LCP INSIGHT CLARITY ADVICE

VISTA MAGAZINE

OUR INVESTMENT VIEW

ISSUE 4 JUNE 2016

BREXIT REFERENDUM
Prepare for a bumpy ride

FIDUCIARY MANAGEMENT
How to tackle the conflicts

ARE YOU ANCHORED TO HIGHER INTEREST RATES?
To hedge or not to hedge

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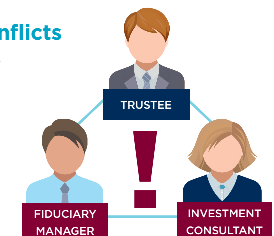

LCP INSIGHT CLARITY ADVICE

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.

On 23 June the UK public will be given what could be a once in a generation opportunity to have its say on the UK's relationship with Europe. Whatever the result, it will have far-reaching economic and political consequences. At the time of writing, the polls show a clear lead for the Remain camp, but the Leave campaign isn't done yet.

Plenty has been written about what the future political and economic landscape might look like either way. But whatever happens, we should expect market volatility over the coming weeks and months as the implications of the vote take shape.

In this edition of LCP Vista, we begin with a look at how markets might react to the Brexit vote. It's surprisingly difficult to reach any firm conclusions – other than to say that there will be volatility. So it may feel natural for pension schemes to wait and see what the result is before considering what, if anything, to do. However, volatile market conditions can often present the best opportunities for patient, long-term investors.

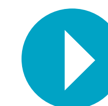
Whilst Brexit is naturally dominating the news, pension schemes need to carry on thinking about the best long-term strategies to meet their liabilities. With this in mind:

- We consider whether pension schemes should invest in timberland
- We take a look at the latest climate change issues, and how fund managers should be preparing for the implications
- We examine longevity risk, and explain why smaller pension schemes in particular need to get a handle on it before addressing their investment risks
- We analyse whether now might be a good time to hedge pension liabilities, and whether Brexit might present some opportunities to do so at more attractive prices
- We discuss the recent growth of Fiduciary Management and outline how to ensure pension schemes get the best outcomes.

Finally, whatever you invest in it's important to monitor your investments – to make sure your strategy is still fit for purpose. Most pension schemes do this with the help of written quarterly reports from their managers and consultant. Ken Willis challenges this orthodox thinking, and outlines a better way.

I do hope you enjoy reading this edition of LCP Vista. If you have any comments or suggestions, please drop me an email. Alternatively, you can speak with your usual LCP contact.

Our related Brexit content



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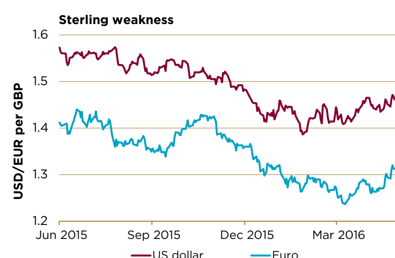
The macro-economic outlook

BREXIT referendum PREPARE for a bumpy ride

With currently around a 25% chance[1] that the UK will vote to leave the EU, our working assumption is that the UK will remain. However, given that a "Leave" result could be very significant for markets, investors should be braced for the potential impact and prepare for a bumpy ride in the run up to 23 June, and potentially for a while afterwards too.

As we approach the referendum, the economy is likely to pause. There are already signs[2] that UK businesses have scaled back their hiring and spending plans due to the uncertainty created by the referendum. Sterling has weakened considerably over the last 12 months.

