perspectives

AllenbridgeEpic
INVESTMENT ADVISERS

Independent, uncompromised, trusted investment advice

Spring 2012

Life ‘in-house’

By John Arthur
Senior Adviser

In 1986 I joined the British Gas Pensions Department just in time to see the pension scheme sponsor, British Gas, privatised. If I am honest, the attraction of the job was a pay rise and promotion to fully fledged fund manager rather than any understanding of the in-house model. Through the ensuing mergers and demergers of the plan sponsor - British Gas, BG, Lattice, Transco, NG (UK) - a number of name changes of the investment management company and 25 years’ service, I have just left what became Aerion Fund Management Ltd, the in-house fund manager of the National Grid (UK) Pension Scheme. During that time I realised that working for an in-house manager was one of the most interesting environments to work in as an investor.

Why?

Because of the clarity of purpose and level of mutual understanding between investor and client.

An in-house manager often works for one client; in the case of Aerion, on just one £14 billion pension scheme. This provides simplicity of purpose and limits any conflicts of interest.

It then becomes easier for the investment manager to work with the client and to understand what the pool of money they are managing is trying to achieve. This may sound simple but too often a pool of money is just that to the investment company and, if a strong understanding between investor and client is not achieved, the money may not be run in the most efficient manner or to suit the client’s requirements.

Expanding on this issue, the investor of pension fund money - particularly of a mature defined benefit pension scheme - has the ability to forecast the cashflows of the scheme well into the future; the level of risk the sponsor will accept can be discussed and, more importantly, understood and built into the investment process; and the management of the assets can be tailored to maximise the natural advantages of this predictable and long term pool of money.

If the relationship between the client and the investor works well then it becomes based on an element of trust, with information shared between the two parties and investment performance measured over years not months. Success becomes the delivery of the client’s requirements, not the outperformance of an often arbitrary benchmark. If this sounds like fiduciary management then so be it!

As an example, if you know what your future cash-flows are then you know how much of the assets you can tie up in illiquid asset classes and harvest the premium for doing this without fear of becoming a forced seller in a poor market environment. You also have a greater ability to back your judgement when you believe markets are at a valuation extreme; you know how much risk the client is happy to take and that you will not have to reverse your positions if your investment was mistimed through the need to cover increased redemptions or fear of having the money removed from your management without discussion.

Within fixed interest you can build a ‘buy and hold’ portfolio targeting the future cash flow requirements of the scheme. At Aerion we were one of the largest investors in Index-Linked Credit throughout the market dislocations of 2008/9, providing a return above the actuarial assumption for the Scheme and an element of matching to the liabilities.

Within equities you can build an investment process that researches the long term value of a company, looking into its competitive environment and analysing the future catalysts of change rather than asking management to predict the next set of quarterly figures.

But, perhaps most importantly, when selecting external managers you can provide them with the same advantages of a long term and predictable pool of money by focusing on the investment managers’ ownership, people and process, rather than their short term performance record. Removing money from external managers can then be done when they undergo structural change, violate the initial investment thesis or when your reason for investing through them has been achieved, not on the basis of a number of years of poor performance, unless it is outside the level of risk agreed. If performance has been poor, you analyse what has changed not why your initial selection failed to deliver.

Of course, the in-house manager is not a protected species; it is only as good as the people it can employ, the individual fund managers can be sacked or the client could lose confidence in the management of the whole in-house team. However, as we move towards a more fiduciary based solution to the management of pension schemes, having that close working relationship between client and investor, plus a high level of trust and understanding between them, should continue to give in-house teams an advantage.

Because the in-house team needs no marketing department their achievements are seldom publicised. This keeps their cost base low but, even before costs, research by WM has shown in-house managed funds perform strongly against externally managed funds over the long term. Having said that, it is not the solution for everyone given the high level of regulatory costs and the management commitment required. However, even where a pension scheme is managed entirely externally, if there are predictable cashflows and the ability to take risk then the external managers should be selected for their ability to take advantage of the long term nature of this pool of capital and be given a mandate that allows them to do so.

So if I feel this strongly about the benefits of working for an in-house pension manager, why have I left and become an independent adviser?

The answer is opportunity.

