Government Actuary's Department

INVESTMENT NEWS

MONTHLY NEWS BULLETIN FROM THE INVESTMENT AND RISK TEAM

01

2 April 2014

MONTHLY UPDATE

Overview

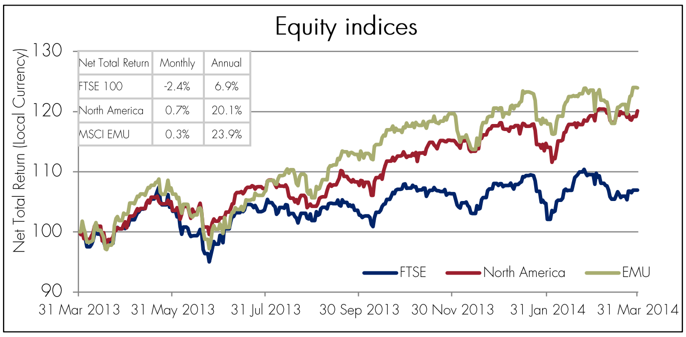
On 19 March, the Chancellor delivered his budget for 2014. It included various changes impacting on savings, including fundamental changes to defined contribution pensions. GAD's Technical Bulletin (available on our website) outlines some of those changes.

UK CPI Inflation fell further to 1.7% year-on-year for February, the lowest level in more than four years and further easing pressure on the MPC to raise interest rates. The 2013 GDP growth estimate was cut from 1.8% to 1.7% alongside ONS figures reporting the UK current account deficit to be a higher-than-expected 4.4% of GDP, only slightly lower than the all time high of 4.6% from 1989. However, whilst the income and current account deficits increased, there was positive news that the trade deficit has narrowed.

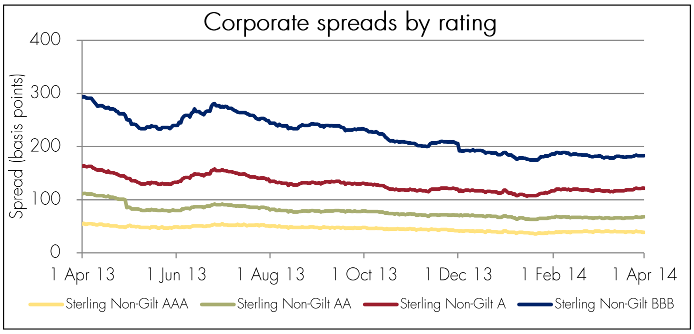
Eurozone inflation was down to 0.5% in March from 0.7% in February, lower than analyst expectations of 0.6%. Some commentators have called for a further cut to interest rates or a bond buying programme similar to the US Fed to counter any deflationary pressure.

Equity markets have seen some volatility, with unrest in the Ukraine hitting European stocks at least temporarily and the announcement of new pensions rules in the UK wiping significant value off insurance stocks as annuities will no longer be compulsory. However, following a sell-off of emerging market assets in 2013 and early 2014, investor sentiment seems to be improving with strong returns in emerging market equities over the month.

Equity markets saw mixed returns during the month



Credit spreads were largely unchanged over the month

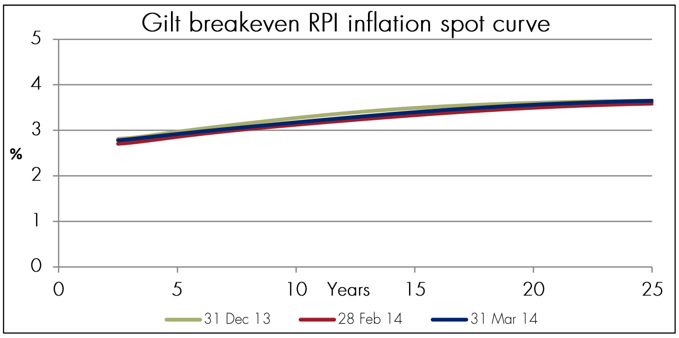


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase February (%y/y)	1.7%
Halifax house prices Feb (%m/m)	2.4%
IPD TR property index Jan (%m/m)	1.1%
PPF 7800 funding ratio	94.9%
VIX (volatility) index	13.88
$/£ exchange rate	1.67

Numbers as at the end of month unless stated

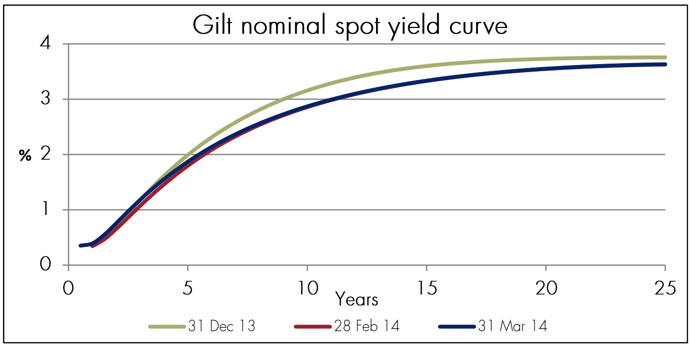
Breakeven inflation was largely unchanged this month