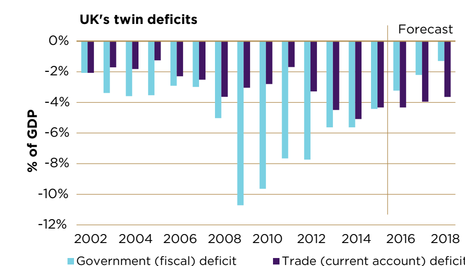


A narrower victory for the "Remain" campaign might not provide the certainty that markets are looking for, bringing an increased risk of a further referendum later on, dampening confidence as the debate drags on, despite David Cameron's insistence that this will not become a "neverendum". Given that it seems to be an outside chance, a "Leave" result would shock markets, with riskier assets hit harder as markets digest the news. Sterling would likely fall further in value, credit spreads may well widen (reflecting increased credit risk), and companies that rely heavily on UK and EU revenues could suffer in equity markets, at least in the short term. However, whilst a fall in Sterling might sound like bad news, investors with significant unhedged overseas investments could actually see their asset values increase – at least in Sterling terms.

The UK currently has "twin deficits", meaning that the government spends more than it earns in tax, and the country imports more than it exports. The UK relies on attracting investment from overseas to sustain these deficits. In the event of a "Leave" vote, it would be unclear on what terms the UK would have access to international markets (not just to the EU), and whether overseas investors would have the same level of confidence in the UK economy. The OECD and IMF[3] believe that Brexit would dent economic growth.

A key concern for investors would be the Bank of England's response: would it raise interest rates to protect Sterling, or lower rates even further in an attempt to boost the economy? We think that interest rate rises would be delayed further in the event of Brexit, at least until the dust settles. For schemes that haven't hedged liabilities this could mean further pain.

The impact for government bond yields is unclear – on the one hand, some investors might move into safer assets and seek to benefit from a "lower for longer" monetary policy, pushing bond yields lower still. However, international investors may retreat, particularly from bonds of up to 10 years to maturity (because these bonds are largely owned by overseas investors), acting to increase yields. On the other hand, many pension schemes have de-risking trigger mechanisms and remain poised to buy more government bonds if longer-dated bond yields rise.



Although the market has focussed on the risk of Brexit, other global risks may be more significant, such as the debt build-up in China and the potential for disruption from the US presidential election in November. It is important for investors to maintain a diversified investment strategy and be prepared to move swiftly should risks increase or opportunities arise.

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In addition to advising both DB and DC clients, Natalie is a key member of LCP's macroeconomics research team, helping to shape our investment advice. Natalie discusses the economic outlook with senior economists and investment managers on a quarterly basis, and helps write our quarterly investment market commentaries.

1 Source http://predictwise.com/politics/uk-politics at 31 May 2016
2 Deloitte UK CFO survey Q1 2016
3 Organisation for Economic Cooperation and Development and International Monetary Fund
Data source: Thomson Reuters DataStream

Timberland

TIMBERLAND: a GROWTH asset

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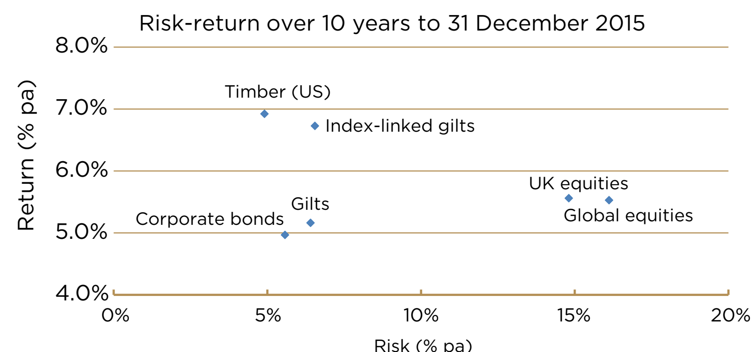
In addition to advising a number of DB clients, Nikki is a key member of LCP's research team that looks into new investment ideas for clients. One area of focus as part of this team has been Timberland. Nikki is also a member of the Fiduciary management research team.

Pension schemes have historically focused on more liquid assets but this is not always necessary when their liabilities are so long term. Illiquid assets sometimes offer better returns as compensation for not being able to sell them easily, which is no bad thing if you can afford to wait.

Timberland investment (ie buying and operating commercial forestry) is one such illiquid asset that has been receiving increased attention with its defensive characteristics, making it especially attractive for pension schemes. Worldwide investment in the space has expanded 10-fold from $30bn in 2006 to over $300bn currently. UK pension scheme investment remains small; however notably the PPF allocated to timberland in 2012.

