Quarterly investment briefing
Quarter 2 2016

First Actuarial LLP

Discussion topic – Brexit special

We do not have a house view on whether the long term impact of leaving the EU is going to be beneficial or detrimental to the UK but it is clear that financial markets are pricing in Brexit as having a negative effect on the UK economy.

The main real world impacts that we believe are being priced in are:

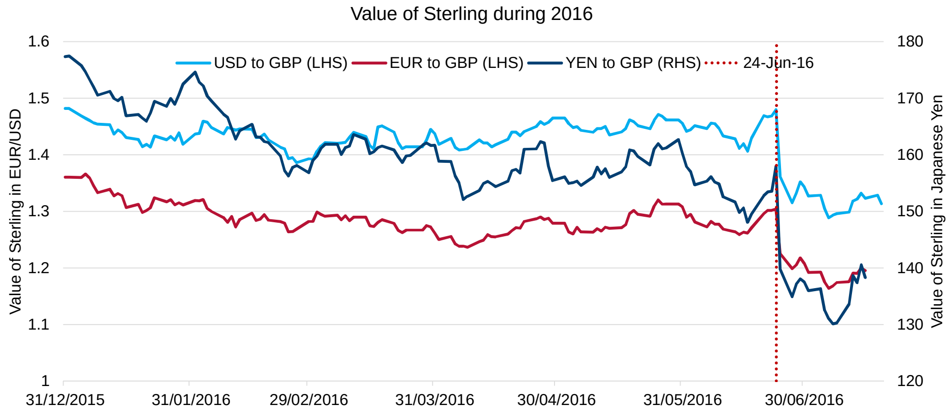
- Reduction in future revenue earned in the UK by companies
- Interest rates remaining lower for longer to stimulate growth

In this edition of the investment briefing we look at the impact of the EU referendum outcome on financial markets (up to date of writing) and discuss the potential actions that could be taken by trustees.

Exchange rates

The vote for Brexit has made investors across the globe more worried about the UK's economic prospects and more reluctant to hold sterling-denominated assets. This has led to a weakening of sterling against the other major global currencies.

This means the value of sterling denominated assets fell for overseas investors, but from the UK perspective the reverse was true. Overseas denominated assets have, all else being equal, risen in value (in sterling terms).

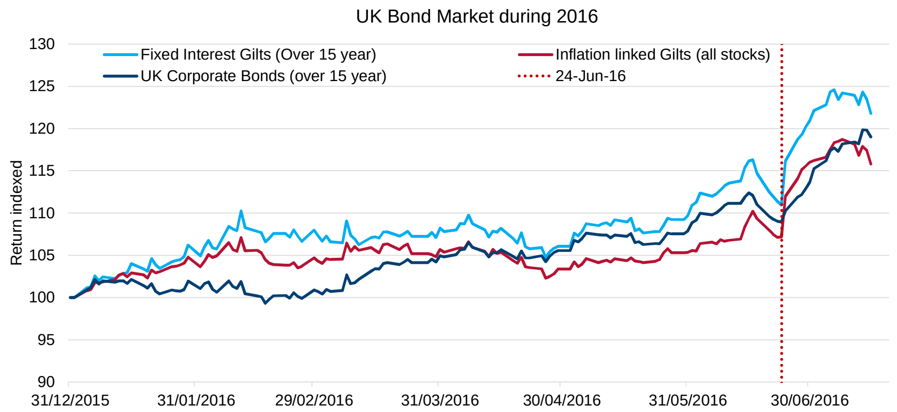


To the extent that schemes have exposure to overseas assets (that are not hedged against currency movements), the fall in sterling will have been beneficial.

For those looking to decrease their overseas currency exposure – which can help reduce overall levels of risk – the weakening of sterling may provide an opportunity to do so.

UK Government bonds (gilts)

The chart below shows that both inflation-linked and conventional fixed interest gilts have performed exceptionally strongly since the referendum. This reflects the dramatic falls in bond yields (which move inversely with price).



Liability valuation methodology differs between schemes, but are often at least partly linked to the price of bonds. To the extent that the assets of such schemes do not match liabilities (eg through investing in gilts or leveraged Liability Driven Investment products) this is typically bad news for pension scheme balance sheets.

There are many factors that impact on the yields available on gilts. Arguably the most important is expectations of interest rates (bank base rates) in the future. The rationale for this is that both cash (earning a base rate of interest) and gilts are near "risk free" investments. Yields on gilts should therefore, all else being equal, be similar to the returns expected from cash.

The fall in yields (and increase in price) is therefore consistent with investors expecting interest rates remaining lower for longer.

Whilst gilt yields are now extremely low from a historic perspective (10 year gilt yield at 0.9% pa), it's worth noting that they are by no means the lowest yields available on government debt across the world. Japanese, German and French 10 year government bond yields for instance are negative 0.2% pa, negative 0.1% pa and positive 0.2% pa respectively.

