

Investment News

Monthly Bulletin from the Insurance & Investment Team

December 2016

Last Month in Brief

In November the UK Chancellor gave his Autumn Statement to Parliament, acknowledging the “sharp challenges ahead” for the British economy. As well as setting out the Government’s plans for the economy and public finances it was announced that following the spring 2017 Budget and Finance Bill, future Budgets will be delivered in the autumn to help promote certainty and simplicity. Details on the Statement can be found here in GAD’s [technical bulletin](#).

The Organisation for Economic Co-operation and Development (the ‘OECD’) said in their recent ‘Economic Outlook’ that Britain’s economy is growing more strongly than previously anticipated but needs extra spending on infrastructure and skills to improve its long-term prospects. They project GDP to grow by 2% in 2016 and 1.2% in 2017, an improvement on the 1.8% and 1% previously forecasted.

Following Donald Trump’s victory in November’s US election, markets responded more positively than expected, with most up around 1% the next day. There were large impacts on some assets, such as the Mexican Peso which fell nearly 10%. There is, however, significant policy uncertainty with investors unsure of the President-elect’s exact plans for fiscal, trade and monetary policy.

Oil prices rose over the month with Brent Crude increasing to above \$55 a barrel for the first time since July 2015. This was following the OPEC (‘Organization of the Petroleum Exporting Countries’) decision to cut production.

Chart 1: Equity Indices

Equity markets were stable over the month

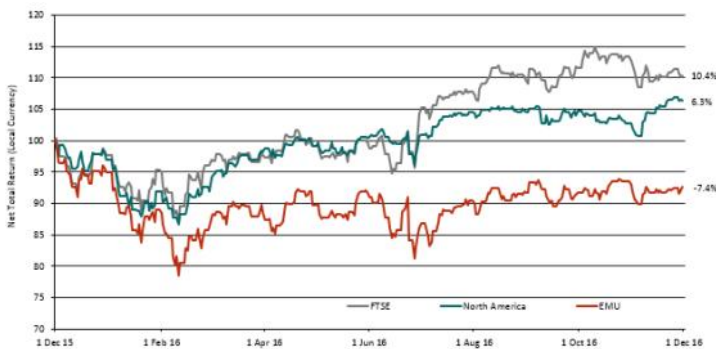


Chart 2: Sterling Credit Spreads

Credit spreads were broadly steady over the month

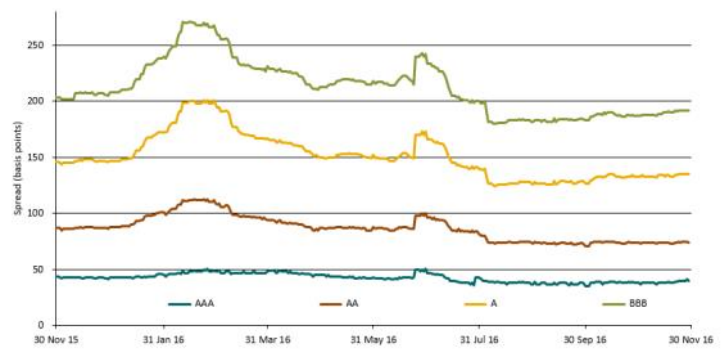


Chart 3: Gilt Yields

Long term gilt yields rose during the month

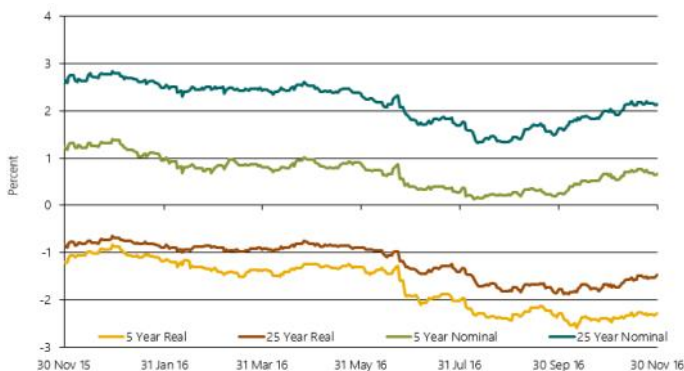
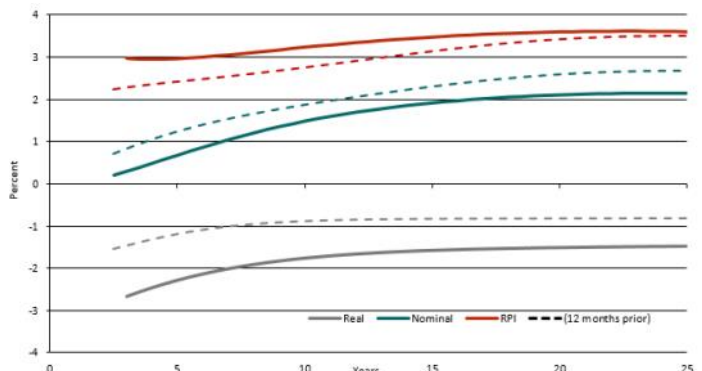


Chart 4: Gilt Spot Curves

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)	0.9%	1.0%	Base rate	0.25%	0.25%
PPF 7800 funding ratio	81.4%	77.5%	\$/£ exchange rate	1.25	1.22
Halifax house prices (monthly change)	+1.4%	+0.1%	VIX (volatility) index	13.33	17.06

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

Investing in illiquid assets

What is an illiquid asset?