What are the key characteristics?

Timber offers compelling returns, low volatility and low correlations with traditional asset classes.



The chart shows that US timber assets have delivered higher and more stable returns than most other assets. Tree growth is the key contributor to returns and also gives diversification benefits, as it is independent of markets. Trees will not stop growing because markets are down!

Of course, it's not without risks - timber prices could fall. In fact, demand for timber products has slowed in developed markets due to slow economic growth; however this is offset by growing demand from emerging economies. The timber is mostly used in construction, furniture, paper and packaging - all relatively basic consumption needs.

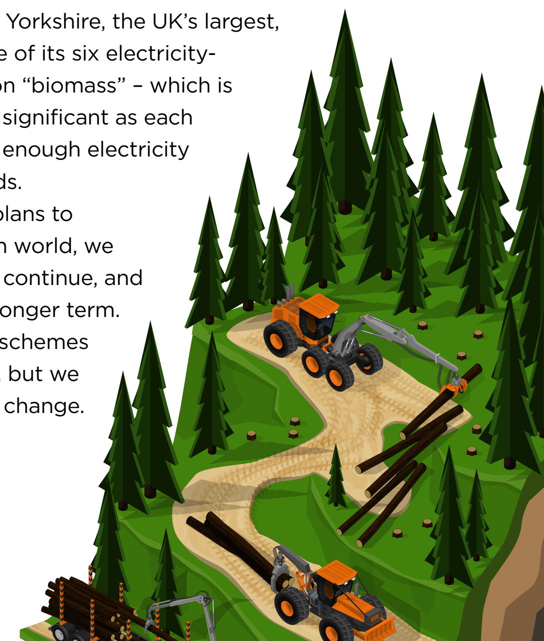
But a timberland fund should never be a forced seller - if the price of timber were to fall then harvesting can simply be delayed until the price recovers.

Socially responsible investing

There are also socially responsible and ethical considerations, and any fund we would recommend would be certified as sustainable by the Forest Stewardship Council.

As trees grow they absorb CO_2 – a key greenhouse gas – and so timber is a true carbon-neutral fuel (at least over the whole growing cycle, and provided new trees are planted). In fact, the Drax power station in North Yorkshire, the UK's largest, has recently converted three of its six electricity-generating turbines to run on "biomass" – which is mostly wood pellets. This is significant as each of Drax's turbines produces enough electricity to run a city the size of Leeds.

With the UK's ambitious plans to contribute to a lower carbon world, we think this is a trend that will continue, and help support timber prices longer term. So far very few UK pension schemes have invested in timberland, but we think this could be about to change.



Responsible Investment

CLIMATE policy: an uncertain ROAD AHEAD?

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Claire is passionate about LCP's responsible investment services, helping her clients to include environmental, social and governance considerations throughout the investment process. Claire is the editor of [LCP Investing Responsibly magazine]

CLIMATE CHANGE COMMITMENTS

Reduce GHG 80% below 1990 levels by 2050

Reduce GHG 40% below 1990 levels by 2030

Reduce GHG 26% to 28% below 2005 levels by 2025

Peak carbon dioxide emissions by 2030

In December 2015, 195 countries adopted the Paris Agreement, the latest in a series of international climate change agreements and the most ambitious yet. It strengthened their previous commitment to aim to hold global average temperature rises to 2°C relative to pre-industrial times and introduced a new aspiration of a 1.5°C limit. It was supported by a series of national and regional commitments – see box below.

The Paris Agreement implies a fundamental transformation of the global energy system with consequences for every sector of the global economy.

- Companies that are involved in the discovery, extraction, refinement or distribution of fossil fuels will need to change or die, whereas there may be opportunities for companies embracing cleaner alternatives.
- Wholesale energy prices may rise due to greater use of carbon taxes and trading systems, designed to encourage the switch from fossil fuels to greener alternatives. Energy intensive industries will be particularly vulnerable.
- Some of the trend towards globalisation may be reversed as pressures mount to "buy local", minimising the carbon footprint.

