

## Investment Update November 2018



### Investment Headlines & Comment

- Something of a rally for Far East equities this month.
- A poor month for bonds and for ultra-long index-linked gilts.
- 45- and 20-year gilt yields now match (the hump has gone).

### Feature Section

This month we welcome a guest contributor, Tom Barton of Pinsent Masons, who considers transparency for transaction costs in defined contribution schemes.

For chairs' statements published after November 2018, trustees need to assess transaction costs and report to members in a prescribed manner. In some respects, this is nothing new. There have been legislative requirements to assess and report on transaction costs for a few years now. However, the reality is that this is all a bit of a sea change. The difference is that there are ramped up disclosure obligations on managers. They now have to disclose information about the costs incurred at investment level in relation to the buying, selling, lending or borrowing of investments. This should help to overcome difficulties experienced by trustees in getting hold of this information.

There is now, essentially, a three-step process in the legislation:

- Trustees request information from their managers;
- That request triggers a formal disclosure obligation on managers under FCA rules;
- Trustees then assess the information and make an onward disclosure to members.

It is really important for trustees to take that first step. There is no automatic disclosure requirement on managers. The obligation to provide information in reasonable time and in a reasonably acceptable form only kicks in once a request has been made. Unless trustees make that request the FCA (arguably) cannot sanction a manager for failing to deliver – and trustees might experience difficulties in delivering on their own assessment and reporting duties.

Logically, therefore, trustees need to not only make the request, but take a little more ownership and flesh out when and in what form they need the information. It would help to align disclosures with scheme years and reporting requirements so far as possible. Once trustees have the information, they then need to make sense of it. That is easier said than done. Transaction costs are not easy to get to grips with. For a start, it is easy to forget they are not in themselves a bad thing; simply part and parcel of investing. There is then the issue of interpretation. Although the FCA rules create a degree of consistency, it will not always be obvious that apples are being compared with apples. Making a value assessment of these costs will be more challenging still. It is also going to be difficult for members to make any sense of this at all. Nevertheless, trustees must report to them and a DWP template shows how.

There is some scope to depart from the precise approach shown by the DWP but, whatever the case, it will need to involve some sort of table setting out the cumulative impact of charges on member pots across all of the investments offered by the scheme. There is a danger that members are going to look at these tables and get the wrong end of the stick. This is a concern, given that these tables have the potential to drive member investment decision-making. So what could go wrong? Members may:

- Feel "nudged" in the direction of the lowest cost funds;
- Miss the benefits of risk management and diversification (which can come at a cost);
- Switch to cheaper funds, but lose out overall given transition costs associated with switching.

More broadly, it will come as a shock to many that they are paying for the privilege of investing for retirement. This shock will come just at the point auto-enrolment contributions reach material levels in April 2019. There is a danger that members could lose confidence in the scheme or in pensions altogether. To guard against future claims, it is not only important to include all of the "small print" warnings – ideally trustees would also include some messaging to help members get to grips with things, and put transaction costs in perspective. As an aside, trustees need to make sure that messaging (important though it is) does not compromise the very strict content compliance requirements associated with these disclosures.

However we dress this up, it is going to be a difficult read for members. But maybe all this information is not really for member consumption anyway. The new transparency measures require trustees to share this information with the world at large – accessible through your favourite search engine with no password protection. The readers will be policymakers, regulators and those looking to refine their benchmarking. There are wider policy objectives at play here. If the policymakers find trends they do not like, then we may see some further action – maybe even price controls of some kind. If they have no further concerns, then we will probably just be left with a slightly clunky disclosure and reporting arrangement which helps trustees and members see what they pay for and what they get.



**Asset Returns and Financial Measures [in Sterling unless marked otherwise]**

The cells in bold with light shading show the best and worst performing asset classes from each column. The commodities and \$-based and unhedged-£-conversion hedge fund returns are excluded from that.

[NB Future returns cannot be inferred from this table alone, but coupled with other items within *Update*, readers can make inferences as to whether they should be higher or lower than the past returns shown below.]