Working with AllenbridgeEpic I can continue to try and aid the pensions industry in delivering performance on what is often an individual’s largest asset. I can also continue to work strategically within an industry that has some it’s most complex challenges ahead of it.

Why AllenbridgeEpic as opposed to another advisory firm?

Simple. It’s independent, offers only advisory services and, through its team of very experienced advisers, has a high level of intellectual capital on which I can draw.

AllenbridgeEpic Investment Advisers provides cost-effective solutions to trustees’ investment-related problems.

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Practical Economics - Effective Investment*

*Article is based on a speech by Karen Shackleton on "Practical Economics" at the LGC Investment Seminar at De Vere Carden Park, Chester on 1st March 2012

By Karen Shackleton
Chief Executive

The excitement and hype surrounding the release of economic data, such as GDP figures, can be both bewildering and unsettling to a lay trustee trying to oversee the investment strategy of a pension fund. Whilst most would admit that Economics forms an essential ingredient of effective investment decision-making, many would also acknowledge that it can be difficult to predict the investment repercussions that arise from a sharp rise in inflation or an unanticipated fall in GDP. This article aims to 'unpack' and simplify this conundrum.

The questionable accuracy of economic data

Let us begin with the data itself. First, the compilation methodology of economic data can vary from country to country. CPI (Consumer Price Index), a measure of inflation, is a good example of this. Around the world, different governments use different baskets of goods, and different weights, to measure inflation.

> Economics is a subject profoundly conducive to cliché, resonant with boredom. On few topics is an audience so practised in turning off its ears and minds… and none can say that the response is ill advised…"
>
> **John Kenneth Galbraith**

This makes a global comparison from one country to the next a less-than-precise science. It is also not uncommon to find governments making changes to the basket. In January 2011, for example, China's CPI rose to 4.9%, much less than the consensus expectation of 5.4%. Yet the response in the Asian markets was muted because, in fact, the lower figure reflected a previously announced change in the weight of items included in the CPI basket calculation. 'Know the compilation methodology' becomes a key criterion to successfully interpreting releases of economic data.

Second, the most accurate reflection of where the economy lies can take time to unfold. In the US, for example, media attention usually focuses on the first GDP release, which is announced one month after quarter end. Yet this can be quite different from the subsequent reports because it is missing some trade and business inventory information. The second report comes out two months after quarter end and the final report is released the month after that. Compare the information released in these three reports in Q3 2011, for example. The first report stated GDP was growing at 2.5%, the second report reduced this to 2% and the final report reduced it further to 1.8%. Such large differences could have a quite dramatic impact on the investment decisions taken in response to the data release.

The ambivalent reliability of economists' forecasts

There is then the problem of forecasting that 'already-somewhat-unreliable-data', ahead of the announcement. The Citigroup Economic Surprise Index measures whether actual economic data - when it is released - is better or worse than economists' forecasts; the 'forecast' being the consensus view as measured by Bloomberg. Positive levels of the index indicate that economic releases have, on balance, beaten the consensus forecast (economists are under-estimating the numbers). Measures below zero show occasions when the forecasts were better than the actual numbers (economists were over-optimistic). The index for the US market, over the past five years, is shown in **Fig.1**. As economic releases begin to beat forecasts (above zero), economists gradually begin to take a more optimistic view with their next set of predictions, until it gets to a point where they become too optimistic and then the trend begins to revert below zero again. Interestingly, we are currently in an environment where forecasts are significantly lower than actual figures (almost one of the highest points on the graph since 2007). Yet in June last year, it had fallen to -117, the lowest reading since 2009, showing a significant swing in sentiment (from optimism to pessimism) in just nine months.