However, there is uncertainty about how, when – and indeed, if – these consequences will play out. Awareness of climate policy risks has increased in recent years and some investment managers are starting to factor them into their investment processes. This provides an opportunity for nimble investors.

But how might a UK vote to leave the EU affect climate policy and the associated investment risks?

In short, we think a Brexit event wouldn't really change the direction of travel, but it would increase uncertainty about the details. The centrepiece of UK climate policy is the Climate Change Act 2008, which requires an ambitious 80% cut in greenhouse gas (GHG) emissions between 1990 and 2050, achieved by a series of five-yearly emission budgets. This would still be a legally binding commitment.

However, a recent academic study[1] concluded that European policy measures are helping the UK to meet its Climate Change Act obligations and Paris commitments. The UK has repeatedly played a lead role in EU climate policy, encouraging more stringent targets – the latest one being an EU-wide emissions cut of 40% between 1990 and 2030 – although it has been less supportive of some of the more specific policy measures, particularly the targets for energy efficiency and renewable energy.

If the UK leaves the EU, it would regain some flexibility over its energy and climate policies. Hence, whilst the overall direction of travel may be the same, there would be even more uncertainty about how we get there. On the other hand, without the UK's influence, the EU may adopt a less ambitious position in future international climate change negotiations, making it perhaps less likely that the Paris Agreement's goals are met.

In summary, Brexit seems likely to increase uncertainty in an area that already poses considerable risk for investors. If you haven't already done so, talk to your investment managers to find out how they are positioning your portfolio to manage climate change risks to pick the winners not the losers.

> *"We should be taking action against climate change today. What we are looking for is not difficult, it is doable and therefore we should come together and do it."*
> David Cameron,
> **Paris, December 2015**

[1] "The EU Referendum and the UK Environment: An Expert Review", available at http://environmentEUref.blogspot.co.uk/.

LCP INSIGHT CLARITY ADVICE

De-risking small pension schemes

Don't forget about LONGEVITY risk

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Murray provides pensions advice to both companies and pension plan trustees, with particular expertise in pension de-risking and longevity insurance. Murray joined LCP's insurance de-risking practice in 2015, with a focus on the project management and structuring of bulk pension transactions.

Many schemes on the journey to ultimate buy-out have already made good progress with de-risking their assets, but often longevity risk has not being given the attention it deserves.

It is important that all schemes progressing on their de-risking journey properly understand their longevity risk. As part of the team using our longevity risk tool (LCP LifeAnalytics) with clients, I have seen many examples of smaller schemes where the longevity risk is the biggest single risk – even before they start de-risking their assets. For these schemes, de-risking their assets might not be the smartest move, as they will be sacrificing returns without really impacting the total amount of risk they face.

So how can schemes measure their longevity risk, and what solutions are available to deal with it?

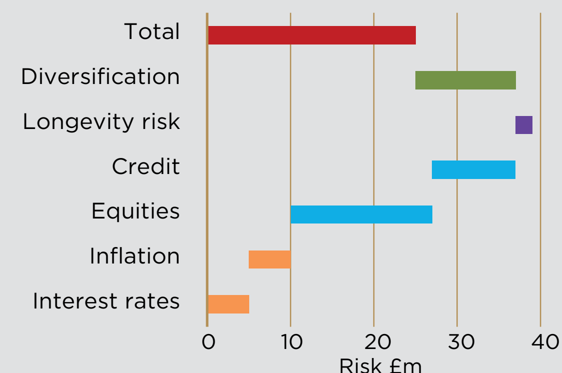
Smaller schemes are usually more exposed to longevity risk than larger ones, particularly if they have a high concentration of their liabilities focused in a small group of individuals (eg retired board members). This is illustrated by a particular type of longevity risk called individual risk. This is the risk that even if your actuary knows with certainty which future mortality table to use (which they don't), how long each individual scheme member lives remains a matter of chance. In large schemes this uncertainty "diversifies away", but in smaller schemes it doesn't.