**Table 1: Investment Data to 30 November 2018**

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-1.6	-6.1	-1.5	7.0	5.3	9.9	5.3
Overseas Equities	1.9	-3.7	5.9	15.9	12.8	13.7	7.4
US Equities	2.1	-2.8	<b>12.6</b>	<b>18.4</b>	<b>16.7</b>	<b>16.5</b>	6.0
Europe ex UK Equities	-0.5	<b>-6.7</b>	-4.1	10.5	7.2	10.1	7.9
Japan Equities	0.8	-3.5	-0.1	12.5	10.8	9.3	5.3
Pacific ex Japan Equities	<b>4.6</b>	-5.8	-2.9	15.2	9.1	13.7	9.9
Emerging Markets	4.3	-3.6	-3.2	16.0	7.5	11.5	<b>10.5</b>
UK Long-dated Gilts	-3.2	-4.7	-1.8	4.8	7.9	7.3	6.0
UK Long-dated Corp. Bonds	<b>-4.0</b>	-5.4	<b>-4.8</b>	4.6	6.3	8.4	6.2
UK Over 5 Yrs Index-Linked Gilts	-3.6	-1.8	-0.9	7.0	8.3	9.2	7.0
High Yield (Global)	-0.9	-0.1	4.1	12.6	8.9	14.1	8.0
Overseas Bonds	0.8	0.4	3.3	8.1	5.6	4.0	5.1
Property *	0.5	<b>1.6</b>	9.5	7.6	11.4	7.9	8.4
Cash	0.1	0.2	0.7	<b>0.5</b>	<b>0.5</b>	<b>0.7</b>	<b>2.9</b>
Commodities £-converted	<b>-11.2</b>	<b>-11.6</b>	3.5	5.9	<b>-8.3</b>	<b>-4.6</b>	2.2
Hedge Funds original \$ basis *	-3.2	-3.1	-0.4	3.6	3.1	5.0	6.6
Illustrative £-converted version *	-1.1	-0.5	3.5	10.4	8.0	7.5	8.1
Euro relative to Sterling	0.1	-0.9	0.7	8.1	1.3	0.7	-
US \$ relative to Sterling	0.1	1.9	6.1	5.7	5.1	1.9	1.3
Japanese Yen relative to Sterling	-0.5	-0.5	4.6	8.6	3.0	0.1	1.7
Sterling trade weighted	-0.4	-0.4	-1.5	-6.0	-1.7	-0.8	-1.1
Price Inflation (RPI) *	0.1	1.0	3.3	3.1	2.5	2.7	2.8
Price Inflation (CPI) *	0.1	0.9	2.4	2.1	1.5	2.2	2.0
Price Inflation (RPIX) *	0.1	0.9	3.2	3.2	2.5	3.0	2.9
Earnings Inflation **	-0.2	-1.1	2.9	2.8	2.4	1.9	3.0
All Share Capital Growth	-2.1	-6.9	-5.2	3.1	1.5	6.0	1.9
Dividend Growth	0.8	2.5	6.3	7.9	6.1	4.8	4.4
Earnings Growth	-3.0	-1.5	61.1	17.6	5.3	2.5	4.7

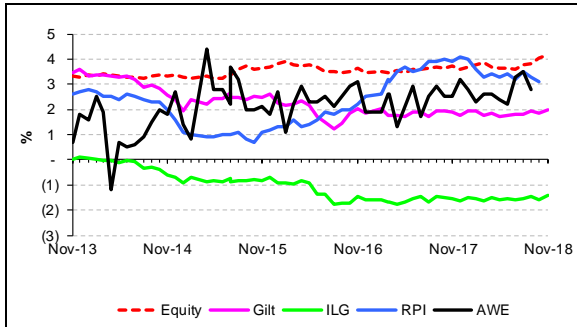
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- UK Equities (incl. dividends and earnings) – FT-A All Share.
- Overseas Equities (incl. regions) – blend of FT All-World / World subindices
- Emerging Markets from MSCI US \$ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment restrictions), conversion to UK £ by J&A.
- UK Bonds – FT-A indices (Gilts Over 15 Years, ILG Over 5 Years)
- UK Corporate Bonds – iBoxx Non-Gilt **Over 15 Year** index (all credit ratings combined)
- High Yield – Merrill Lynch Global, £ Unhedged
- Overseas Bonds – JP Morgan Traded Unhedged World ex UK
- Property – MSCI IPD UK Monthly Property Index
- Commodities – GSCI Total Return, converted to UK £ by J&A
- Hedge Funds Composite – HFRI US \$ based total return index plus converted to UK £ by J&A. NB A smooth “cash+x%” return will only be shown in the base ‘hedged’ currency, here the US \$.
- Cash – an indicative index based on the three-month London Interbank Sterling mid-rate, calculated internally by J&A
- Price and earnings inflation – RPI, CPI, RPIX, and Average Weekly Earnings (whole economy, not seasonally adjusted, latest provisional data)
- Currency data – London close, from the Financial Times
- \* denotes data lagged by 1 month, \*\* by 2 months – these reflect the later publication dates of these data items.

