HYMANS ROBERTSON

investment perspectives

April 2017

In this issue:

Welcome

We continue to live in an uncertain political environment: we are just three months into the Trump presidency and perhaps only a little wiser now as to how this will pan out; the UK has entered the period of post triggering Article 50 with a Snap General Election; and Europe has a year of multiple elections.

Despite this, markets have continued their relatively resilient path. Graeme Johnston provides his views on how things may unfold.

We then have two articles that look at two very topical investment issues:

- First, following the devaluation of sterling since June 2016, Dave Morton sets out some thoughts around the strategic role of currency hedging within equity mandates.
- Next, Chris Arcari takes a look at an area of debt investing typically referred to by its 3 letter acronym: ABS and the subset of this market known as CLOs.

In the final piece of this quarter's publication we include a summary of our response to the Financial Conduct Authority's (the FCA's) interim report on its Asset Management Market Study. The FCA launched its market study in November 2015 with a view to understanding how competition is working for retail and institutional investors. In November 2016 the FCA issued its interim report. This important study will have an impact on the way asset managers, fiduciary managers and investment consultants conduct business. In this interim report the FCA sets out its initial findings and a series of proposed remedies to issues it has identified. The FCA sought responses to a series of questions around the proposed remedies, with the FCA expecting to deliver its final report setting out proposed amendments to FCA rules as early as Q2 2017.

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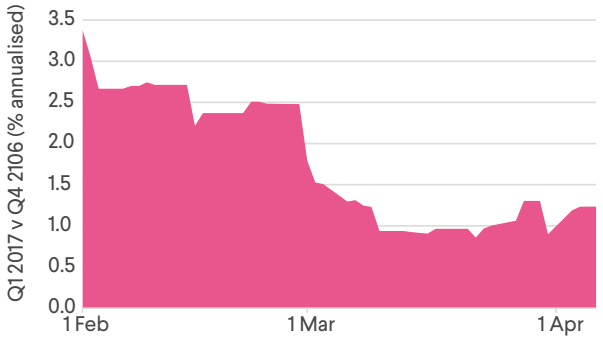
Capital markets update

The signals from economic indicators were a little mixed over the first quarter of the year. Business survey data across the world continued to point strongly to sustained momentum in the global economy: official economic releases, particularly in the US, seemed more subdued.

Chart 1 shows the GDPNow indicator published by the Federal Reserve Bank of Atlanta for the first quarter. This estimates US economic growth using the cumulative evidence from official statistics as they are released. It currently suggests annualised first-quarter growth of little more than 1%. Headline inflation drifted higher in most parts of the world, extending last year's trend, as earlier commodity price falls fell out of the calculations. Core inflation numbers, excluding food and energy, were stable, excepting an upward drift in the UK, where the effect of sterling weakness started to feed through.

On balance, economic developments probably strengthened the case that the environment has shifted from "lower for longer" to "low for long".

Chart 1: GDPNow forecast for US growth



Source: Datastream

In the US, the Federal Reserve raised interest rates again in March, continuing its plan to normalise interest rates gradually. Investors had not discounted this degree of resolution at the start of the year, expecting further tightening to require more unequivocal evidence of economic strength. Elsewhere, it will take more compelling evidence of sustained economic recovery to move interest rates, but there are hints that monetary easing may be over – one vote for a UK rate rise at the MPC's March meeting; the ECB suggesting that the risks of deflation have largely disappeared.

