

investment perspectives

May 2018

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Welcome

Welcome to our spring edition of Investment Perspectives.

Rather like transfer deals in the English Premiership, prices were already a touch eye watering, but continued to go higher anyway in 2016 and in 2017. For 2018 it's all change, with the start of the year posting negative returns on equities (especially UK equities) and government bonds. We have been saying for some time that it would be hard for equities to make much headway while bond rates normalised (whatever that might mean in practice), and there was always the risk of a policy mistake or a jump in inflation to scare the market. February was a gentle reminder that markets can be volatile and that equities and bonds can both go down at the same time. For now the trajectory of markets appears to be "stable".

With this backdrop, following Graeme Johnston's review of markets, we look at two opportunities that can be used by trustees to help achieve more predictable outcomes:

- Recognising that many pension fund trustees would prefer to have a little more certainty in their equity returns, we take a look at the use of equity option strategies to control outcomes; and
- With many pension funds having already turned to private corporate lending as a source of more predictable but high yielding returns, Claire Cairney takes a look at real estate debt, which offers an alternative source of credit and illiquidity premium across the full range credit risk from senior secured investment grade to mezzanine.

Away from the markets, there are plenty of regulatory issues affecting pension funds. One to look out for is the CMA investigation - the CMA has started to report back to the industry ahead of the final recommendations. This will lead to some important changes to the way in which our industry operates and we will be commenting on this in future Investment Perspectives as we see more detail from the CMA.

Another key regulatory change is MiFID II, which has come into effect from the start of 2018. One of the many areas this covers is the reporting of all costs by asset managers. Specifically relating to DC schemes (for now anyway), the FCA has also released guidance on disclosure of transaction costs. William Chan, who leads our DC investment research, provides more background to the challenges around calculating transaction costs and interpreting disclosures in our fourth article.

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Capital markets update

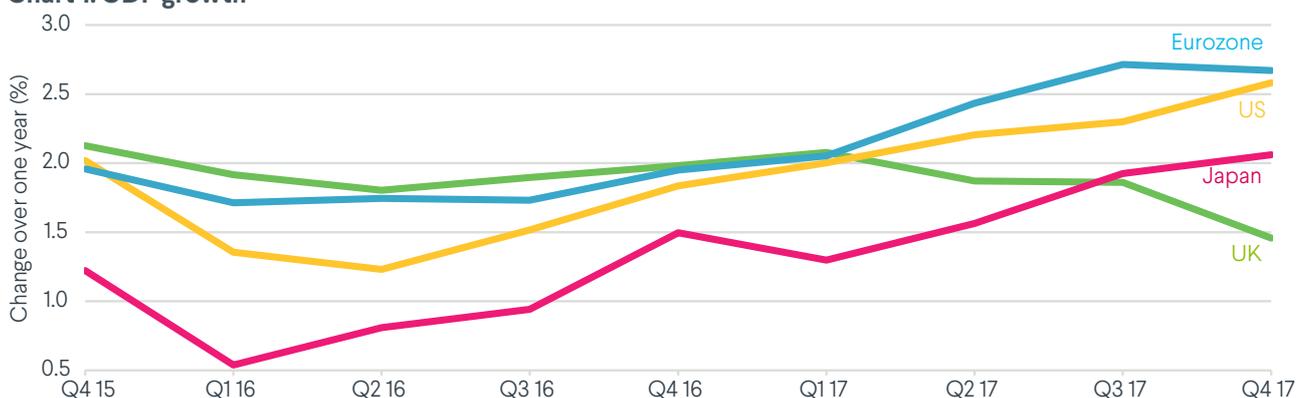
Although the global economy ended 2017 in fairly fine fettle, with the latest estimates for Q4 growth outside the UK suggesting that year-on-year momentum remained intact (chart 1), there have been some signs of a subsequent moderation in growth. Business conditions, as reflected in PMI manufacturing surveys, have perhaps cooled a little in 2018 without threatening to fall to levels consistent with contraction. And economic surprise indices, which compare economic releases with prior forecasts, have also turned down. Outside Japan, where the current economic expansion is the longest since 1989, they do not yet suggest that hard data is routinely disappointing expectations to a significant extent. There has been nothing this year to match the concern that a US recession might be imminent (that marked the start of last year), although rising trade tension between the US and China has clouded the outlook in recent weeks.