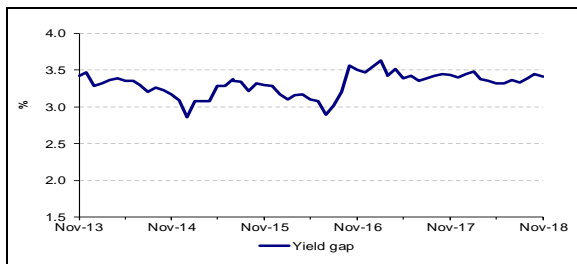


## Yields and Yield Gaps

Figure 2: Yields, Inflation and Yield Gaps



The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

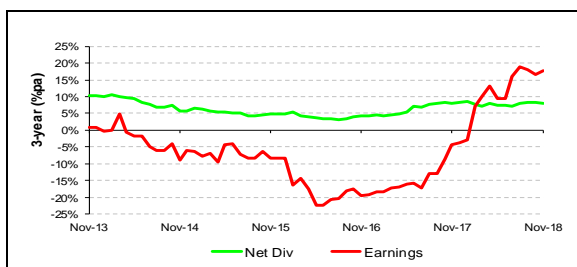
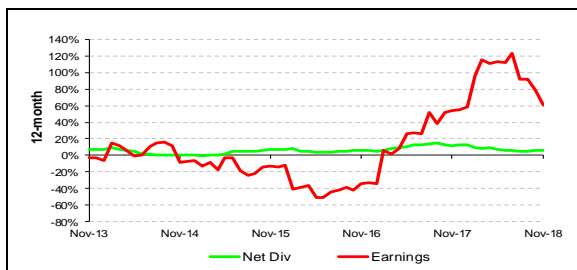


The gap gives a current expectation around 3.4% for longer-term inflation including the risk premium for gilts, relative to index-linked gilts.

## Growth in Earnings and Dividends

These charts show movements in rolling 12-month and 3-year dividend and earnings growth for UK Equities over the last 5 years. [NB the charts have different scales]

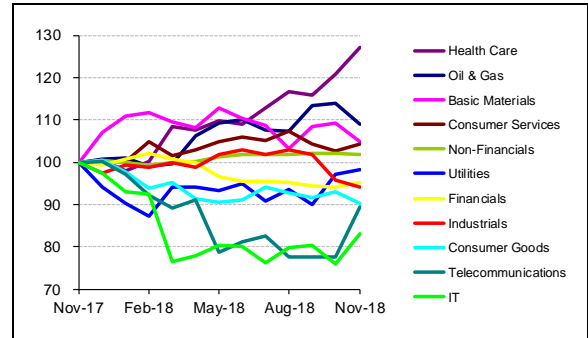
Figure 3: Dividend & Earnings Growth



Note: Earnings data from mid 2015 onwards is under review by FTSE Russell as one-off events may be affecting the prospective P/E ratios

## UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



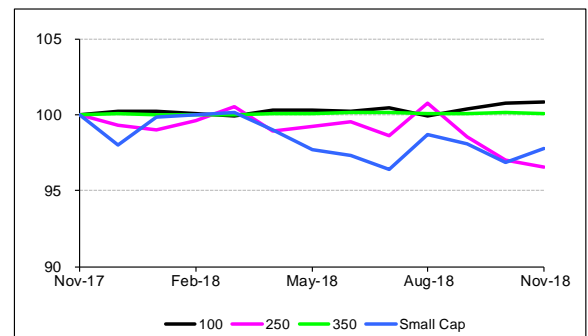
Note: Sector labels for relative lines are in end-value order

There was a modest rise this month in the rolling 12-month sector dispersion (from 42% to 44%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-5.8	-4.7	7.4
Basic Materials	-5.4	-4.6	3.4
Industrials	-3.5	-14.3	-7.4
Consumer Goods	-4.5	-8.7	-11.1
Health Care	3.6	2.3	25.3
Consumer Services	-0.1	-8.7	2.7
Telecommunications	13.2	8.4	-11.9
Utilities	-0.4	-1.2	-3.1
Non-Financials	-2.0	-6.1	0.3
Financials	-0.5	-6.1	-6.2
IT	7.9	-1.9	-18.0
All Share	-1.6	-6.1	-1.5

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



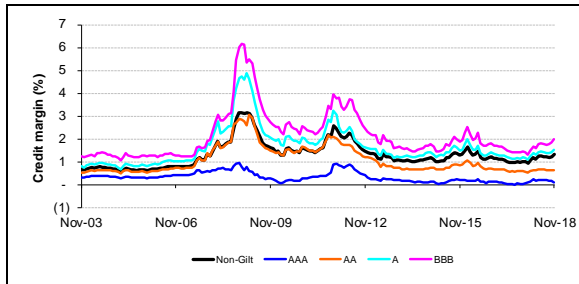
Mid Cap fell in relative terms this month, but Small Cap rose.