Government bonds and interest rates

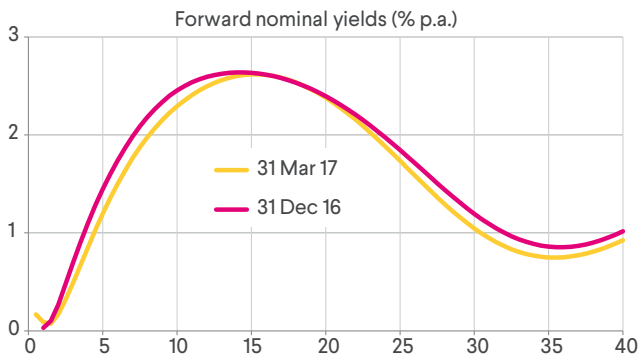
Despite the Fed's unexpectedly tough stance, government bonds held up well in the first quarter. 10-year US Treasury bond yields actually fell a little. Bond investors are usually willing to take a gloomy view of events and perhaps took their economic cue from the downbeat signal from official statistics. The Fed's statement accompanying the rate rise provided some comfort – essentially, they confirmed that they meant what they said about normalising rates, but they also meant what they said about doing it slowly.

10-year gilt yields had spiked up at the start of the year, unsettled by unexpectedly large rises in January and February CPI inflation. But they later fell into line with global influences and also finished marginally lower over the quarter. That means our view on gilts is much as it was – that yields are more likely to rise further than fall.

Chart 2 shows forward gilt yields, essentially the path of interest rates implied by gilt prices. A peak of under 3% p.a. in 15 years seems too low. The longer-term decline to 1% p.a. should not be interpreted as an economic forecast. It reflects hedging demand and, though that is likely to remain strong, this is an area to avoid for those who don't need to manage interest rate risk. Even those who do might consider whether risk reduction elsewhere offers better value.

Similar arguments apply to index-linked gilts. Short-term economic risks may be limited and hedging demand probably provides an even greater support, but valuations look even less appealing than they do for conventionals.

Chart 2: Forward gilt yields



Source: Bank of England

Other bond markets

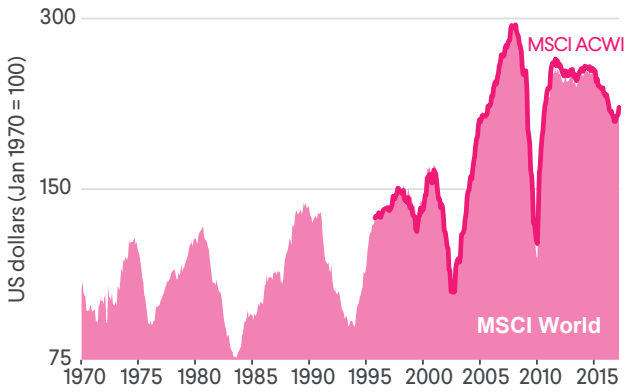
Absent a deterioration in default experience, investors' search for yield is likely to provide continued support for credit markets. However, yield spreads have compressed significantly and absolute returns are likely to be unexciting in the medium term.

Strategic diversification and more predictable income remain the best arguments for investment and the reinvestment risk that comes with what are generally short-dated instruments is acceptable when valuations across markets are so high. In broad terms, we think illiquidity risk and complexity risk are better rewarded than pure credit risk. In speculative-grade markets this leads us to a preference for direct corporate lending over traded bond and loans markets. In investment-grade markets, as we discuss in a later article, it is manifested in opportunities in asset-backed securities relative to traditional corporate bonds.

Equities

Decent global economic momentum and, in the US, a focus on the more positive aspects of the Trump agenda (lower corporate taxes rather than protectionism) have provided a tailwind for equities in recent months. We remain sceptical that it can be sustained, because the fundamental drivers still argue for low long-term returns.

Chart 3: Global equities – real earnings per share



Source: Datastream, MSCI

Even if the US has shaken off the downturn of the last couple of years, we think the scope for strong earnings growth is limited. Chart 3 shows real earnings per share on global indices (in US dollars as a proxy for local currency). Although the drop since late 2015 is substantial, current levels are still well above the cyclical lows from which strong growth has been generated in the past. And while any rises in bond yields have been shrugged off so far, valuations remain well above levels that can, in our view, sustain returns high enough to compensate for risk.