A more immediate concern for markets has been the possibility that the longevity of the upturn in growth would stoke inflationary pressure. So far, the evidence is scant. Core inflation in the US and Eurozone has changed little since the middle of 2017; it has edged above zero in Japan, but it has turned down a little in the UK. Markets were unsettled by unexpectedly high US wage growth in January, but that has not been sustained since.

The mixture of solid growth and stable inflation has allowed central banks to stick with their (very) modest tightening bias. The European Central Bank (ECB) remains on course to finish its Quantitative Easing (QE) programme in September; the course of US monetary policy seems little affected by the advent of a new Chair, Jerome Powell – interest rates were raised by another 0.25% p.a. in March; perhaps more surprisingly, there has even been talk of a UK rate rise in May.

Even if there has been little change to the economic background, the flow and ebb of optimism on growth and concern about inflation has led to some swings in markets this year. But, over the first quarter as a whole, the net changes in global equity and bond markets were modest – a negative return of 7% from UK equities was an outlier. Hence little change to our view that medium-term returns will be subdued. As we noted last time, a continuation of benign economic conditions is no panacea. That is likely to bring further normalisation of interest rates and at least the rise in government bond yields already implicit in yield curves. That, in turn, threatens to undermine the stretched valuations in riskier markets – the primary driver of the strong returns of recent years. Any tactical management should recognise the risk of a short-term correction from current levels. Equities have fallen significantly from their January peaks and valuations are not as stretched as they were but, even if it is not shouted quite so loudly, the watchword remains de-risk, diversify or (apologies) defend through protection strategies.

Chart 1: GDP growth

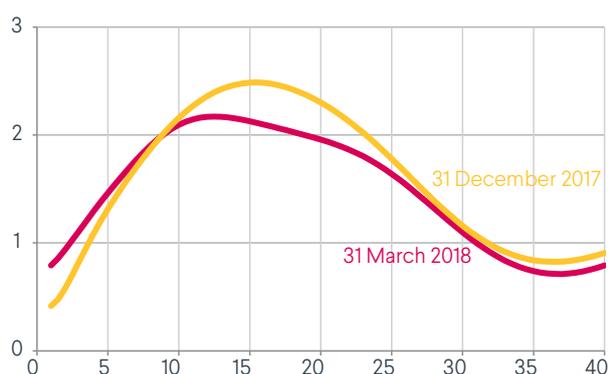


Source: Datastream

Government bonds

Ideally, we would satisfy our appetite for de-risking by holding some cash. With 10-year yields around 1.4% p.a., we are still reluctant buyers of gilts, albeit a little less reluctant than we were when they were 1.2% p.a. at the end of 2017. This modest rise was consistent with what was happening in other major markets. For gilts more specifically, our reluctance to buy increases with maturity. Although 10-year yields rose a little in the first quarter, 30-year yields fell – in the jargon, the long end of the yield curve flattened. This exacerbates an issue we have highlighted before: the very low level of future interest rates implied by gilt prices. Forward gilt yields (implied yields on a year by year basis) as shown in chart 2 are well below 1% p.a. beyond 30 years. Where de-risking involves an increase to interest rate hedging programmes, we still recommend a flexible approach that concentrates on shorter maturities for the moment.

Chart 2: Forward gilt yields



Source: Bank of England

The real yield curve remains much flatter. Beyond 10-year maturities, inflation protection got a little bit cheaper in the first quarter and, on average, still seems fairly valued. The fact that the annual cost of protection over 40 years is significantly cheaper than the cost of protection over 20 years appears anomalous.

