Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

May 2016

Last Month in Brief

April saw a mixed bag of economic news announced. The Eurozone appeared to show signs of stronger expansion, with growth announced to be above expectations at 0.6% over the first quarter; meanwhile Eurozone inflation was below expectations at –0.2% and unemployment fell slightly to 10.2%. In the UK growth slowed to 0.4% in the first quarter of the year, hit by a sharp fall in construction output; however inflation rose to 0.5%. The Bank of England's Monetary Policy Committee was unmoved, with a 9-0 vote in favour of holding the base rate at 0.5%.

Elsewhere the US economy sharply slowed to an annual rate of 0.5% from 1.4% in the previous quarter; the Federal Reserve kept rates at the same level they have been since December 2015. The Federal Reserve did not mention global risks in its announcement, leading analysts to speculate that there may be a rate rise in June. The global risks appeared to have subsided due to stronger economic data coming out of China. Growth was 6.7% in the first quarter, above expectations and greater than target, while retail sales and investment grew by more than 10%. Elsewhere in Asia, the Japanese central bank shocked investors by deciding against further stimulus measures in response to deflation and weak growth figures.

Chart 1: Equity Indices

Equity markets were a little higher than the previous month

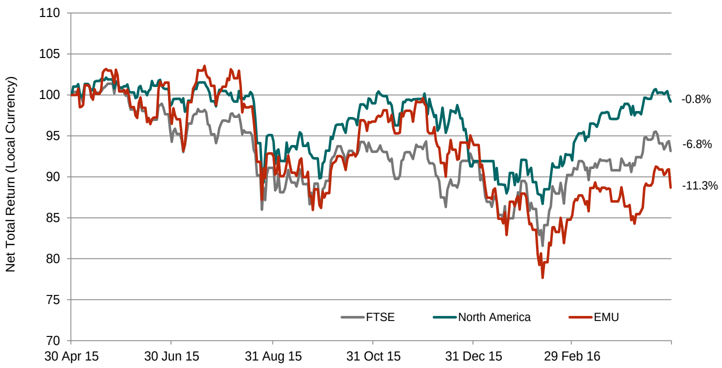


Chart 2: Sterling Credit Spreads

Credit spreads fell slightly during April

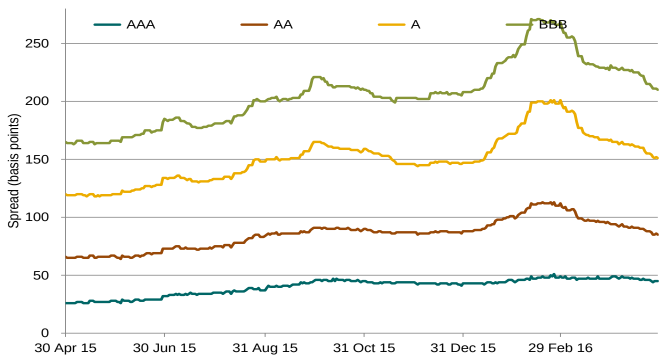


Chart 3: Gilt Yields

Gilt yields rose over month

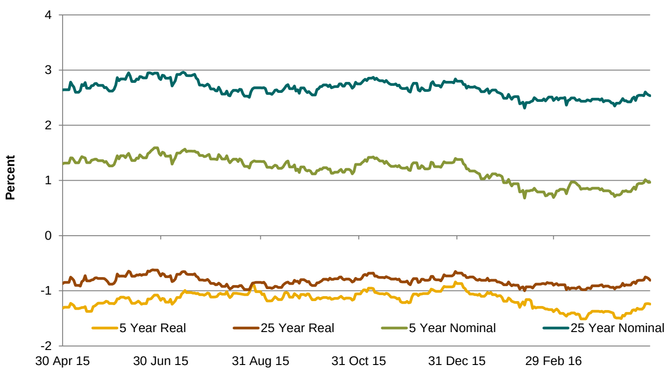
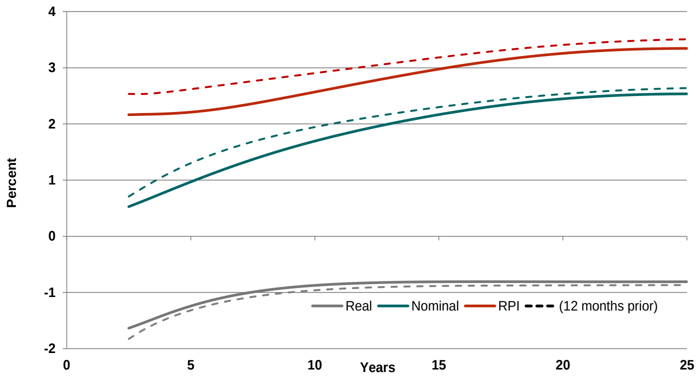