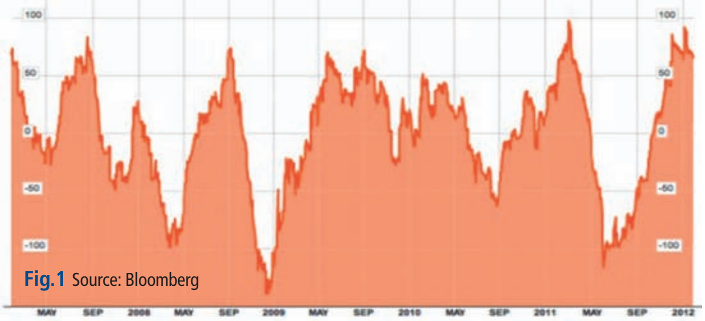

Fig.1 Source: Bloomberg

Reflection and prediction in equal measures

One way to assess how good an individual investment manager is at economic forecasting is to explore whether or not they reflect on what they said previously and compare it to what actually happened. Of course, an economist is much more inclined to do this if he or she gets it right most of the time! But trustees who implement a disciplined, rolling quarterly cycle of 'reflection and prediction in equal measure' will develop a rigorous and objective methodology for assessing the quality of their economist's input to the investment approach. Key elements to such a cycle might include:

- **Reviewing** forecasts from previous periods
- **Analysing** actual economic releases during the past quarter and comparing with forecasts
- **Challenging** the manager where there are significant deviations
- **Requesting** forecasts for next periods and discussing them
- **Clarifying** the anticipated impact on the portfolio…

The tricky relationship between economics and markets

It is natural to expect there to be a fairly direct link between the economy and stock market performance. Yet US investment firm Gerstein Fisher analysed this relationship for eight markets from 1993 to 2010, with unexpected results. They concluded that the correlation between economic growth and stock market performance was surprisingly tenuous, and in China and Korea, over the period analysed, it was actually negative - **Fig.2**.

China's economy, for example, grew by nearly 16% per annum (in nominal, US-dollar terms) but the equity market fell by 2.25% per annum over the 18-year period.

Gerstein Fisher put forward several possible reasons for this unexpected relationship, including:

- Expected economic growth is already discounted in current prices
- Globalisation of companies is breaking down the relationship between the domestic economy and its stock market. For example, S&P 500 companies are often global businesses that just happen to be listed on the US stock exchange.

Trustees can challenge their economists by asking them to confirm and clarify the expected relationship between forecasted economic data and the underlying stock or bond markets, as well as the likely sensitivity, or the magnitude of the impact, of those different indicators. By forcing the economist to make a direct link between the economic data and the underlying investments, trustees will be left with a much clearer picture of how their portfolio will be impacted under different economic scenarios.

The importance of a one-sentence wrap and its impact on investment

Whilst many of us have sat in awe and listened to credible economists giving impressive speeches on the economy that makes it clear they have both insights and the depth of knowledge to make it worthwhile attending, the very best economists are the ones who can summarise, in one sentence, the key elements of their message. They then go on to provide a clear explanation of how the indicators discussed translate into investment decisions. The audience is left in absolutely no doubt over the relationship between the economist's forecast, the impact on the markets, and the investment decision they should then make.

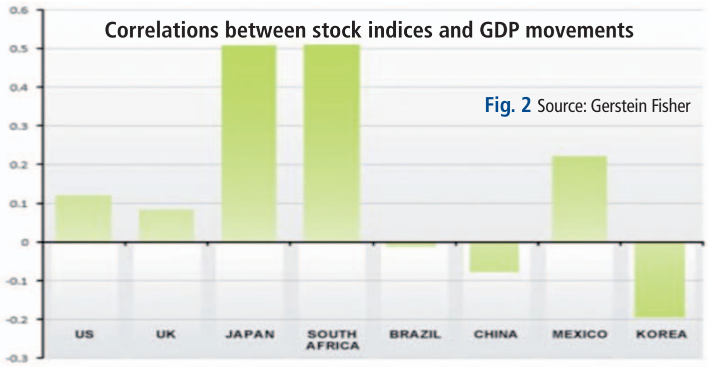
Correlations between stock indices and GDP movements

Fig. 2 Source: Gerstein Fisher

Disenfranchising the economist from the portfolio manager

Sadly, many investment managers dilute their economist's skill by developing an unclear investment process that leaves the economic input disengaged from the final stock selection in the portfolio.

A full understanding of a fund manager's investment process is essential and, importantly, of how the economic views are taken into account in the decision-making. This takes trustee and adviser time and effort; it requires a good deal of transparency by the manager and demands on-going monitoring and challenge.

Some of the common pitfalls in decision-making include tactical overlays (overlaying the strategic view set by the economist with short term fears), 'top-down' versus 'bottom-up' methodologies interfering with each other (lack of clarity in approach), and portfolio construction (which stocks and how much in each?).