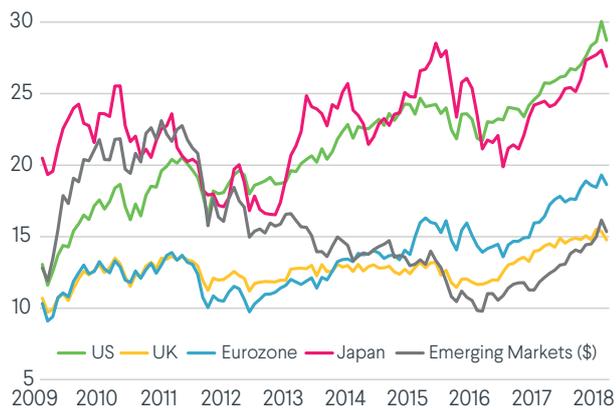
Other bonds

A buoyant global economy has been good for credit markets, helping to minimise default levels. Forecasts suggest that defaults will be lower in 2018 than they were in 2017, as the effect of the fall in oil prices in 2014 and 2015 on indebted energy companies fades further. Of course, one consequence of the favourable background has been to drive yield spreads down to historically low levels. Spreads widened a little in the first quarter: modest tightening at the start of the year as economic optimism mounted was more than unwound as the optimism waned. The rise in spreads is insignificant in any longer context. Our view is still that rewards for pure credit risk are meagre and we would be inclined to reduce exposure. We still see relative value in areas where returns are to factors other than pure credit risk, especially illiquidity. In credit markets, as elsewhere, diversification is particularly important in uncertain times. The last decade has opened up new opportunities for institutional investors as banks have retrenched. We highlight another of these opportunities, commercial real estate debt, in a later article.

Equities

In terms of reported corporate profits, the fundamental background for equity markets remains strong – not so surprising given the momentum of the global economy and the few months' lag in reporting. As we noted last quarter, the strength of earnings growth has been crucial to the global equity rally since late 2016, when rising bond yields and interest rates had the potential to undermine the revaluation that had underpinned the rise of the previous 5 years. From that perspective, looming threats to future growth – rising trade and geopolitical tension, concerns about the sustainability of growth in the tech titans that have lately been at the forefront of the upward charge – could be critical. And expectations are high. Based on Standard & Poor's estimate of consensus forecasts, US operating earnings per share (eps), i.e. excluding one-off charges, are forecast to grow by 25% between 2017 and 2018. Even allowing for a generous contribution from tax reductions that will be challenging.

Chart 3: Shiller price-earnings ratios



Source: Datastream, Hymans Robertson

We take a more sceptical view: there will always be years when earnings growth is strong, but these reflect fluctuations round more modest long-term trend growth. Chart 3 shows “Shiller” price-earnings ratios, which attempt to look through these cyclical variations by using the average of the last 10-years’ eps adjusted for inflation. On this measure, the correction in equity markets has only done a little to improve valuations. The US (accounting for over half of global indices) may be mainly to blame for the high level of valuation, but valuations in other major developed markets are at or close to post-crisis highs. Emerging markets, despite their relative strength of the last two years, still look less stretched relative to their own recent history. Overall, on valuation grounds we would still be looking for opportunities to reduce, or protect downside exposure to, equity risk.

Chart 4: IPD UK Monthly Index - gross reversionary yield



Source: IPD

Property

As is usual, the swings in other financial markets impinged little on UK commercial property. In aggregate, capital values and rents continue to edge higher and Industrials continue to drive most of the growth. Anecdotal evidence suggests bargaining power continues to ebb from landlords to tenants in some office and retail markets. There are also some signs that the pace of rental growth in industrials is easing – just as the sector’s IPD Monthly reversionary yield (based on current market rents) dips below the overall reversionary yield for the first time in the index’s 30-year history (chart 4).

The overall IPD Monthly reversionary yield is edging down towards 6% p.a., already as low as it has been for a decade. Income-based yields (based on historic rent reviews and adjusted for vacancies) are close to 5% p.a., but still higher than in the wake of the EU referendum. They still offer a significant premium over gilts, but the premium over equities is towards historic lows. The additional security of property income retains an appeal in more volatile conditions, but we would be taking an increasingly defensive stance towards property. In particular, the inflation-linked underpinning of long-lease strategies looks increasingly valuable. These strategies also tend to benefit from a relatively high tenant quality compared to the market as a whole.



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Predictable returns from equities?

Structured equity, or controlled equity, is a means of achieving a predefined return profile to suit your needs.

The best use of structured equity is where it is designed with a specific objective in mind, not where a one-size-fits-all product is pulled off the shelf and grafted onto the current strategy. Reasons for choosing a structured equity solution might include:

- maintaining broad equity market exposure, but protecting funding leading up to an actuarial valuation;
- maintaining broad equity market exposure, but needing some ongoing absolute level of protection (“stop loss”) to help manage covenant risk; and
- creation of low volatility equity exposure by giving away some upside to partially fund downside protection.

In each case the aim is to deliver more predictable returns.

What is structured equity?