Property

The post-referendum correction in UK commercial property was modest in absolute terms and did little to address our longer-term concerns. Income yields, after taking realistic account of long-term costs, are low and rental growth is slowing. There is probably still a little more scope for cyclical income growth from property than from equities. However, short-term momentum, as earlier rises in rental values crystallise in rent reviews, has brought reversionary potential down from historically high levels over the last year. A reduction in void levels might offer a further boost, although recent progress – against a background of improving rents – has been surprisingly slow. Here, too, downward pressure on valuations seems likely to dominate returns in the medium term.

Nevertheless, UK property has underperformed global equities significantly over the last year or so – rebalancing disciplines may be suggesting selling equities to buy property. Of course, a large part of the underperformance reflects sterling weakness. We discussed the need to review currency policy last time and cover the topic in more detail in a later article. One's view on whether sterling is likely to return to long-term real valuation levels or to be secularly weak will be an important consideration in whether to implement rebalancing trades or to shift strategy away from sterling-denominated assets.

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Finding value in credit markets

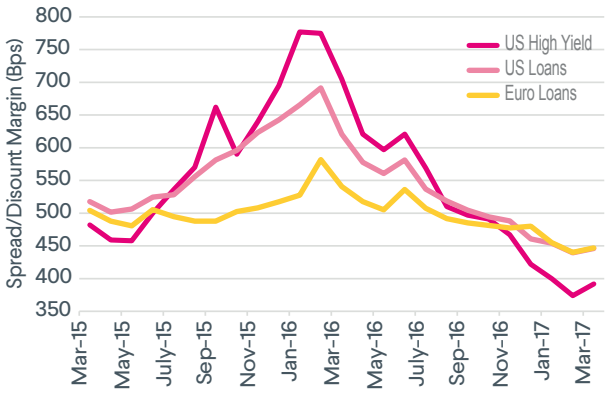
Credit markets experienced a strong rebound in 2016 which has continued into 2017. Arguably credit investors can't expect the same level of returns to be sustained from here. At best, they should expect returns to be more in line with income from coupons, rather than looking for any further capital appreciation.

However, by digging further into the details, we continue to find opportunities in credit markets that offer attractive relative value. In this article we consider asset-backed securities (ABS) and one particular sub-sector, collateralised loan obligations (CLOs).

Market overview

Credit markets were weak in 2015 and early 2016. Investors had general concerns about a potential global economic slowdown and specific concerns about the oil price falling below $30 per barrel. (The US shale oil boom had been largely financed by credit, particularly through US high yield bonds.) As 2016 progressed, an oil price recovery and, later on, the shock election of Donald Trump (quickly seen as a growth-friendly shock) provided support. Credit markets also benefited from the extension of the ECB's QE programme to include the purchase of corporate bonds.

Chart 4: Sub-investment grade yield spreads[1]



[1]US high yield government option adjusted spreads from BofA Merrill Lynch US Master Index (H0A0). US loans Credit Suisse Leveraged Loan Index 3-year discount margin. European loans Credit Suisse Western European Leveraged Loan Index 3-year discount margin.

Finding value

Although yield spreads have tightened across credit markets (Chart 4), the shift has not been uniform. One area where we think that relative value has improved is the floating-rate ABS and, in particular, collateralised loans.

ABS are bonds for which the interest and redemption payments due are provided by other assets, most commonly a pool of underlying debts. Residential mortgages would be one example and residential mortgage-backed securities (RMBS) are a major component of the ABS market.

ABS are issued in tranches: in descending order of priority, senior, junior (mezzanine) and equity (unrated). A given tranche will receive no income or capital payments unless all higher-priority tranches have received all payments due in full; it will in turn be paid in full before lower-priority tranches receive anything. Reflecting the relative risks, low priority means a relatively low credit rating but a relatively high coupon. The process of creating ABS by pooling and tranching is known as securitisation.

