

Changing face of QE – Is this the calm before the storm?

Is this the start of a winter of discontent or just an autumn squall; how should trustees react to the changing face of QE?

Over the past five years investors have been amply rewarded simply for staying invested and avoiding holding cash. Moreover, in that period returns have gradually accumulated with little underlying concern.

However, the end of Quantitative Easing (QE) from the Federal Reserve is nearly upon us and there is potential for this to cause a re-assessment of where economies and markets are heading. We think the time is nigh for trustees to re-assess and re-examine a few central themes within their portfolio, to ensure they are able to cope with the challenges of the next five years.

To be clear we are not predicting we are on the edge of another crisis, although as we finalise this paper in early October markets have become a little bumpier than recent past. Our message is that the time of a significant change is a good time to re-assess your portfolio; ensure it is resistant to any shocks before they arrive not after.



What are the key issues?

There are four key areas we encourage clients to consider:

- 1 Take enough risk** - we don't see the past five years being repeated. Is there sufficient risk, across various sources, within your portfolio to get the returns required under the funding strategy?
- 2 Liquidity** - we believe it is important to understand which holdings are illiquid. It may not be those you expect. Are you getting rewarded for that illiquidity or are you missing out on returns by not holding truly illiquid assets?
- 3 Volatility** - will increase. Are you comfortable with the level of volatility in your portfolio at normal, not current levels?
- 4 Diversification** - have you got a truly diversified portfolio? Do you understand the underlying source of returns?

Before we go on to examine each of these four areas in more detail let's first consider how we got here.

How have we got here?

Over the past five years it has mattered little which asset class you were invested in; you got a good real return (i.e. in excess of inflation) in the region of 4 to 7% per annum. The chart to the right shows the returns across various assets, from risky assets such as equities, property and high yield bonds to the safer corporate bonds and gilts. All produced strong returns. An entirely passive strategy, in terms of asset allocation, stock selection etc. would have worked absolutely fine over the past five years.

So how were these stunning and above average returns achieved? Well it certainly wasn't on the back of above average growth, with UK GDP for example growing on average by 1.8% a year (after ONS revisions) over this period; below its average over the last 60 years of 2.4% p.a.. We would also argue that it's not in anticipation of above average economic growth going forward. The IMF, amongst many others, is revising downwards their estimates of global growth.

Our concern is whether the above returns have been largely driven by QE, or in other words QE has brought forward asset class returns. If true, the parallels with the pre-crisis period are stark. Leverage and debt brought forward economic growth by bringing forward consumption, this only works for so long, as history has shown us with GDP growth being significantly reduced post 2007.

Such policies move around the timing of when economic activity occurs; they don't alter the total quantum of activity. Has QE done exactly the same but with asset prices rather than GDP? Instead of altering the quantum of returns available has it just brought future returns forward and therefore suggests for lower returns in the near future?

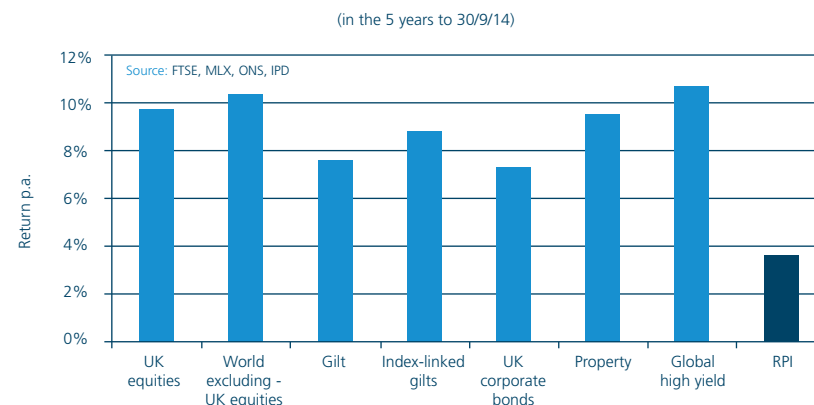
Pension schemes' attitude to liquidity

Liquidity is one of those wonderful things that is always there until you actually need it.