Structured equity allows investors to restructure their equity return profile using equity derivatives, and in particular options. By way of a reminder, options carry the right, but not the obligation, to buy or sell a stock or an index at a specified date in the future at a specified price. They come in two basic types:

- 1 The most basic protection is provided by using put options. Buying a put option enables an investor to sell at a fixed price and so limit the potential losses from falling equity markets. The seller receives a premium for taking on the risk of having to buy at the fixed price. So you might pay a premium to have the option of selling the FTSE 100 index at 6500 in one year’s time.

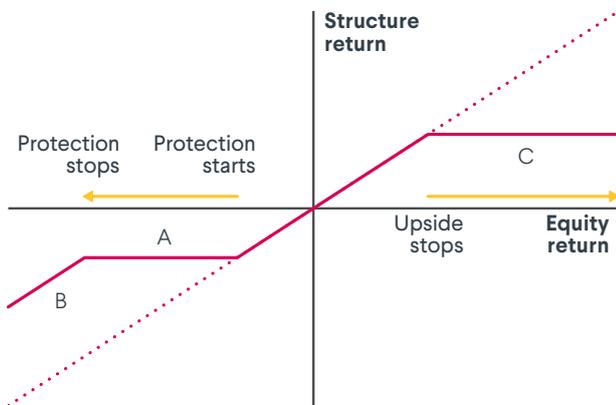
- 2 Buying a call option enables an investor to buy at a fixed price. The seller receives a premium for agreeing to sell, if required, at that price. So you might choose to take a premium from another investor in return for allowing them the option of buying the FTSE 100 index at 7,500 in one year’s time.

Options will have a defined expiry date – typically between 1 and 3 years, but could be shorter or longer. By overlaying or replacing equity investment with an appropriate combination of equity options, investors can redistribute their return profile, in order to help make returns more predictable at an acceptable price.

The most common solution considered is referred to as a “put spread collar”. The key objective of this strategy is to keep investing in equities, but to buy some downside protection and pay for the premium by giving away some upside if equity markets rise more than expected (which is equivalent to de-risking if equity markets rise).

The payoff diagram of an example put spread collar (PSC) at expiry is shown in chart 5.

Chart 5: Typical Put Spread Collar



The PSC has three components:

- A** Buy a put option, to protect equity return below a certain level by paying a premium.
- B** Sell a put option, to remove the protection below a level lower than the floor to cheapen the premium.
- C** Sell a call option, to give away equity return above a certain level to further cheapen the premium.

As is often the case, the level of upside given away by the call option can be chosen such that the premium for the overall structure is nil. However, it would be equally valid to consider a PSC with a non-zero premium, particularly if there is a desire to retain more upside over the term of the option or if there was some asymmetry in pricing.

Impact on return

Chart 5 illustrates that the return profile of the PSC (the solid pink line) is quite different from that of holding equities alone (the dotted pink line), and in practice, this profile can be tailored to meet a pension fund's specific needs.

The actual return achieved on the option strategy may be higher or lower than the market return for any given equity market outcome. However, options are not a free lunch. Even if an option strategy is sold as "nil premium", it will typically cause a slight drag on the average expected return reflecting the pricing of options.

For this reason it is important to compare the expected return profile with the simple alternative of holding a combination of equities and cash.

Return profile prior to expiry

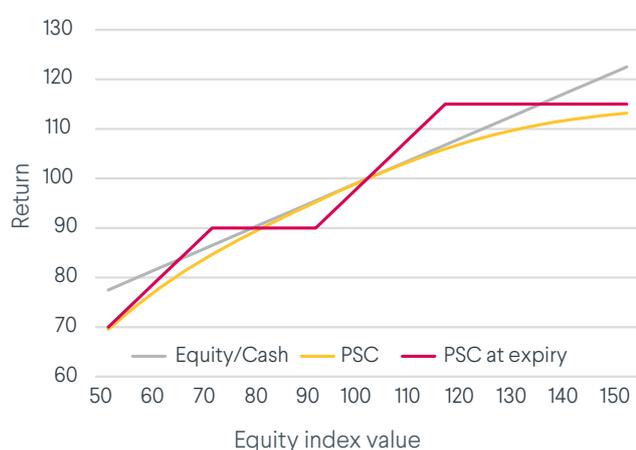
In practice, the options might not be held to expiry, so the return profile prior to expiry may be just as important as the return profile at expiry.

Chart 6 (overleaf) shows the value of the PSC (vertical axis) vs the underlying equity index value (horizontal axis) as a percentage of starting values (100%). The pink line shows the payoff profile at expiry (as in chart 5). The yellow line shows the payoff profile if the strategy is liquidated immediately following inception. The grey line is the payoff profile of a portfolio of 45% equity and 55% cash.