A couple of features to enhance the creditworthiness of ABS are typically built into the securitisation process:

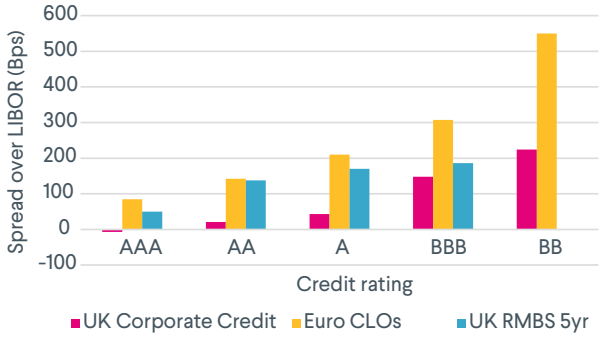
- Over collateralisation
  The capital value of the underlying assets is greater than the repayment value of the ABS.
- Excess spread and reserve fund
  Income due from the underlying assets is greater than that required to meet the income payments on the ABS and any fees. This "excess spread" is transferred to a "reserve fund" which can be used to top up payments due on ABS if the underlying assets suffer income reductions or capital losses.

Investing in ABS requires significant expertise to analyse the collateral/assets backing the securitised bonds. ABS therefore tend to provide (and investors should certainly require) a premium over traditional corporate bond yields to reflect this added complexity. The ABS market lagged other credit markets in 2016 and, as a result, we think these complexity premiums are currently at attractive levels.

One ABS sector where we see particularly good value is CLOs. These are backed by pools of loans to large sub-investment grade corporate borrowers. The loans market has seen less spread compression than comparable fixed-rate high yield bond markets, and so CLOs have relative value attractions arising from both the underlying assets and the ABS structure.

Chart 5 compares yield spreads available on CLOs, RMBS and traditional corporate bonds of equivalent credit ratings.

Chart 5: Market spreads as at 31 March 2017[3]



[3] UK Corporate Credit: AAA-BBB illustrated by BofA Merrill Lynch Sterling Investment Grade 3-5 yr index (UR12), BB given by spreads on BofA Merrill Lynch Euro-Currency High Yield Index (HP00). Euro CLOs and UK RMBS 5yr spreads provided by JP Morgan

Nor is there any evidence that ABS are riskier than their credit ratings might imply. If anything, the opposite is true, as suggested by the comparison between European CLO and corporate bond default rates in Table 1. Though the CLO market is traded, it is influenced by the underlying syndicated loans which serve as the collateral to these bonds. Therefore, it is not unreasonable to expect a lower degree of liquidity in this market versus the traditional corporate bond market, particularly at times of market stress and for lower quality issues. However, pension schemes should be able to exploit their position as long-term investors and still benefit from regular interest and principal payments provided the bonds do not default.

Market access

Investors can gain exposure to this market through a segregated ABS mandate, which also facilitates bespoke targeting of the portfolio credit rating, or as part of a multi-credit mandate, where managers will make an opportunistic allocation to the asset class.

In summary, an allocation to asset-backed securities has the potential to provide an attractive risk-adjusted contractual yield and additional portfolio benefits including:

- Credit risk protection through capital structure seniority
- Security in the form of asset-backing collateral
- Mitigation against capital value impact of rises in interest rates (floating rate)
- Diversification benefits/low correlation to equities and other traditional asset classes

Access to the asset class can be through a multi-credit approach or through a standalone allocation to the asset class.

Table 1: European default rates 1994-2013[2]

Original credit rating	Number of CLO bonds	CLOs		Corporate bonds	
		Default rate	Loss rate	Default rate	Loss rate
AAA	1992	0.00%	0.00%	0.00%	0.00%
AA	1005	0.00%	0.00%	0.39%	0.26%
A	1119	0.45%	0.08%	1.13%	0.72%
BBB	1069	0.28%	0.21%	8.08%	4.75%

[2]Insight, S&P, and Moody's.