Putting longevity risk in context for smaller schemes

LCP LifeAnalytics measures all components of longevity risk and allows longevity to be properly integrated and assessed alongside investment and other risks.

Now let's look at some examples for two schemes that have scheme liabilities of around £150m. The following charts show how the total risk is built up from its component parts.

Example of a scheme early in its de-risking journey

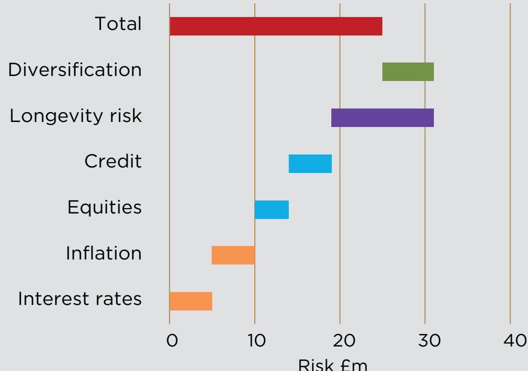


- This is a scheme early in its de-risking plan – it's got an LDI strategy, but still has a significant allocation to equities and corporate bonds
- The membership is relatively young, and there are lots of members with mostly small benefits
- Longevity risk is small in the context of other risks (4% of total risk)
- Asset risks dominate, particularly equity risk
- De-risking recommendation: concentrate on other risks in the short term (assets, interest rates and inflation)

De-risking small pension schemes

Don’t forget about longevity risk (cont.)

Example of a scheme further along its de-risking journey

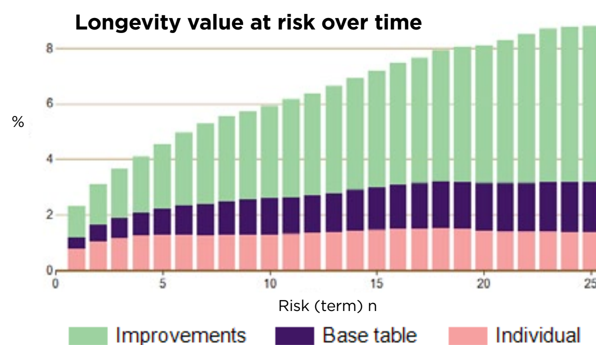


- This scheme has made progress with asset de-risking, including selling down the majority of its equity holdings
- The membership is older, and there are a small number of big pensions in payment
- Longevity risk is significant (50% of total risk, 10% of technical provisions liabilities)
- De-risking recommendation: this scheme needs to analyse its longevity risk in more detail, particularly individual risk

Measuring individual risk

Smaller schemes which have identified longevity risk as a significant issue will then need to understand the nature of their risk, and in particular the level of individual risk they are exposed to. Individual risk can vary widely depending on a scheme’s membership profile and benefits (we have seen a range from 0.5% up to 10% of liabilities).

What solutions are best placed to deal with longevity risk depend on how it breaks down into individual risk, improvements risk and base table risk. It is therefore important that it is modelled in detail. We believe that LCP LifeAnalytics is the only model in the market than can do this in a robust way.



How can you deal with longevity and individual risk?

Once a board of trustees has established how much longevity risk they are running, then it’s time to think about whether and how to deal with it. There are a variety of options available:

Buy-out: when a scheme pays a premium to an insurer and the insurer takes on all responsibility for paying the pensions for the scheme’s insured members. This will transfer all investment, inflation, longevity and individual risks to the insurer. However, small schemes face specific challenges when approaching the insurance market – David Stewart gives his top tips for engaging effectively with insurers in his recent blog.

