HYMANS ROBERTSON

Investment Perspectives

August 2019

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Welcome

Welcome to our summer 2019 edition of Investment Perspectives

As children return to school, parents may start looking towards the upcoming school year using the last report card as a guide to how to develop and prepare for next year. The school report card for global markets would contain words that would not be viewed positively. Uncooperative could be used to describe US-China trade relations over the past year. Erratic behaviour would be a term used to describe investor reaction – Chris Arcari outlines in his Capital Markets Update that less than positive news about the global economy has led to asset price appreciation in recent times. Closer to home, procrastination of the response and implementation of Brexit has been a theme for the past year.

There are also other common report card themes within the articles for this quarter:

- The Regulator believes there is room for improvement on the DB governance side – Ross Fleming and Russell Chapman provide more detail and insights on how the setting of investment strategy can assist;
- Being open to new ideas or rethinking existing ideas is explored in Linda McAleer's article on the development of UK residential housing assets as an alternative to the traditional UK commercial property sector – it is still early days but there continues to be growing interest; and
- Emma Cameron and Emma McCallum show how cashflow-driven investing can be part of a disciplined strategy designed to assist schemes in meeting their long-term risk, return and funding objectives.

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Capital markets update

Consensus forecasts do not point to an impending recession but it is fair to say we are "late-cycle" – global growth is expected to slow and the risks to the downside have increased. Actual realised "hard" economic data and surveys reflecting sentiments and beliefs, so called "soft" data, have pointed to a slowing of the global economy in the second quarter. While the US economy continues to outperform global peers, growth eased to 2.3% year-on-year in the second quarter. Monthly GDP figures revealed the UK economy showed signs of weakening in the three months to April, with the economy shrinking 0.4% in April, mainly due to a dramatic fall in car production, with uncertainty triggered by the initial Brexit deadline leading to planned shutdowns. To some extent, a slowdown in Q2 was expected: in the US, as the effect of last year's tax cuts has fallen off and, in the UK, the boost from early completion of orders ahead of the UK's original EU departure date has faded.

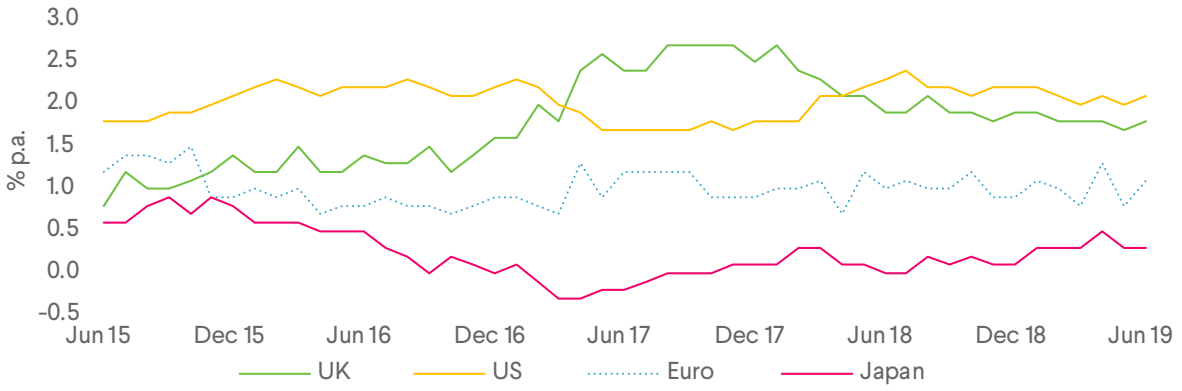
However, anxieties about cross-border trade are creating a more difficult business environment. After being revised sharply lower in the first quarter, global growth forecasts for 2019 have now settled around 2.7%, versus growth of 3.1% in 2018. However, the second quarter has seen forecasts for global growth in 2020 being revised lower. Continuing deterioration in expectations for global manufacturing, as indicated by the manufacturing Purchasing Managers Indices (PMIs), suggests momentum is more fragile than anticipated.

At the same time, inflation pressures seem to be fading. Real wage growth in the US, on the back of record low levels of unemployment, has continued to move higher, but the impact of rising wages on broader inflation measures remains elusive (Chart 1). Data for the UK and Europe show real wage growth has started to ease a little in recent months, but remains positive. Forecasts for inflation indicate that CPI is around central bank targets in the US and UK for the next couple of years, and remains stubbornly below target in the Eurozone.