The main advantage of this PSC over an equity/cash portfolio is to fully benefit from equity upside up to 15% if held to expiry. However, as chart 6 shows, the PSC at inception performs no better than a portfolio comprising 45% equity and 55% cash. This assumes no transaction costs in the PSC premium. The shape of the yellow line only begins to closely resemble the pink line as it gets fairly close to expiry, typically with less than six months remaining.

In addition to how option pricing changes over the term of the contract, it is also important to understand how the value of an option strategy may change in response to changes in market conditions, such as an increase in equity market volatility.

Chart 6: Return at inception, expiry and of equity/cash



Key takeaways

Equity options allow investors to help convert equity investing into a more predictable return at an acceptable price.

The relevance of using structured equity over other strategies aiming to deliver more predictable returns, such as higher yielding credit strategies, will depend upon relative value; when credit spreads are fair value or better, a credit solution might be the best way of earning predictable returns. However, at other times, e.g. when spreads on high yield bonds are 2% p.a. below average as they are now, a structured equity solution may offer better risk adjusted returns.

The optimal implementation solution for a pension fund may change over time; at times the cost of protection will appear cheap, at other times you may be better rewarded by earning a premium for paying away upside. While this means that the design stage of derivative strategies tends to require a bit more thinking about than traditional strategies, living with an equity derivatives strategy can be pretty straightforward once implemented.

A benefit of structured equity is that it can usually be implemented with much less capital than holding physical equities. It can have maximum benefit where there is also a need to free up capital from equity assets that can be used for other purposes, such as providing collateral for managing interest rate risk.



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Commercial Real Estate Debt

UK institutional property funds tend to be the sole investor in the properties they own. In the wider global commercial real estate (CRE) market, a large proportion of investment is financed by a combination of equity and debt.

For a long time, there have been large CRE debt markets in the US, Eurozone and UK. Until a decade ago, provision of CRE debt finance was predominantly the domain of the commercial banks. As they pared back their participation in the wake of the global financial crisis, private debt funds and other institutional investors emerged to fill the funding gap. As such, CRE debt represents an opportunity that is complementary to the direct corporate lending with which investors have become increasingly familiar.

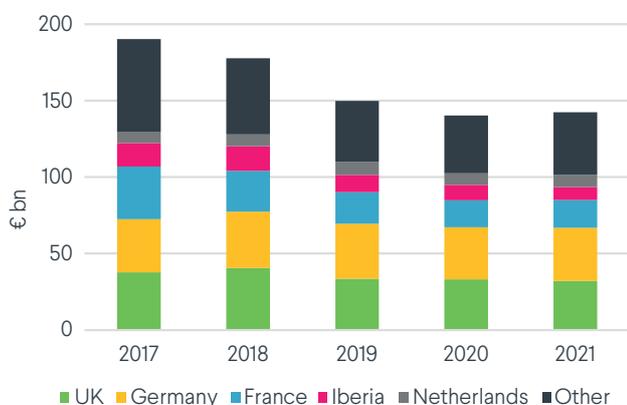
Our focus in this article is on secured CRE debt (i.e. in the event of default, the lenders can take control of underlying properties) and on the European market (including the UK). The European CRE debt market is over £500bn (including c£200bn in the UK). The pattern of redemptions of outstanding debt is shown in chart 7 below. In total, over £190bn is due to mature and therefore need re-financing, in 2018.

Characteristics of CRE debt

As with the broader corporate lending market, the seniority of any CRE debt, i.e. its position in the capital structure, is a key element of risk. The most senior lenders have a 'first lien' claim on the underlying property assets in the event of a default. Their debt must be paid back in full before more junior lenders receive any payment. In return for the increased risk, the junior debt will carry a higher rate of interest.

A key metric of seniority of property lending is the loan to value (LTV) ratio, i.e. the extent to which an investor in a given part of the capital structure is protected by equity and more junior debt capital. For a given tranche of debt, LTV is calculated as the total nominal value of the tranche and any more or equally senior debt tranches, all divided by the value of the underlying property. For example, holders of debt with a 60% LTV can withstand a fall of 40% in the property's price before it is no longer sufficient to cover a full principal repayment in the event of a default.