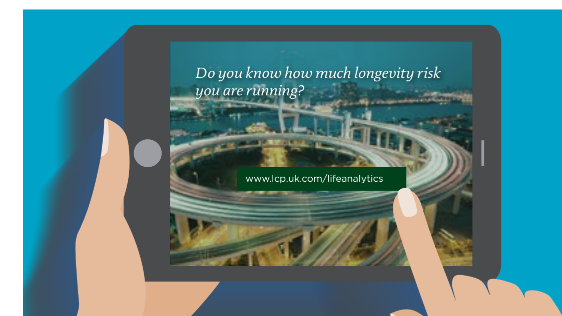
Buy-in: this is similar to a buy-out but the insurer makes payments to the scheme which, in turn, pays members.

Top-slice buy-in: where a scheme insures its largest liability members (eg former senior executives), this deals with individual risk directly by removing a significant risk concentration. Some insurers may also offer the ability for the health of members to be taken into account in a top slice which could lead to a lower price. This is discussed further by my colleague Gareth Davies in his recent blog.

For a scheme with a lot of individual risk a top-slice might be a sensible option, and it may well be more cost-effective than a full pensioner buy-in or buy-out. And by taking out the high risk members, it would leave the scheme with a more regular shape of liabilities which traditional insurers would find more attractive, paving the way for a full buy-in or buy-out in the future.

What now?

The analysis and hedging of longevity risk has traditionally been restricted to larger and medium sized schemes, with smaller schemes focusing on their investment exposures. However, I think this is potentially flawed – as smaller schemes often have bigger exposures to longevity risks, particularly individual risk. This could be very significant for those that have already embarked on an asset de-risking programme, so it’s very important for smaller schemes to properly understand their longevity risk and the potential actions they can take to reduce it. Thankfully, the solutions are now available to do this cost-effectively. Visit **www.lcp.uk.com/lifeanalytics** to learn more.



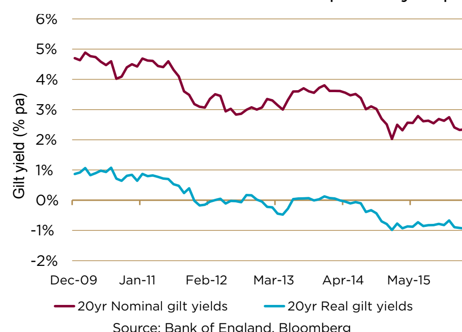
Liability-driven investment

Are you ANCHORED to HIGHER interest rates?

One of the most important investment decisions that a trustee board will ever make is how much of the scheme's liability risks to hedge. It's not easy, as the magnitude of getting it wrong can be very large and lead to significant worsening in the funding position, or regret risk if you do hedge and long-term yields subsequently rise.

And it hasn't got any easier recently; the downward movement in gilt yields continues (see chart below). Those that did decide to hedge a few years ago can give themselves a pat on the back for getting it right, but for those that held off, these further falls have brought continued angst and now make committing to hedging even harder.

So why is it that most pension schemes still have significant amounts of unhedged liabilities? This can at least be partially explained by a

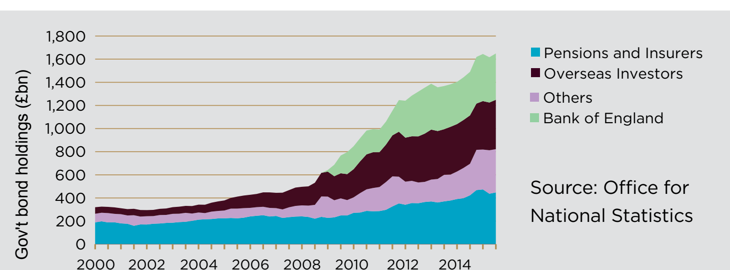


Source: Bank of England, Bloomberg

branch of economic theory: behavioural finance. This suggests that most people, even professional investors, simply don't make truly rational investment decisions. Instead, their emotions and unconscious biases that have evolved over millions of years influence their decisions.

One of the key concepts of this theory is "anchoring" – being influenced by past information when looking into the future. In the case of this critical hedging decision it's easy to be anchored to much higher yields of ~4%-5% pa that were available only a few years ago and unconsciously assume the only way from here is up. So it's not surprising that many schemes have decided not to hedge all their liabilities.