The subdued inflationary environment provides room for manoeuvre for central banks and, reflecting the risks to global growth, policymakers are hinting at using this room. Messaging from the European Central Bank (ECB) and the US Federal Reserve (Fed) has increasingly pointed towards monetary easing. Notwithstanding the US rate cut in July, we note the US rates markets continue to price in more interest rate cuts than consensus forecasts from the Fed. The situation is less clear cut in the UK, where the Bank of England (BoE) is reluctant to commit to rate cuts or hikes in advance of the Brexit outcome.

A disorderly Brexit might harm short-term growth, which would support the case for lower rates, but could trigger a further fall in sterling, creating a spike in inflationary pressures. This would potentially require interest rate rises to return inflation to target, in line with the BoE's central mandate. Notably, the second quarter saw a return of sterling weakness – it slipped 3.5% in trade-weighted terms, as political uncertainty grew.

Chart 1: Core CPI Inflation

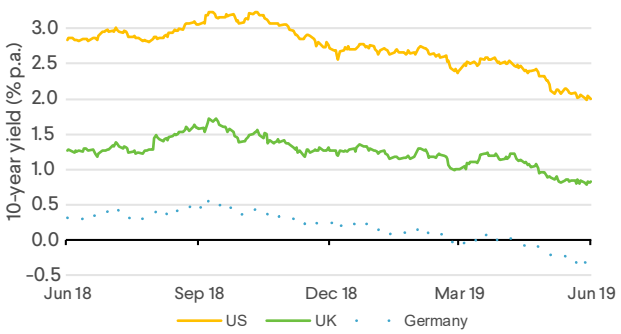


Source: Datastream

Government bonds

A sharp fall in government bond yields (Chart 2) has been consistent with the weakening in economic data and concerns surrounding the global outlook. 10-year US Treasury yields slipped almost 0.4% p.a. in the second quarter. Gilt yields, both nominal and index-linked, have followed the global trend, nearing record low levels. While both domestic and global economic risk, as well as hedging demand, may prevent a rise in UK yields in the short-term, they remain at levels which are at odds with even a subdued long-term economic backdrop. We continue to see little medium-term value offered by current yields.

Chart 2: Conventional government bond yields



Source: Bloomberg

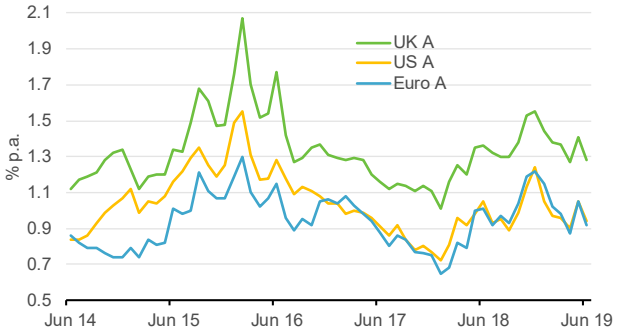
Other bonds

Global credit markets have largely ignored the less positive economic data and outlook: credit spreads snapped back in June after a brief sell-off in May, to end the quarter generally tighter. Sharply lower government bond yields may help to stabilise or lower costs for companies that refinance debt at lower interest rates and longer maturities and, despite global growth risks, the default environment is predicted to remain benign for now. The shift in messaging towards looser monetary policy has supported inflows to global credit markets this year, but there is scope for disappointment if market expectations of monetary easing prove overdone.

Sterling corporate investment-grade yield spreads have largely followed global moves (Chart 3) and the premium over equivalent global peers is not out of line with historic norms. Global spreads remain around long-term median levels. Lower underlying government bond yields have contributed more than half of year-to-date total returns in fixed-rate corporate markets, but any boost from further falls given current levels may be less likely. As a result, we have a preference for floating-rate credit assets, where returns are less vulnerable to underlying rate moves.

Speculative-grade credit spreads, particularly the higher quality portion of the market, remain well below long-term median levels. We prefer private credit markets, both in corporate and commercial real estate lending, where investors benefit from better credit spreads and structural protections for lenders.