Chart 7: Maturity profile of European real estate debt



Source: CBRE European Commercial Real Estate Finance 2017 Update

Other factors will be relevant to the assessment of the risk of CRE debt. Most notably:

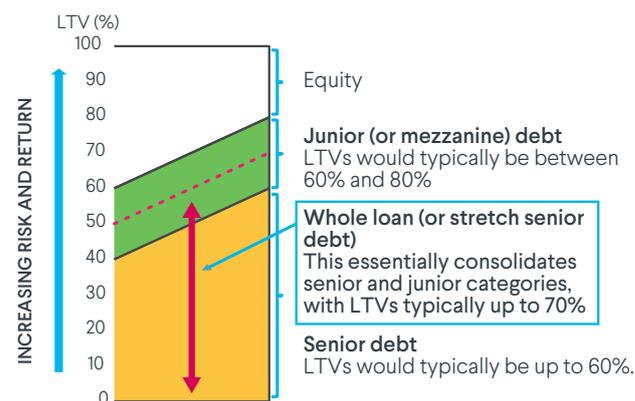
- The quality of the property based on location, design, energy efficiency, etc. The usual distinction of commercial property into prime and secondary (and sometimes tertiary) assets is relevant here. The usual caveat that one investor's prime property is another investor's secondary property is also relevant.
- The quality of tenancy, based on financial strength of tenants, average length of tenure and occupancy level.
- Track record of equity owner and robustness of business plan. This is particularly important in respect of "transitional" properties (i.e. properties requiring a significant degree of asset management in the form of refurbishment, partial redevelopment or modification of use).
- Income cover i.e. the number of times rental income is able to cover debt repayments on equivalent and prior ranking debt. (Assumptions about likely future rental growth may also be relevant). This is less important for transitional properties, which typically initially have high vacancy levels.
- The financial strength of the borrower. Loans are often non-recourse to sponsor, but a strong borrower can put more equity in to a deal if required.

CRE debt is either structured as a floating rate loan, with interest paid as a margin over market cash rates, or issued at fixed rate. Loan terms are normally in the range 5-7 years. The market is private in nature, with no established secondary market. As a consequence, property debt is not rated by the public rating agencies, although managers of institutional funds normally assign their own internal rating to the debt. The ratings that managers assign will be based on their modelled risk of default and expected recovery of capital in the event of default.

Classification of debt

We identify three main types of CRE debt as illustrated in chart 8:

Chart 8: Example capital structure



Implementation

We describe below the main strategies adopted by managers of CRE debt. (There is no common terminology across the market and managers will use different names to describe their own strategies and target assets). In decreasing order of quality (and increasing order of risk and expected return), they are:

Core senior

These are strategies lending against prime, high quality properties at conservative LTVs. This type of lending, though unrated, is typically considered as equivalent to investment grade because of the larger equity cushion and higher quality underlying property leading to higher expected capital recovery in the event of default.

Added-value senior

These strategies also concentrate on senior, secured lending, but will be less conservative in respect of the quality of underlying properties. They may lend on transitional and secondary properties – and/or relax the seniority of lending – they may include some whole loans.

Junior/Mezzanine

These strategies focus on subordinated, though still secured, lending.

Investing in any of these strategies will typically be through closed ended funds, with a range of terms typically between 5-10 years. Table 1 on page 11 provides a summary of some typical risk and return measures for the three strategies.

Table 1: Risk and return measures

Strategy	Core Senior	Added-value senior	Junior/Mezzanine
Credit quality (notional)	Investment Grade (A/BBB)	Sub-investment Grade (BB)	Sub-investment Grade (B)
Yield (gross)	Libor + 2.0% - 2.5% p. a.	Libor + 4% - 7% p. a.	Libor + 7% - 12% p. a.
Default risk	Very low	Low	In line with corporate high yield
Expected recovery on default	High	Reasonably high	Low
Management fee	0.5% p. a.	1.0% p. a.	1.5% p. a.
Incentive fee	-	10% subject to a 4% p. a. preferred return	15% subject to a 5% p. a. preferred return
Target return net of fees	Libor + 1.5% - 2.0% p. a.	Libor + 4% - 5% p. a.	Libor + 6% - 8% p. a.