Such pitfalls ultimately dampen performance opportunities with mediocre results ensuing. But that is a topic for another article...

We welcome two new team members

John Arthur
Senior Adviser

John Arthur has over 25 years' experience within the defined benefit pension industry, most recently as Director of Client Services at Aerion Fund Management and previously as a Fund Manager covering UK and international equity markets.

At Aerion Fund Management, the in-house Fund Manager for the £14bn National Grid UK Pension Scheme, he was responsible for communicating directly with the Scheme's Trustees, advisers and Secretariat regarding all investment matters, including long term strategy for matching the Scheme's liabilities and managing the scope and terms of agreement with investment managers. During this time, John was also a member of the Investment Group responsible for agreeing all investment processes used within Aerion and a Member of the Management Committee of the in-house Fund Manager.

As Investment Director of International Equities, he was responsible for a team of investment professionals managing £2bn in overseas (ex UK) equities and directly managing a portfolio of £1bn in European equities.

Neil Morgan
Senior Adviser

Neil Morgan joined AllenbridgeEpic from Bluefin where he was Head of Investment Consulting Practice and a Senior Investment Consultant. While there he provided investment consultancy advice to a broad range of DB and DC pension schemes.

For DB schemes this involved working with Trustees and plan sponsors to improve schemes' funding levels through measuring and monitoring investment risk, and implementing de-risking programmes based on tolerance for risk and prevailing market conditions. For DC schemes this primarily involved scheme governance and default fund design, both for trust-based and contract-based schemes.

Neil has spent the past ten years in the investment consultancy industry, having also worked at JLT and Hewitt Bacon and Woodrow.

Prior to that he was involved in developing quantitative risk modelling tools; was Head of Equities for Saudi International Bank; was Head of Investment at the Esso Pension Fund (when it was all internally managed); and started his career as an economist and market strategist with Prudential Portfolio Managers.

Our current team of industry experts

AllenbridgeEpic Investment Panel

Senior Advisers

John Arthur	Grant Ballantine	Jonathan Barber	Nick Broadhead	Alistair Haddow
Philip Hebson	Stuart Hepburn	John Heskett	Bill Horwood	Neil Morgan
Ian Morley	Peter Murray	Keith Percy	Alan Saunders	Peter Scales
Karen Shackleton	David Somers	Alick Stevenson	Philip Williams	

Sector Specialists

Seamus Gillen	Marisol Hernandez	Philip Ingman
Ray Maxwell	Trevor Robinson	James Walton

A resume for each adviser and specialist is available on the AllenbridgeEpic website

UK ground rent funds - good value, RPI panacea or an obscure alternative?

By James Walton
Sector Specialist

Introduction

Ground rents have been popular with private investors for many years but are now proving more attractive to institutions due to a combination of attributes. Specifically ground rents offer:

- Low correlation to underlying capital value movements in direct property (for average durations greater than 80 years)
- RPI and upward-only rent review provisions
- Low long-term volatility compared with direct property
- Position at the top of the capital stack. Ground rents rank higher than senior debt
- If the ground rent is not paid the freeholder takes control and ownership of the whole asset; albeit such a lease forfeiture is a rare occurrence, it is one which happens occasionally for residential ground rents
- Ground rents typically offer a total return in the 5-8% range.

Structure

UK residential and commercial leaseholds are drafted by builders to create tangible and transferrable investment value for the freeholder of the property. The ground rent owner (i.e. the freeholder) is entitled to certain rights beyond the collection of the ground rent itself. These include:

- Insuring the physical asset with building insurance/all risks insurance. The leaseholder is obliged to pay the proportional premium to the insurer which the freeholder chooses. This extra source of income typically adds a further 20-30% over and above the ground rent income itself
- Permission to undertake building extensions
- Renew or extension of the ground lease
- Enfranchisement or purchase of the freehold by the leaseholder.

In commercial property, the asset is given back to the freeholder at the end of the lease. In most cases, the leaseholder is obliged to return the asset in the same state it was let. Leases are either written inside of or outside of the Leasehold Reform, Housing and Urban Development Act 1993. There are a series of different statutes which apply to those written within this Act but mostly these are to do with enfranchisement and collective enfranchisement rights. Specifically, enfranchisement is the action of the leaseholder forcibly purchasing the freehold. On commercial assets, enfranchisement does not occur.