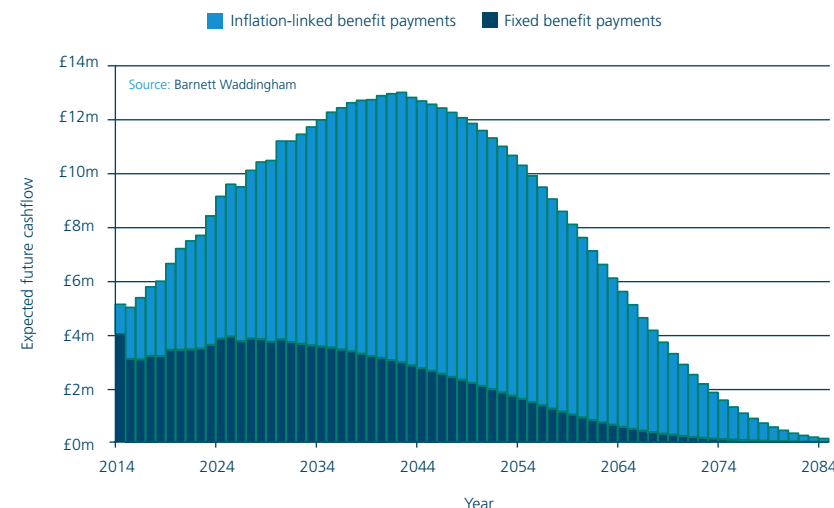
Pension schemes tend to like liquid assets. However, members' benefits extend over many years (the expected cashflows from even a closed scheme, as illustrated in the chart to the right, will extend over the next 60/70 years) so why is it that they desire to have the ability to liquidate the vast majority of their assets at very short notice?

One possibility is that trustees want to have flexibility to amend their asset strategy if they see a more attractive investment opportunity elsewhere. This doesn't seem a likely explanation to us. If anything trustees are criticised for acting too slowly, not speedily, to changes in investment opportunities.

Returns across various asset classes



Undiscounted future expected cashflow



A plausible explanation is that schemes do not in fact view their liabilities stretching out over the next 70 years; instead they are focusing on paying benefits out of assets over the next 10-20 years and then hoping to be in a position to buy-out their liabilities with an insurance company. Whilst this clearly reduces timeframes and requires a greater consideration on liquidity once buy-out becomes close for many schemes, this is still decades away.

What we suspect is happening is that trustees are not investing in truly illiquid assets because they do not have full trust in fund managers and they are wary about becoming locked in to an underperforming fund. They lack the control to review and make a change if circumstances change.

This is especially true at the pooled fund level, less so for larger clients with access to segregated mandates. Whilst this appears a rational conclusion to reach from a governance standpoint we would encourage trustees to keep this under review in light of the potential investment returns that can be generated from a less liquid portfolio with a long time horizon.

An aside; we have recently had the budget changes that may fundamentally alter the way members take their DB benefits and may therefore redraw the cashflow chart shown above. In the very early days this has yet to materialise but will clearly need careful monitoring by trustees.

Are pension scheme assets as liquid as trustees think?

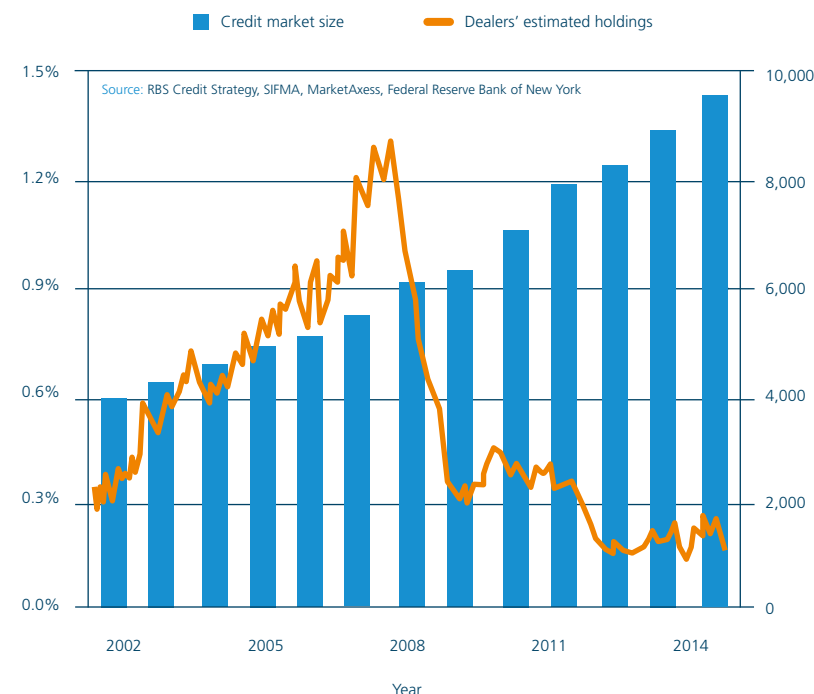
Whilst we suggest above that pension funds perhaps have the option, if perhaps not the governance or control, to invest more in illiquid assets we also think they over-estimate the liquidity of their existing portfolios. We would define a liquid market as one where investors can readily convert their investment into cash, without incurring significant costs or having to sell significantly below the prevailing market price.