An investment is considered illiquid if it cannot be quickly and easily sold or exchanged at a predictable price. Liquidity is driven by a range of factors including: demand from investors; scale and sophistication of any market for buying and selling; and the homogeneity of the asset being sold. Investors often demand a higher return for illiquid assets because they can't be sold quickly and they are harder to price; this can be a disadvantageous for investors who need to meet liabilities or want to take advantage of other investment opportunities.

Common illiquid asset classes include infrastructure (physical projects such as airports, roads, hospitals, or renewable energy projects, see Box 1), property, hedge funds and private equity. Infrastructure-type assets are particularly illiquid and investors will generally hold the investment for a period of many years, never intending to sell until maturity of the asset.

Box 1: Renewable energy as infrastructure investment

There has been an increasing emphasis on renewable energy, such as solar power, offshore and onshore wind power. The sector has seen dramatically reduced costs, increasing their competitiveness with non-renewable energy sources. Investments can benefit from low long term annual return variability, as well as implicit (and sometimes explicit) inflation protection.

However, regulatory risk is a key consideration due to the predominance of subsidies which can be altered at short notice; this can be mitigated by investing in developed markets with predictable regulatory regimes.

Why invest in illiquid assets?

In recent years there has been a growing demand for illiquid assets as investors expect a greater return to be gained over more liquid alternatives (to compensate for the lack of liquidity). Since 1995, pension funds have increased the proportion of their portfolio invested in illiquid asset classes from 5% to over 20% (*Asset Management: A Systematic Approach to Factor Investing, Andrew Ang*).

Before making a purchase an investor will assess whether the illiquidity premium, the return in excess of a similar liquid asset, is high enough to justify taking on the additional risk. Different investors will have a different opinion as to the appropriate illiquidity premium, which leaves scope for negotiation and potentially high returns if the right price is paid (balanced by the risk of poor returns if valuations prove too optimistic).

Another key reason for investment in illiquid assets is that they offer diversification to an investment portfolio, which leads to more stable portfolio values through time.

What are the risks of illiquid assets?

A high level of expertise is often required to invest in illiquid assets. When investing in an infrastructure project, a team of internal experts or external advisors will be required to project the risks and returns of such a project, and arrive at a reasonable price to pay. In general hedge funds and private equity funds will not deal with smaller investors. Indeed, there is regulation around the sale of such

investment products to unsophisticated investors. This additional required expertise is costly and excludes many potential investors whilst the uncertainty around returns and risk opens investors to mispricing.

There are other additional risks involved in buying and holding illiquid assets which are specific to the individual asset class. For example:

- > Hedge funds have a greater associated credit risk due to the increased risk of insolvency due to high risk derivative positions
- > Investing in infrastructure demands a high initial outlay of funds. Depending on the project there may be a considerable period of time before any income is received. This delay may present a cash flow problem to the investor

Who typically invests in illiquid asset classes?

As a result of the complex nature and large financial commitment to illiquid assets, the majority of direct investors are institutional investors. Specifically, pension funds and sovereign wealth funds are key buyers of such investments. Figure 1 shows the increase in investment to other assets (largely illiquid assets) from pension funds over the last 10 years.

The attributes of illiquid investments which represent risk for many investors may actually present an advantage to institutional investors who are better placed to cope with these risks. They can demand a higher return due to the lower level of competition for the asset. For example, the long-term nature of the investment may tie in well with a pension fund's objectives, especially if they also have holdings of more liquid assets in order to meet their short term liabilities.

Figure 1: Asset allocation for the average pension fund

Pension fund investment to 'other assets', made up largely of illiquid assets, has increased over the last 10 years.



Source: Willis Towers Watson, Global Pensions Asset Study 2016.

Will demand for illiquid assets go up?

Due to low interest rates and the current economic environment, asset values are high across most traditional asset classes. This may lead pension funds and other institutions to continue to search for returns elsewhere. Illiquid assets, specifically infrastructure, may offer opportunities for such investors who can bear the illiquidity and other risks, whilst also leading to wider economic benefits. However, supply, which is driven by factors such as economic growth, government policy, and regulation, may not always meet demand. Due to the one-off nature of such projects opportunities may not always be available to investors.

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