Current opportunities

Relative to corporate credit markets, CRE debt can offer both some diversification of underlying risk and the possibility of enhanced returns due to an illiquidity premium. Relative to pre-crisis levels, loan margins continue to be higher and LTVs lower. Relative to public credit markets, covenants to protect lenders in loan documentation are stronger. We see a range of opportunities to suit investors with varying risk/return appetites, provided in each case they are able to tolerate illiquidity over a period of years.

- Investors looking to enhance returns from investment-grade corporate bond portfolios without materially impacting credit quality may see core senior strategies as an attractive complementary allocation. This type of lending can still provide an attractive pick-up in yield relative to similarly rated public corporate bonds. However, there has been a significant amount of capital raised for core senior strategies in recent years as banks have returned to compete with other institutional investors. This has resulted in significantly more reduction in credit spreads than in other parts of the CRE debt market.
- Investors looking to diversify a growing allocation to return-seeking income assets may view added-value senior strategies as an alternative to existing corporate lending that can provide similar returns. These strategies have not suffered much competition from banks, given the increased cost of capital banks incur holding the underlying, less secure, assets. Discerning managers are still able to source well-located, good-quality and well-let assets. These strategies are not without risks but, in general, they can be considered as equivalent in quality to the speculative-grade corporate debt already held in typical portfolios.
- Junior strategies may be of narrower interest. This area of the market is relatively small, higher risk and investing can take time. Investors who have the scope to make allocations to a “special situations” portfolio as part of their overall investment in growth assets may find opportunities here.



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Transaction costs and transparency: hype or gripe?

With recent headlines such as “Large hidden fund charges revealed by MiFID II rules” and “Asset managers under fire as impact of transaction costs revealed”, you may be forgiven for thinking that there has been a radical transformation within investment management.

The attention is due to MiFID II (Markets in Financial Instruments Directive) regulation, which came into effect in January 2018 and now requires asset managers to:

- aggregate all costs and charges which are not caused by the occurrence of underlying market risk; and
- provide an itemised breakdown of costs and charges if requested by a client.

This means that all underlying transaction costs incurred in running and maintaining an investment portfolio will need to be reported. Also from January 2018, the Financial Conduct Authority (FCA) released regulatory requirements, along with guidance, on a methodology for disclosing transaction costs within DC schemes. Therefore, it is likely that publicity will escalate further as DC Chairs’ Statements and Value for Member assessments are completed this year.

The current controversy

The recent press articles focus on the transaction costs that are now being revealed as an addition to the Ongoing Charges Figure (OCF) that most industry participants are familiar with. Readers will have seen a sample for retail funds as shown in table 2.

The headline grab is that investors often pay transaction costs that, themselves, make up a high proportion of the aggregate cost (actual cost of ownership). However, we believe that this message provides the wrong focus. As part of common industry practice, transaction costs are already incorporated as a reduction to a fund’s gross return – it should not be aggregated with costs such as the OCF. We explain why this is the case in our value framework section on page 13. Therefore, it is much more important to analyse what potentially makes up the headline transaction costs number and then make an assessment of whether the actual transaction cost represents good value, fair value or poor value.

Table 2: Fund costs

Fund	OCF (% p. a.)	Transaction costs (% p. a.)	Actual cost of ownership (% p. a.)
Woodford Equity Inc	0.75	0.28	1.03
Invesco Perpetual Global Target Returns	0.88	0.35	1.23
JPM Global Macro Opps	0.78	0.66	1.44
Lindsell Train Global Equity	0.75	0.01	0.76
L&G Global Inflation-Linked Bond Index	0.27	0.22	0.49

Transaction costs – Looking under the bonnet

When it comes to transaction costs, the guidance from the MiFID II regulations distinguish between:

- 1 The costs related to transactions initiated in the course of the provision of an investment service and investing or disinvesting into a fund, e.g. entry and exit charges in and out of funds, platform fees.
- 2 The costs related to transactions initiated in trading the underlying financial instruments or securities within the fund. Table 3 provides more detail on this, focusing on three example asset classes – equities, property and LDI.

Table 3: Transaction costs

Explicit	Implicit
Costs that are separately charged to, and paid by, the investment product.	Costs that are included within the price at which the transaction takes place.
<p>Equities:</p> <ul style="list-style-type: none"> • Brokerage commissions • Stamp duty on UK equity purchases • Withholding taxes • Securities lending costs • Hedging costs for hedged global mandates <p>Property:</p> <ul style="list-style-type: none"> • Stamp duty and land tax on UK purchases • Operational costs involved in the transaction, e.g. legal, valuation, environmental surveys <p>LDI:</p> <ul style="list-style-type: none"> • Central clearing costs (if cleared) • Dealing spreads when contracts roll • Rebalancing costs (if applicable) 	<ul style="list-style-type: none"> • Slippage costs – change in asset prices between placing and execution of an order. Provides a potential indication of trading inefficiency. • Market impact – the adjustment to asset prices as large transactions, in particular, are implemented over a period of time.