Chart 3: A-rated investment-grade corporate credit yield spreads



Source: ICE Index Platform

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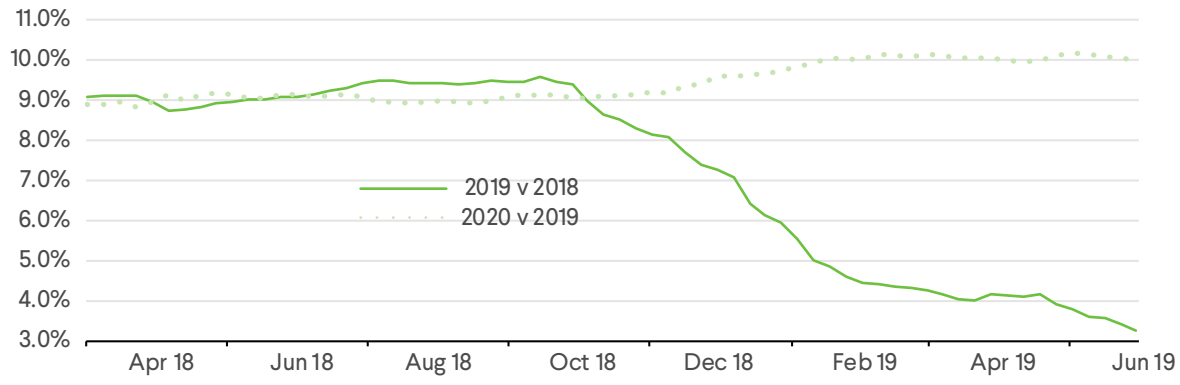
Equities

Equities performed strongly in the second quarter, looking through any short-term disruption and helped by Q1 earnings coming in ahead of expectations. Forecasts for 2019 earnings growth held firm and even rose slightly during the second quarter, although they have started to ease again in the last few weeks (Chart 4). We think there are short-term risks both from a further slide in earnings forecasts and, as before, disappointment about the support from monetary easing.

There is also evidence that the impending Brexit outcome is starting to make for a more difficult technical environment for UK property – investment volumes in the first quarter were the lowest they had been since the third quarter of 2016. Secondary market pricing of UK property funds is showing signs of a shift in the balance of interest from investors. Strong demand had kept the secondary market pricing of funds above net asset value, but prices have been falling in recent months towards, or in some cases, below, bid price.

Chart 4: MSCI World Index forecast earnings growth



Source: Datastream

For the longer-term, cyclically-adjusted price earnings ratios are not at extreme levels – the impact of an expensive US market is offset by relative cheapness elsewhere. Global valuations are starting to look a little stretched, but not entirely dependent on very low current levels of real yields. However, we do not expect real yields to return to pre-crisis levels because we do not believe global growth will return to pre-crisis levels. We are not convinced that market expectations of longer-term earnings growth have adjusted to reflect this, leaving a more sustained slow-down in earnings growth as the greatest long-term risk for equity market returns.

Property

Annual rental growth is as low as it has been for 5 years, although there are signs that it is stabilising. In May, the MSCI IPD UK Monthly Property Index fell for the first time year-on-year since 2017, when the impact of the Brexit referendum result was still being felt. Until now, the return from income has more than offset falls in capital values. The combination of these lower capital values and very modest rental growth has resulted in some very gradual yield expansion over the last 9 months, but initial yields and reversionary yields are extremely low versus long-term history.

Conclusions

We think the uncertain trade environment means the main risk is of a further slowdown in global growth. Muted inflationary pressures give central banks more room to cut rates, a side effect of which may be to calm risk markets, but it is less obvious whether the risks to longer-term global growth are amenable to being sorted out by monetary policy.

Recent moves in sovereign bond markets may suggest a more difficult outlook than is reflected in the data, but there still appears to be divergence between the signals being sent here and what is implied by other asset classes. Moves in equity and credit markets do not appear to be discounting this gloomier outlook. As a consequence, we would continue to advocate holding a little more cash than usual. We continue to prefer equities to property in growth-orientated portfolios and would advocate diversifying credit portfolios, potentially by trimming speculative-grade credit exposures.

A journey plan towards the ultimate destination

Trustees will be aware that The Pensions Regulator (TPR) is busy working on a more prescriptive DB code of practice on scheme funding[1]. We expect a shake-up across the industry, as TPR aims to implement measures which will "optimise" scheme funding in the wake of several high profile corporate failures, and provide itself with new and improved regulatory powers to intervene when expectations are not met. These include:

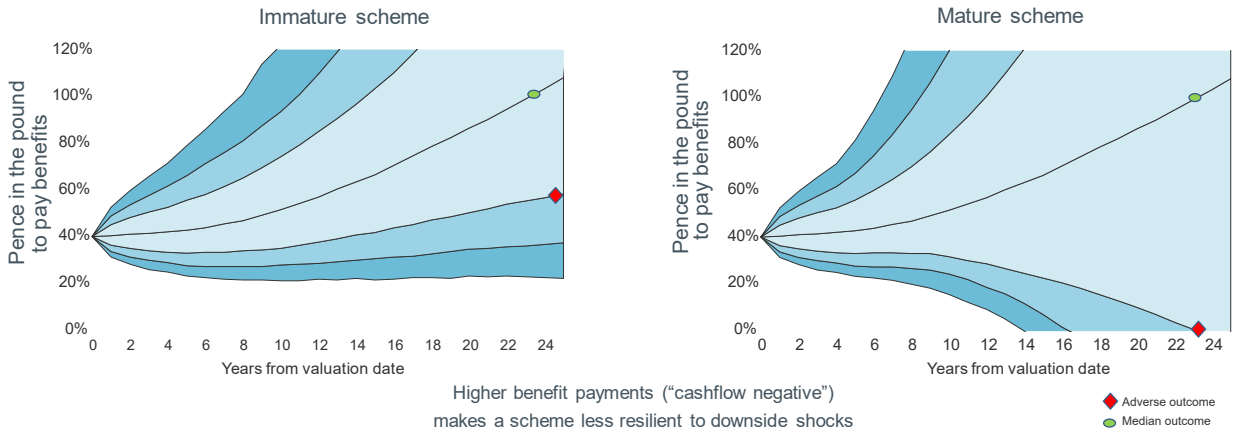
1. **A more directive approach for setting funding strategy** – either "comply" or "explain";
2. **A focus on risk management** – a further push for integrated risk management (IRM) to become standard industry practice;
3. **More regulatory scrutiny** – with serious penalties;
4. **More governance reporting** – via a DB Chair's Statement; and
5. **Setting of long-term funding objectives** – trustees and sponsors will need to consider their ultimate long-term goal and set a clear plan for getting there within a realistic timescale.

With that in mind, trustees and sponsors should not fall into the trap of considering scheme funding in isolation from the investment strategy being run. In a "comply or explain" world, many of the flexibilities on funding could be locked down, and investment is the area we see with the greatest potential to add value. Rather like determining how and where to take your summer holiday, we see the following factors as being critical to the success:

- Understanding your maturity – a key driver of ending up at the right destination;
- The journey plan – focus on how you're going to get there; and
- Resources at your disposal – these need to be managed and spent wisely.

Understanding your maturity

Chart 5



[1] Last year's White Paper from TPR (**Protecting DB Pension Schemes)** and our update on this (**Hymans Robertson - A stronger pensions regulator**) provides further context. We have also provided a further update related to this year's Annual Funding Statement (**Hymans Robertson - Summary of 2019 DB Annual Funding Statement**).

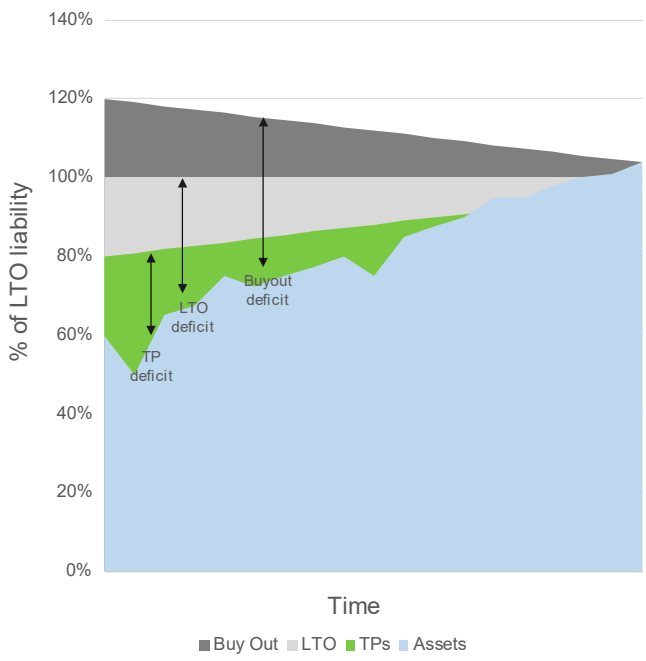
The implications from adding 'maturity' into the mix shows TPR are serious about schemes quickly reducing their deficits and the investment risks being run – the more mature the scheme, the more amplified is the level of downside risk within a scheme's investment strategy. In Chart 5 on the previous page, two schemes which are identical in every way except for maturity, are projected over a 20-year period giving a 'funnel of doubt'. Both medians reach a similar outcome (the green dots in each chart), but the more mature scheme is less resilient to the downside shocks – this scheme is paying out more in benefits when these asset shocks occur and has less time to recover. In an extreme scenario, the more mature scheme essentially runs out of money (the red dot on the right hand chart). Therefore, it's vital for schemes to consider how their maturity profile fits alongside the investment considerations.

Journey plan

Most DB schemes will have articulated, in some shape or form, when and on what basis they are targeting full funding. This is often thought of as the "destination" for the funding plan, and the route there on, often known as "journey planning".