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Managing currency exposure

Since the result of the EU referendum, sterling has weakened significantly against most other currencies.

In the 12 months to 31 March, an unhedged UK investor in global equities would have earned a return of almost 30%; hedging would have reduced that to just under 18%. In this article, we outline some considerations around managing currency risk.

Agreeing a strategic level of currency hedging

Traditionally, the listed equity portfolio has been the main source of currency risk for UK pension schemes. If you believe that currency risk does not provide additional expected return, then a simple objective might be to minimise the volatility of the portfolio resulting from currency movements. Any reduction in the "risk budget" from currency volatility can then be better deployed into strategies that are expected to earn a return.

Any analysis will reflect the balance between UK and non-UK listed equities, as well as the composition of the non-UK equities. US equities usually make up the majority of the non-UK equities, with Eurozone equities the next biggest component. So, while not always the case, US dollars and euros usually account for most of the "primary" currency risk – determined by the currency of the stock price – in the equity portfolio.

However, determining the "right" level of hedging requires investors to consider "secondary" currency exposures as well. Although a company may be listed on a particular exchange and priced in the relevant local currency, its revenues may come from multiple currencies. For example, around 25% of UK companies' revenues come from the US. In some cases, the mismatch is so great that companies pay dividends in a currency other than the local currency of the country of listing. Typically, this would be US dollar dividends paid by global companies listed on non-US exchanges, such as BP in London.

Some straightforward analysis of historic returns suggest that a typical currency hedge ratio around 70% would minimise the volatility on a global equity portfolio. However, the outcomes of even this simple approach are very much time-dependent. There have been plenty of periods when hedging currency would not have reduced volatility.

The outcomes can also vary by currency – in Japan, equity and currency risk have tended to offset one another more than is the case elsewhere. Although it is relatively unusual to date, it is not unreasonable to use such analyses to take a different view on the appropriate level of strategic hedging for different currencies.

In the absence of a strong view on the long-term impact of currency risk, one practical way to recognise the complications is to hedge 50% of non-UK equity exposure as a simple strategic compromise – better to be half right than 100% wrong. Practical considerations may refine this to exclude hedging of certain currencies because the associated risk is insignificant to a scheme or the cost is too high (often the case for emerging markets).

Most pension funds now hold lower allocations to equities than a few years ago, but they may have replaced some of the currency exposure through investments in non-sterling bonds and other alternative investments. Separate consideration is required for these assets and the answer should reflect the rationale for investment. The typical starting point for most overseas bond exposure is to hedge it back to sterling to ensure that the target return from income-based assets is not swamped by currency movements. Emerging market debt, where long-term currency appreciation may well be part of the investment case, could be an exception.

What opportunity does sterling offer today?

Whatever decision is made about the strategic approach to hedging, varying exposure tactically around the benchmark position may also be considered as part of a wider framework of risk and return management. Following sterling's plunge since the middle of last year, this may seem an appropriate time to increase hedging ratios to protect the windfall gains from currency exposure. A tactical assessment would typically involve (at least) three elements.

I. Valuation

Although it is most relevant over the long term, valuation would be included. Often this will involve a comparison with the exchange rate against a level consistent with Purchasing Power Parity, based on the idea that exchange rates adjust over the long term to reflect relative inflation. Chart 6 compares the sterling-US dollar with its average CPI-inflation adjusted exchange rate since 1980 and suggests that sterling currently looks cheap.

Chart 6: $/£ CPI-adjusted

II. Fundamental

The chart also shows by how far and for how long exchange rates can diverge from PPP measures. Just because sterling looks cheap does not mean it is destined to strengthen quickly. Fundamental factors can have more influence over the medium term, e.g. the relative outlook for growth, divergence in monetary and fiscal policies, current account balances and capital flows. This may be particularly important in current circumstances, when structural changes to the UK economy following Brexit may diminish the importance of historic valuation as a guide to the future.