The value framework

With the above information at hand, we believe the following three point framework should be used in determining the appropriateness of transaction costs and transparency reported:

1. What is the fund's purpose?

At the end of the day, a fund can keep transaction costs to zero if it refuses to trade. However, this is not what investors want or expect. Even a passive fund like the L&G Global Inflation-Linked Bond Index Fund has to trade if a large bond issue comes to market and becomes a meaningful part of the index being tracked. Therefore, the real question to assess is whether the 0.22% p.a. transaction cost shown in table 2 helps this fund track its underlying benchmark over time as efficiently as practicable.

Another example from table 2 is the Invesco Perpetual Global Target Returns Fund. The purpose of this multi-asset fund is to combine a number of different (and relatively uncorrelated) trade ideas to achieve a long term return above cash. These ideas will experience natural turnover through achievement of a risk and return target or through acknowledgement from the manager that they had made the wrong call. In either case, the costs incurred reflect the management approach that investors signed up for. In respect of unsuccessful trades in particular, it is absolutely necessary that managers cut their losses rather than hoping for something to turn up for the sake of containing transaction costs.

2. Are transaction costs consistent with fund objectives?

Transactions are necessary to keep a portfolio with holdings that the manager finds attractive and sell holdings that they find relatively unattractive. Ultimately, the level of transaction costs should be consistent with the fund's stated investment strategy and style. For example:

- Referencing table 2, we would expect Lindsell Train's equity fund to have lower transaction costs relative to a momentum-oriented equity manager; and
- We would expect a buy-and-maintain corporate bond manager to have lower transaction costs than a traditional active corporate bond portfolio.

3. Are transactions implemented efficiently?

Our research team will assess a manager's trading and implementation efficiency as part of the due diligence process, but this is second order relative to the first two points above. An example of the trading efficiency that would be assessed can be illustrated with a commercial property transaction. It is common for an intermediary to be used in a sale to obtain the best secondary market pricing possible. While a fee / transaction cost will be paid to the intermediary, the reality is often that the transaction will result in a better price than if the sale was completed with no intermediary and with no transaction costs incurred.

Conclusion

As investment managers and platforms come to grips with the reporting and disclosure of transaction costs under this new framework, it is the job of investment advisers to help clients interpret and extract valuable information from the transaction cost analysis.

A good starting point in such an analysis would be to consider a portfolio snapshot at the start of the analysis period and calculate the return for the entire period assuming no transactions were undertaken – let's call this the inertia portfolio return. We can then compare this to the actual gross return generated by the portfolio, i.e. allowing for changes made. By doing this over a period of time we can answer the following questions:

- Does the manager meet their investment objectives with the inertia portfolio they held at the outset, assuming no transactions?
- How much value has been added or detracted from the manager's trading or transactions (relative to the inertia portfolio)?

Over time this analysis provides us with additional information that we can use in our monitoring of the manager, which then feeds through to our research rating or value for money assessment.



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Market returns to 31 March 2018

	Yield % p.a.		Returns to 31 March 2018 (sterling, % p.a.)		
	31 Dec	31 Mar	1 year	3 years	5 years
Equities					
Global	2.3	2.4	2.9	10.9	11.6
UK	3.6	3.9	1.2	5.9	6.6
Developed markets ex UK	2.2	2.3	2.4	11.3	12.7
Emerging markets	2.6	2.6	8.8	10.4	6.9
Bonds					
Conventional gilts	1.5	1.5	0.5	3.4	4.2
Index-linked gilts	-1.7	-1.7	0.5	7.0	6.9
Sterling corporate bonds	2.7	3.0	1.6	4.0	5.5
High yield (US) *	6.2	6.6	3.7	5.2	5.0
Emerging market debt	6.5	6.3	0.1	7.8	1.0
UK Property	-	-	11.3	8.9	11.8
Hedge Funds *	-	-	5.4	1.8	3.6
Commodities	-	-	-2.3	4.0	-4.4

* 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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