With the performance of assets over the last few years, and often with a favourable impact from longevity, we have seen many schemes achieve their primary target – full funding on a technical provisions (TP) basis. However, it isn't 'job done', merely that the focus just changes to a stronger funding target – whether that's a buyout target, 'gilts plus a margin', LTO (long-term objective) target or a self-sufficiency asset-based target. However, for many trustees, recognise that the cost of a full buyout could still be out of reach just now and that allowing time (for the Scheme to mature) can reduce that cost. Chart 6 to the right provides a simple illustration of the interaction of bases and the asset portfolio.

Chart 6: Interaction of different funding bases and asset portfolio



Beyond the point where the green and blue shaded areas intersect, we believe that many trustees have not given enough thought to the most appropriate investment strategy. Identifying what a 'run-off' portfolio would look like is helpful. There are a variety of approaches to derive this – ranging from more approximate to more precision engineering, including consideration of how to deal with longevity risk over time.

Setting a run-off portfolio, and time horizon to reach that target, helps:

- To create a clearer measure of performance against the objectives;
- Decision-making as there is a clearer rationale for running less risk/more risk – and understanding the impact of the different levers; and
- To compare the portfolio you have and what the terminal portfolio might look like eventually.

Managing your spending and resources

Schemes' investment strategies have evolved and will continue to do so, from heavily dependent on 'growth', to more focus on income-generating strategies (to deliver benefit outgo) with a more predictable return stream and increased protection against unrewarded risks. Clearly, a 'cashflow driven investment' (CDI) / run-off approach would focus predominantly on income assets with a balance between liquidity and illiquidity (this is discussed in more detail in a later article). More mature schemes targeting buyout may prefer more liquid, higher quality income assets.

In summary, we expect the new funding regime will have far reaching consequences for trustees and sponsors that are likely to restrict the scheme's flexibility. Therefore, focusing on the investment strategy both now and in the future will be critical to ensure that you are able to achieve the best outcome for your scheme in the future.

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Investing in UK housing

UK pension schemes have been investing in UK commercial property for many years but have little exposure to the residential sector. Interest seems set to grow as a more diverse range of opportunities emerge for institutional investment, both in the private rented sector and with various strategies aimed at affordable housing.

Market backdrop

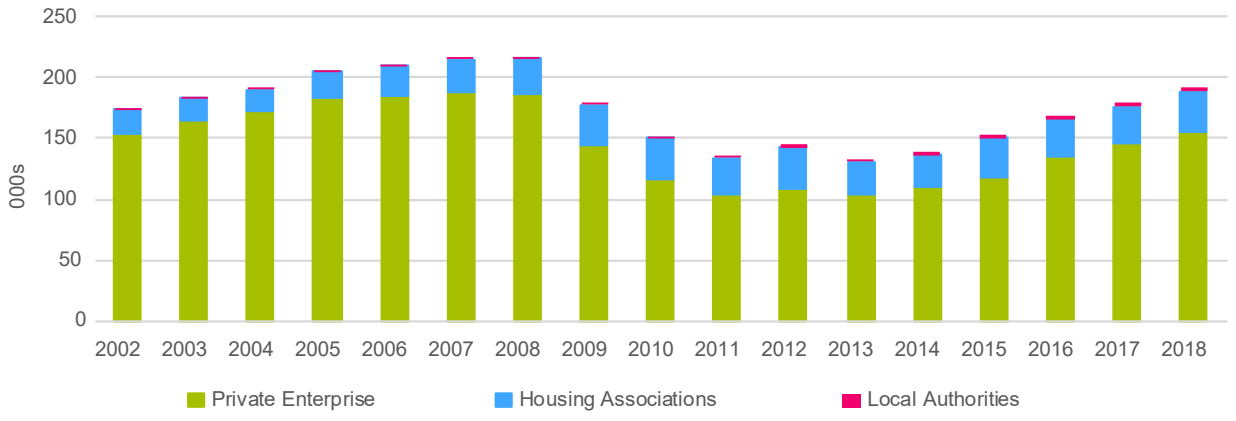
Population growth, together with a changing demographic structure, underpins the ongoing demand for residential property. The latest ONS (Office of National Statistics) projections show the number of UK households has increased from 20.5m in 2001 to 23.2m in 2018 and is projected to grow to 25.2m by 2030. The private sector and, to a lesser extent, housing associations have been responsible for housing supply since the 1980s. Supply dropped sharply after the global financial crisis ("GFC") in 2008 and has not yet recovered to pre-crisis levels.

Housing affordability deteriorated after the GFC, particularly for first-time buyers, due to a tightening of mortgage lending criteria, rises in house prices and lower rises in wages. This resulted in the number of mortgages for first-time buyers almost halving between 2007 and 2008. Affordability conditions remain tough, home ownership rates decreased across all UK regions for 25-35 year olds between 1995 and 2018, with London in particular seeing a drop from 47% to 20%.