Chart 4: Gilt Spot Curves

Yield curves remained upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.5%	0.3%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	81.0%	79.8%	**$/£ exchange rate**	1.47	1.44
Halifax house prices (monthly change)	2.6%	-1.4%	**VIX (volatility) index**	15.70	13.95

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Pension schemes and shareholder activism

Shareholder activism is using a shareholder's rights to influence a company's behaviours and decisions. This activism will generally take the form of various votes held at company annual general meetings, and contrasts to the passive investing through investment trusts that as become common in recent years.

The spate of recent high profile shareholder votes against executive pay are perhaps one example of activism. However activism need not just cover shareholders' influence on executive pay, it may also cover shareholders trying to influence a company's decisions on social and environmental issues, or trying to influence governance.

Types of activist

One of the primary groups of shareholder activists are hedge funds, with activist funds managing $100 billion as at March 2015. Traditionally they have sought to change a company's strategy by purchasing a large proportion of a company's shares and gaining control of the board. The consequences of this activism are uncertain, with some arguing that it improves a company's prospects while the less positive "corporate raiders" characterisation has been used, due to their hostile takeovers and occasional drastic actions.

Beyond the activist hedge funds there is a spectrum of more passive shareholder activism, which takes the form of meetings, letters and shareholder votes. This form of activism would be more familiar to a pension scheme or asset manager. However, many trustees and managers may be unsure about how to approach a world of increased shareholder activism, as they are faced with the twin issues of needing to maximise returns while also representing a large and diverse group of people's investments and possibly facing pressure to represent them in a certain manner.

Impact on returns

A 1993 study publish in the Journal of Financial and Quantitative Analysis specifically studied "the efficacy of pension fund activism by studying nine major pension funds" in the USA. It found that "there was no evidence of significant long–term improvement in either stock price or accounting measures of performance" as a result of activism. However, the study considered a much shorter timescale than pension funds would typically need to invest over to meet their liabilities. In addition, other studies have suggested that an activist approach to public investing, particularly through hedge funds, has produced returns in excess of a passive approach in recent years.

Box 1: Key recent incidents involving shareholder votes against executive pay:

- Weir Group, whose Chief Executive's pay was voted down in a binding ballot.
- Shire, whose remuneration report passed with just over 50% of the votes.
- BP, who had 59% of shareholders vote against their CEO's pay package.
- Norway's sovereign wealth fund, the world's largest, has announced it will target firms that it believes are overpaying their directors.

Issues for pension schemes

Some investors, use activism to address specific issues and concerns. For example, in 2010 the Environment Agency Pension Fund supported a shareholder resolution against BP in respect of their disclosures and strategy and asked their fund managers to engage with companies over health and safety and environmental concerns.

Box 2: Assets under management in activist hedge funds have grown quickly in recent years. Data from Hedge Fund Research.

In the UK, there are increasing pressures and requirements on pension schemes trustees to disclose their policies on environmental, social and governance issues. This disclosure must cover their policies in relation to the extent to which these issues are taken into account in investment decisions, and their policy in relation to the exercise of rights (such as voting) attached to investments.

In addition to this requirement, the Government has also sought to encourage collective engagement by investors in companies through the recommendations of the Kay Review into UK equity markets and long-term decision making. The report made a number of recommendations that sought to encourage companies to engage in greater consultation with shareholders.

Pension scheme trustees must balance these considerations against their responsibility to protect members' best interests. As a result, trustees should consider these issues alongside the effect that socially responsible investing might have on investment returns.

Hence, decisions about how pension schemes and other investors should react to greater shareholder activism are complex, with a number of issues at play. There is uncertainty about what scheme members or investors desire in terms of investment policies, and the effect of these policies on investment performance. However it appears that activism, whether it be in terms of seeking strategy change, rejecting executive pay levels, or changing environmental or social policies, is on the rise.

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