Whilst the Government bond market remains very liquid, the level of liquidity has been deteriorating in the credit markets for some time. Arguably the level of liquidity has only been as good as it has been due to the vast levels of new issuance over the last few years, with the corporate bond market doubling in size over the last ten years.

One of the main causes for that deterioration in liquidity is regulatory changes on banks; investment banks are less willing to buy and hold bonds.

We expect that this is a structural change that trustees will have to deal with for the foreseeable future. At the same time as bond liquidity is falling, investors are being compensated less and less for taking on that illiquidity. The implication for trustees is to be comfortable now whilst times are good with the management of your credit portfolio. If you are not, if a crisis hits, it may well be too late to adjust.

Market grows but dealers pull back market size (\$bn) vs dealer holdings (%)



What about volatility – why is this so low and is it linked to lack of liquidity?

We have noted in previous market commentaries that the low level of volatility was starting to give us cause for concern. The concern arises if it leads investors to invest in assets, thinking they are not risky, and then when volatility returns they are forced to sell. This concern could be exacerbated by low liquidity in markets. Equity volatility has been low recently, as highlighted by the chart on the right, that provides a measure of the expected volatility of the US equity market. However, the lack of volatility is not just confined to the equity market. The volatility in the bond and foreign exchange markets has also been at historic lows.

We think the lack of liquidity and lack of volatility are purely coincidental and are not linked. We feel the current low levels of volatility are a function of the stage in the business cycle the global economy is in and the near cult status that a number of central banks have attained in their ability to solve all of the global economy's woes. The key question for all investors is whether the low levels of volatility are part of a new age of investing whereby monetary policy is better able to control and manage the level of risk within the economy? Alternatively, is it a temporary lull exacerbated by the commonality of monetary policy across the developed world?

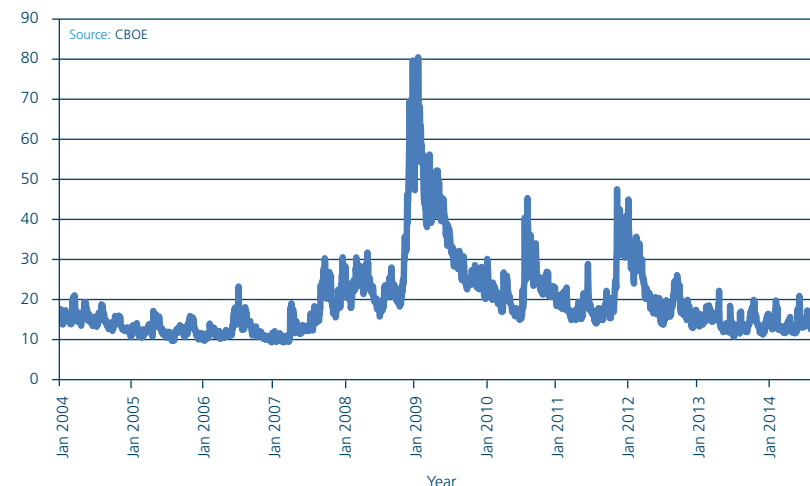
This is an easy one, central bankers are no more adept at stopping the next crisis than they were when they were complicit in the build up to the previous one. They have undoubtedly played a significant role in steering the recovery this far and reducing the volatility of markets along the way. However, as we come on to see and have hinted at already, they themselves may well be the cause of greater volatility going forward given the expected divergence in policy.

Divergence of economies and returns – is this the catalyst for a return of volatility?