III. Technical

Technical factors can dominate in the short term. Momentum is often a powerful force on the foreign exchanges and cost of carry (i.e. interest rate differentials) can drive significant speculative flows from one currency to another.

Those with sufficient internal governance resource could consider establishing their own simple decision framework based upon a small number of relevant measures, such as those outlined above, to manage currency risk. More commonly, tactical management would be delegated to an external manager. Here, the implementation may be more sophisticated and the proportions would vary across managers, but the ingredients would be the same.

What action should you take?

There is simply no one-size-fits-all answer to managing currency risk. Investors should instead aim to construct an appropriate solution consistent with their investment objectives and beliefs. This will involve:

- **Identifying what risks you are trying to mitigate.**
  - Is your main concern to limit the volatility of returns or are you more concerned about downside risk if sterling declines over time?
  - Are you looking for a simple solution or might different currencies require different treatment?
  - Do you think differently about the risks associated with currency for equities and debt or other assets?
- **Deciding on how to implement your chosen solution.**
  - Are sterling hedged share classes of pooled funds available or do you need a separate overlay programme?
  - If you choose a separate overlay programme how do you arrange to sell assets if required to settle currency hedging losses arising from sterling weakness?
  - Do you stick passively to your strategic hedging levels or seek to exploit tactical opportunities in foreign exchange markets. If the latter, do you control this in-house or appoint a currency manager?

Conclusion

Currencies will continue to affect returns that investors earn. However, the outcome from currency exposure is by no means certain or predictable, at least over the short to medium term. Hence, whether it makes sense to hedge some, all or any of the currency exposure in your portfolio will depend upon investor-specific factors as well as market pricing.

Investors should identify where they have exposure to currency, assess what risks this presents, and then consider the extent to which they want to manage them.

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Our response to the FCA Asset Management Market Study Consultation

The Terms of Reference for the FCA study include:

- How asset managers compete to deliver value?
- Are asset managers willing and able to control costs and quality along the value chain?
- How do investment consultants affect competition for institutional asset management?
- Are there barriers to innovation and technological advances?

In this article we provide a summary of our response to the FCA interim report. In brief, we fully support efforts to improve transparency and ensure greater value for money for both retail and institutional investors. There are many areas set out in the study where we agree with the FCA's findings and proposals, but there are some areas we would challenge; this is particularly in relation to the FCA's summary of the investment consulting market.

You can download our full response from our website here.

1 The FCA believe the investment consulting market is too concentrated. We believe the investment consulting market is more diverse than the study would suggest:

The investment consulting market is significantly less concentrated than it was several years ago, with a range of new entrants. Added to that trustees have a wider choice of implementation methods than ever before. There is greater diversity in the business models of investment consultancies than the FCA report infers, with some offering fiduciary management services as well as advice, and others, such as ourselves, offering pure advice-based business models.

2 We agree that the value of consultants' advice should be assessed, but measured against clients' specific objectives not an arbitrary benchmark:

Clearly there are challenges, but it is also clear that institutional investors find it difficult to assess the quality of advice they receive. We would be keen to work with the industry to develop a common set of guidelines and best practice to measure the value added by consultants. It's widely recognised that qualitative measures are required alongside any quantitative measures.

It is also worth noting that a scheme may see a good 'outcome' irrespective of the advice (in a bull market asset values may rise improving funding levels – but downside protection wasn't in place for example). The reverse is also true. A scheme could receive good advice to reduce risk and volatility and then lose out on the upside in the event of a market bull run.

3 The regulatory regime for strategy advice needs to be appropriate. We do not believe there is a failure of market competition that needs to be regulated:

Our view is that the FCA's proposal for a Market Investigation Reference (MIR) to the Competition and Markets Authority (CMA) is not an appropriate course of action. The professionalism of trustees, through widespread use of independent trustees, has introduced significant knowledge of what is offered by consulting firms, increasing the ability for comparison of quality and advice provided by consultants. It's hard to see how an investigation by the CMA will help the industry arrive at a means of better assessing the quality of strategy advice delivered by consultants.