The scope of leaseholds is wide and terms vary greatly. Lease terms are typically 125 to 999 years. The initial rent can vary from £100-£250 per year with reviews between 3-10 years.

For leaseholds with bank debt secured against them, the bank forces provisions within the lease that prohibit cancellation of the lease unless signed off by the mortgagee. At this point there are usually clearly defined step in rights which allow the bank to assume all the rights of the leaseholder.

Capacity

On an institutional basis, ground rent funds remain relatively small and hard to assemble critical mass. Specialist operator skills are required to assemble and scale the portfolio. The combined gross asset value (GAV) in ground rent funds in our sample is just over £1bn. It's difficult to position this GAV against the total investable ground rent opportunity. CBRE said that £830m in new ground rents were created against new completed private sector flats between 2005 and 2010. It is expected that there is still ample capacity left in the market.

Sectors and investors

Residential ground rent funds have been dominated by retail investors while commercial ground rent funds have been filled with institutional investors. Very few funds try to appeal to both types of investor. Typically the reason given is that retail investors and institutional investors are driven by different economic factors, which leads to different subscription and redemption requirement timing.

Opportunity cost and allocation

Given that some gilts are yielding negative real rates of return, the draw to a 100 year plus income stream which produces a 5-8% total return is attractive. Ground rent allocation normally comes out of the fixed income allocation rather than the real estate allocation. The reason for this is because they behave more like fixed income than real estate. The rents being achieved on ground rent funds with near 100 years weighted average unexpired lease term remaining are pricing very closely to 20-25 year sale leasebacks offered by some large commercial tenants. The rationale here is, why buy 20 years of income for the same price as 100 years?

Conclusion

Ground rents offer a unique, inflation linked or upwards only rent review structure. They are lowly correlated to the underlying direct property asset as weighted average unexpired lease terms are high. Ground rents with less time left on the lease can equally offer an access route to direct property as the lower the term, the more like the direct property it will behave.

AllenbridgeEpic is undertaking a review of the UK ground rents funds universe and the relative value of each product with a particular focus on how the funds mitigate risk, price their ground rents and actively manage their portfolios.

Please contact james.walton@allenbridgeepic.com if you would like further information.

In each issue of Perspectives we give a list of ten questions trustees should explore with their investment managers.

Here is our updated list:

1. Would you be advising us to be investing in Government inspired infrastructure projects and, if so, on what terms?

2. Do you consider that the current appetite for emerging market equity funds is starting to become over-heated or is this genuinely the start of a strong growth phase within those economies?

3. The majority of UK pension funds with overseas equity investments are aggressively underweight in Japan. Is this an appropriate view for the next three to five years?

4. Are you forecasting an expansion or contraction of profit margins in the USA? How does your view affect your current weighting in US stocks?

5. As a pension fund, we need to take "the long view", and want to ensure that we play our part as responsible shareholders. What is your company's record, as an investor, in pro-active involvement in companies? Can you give any examples?

6. Do you think ETFs are a suitable vehicle for pension funds? What is the performance of the largest of your firm’s UK funds over the past decade, against the FT All Share?

7. Why do investment managers and consultants continue to seek strategic holdings in index linked gilts when there is such a shortage of supply relative to demand; wouldn’t it be more appropriate to consider other bond asset classes?

8. Where are the best opportunities to invest in property?

9. We have yet to see the long term effects of quantitative easing and a period of high inflation, or deflation, is still a possibility. Do you see it as worthwhile to protect the fund against these outcomes?

10. If the underlying issue with Greece is its lack of competitiveness, and this has yet to be addressed, how long before the markets again focus on the economic instability of this country and again push up sovereign debt yields in the weaker countries in the Euro zone?

Customers should seek professional advice specific to their circumstances and requirements. Please note the value of investments, and income from them may fall as well as rise, this includes equities, government or corporate bonds, and property whether held directly or in a pooled or collective investment vehicle. Further, investments in emerging markets or private equity may be more volatile and less marketable than in established and quoted markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the amount originally invested. Past performance of asset classes and/or investment managers is not necessarily a guide to future performance.