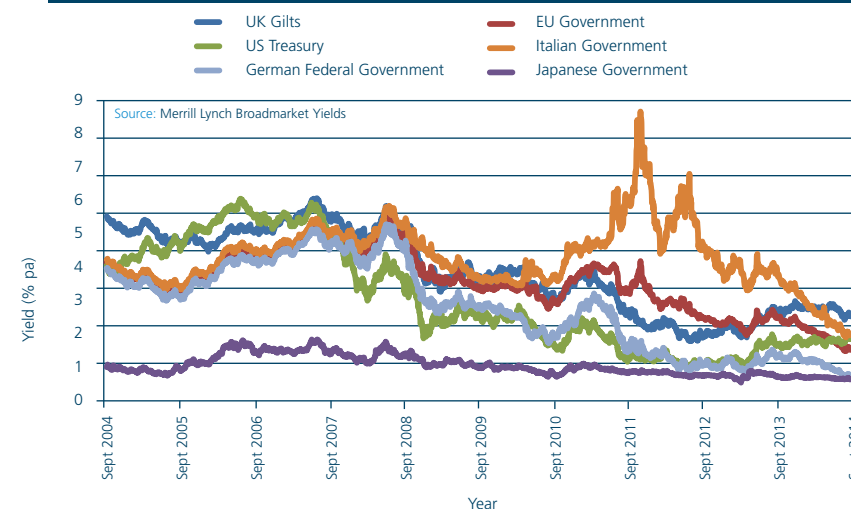
Over the past five years there has been, in the developed world at least, a remarkable convergence in terms of economic policy. We have had an era of very loose monetary policy with short-term interest rates at record lows. This has dragged down long-term government yields as evidenced by the chart to the right. At the same time there has been a gradual fiscal tightening in the aftermath of taking a large amount of private sector debt onto public balance sheets, as governments reduce (although don't eliminate) deficits.

This is almost certainly going to change in 2015 as the Bank of England and the Fed start to raise rates. In the meantime the Bank of Japan continues QE and the European Central Bank may yet join in (having not yet resorted to buying government bonds). The pace of structural reforms is also now significantly different across economies. Whilst we have long argued and positioned clients to expect only slow and gradual rate rises we still feel the actual act of raising rates will create uncertainty and volatility and perhaps more importantly bring back into focus the long term economic fundamentals underlying asset class returns.

VIX - measure of implied US equity market volatility



Regional government bond yields



Over-reliance on QE and lower growth rates?

We wrote in our note this time last year that we expect the UK economy to grow at a slower rate than it has done historically due to a number of structural factors. One outcome of this would be that long dated gilt yields would ultimately settle at a level below that seen historically. If our view is correct, this will ultimately feed through to lower returns on other asset classes too. Similar arguments apply to the US and Eurozone economies – still the largest two economic blocs globally.

The fundamental assessment needs to be how much of past and future asset class returns are linked to loose monetary policy and QE. We saw in 2008/09 that an apparently diverse pool of assets all behaved as one, due to the fact that many were relying on leverage to provide their returns. There is a risk that we find ourselves in a similar situation today; instead of leverage being the common factor is it ultra-loose monetary policy?

In our view, the key considerations are:

- Are equities vulnerable to rate rises? Historically they have been, but will this time be different? We suspect not.
- How many high yield issuers are only solvent at current interest rates?
- Do central banks still have the ability to control interest rates and longer dated yields given the size of their balance sheets?
- How many currencies are going to be used as a policy tool as QE ends? Is this the real start of the 'currency wars' and competitive devaluation?

We could go on.

So how should trustees react to all these factors?

Bearing in mind the low levels of liquidity in many markets we would therefore encourage trustees to ensure:

- They have a truly diversified portfolio. This includes understanding the underlying drivers of returns to their portfolio. Portfolios will be more volatile in the future than they have been in the last five years. Is the scheme able to accept this higher level of risk?
- Whilst appearing contradictory to the above proposal, trustees should equally ensure they are taking sufficient risk to enable them to achieve the returns they need under their funding plan. Whilst volatility is expected to increase, we expect returns to be lower. Far from the ideal scenario.
- Be comfortable with their asset allocation and overall strategy. Will a completely passive approach in terms of asset allocation and stock selection work as well over the next five years as it did in the previous five? We think not. With QE ending the economic fundamentals will start to assert themselves and therefore a closer look at strategies, and the changes that have occurred in underlying indices, will be required.

In our next quarterly note we will expand on some of these themes further – looking at how well the still new investment styles of diversified growth and absolute return funds have fared during the calm times and more importantly assessing whether they remain robust in the event of a less liquid, more volatile, lower returning future.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:



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