The Law Commission's 2014 report on the fiduciary duties of investment intermediaries looked at whether the asset allocation advice delivered by investment consultants should be brought into the FCA's regulatory perimeter. It concluded that extending regulation in this area was unjustified.

There is a danger of applying a regulatory regime that's fit for one market on to another where its application would be less appropriate; particularly where high standards already exist.

4 Actively managed funds can be strategically valuable to a portfolio:

For some asset classes active management is a zero sum game. Reflecting this, most of our clients have a proportion of their core listed equity and bond market exposure via passive management.

However, there are some asset classes that are strategically valuable to a client where there are no passive options, for example alternative forms of credit and UK infrastructure.

The FCA study analysis of manager risk is almost entirely focused on tracking error, which fails to recognise the more relevant measures of absolute risk or risk relative to liabilities. Tracking error is not the focus of all institutional investors when considering active mandates. Instead, we note that active management can be as much about targeting risk-adjusted returns, as it is about seeking outperformance of a sometimes arbitrary benchmark. This point applies equally to listed markets and alternative investments.

5 Managing the use of fiduciary management:

Use of fiduciary management can make sense as an option for schemes with lower governance budgets, particularly smaller schemes, as a means to benefit from scale through pooling assets on implementation.

Disclosure of potential conflicts associated with fiduciary management is widespread, and the use of external oversight growing, albeit from a low base. However, we do share the FCA's concerns on conflicts of interest around firms offering independent investment advice whilst also providing the underlying investment product.

We do have some concerns that a primary focus on lower cost solutions would have unintended consequences. If the industry is directed towards achieving lower costs through service consolidation, this could lead to greater use of combined advisory and fiduciary services through a single entity, with inherent conflicts. There would also likely be consolidation in the market as fewer entities support these larger scale operations.

6 Reporting standardised costs and charges:

We agree with the FCA that institutional investors would benefit from standardised disclosure of fees and charges for all asset management products, but only if the information is delivered in the context of value for money, rather than cost alone. The challenge lies in devising a framework that delivers this in a way that avoids the traps of short-termism or one that presumes lowest cost leads to best outcome.

Striking a balance between sensible transparent disclosure without creating an unwieldy and expensive process for doing so will be key.

We support disclosure of an Ongoing Charges Figure that includes all fees, charges and costs other than transaction costs, and separate disclosure of estimated implicit and explicit transaction charges.

We also believe that disclosure of fiduciary manager fees should be unbundled to show the balance of fees and charges that go to the fiduciary and those that go to the underlying managers.

One of our key concerns is that if the FCA over-regulate or increase the cost of participating in the market, they will actually reduce the level of competition in the investment consulting market.

Market returns to 31 March 2017

	Yield % p.a.		Returns to 31 March 2017** (sterling, % p.a.)		
	31 Dec	31 Mar	1 year	3 years	5 years
Equities					
Global	2.5	2.4	33.1	16.4	14.6
UK	3.5	3.5	22.0	7.7	9.7
Developed markets ex UK	2.4	2.3	33.7	17.6	16.0
Emerging markets	3.0	2.8	35.6	12.9	6.6
Bonds					
Conventional gilts	1.6	1.4	6.6	7.8	5.2
Index-linked gilts	-1.7	-1.7	19.9	13.1	8.9
Sterling corporate bonds	2.9	2.8	10.7	7.9	7.8
High yield (US) *	6.5	6.2	16.9	4.6	6.8
Emerging market debt	7.3	7.0	24.1	7.2	3.3
UK Property	-	-	3.8	11.2	10.0
Hedge Funds *	-	-	5.7	1.9	3.9
Commodities	-	-	28.1	-2.9	-3.8

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

* Return in $
**Property and Hedge Funds to end February 2017

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