The fall in UK owner-occupation has been more than offset by growth in the private rented sector ("PRS"). This now accounts for about 20% of all households. According to Savills, the sector has doubled in value over the last decade and is now worth over £1.5 trillion. However, the rise of PRS does not help those who cannot afford to pay market rents or those trying to get a foot on the property ladder. A number of government-run initiatives have been launched to improve affordability, with the aim of delivering at least 300,000 new homes every year by 2022. Many are directed at "affordable housing", which currently makes up less than 20% of the UK housing market, but is projected to account for around 40% of the 300,000 target. By controlling the planning regime, local authorities are influencing the type of housing that is built and made available. Local planning policies are typically obliging developers to allocate a proportion of any new build site to affordable housing. There are a few tenure types included under the affordable housing umbrella:

- Social housing – made available at around 50-60% of prevailing market rent;
- Affordable renting – offered at 80% of market rents; and
- Shared ownership – allowing home buyers to purchase a percentage of the equity in their home (taking out a mortgage to do so), with a third party also owning a stake in the home.

Chart 7: House building: permanent dwellings completed in UK



Source: Ministry of Housing, Communities and Local Government

Investment opportunities

Asset managers are offering an increasing variety of strategies as a result of the changing structure of the UK housing market. These typically involve institutional investors providing capital in exchange for receiving rental income. In most cases, returns will be driven by this income and future growth in income rather than capital appreciation. Strategies should therefore provide some diversification from the traditional UK commercial real estate market. We explore the four main tenures mentioned above that asset managers are focusing on to provide exposure to the sector.

Private Rented Sector

Historically, the UK PRS has been fragmented and dominated by landlords with relatively few properties under management. This has typically meant that income leakage (the proportion of gross rental income required to meet management costs) has been high. However, the growing number of long-term renters has led to the rise of purpose-built, private rented accommodation. This allows asset managers to generate greater economies of scale, by reducing income leakage and potentially from negotiating discounts from developers. In some cases, there may be an overlap of potential tenants with the affordable housing strategies outlined below, and so the success of the latter could be a headwind for the PRS.

Affordable housing – Social housing

There are almost 1,700 Registered Providers ("RPs") in the UK and, since 2012, they have raised over £14.4bn of debt in capital markets. Products have been established for institutional investors to invest in RP debt, which tends to be long-term, inflation-linked and have a quasi-government covenant. However, offsetting these attractive features for pension funds, yields are often low for the level of illiquidity that has to be accepted.

Affordable housing – Affordable renting

Homes for affordable renting are typically leased for 20+ years to a RP, which sub-lets to the underlying tenants. The investor receives an income yield from the RP. Income leakage is typically 20-30% (slightly below typical leakage from the PRS). Grants can be provided by the government to RPs when additional funding is required to make a development scheme viable. This can lower the investor's purchase cost and result in a higher income yield than other parts of the residential property market. Investment carries some risk of changes to government policy. For example, annual rental growth is currently capped at CPI -1%, will increase to CPI +1% from next year, but could be amended again at some point in the future.

Affordable housing – Shared ownership

Institutional investors in shared ownership schemes will fund a significant proportion (generally between 25% and 75%) of the property value through a lease agreement with the occupier, usually through a RP. The occupier pays a market-level rent on the proportion of the property that they do not own and this rental income is currently set to grow at an annual rate of RPI + 0.5%. Shared ownership lease agreements are usually for 100 years or more but occupiers have the right to increase their ownership stake gradually, which means investors face prepayment risk.

Expected returns

The following table summarises a breakdown of target returns for each tenure type from a selection of fund managers in the sector:

Table 1: Target returns of various tenures

Tenure	Net income yield (p.a.)	Expected annual growth in income	Typical leverage (loan to value)	Targeted net return (p.a.)
PRS	4.5%	c.3%	0-30%	6-7%
Social housing	2-3%	CPI + 1%	0-30%	c.4.5%
Affordable renting	3%	CPI + / - 1%	0-30%	5-6%
Shared ownership	4.5%	RPI + 0.5%	0-30%	4.5-7%

Source: Hymans Robertson

Products on offer

A handful of pooled funds dedicated to PRS have been available for several years. From time to time, products dedicated to another single strategy, such as social housing, are launched. What we see today is a growing number of products being launched to target a combination of affordable housing tenures, normally with a small element of PRS alongside. Target returns tend to be between 6-8% p.a. with leveraged strategies or those with exposure to development risk offering slightly higher returns. Products are aiming to deliver cash flows that are largely inflation-linked over a period of 15-40 years. The main risks to these strategies are government policy risk, credit risk of the RP and potentially some development risk.