The rational approach is to consider the balance of supply and demand in markets and use this to guide you on future yield movements.



Source: Office for National Statistics

The chart shows the ownership of UK government bonds and how this has changed over the last 15 years. There are 3 points of note that I always draw from this chart:

1. Holdings by pension schemes (and insurers), in blue, have increased materially over the last few years. As pension schemes continue to mature and de-risk, I don't see this trend abating.
2. The volume of issuance has increased significantly – but the government has plans to keep a lid on this, and this won't increase indefinitely.
3. The scale of the Bank of England's ownership, acquired through its QE programmes, is clear to see (in green). There is limited incentive for the Bank to sell these holdings until the economy is growing robustly and inflation is back on target.

All of the above might suggest that any rises in yields will probably be limited, at least in the short term, and adding hedging now is likely to be a sensible approach. But the elephant in the room is Brexit – does this change the conclusions we've drawn above? In two words "probably not".

You could argue that if we do "Brexit", then gilt yields might rise to reflect the UK's weakened ability to service its debts, if you believe that this would lead to slower and more uncertain growth for the next few years. In this environment, I suspect interest rates would keep low for fear of weakening the economy, and any rise in long-dated gilt yields would be kept in check by hedging demand from pension schemes ready to leap on any upward movement.

But we shouldn't ignore the possibility of a rise altogether. I think the best strategy would be to monitor the market closely and put in place processes so that you can take advantage of any rises. Being prepared and able to act quickly is often the best strategy.

James Fermont

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James helps his clients understand their pension scheme, how best to generate returns, and how best to manage risk. He is a member of LCP's Liability-driven Investment (LDI) research team and regularly meets with fund managers and investment banks to discuss strategies to manage inflation and interest rate risk.

Watch our 2 part video series on liability-driven investment

LCP SpotLight

How to AVOID the GOLDILOCKS problem

Ken Willis

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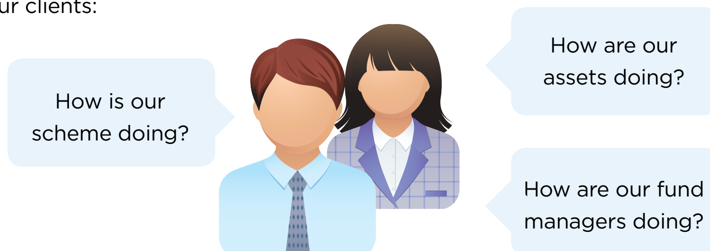
Ken helps his clients deliver improved investment returns, with better managed risks, and more confidence that they can deliver the benefits to their members. He helps them to focus on what really makes a difference – by listening to their needs and giving them clear pragmatic advice.

Most pension schemes arrange their trustee or investment committee meetings in a "Goldilocks" period in the middle of each quarter – not too close to the end of the previous quarter so that reporting information isn't ready yet, and not too late so that the information is so old to be of no use. Information becomes less useful with time and most pension trustees discuss quarterly investment reports about two months after the reporting period has ended – often with little idea what's happened since.

At LCP, we don't do things differently just for the sake of it – we do so to focus on what our clients want, and have always wanted, to deliver them a better service. We focus on the questions that are important to our clients:



We've been helping our clients answer these questions for years – but now we can answer all these questions in real time too – any asset, any manager, any time period.

Why have we done this? We asked ourselves in today's world, where we have huge amounts of information at our fingertips, is there a better way to review your investments? We think up-to-date information is simply more useful and leads to better and more informed investment decisions.

Too early, too late, how about just right?

LCP SpotLight

We shine a light on any asset, any manager, any time period

With our innovative software, known as LCP Spotlight, we can now answer these questions in real time, whenever our clients ask, over any time period, compared to any benchmark or to any other manager. So now when we have meetings with our clients we can spend more time discussing how their assets and fund managers have performed up to the date of the meeting rather than some arbitrary calandar data.

