INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

4 March 2013

01

MONTHLY UPDATE

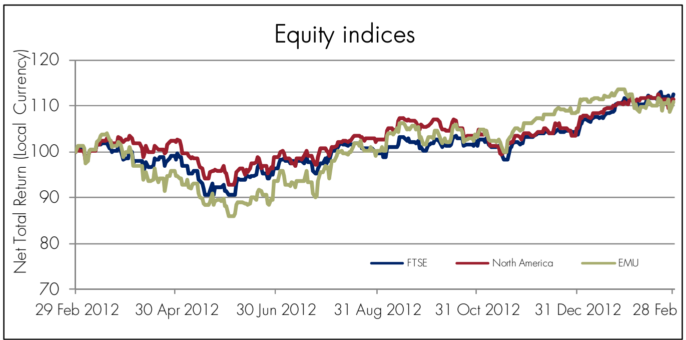
Overview

For the first time since 1978, Moody's has stripped the UK of its AAA credit rating citing expectations that growth will "remain sluggish over the next few years". Sterling fell to a two-and-a-half year low against the dollar following the announcement. The UK has followed the footsteps of the US and France, which lost their AAA ratings in 2011 (from S&P) and 2012 (from Moody's) respectively. Germany and Canada are now the only major economies to have the top rating from all three rating agencies.

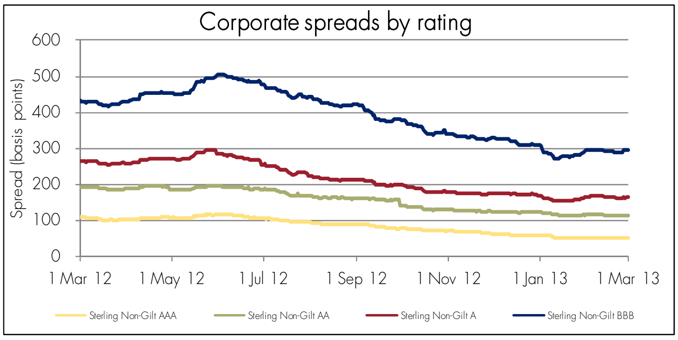
The Office for National Statistics has increased its official UK growth figure for 2012 from flat to 0.2%. Growth in the first and third quarters of the year was revised upwards to –0.1% and +1.0% respectively, the latter being boosted by Olympic ticket sales. In an attempt to increase lending and boost the economy, Bank of England deputy governor Paul Tucker has recently raised the possibility of introducing negative interest rates.

Following two days of talks, European leaders succeeded in agreeing a budget covering the remaining part of the decade. The deal represents the first real-terms budget cut in the EU's history, and will now be voted on by the European Parliament. However, political uncertainty remains in Europe where Italy's borrowing cost rose following inconclusive election results.

Equity markets showed modest growth over the month



Credit spreads were broadly unchanged

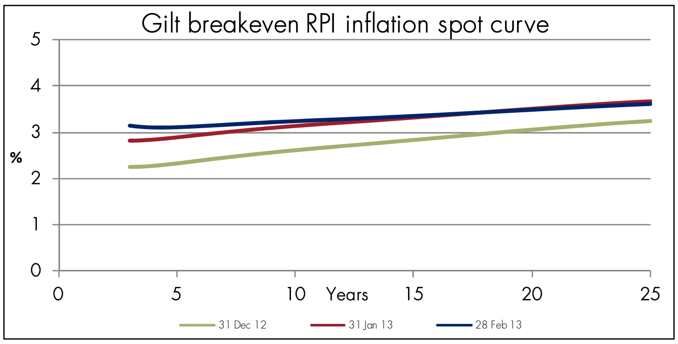


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase Jan (%y/y)	2.7%
Halifax house prices Jan (%m/m)	-0.2%
IPD TR property index Jan (%m/m)	0.4%
PPF 7800 funding ratio	83.7%
VIX (volatility) index	15.5
$/£ exchange rate	1.52

Numbers as at the end of month unless stated

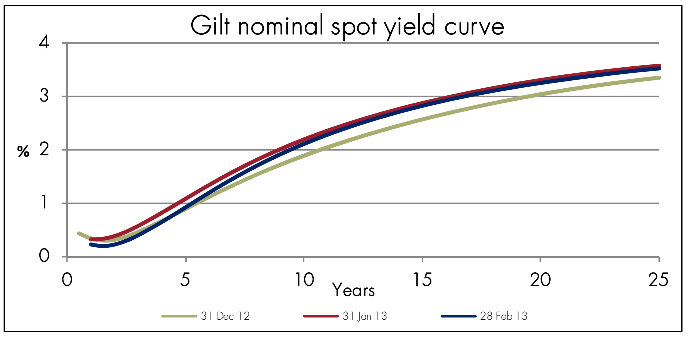
Breakeven inflation increased at shorter durations this month