Those intending to increase their exposure to gilts, including those doing so through leveraged LDI funds, may wish to revisit their plans in light of lower yields. However this should be done in the context that gilt yields could still fall further from here.

Phased and triggered approaches to purchasing gilts or leveraged LDI funds may have appeal to those not wishing to lock into gilt yields at current levels.

Credit markets

By "Credit" we mean lending money to organisations who present a credit risk i.e. the risk that the organisation won't pay you back. This includes UK corporate bonds (lending money to companies in the UK bond market).

UK corporate bonds, like gilts, are priced relative to expectations of base rates of interest in the UK (albeit with an allowance for credit risk). As such UK corporate bonds (plotted in dark blue in the chart in the previous section) have followed gilts upward in value to reflect interest rates likely staying lower for longer.

Yields on long dated UK corporate bonds (as measured by the iBoxx sterling non-gilt index) are only yielding 2.6% pa – an all-time low and only just over 1% pa more than gilts of equivalent duration.

We are supportive of seeking a more diverse and global exposure to credit and there are a number of funds designed to gain exposure to broader credit markets.

The potential for the process of Brexit to be damaging to the UK corporate bond market increases the need for diversification of credit exposure.

This, along with significant gains made recently by UK corporate bonds, means that diversification of credit exposure is high up on our list of potential actions for pension schemes.

Property

Repeating the comments about exchange rates, investors are more reluctant to invest in UK based assets since the referendum, and there are few assets that are more clearly UK based than UK property. As such there have been large flows out of UK Property funds recently.

This has led many UK property funds to adjust the valuations of the property funds downwards by 5% or more. Many also suspended disinvestments from their funds for a period of time.

We continue to monitor the situation in the property market but do not suggest any special action is taken on UK property investment at this time.

We do however think that pension schemes (as long-term investors) can benefit from investing more in illiquid assets such as property. There are now an increasing range of means to access assets such as overseas property, infrastructure and private debt. These should be considered by pension schemes with a long-term investment time horizon.

Equity markets

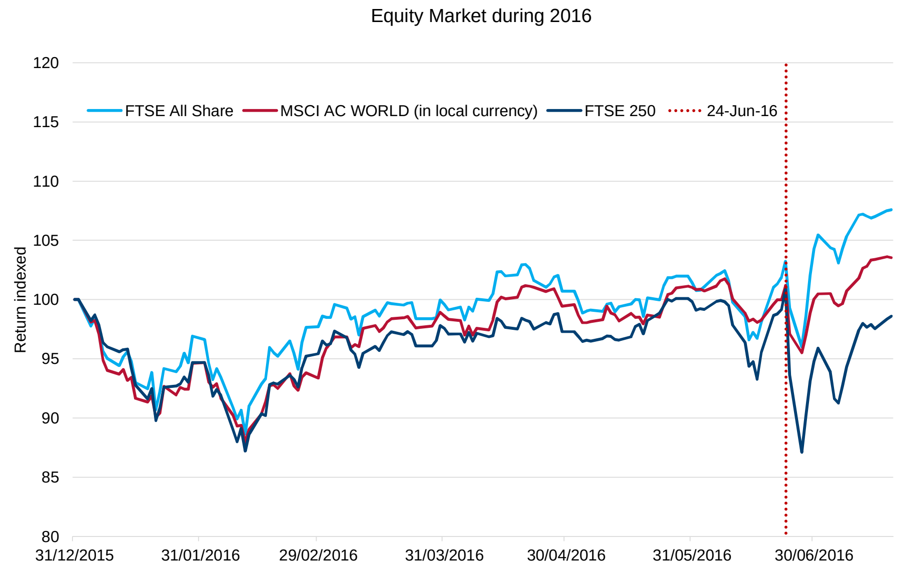
Global equity markets (see MSCI AC World opposite) were only modestly and temporarily affected by the Brexit vote as the UK accounts for only a relatively small proportion of the global economy.

UK equity markets (see FTSE All Share opposite) dropped sharply on the morning after the EU referendum but are now ahead of where they were before the referendum. This may seem odd until you consider that the FTSE All Share is dominated by global companies (such as BP and HSBC) who only gain a relatively small proportion of their earnings from the UK.

Offsetting the impact of the vote for Brexit on these companies' future UK earnings are the following factors:

- An increase in the value of overseas earnings through sterling weakness
- A reduction in the discount rate used by investors to put a value on future earnings, consistent with interest rates remaining lower for longer

For smaller UK Companies (see FTSE 250 opposite) the vote for Brexit has a larger impact. This reflects their higher reliance on the UK economy. However shares in these companies have recovered to pre-referendum levels due to the strong offsetting impact of lower discount rates used to value future earnings.



The vote for Brexit has had little impact on a typical pension scheme's equity portfolio. Sponsors and Trustees should expect volatility through the Brexit process. They should ensure that they are able to accept the level of volatility and look to reduce exposure and/or improve diversification if they are not.

Small print

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