The feedback we have had from our clients has been overwhelmingly positive and has helped engage trustees more with their assets and investment strategy.

And it's not just about being up-to-date either. No matter how good your adviser is, I bet you can think of some good questions he won't have thought you'd ask.

Now these questions can be answered in the meeting – even if your adviser hasn't prepared the numbers in advance. That saves everyone time, and will ultimately save you money.

We have revolutionised performance monitoring, not to be different, but to deliver a better service to our clients and to continue helping our clients know what they have always wanted to know.

Monitoring investments over calendar quarters, with a 10 week data lag, with trustee meetings having to be fixed in the Goldilocks space, will soon seem as old fashioned as going to a video store to rent a movie.

LCP INSIGHT CLARITY ADVICE

Fiduciary Management
How to TACKLE the CONFLICTS

Delegating the management of a scheme's entire asset portfolio to a fiduciary manager is an enormous decision for pension scheme trustees. It can be costly and challenging to set up and even more so to unwind the often complex investments. If it's done right though, it can take a weight off trustees' shoulders.

Trustees should be fully informed, by considering a range of different providers and approaches.

There is clearly a conflict if the person advising on the fiduciary solution is part of an organisation which also offers these services. In addition, if fees are based on assets under management, a fiduciary manager may not be incentivised to select external funds, even if other managers have more expertise, favour lower-fee funds or asset classes or proactively raise de-risking opportunities.

With heightened market volatility as the EU referendum approaches, there may be good de-risking opportunities. So it is more important than ever to have in place a strategy that is designed to monitor and capture these through de-risking triggers, buy-in and buy-out.

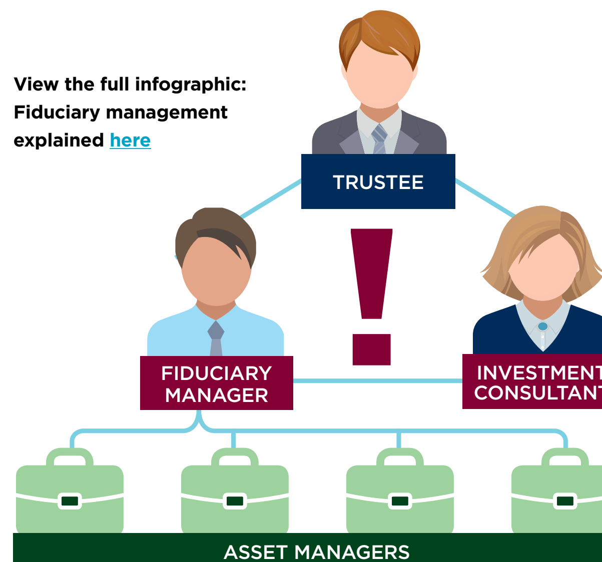
How can trustees tackle these conflicts?

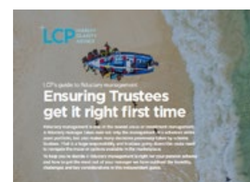
The key is establishing a suitable governance structure. An independent, investment consultant can equip trustees to select the best provider, through a robust and transparent process and set appropriate high-level objectives, risk tolerances and benchmarks. It is important to negotiate favourable fee terms, ensure transparency of underlying costs and align any performance-related fees to the scheme's objectives.

An increasing number of trustees are choosing to use an independent investment consultant to monitor their arrangements, assess performance objectively and provide ongoing challenge, to get the best out of their fiduciary manager.

As an independent consultant we are able to offer clients wholly unbiased, unconflicted advice to help them select and monitor their fiduciary manager. You can learn more by visiting www.lcp.uk.com/fiduciarymanagementoversight

View the full infographic: Fiduciary management explained here





Download our independent guide - Ensuring trustees get it right the first time

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Katie helps her clients to ensure that they are maximising investment returns, while minimising risks. Katie is also a senior member of LCP's fiduciary manager research team providing independent advice in areas that clients recognise are fraught with conflicts.

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LCP is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics.

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