to exploit this opportunity and received a premium of £2.5m for selling a swaption. This pension scheme was already well hedged with 80% of its liabilities covered by swaps in its LDI portfolio. Whilst the scheme did not have any explicit plans to further hedge its liabilities, it was recognised that it would probably do so if market interest rates were significantly higher.

Our view is that the prevailing low yield environment is likely to continue for at least the next five years. If we're right, the scheme will benefit by £2.5m since the swaption buyer would not exercise its rights.

Conversely, if long-term yields do rise (by more than 1.5%), then the swaption would be exercised and the pension scheme would be required to enter into a hedging swap. However, all this would mean is that the scheme would have increased its liability hedge from 80% to around 95%, at very attractive yields compared to today - in other words, this is exactly what the scheme's trustees would probably have done anyway. Importantly, if this happens, then because of the rise in yields, the scheme's funding position will probably be in a materially better position.

So, in a sense, this strategy was a bit like a win/win.

There are lots of different ways these kinds of options can be used, some improving yield (such as this example) and some managing downside risk; and whilst this example is using an interest rate option, these kinds of instruments are available in a very wide range of different asset classes, such as credit and equities. I would encourage schemes to consider how these kinds of strategies could be employed in their schemes.

Example:

A £100m 5-year swaption on a 30-year swap, struck at 4% pa means that:

In 5 years' time, the buyer can choose to enter into a 30-year swap with the seller, sized at £100m and with a rate of 4% pa, regardless of market rates at the time.



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- A brief tour of the current economic conditions and LCP's views on which assets are attractive at the moment
- Recent developments in credit markets
- How pension schemes can invest in credit, both for return and for liability matching

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