Next steps

Residential property strategies can offer a means of diversifying existing UK commercial property exposure, mainly through generating a combination of income and income growth. There has been little allocation to the residential sector from UK pension funds so far, but we anticipate that interest will pick up as the number of viable options in the sector expands, particularly for strategies with the potential to deliver long-term contractual income that is inflation-linked.

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Cashflow-driven investing

While the term Cashflow Driven Investing (CDI) is a relatively recent recruit to the investment toolbag of pension schemes, the concept of cashflow driven investing is not new. It is also how insurance companies have invested to back their annuity funds for many years. The increasing attention on CDI can be attributed to the maturity of DB schemes and the growing number of schemes that are now cashflow negative. However, it is not only cashflow negative schemes that can benefit from a CDI strategy.

What is CDI?

In simple terms, a CDI strategy involves holding assets that are expected to deliver a predictable stream of cashflows. The objective can be the delivery of specific cashflows to meet benefit outgo, thus avoiding selling assets at uncertain prices, or on delivering a more predictable and certain level of return.

How does this help meet your strategic objectives?

Our earlier article on journey planning explained that long-term funding plans are a key focus of the Pensions Regulator at present. Being clear about where you are aiming, whether that be self-sufficiency or maybe buy-out, is not only good practice but also gaining regulatory momentum.

CDI strategies lend themselves to schemes aiming to achieve and maintain their long-term funding with a high degree of certainty through investing in a portfolio of assets that will deliver predictable cashflows. This is particularly relevant for trustees looking to invest for self-sufficiency rather than annuity settlement, although CDI can be used as a step on route to buy-in or buy-out too.

In an environment where gilts yields are so low, there will be many trustees and sponsors that will struggle to justify a 'gilts only' investment strategy. A well-constructed CDI portfolio can provide a consistently higher asset yield, up to as much as 1.5% over gilts over the term of liabilities, whilst also offering a level of security.

Aligned to integrated risk management (IRM), CDI also lends itself to basing the funding plan discount rate on the CDI portfolio asset yield (albeit with appropriate haircuts for expected default risks and prudence).

What should a CDI strategy look like?

There are many competing CDI solutions and products, but this is not a 'one-size-fits-all' strategy. The target CDI will depend on specification of the long-term objectives and cashflow requirements. The optimal answer is therefore likely to involve a degree of tailoring even if not fully bespoke.

A scheme looking for stable cashflows but without the need for much additional return over gilts may find that a simple solution using investment grade corporate bonds alongside LDI satisfies their requirements. Another with a higher return objective may seek to achieve the yield enhancement by supplementing the credit premium using assets providing illiquidity and complexity premia. Key to either is the preponderance of predictable and ideally contractual cashflows.

CDI strategies fit nicely within our Growth, Income, Protection (GrIP) framework we've been applying with clients for some time now. Indeed many clients already adopt some form of cashflow based investing within their existing investment strategies, without actually calling it CDI.

Choosing the right building blocks

The broad opportunity set of possible assets to construct a CDI strategy is illustrated in Chart 8. Bonds and other credit investments lend themselves particularly well to CDI strategies, given the predefined contractual cashflows; other income-based assets such as infrastructure and property can play a part too. It is useful to consider short, medium and long-term income needs separately.

As illustrated below in Chart 9, a CDI strategy might be composed as follows:

- Short-term cashflows met by investing in a combination of investment grade corporate bonds, high yield debt, direct private loans and asset-backed securities to capture a higher yield.
- In the middle-term, the focus is on investment grade corporate bonds and real estate and infrastructure debt. For the long-term, we can make use of long-term yield enhancers that often have the added attraction of some inflation linkage such as long lease property coupled with high quality credit and gilts, reflecting the fact that default risk is more uncertain over longer timescales.

Using a range of income assets diversifies the sources of risk premia.