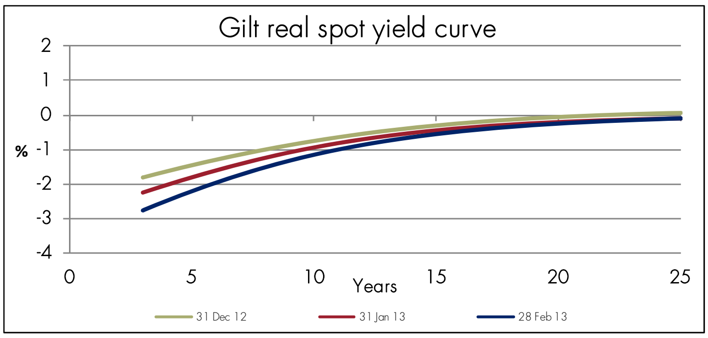
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	7th Mar
UK Trade	12th Mar
Producer Price Index	19th Mar
RPI / CPI	19th Mar
Minutes of MPC meeting	20th Mar
UK GDP Q4 (final estimate)	27th Mar

Nominal yields fell slightly this month



Real yields fell this month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

INVESTMENT NEWS

02

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Long run expectations

The financial landscape has changed following the crisis of 2007-08. The high returns enjoyed in the latter part of the previous century seem unlikely to be repeated anytime soon, and adapting to this new environment may prove to be difficult for some market participants. This month, we discuss the range of returns investors might now expect and some of the implications of this new landscape for pension funds.

Background

The years since the financial crisis have been characterised by considerable political and economic uncertainty. The eurozone crisis continues to be a source of significant turmoil. Greece has been in recession since 2008, and has required both debt write-downs and billions of euros in bailout funds to hold the currency bloc together. The situation there is far from resolved. It took European Central Bank (ECB) President Mario Draghi announcing that the ECB would do "whatever it takes" to save the euro in order to reign in yields on Spanish bonds from almost 8%. Outside the currency zone, the future relationship between the UK and the EU is now being questioned. In the US, there is uncertainty over the Federal Reserve's economic stimulus package, and growth in China has begun to slow. These factors all contribute to an environment of low confidence and restricted growth.

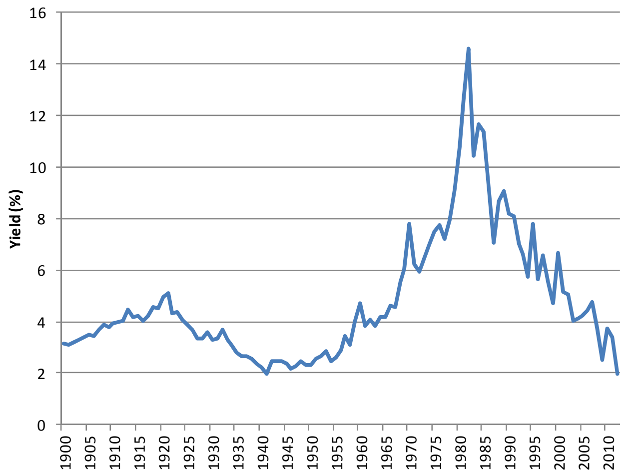
Current landscape

With interest rates at all-time lows (see Box 1), real yields on sovereign debt have fallen and are even negative. The market expectation is generally that short-term nominal interest rates will remain very low for the next few years, before rising steadily. According to Barclays, real returns earned on cash over the short term are expected to be around –1.5% and on good quality government bonds around –2% (Source: Barclays Equity Gilt Study, BEGS).

Equity returns are generally viewed as a combination of a risk free return (on cash, or appropriate government debt) plus a risk premium. As risk free rates fall, equity returns are therefore expected to do similarly. Barclays estimates real returns in the region of 3-4% might be expected over a similar period (Source: BEGS).

It could take 6-8 years for short term real interest rates to become positive (Source: Credit Suisse Global Investment Returns Yearbook 2013, CSYB). If rates rise faster than the market anticipates, holders of long dated bonds may find themselves exposed to a loss as bond prices fall. The risk and significance of that depends to a large extent on the circumstances of the investor—those holding such bonds to match liabilities might be relatively willing to accept it as the reported liabilities also fall.

Box 1: Yields on long US bonds, 1900-2012



Data source: http://www.econ.yale.edu/~shiller/data.htm

In short, markets do not expect short term real rates to reach the levels observed in the latter part of the 20th century (Source: CSYB). Similarly, equity returns are unlikely to generate the levels achieved in that period which is becoming considered as exceptional, and not to be taken as a guide to the future.

Implications for pension funds

Defined benefit pension funds are acutely affected by this fall in expected asset returns. Historically, investment returns of 5% above RPI inflation might have been achievable and considered a suitable target. However, such figures are generally based on the experience of those funds over the previous 30 years and are perhaps no longer appropriate.

A lower level of asset returns today is likely to reduce the valuation discount rate and lead to a deterioration in scheme funding levels. Further, lower expected returns in the future are likely to hamper the ability of schemes to recover. Sponsors are therefore likely to face pressure, not least from regulators, to make additional payments to ensure their schemes remain adequately funded. At a time when sponsors themselves are likely to be struggling financially, this environment makes it more difficult for defined benefit schemes to continue.

For defined contribution schemes, if returns are lower then higher contributions are required to provide the same benefits. While contributions of 10% of salary might have previously allowed retirement on half salary, the fall in real returns means that 16-20% might now be required (Source: CSYB). For some, that might be unaffordable leading to a fall in retirement income. Fund management charges and fees might come under increasing scrutiny and competition, as for example 1% might represent up to half of the gross real return.

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