Sources for charts on this page:  
Financial Times, Office for National Statistics, J&A



**Bond market information**

**Figure 5: £ Non-Gilt Credit Margins**



**Table 2a: Over 15 Yr Corporate Yields & Margins**

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jun '18	2.70	1.76	0.94
Jul '18	2.70	1.79	0.91
Aug '18	2.66	1.79	0.87
Sep '18	2.79	1.93	0.86
Oct '18	2.74	1.86	0.88
Nov '18	<b>2.96</b>	<b>2.00</b>	<b>0.96</b>

**Tables 2b, 2c: £ Market Size (£bn) and Maturity**

Category	Mkt Val @ Nov 18 & 15, 12			Weight (%)
	Nov 18	Nov 15	Nov 12	
Gilts (42)	1,295	1,227	1,115	69.6
Non Gilts (1,095)	566	535	535	30.4
AAA (147)	118	97	142	6.3
AA (168)	82	97	67	4.4
A (340)	157	158	177	8.4
BBB (440)	208	183	150	11.2

Category	Mkt Val @ Nov 18 & 15		W't (%)	Dur'n (yrs)
Gilts (42)	1,295	1,227	69.6	11.8
< 5 Yrs (11)	351	350	18.9	2.8
5-15 Yrs (11)	345	335	18.6	7.9
> 15 Yrs (20)	599	541	32.2	19.3
Non Gilts (1,095)	566	535	30.4	7.6
< 5 Yrs (382)	189	157	10.1	2.7
5-15 Yrs (478)	242	231	13.0	7.3
> 15 Yrs (235)	135	147	7.2	15.0

**Tables 2d, 2e: € Market Size and Maturity (Nov 18)**

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (358)	6,122	59.1
Non Sovereigns	4,237	40.9
AAA (884)	1,201	11.6
AA (715)	1,077	10.4
A (996)	909	8.8
BBB (1,291)	1,050	10.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (993)	2,361	22.8
3 – 5 Yrs (1,136)	2,182	21.1
5 – 7 Yrs (877)	1,694	16.4
7 – 10 Yrs (793)	1,855	17.9
10+ Yrs (445)	2,266	21.9

**Table 2f: Breakdown of £ Index-Linked Market**

Category (Number of issues)	Mkt Val (£bn @ Nov 18 & 15)		W't (%)	Dur'n (yrs)
Gilts (30)	658	486	100.0	21.6
< 5 Yrs (3)	59	49	8.9	2.4
5 – 15 Yrs (8)	160	126	24.2	8.7
> 15 Yrs (19)	440	310	66.8	28.9

**Table 2g: High Yield bond yields (BB-B indices)**

Month End	US (%)	Euro (%)	Sterling (%)
Jun '18	6.17	3.69	5.69
Jul '18	6.06	3.51	5.65
Aug '18	6.02	3.61	5.68
Sep '18	6.02	3.58	5.78
Oct '18	6.45	3.91	5.84
Nov '18	<b>6.71</b>	<b>4.37</b>	<b>6.37</b>

Sources: DMO, FTSE, iBoxx, J&A, MLX

**£ Gilt Market “main” Issuance**

- £2.25bn, 1<sup>5</sup>/<sub>8</sub>% 2028 (1.96x, 1.49%, 0%, Sept '18)
- £2.30bn, 1<sup>3</sup>/<sub>4</sub>% 2037 (1.75x, 1.92%, 15%, Jun '18)
- £0.56bn IL<sup>1</sup>/<sub>8</sub>% 2056 (2.13x, ry -1.43%, 11%, Mar '18)

Note: Issuance amounts are nominals. The first % figure in each row is the yield or real yield. The second % figure is the additional amount taken up under the Post Auction Option Facility (PAOF), as a % of the amount of the issue. PAOF does not apply for syndication cases.