Chart 8

Income focused opportunities in credit

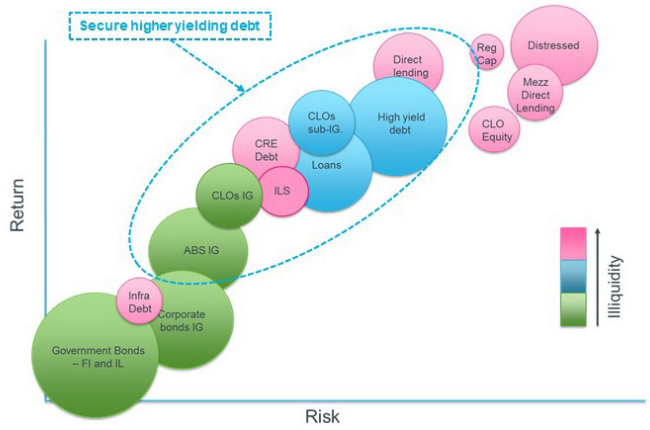
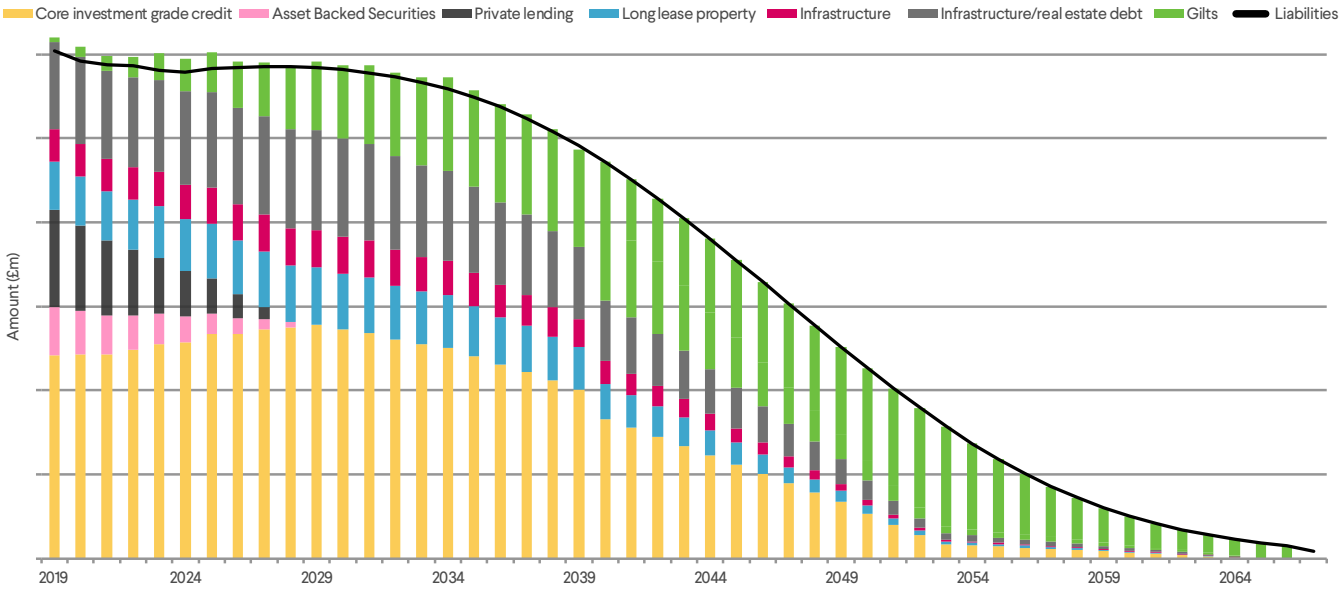


Chart 9



So, is CDI right for you?

CDI strategies built around income assets can be used to increase the predictability of return and provide cashflow certainty. CDI investing lends itself to tailoring solutions to meet your needs.

There is no need to be unnecessarily complex when developing a CDI solution. Simple solutions should be able to achieve most of the same outcomes as a complex fully cashflow matched solution; indeed, given the uncertainties in liability cashflows it is often more important to retain some flexibility to capture the best market opportunities at the time.

Whether you are looking to meet a long-term self-sufficiency objective or just better match your cashflows in the short-term, a CDI strategy, built around income assets, may be right for part of your scheme investments.

Please speak to your investment consultant if you would like more information.

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Market returns to 30 June 2019

	Yield % p.a.		Returns to 30 June 2019 (sterling, % p.a.)		
	31-Mar 19	30-Jun 19	1 year	3 years	5 years
Equities					
Global	2.5	2.5	10.1	14.0	13.2
UK	4.2	4.1	0.6	9.0	6.3
Developed markets ex UK	2.4	2.3	10.9	14.6	14.2
Emerging markets	2.9	2.9	8.3	12.5	9.5
Bonds					
Conventional gilts	1.4	1.3	4.9	2.0	5.5
Index-linked gilts	-1.9	-1.9	8.6	5.7	9.1
Sterling corporate bonds	2.9	2.6	6.8	4.6	5.8
High yield (US) *	6.7	6.4	7.6	7.5	4.7
Emerging market debt	6.4	5.9	14.3	6.3	5.5
UK Property	-	-	4.0	6.6	9.1
Hedge Funds *	-	-	2.5	4.3	2.4
Commodities *	-	-	-3.6	3.8	-0.4

* Return in $

Source Datastream:
FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities
BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

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