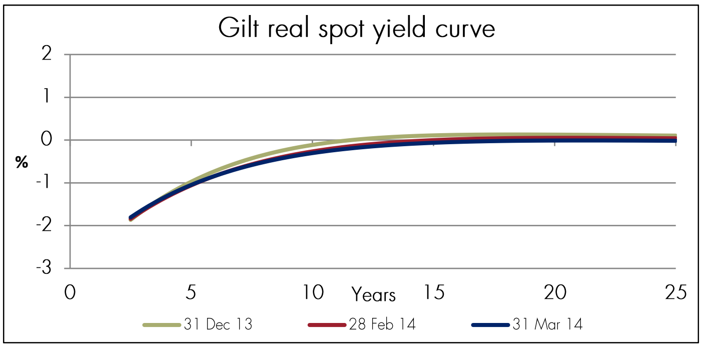
CALENDAR OF EVENTS AND DATA RELEASES

UK trade Jan 2014	9th Apr
MPC interest rate announcement	10th Apr
RPI / CPI	15th Apr
Labour Market Statistics	16th Apr
Minutes of MPC meeting	23th Apr
UK GDP (Q1 Preliminary estimate)	29th Apr

Nominal yields are largely unchanged this month



Real yields are largely unchanged this month



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

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Tracking Alternative Indices

In May 2011 we looked at non-market cap approaches and whether these can improve investment performance. This month we re-visit the topic and consider possible alternative approaches.

Investment management

When assigning assets to managers, investors can choose between active management, where the manager attempts to generate maximum returns given certain restraints by the investor, and passive management, where the manager attempts to track the returns of a benchmark index. Traditionally, passive management has focussed on tracking market capitalisation based indices, such as the FTSE 100 or S&P 500. Traditional passive management has been criticised as some commentators suggest it leaves investors over-exposed to large market cap firms. Further, greater weight must be placed on any equities that become overpriced, or in the case of bond indices firms that issue more credit. Recently a number of alternative indices have been developed. Indices that use non-market cap approaches to select or weight their constituent stocks are commonly known as 'smart beta' indices. Smart beta can also be known as 'advanced beta', 'alternative beta' or 'strategy indices'.

Alternative Indices

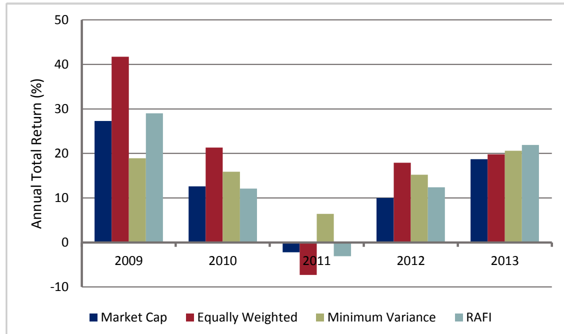
There are a number of methods that can be used to select or weight the components of a market index. Smart beta indices attempt to identify a risk factor that should be rewarded over time, for example size (smaller companies are more sensitive to economic shocks and hence investors may require a higher return to compensate), and construct index weightings based on the risk factor. Some of the more common approaches include:

> Fundamental indices, which weight stocks according to some economic factor, for example cash flow, sales or asset cover. Using such factors can make the index less susceptible to market sentiment and protect against overpriced investments.

> Defensive indices, where components are selected for their low volatility and low risk. Tracking a defensive index can allow investors to minimise their losses during a market downturn, however, it is likely that returns will be limited or will lag behind the market during an upturn.

> Thematic indices, which follow an investment principle, for example it may look to index UK listed companies that derive significant revenue from the US. Tracking a thematic index will give the investor exposure to the desired sector or region without the issues that can arise from directly investing.

Box 1 — Alternative indices returns



Source: FTSE

The chart above shows the annual total return on the FTSE 100 using alternative indices from 2009 to 2013. The chart shows how the returns vary depending on indexation. The 'market cap' index shows the traditional FTSE 100, whereas 'equally weighted' holds the same stocks as the FTSE 100 but with equal holdings of each stock. The 'minimum variance' approach uses a rules based strategy with the aim of minimising the volatility of the FTSE 100. The 'RAFI' index comprises the 100 largest firms weighted by a combination of total cash dividends, free cash flow, total sales and book value. Whilst smart beta indices may outperform market cap indices over certain periods, there are other periods where performance will trail market cap indices.

Smart Beta Funds

Smart beta funds, that track non-market cap indices, are becoming more popular with investors, with around $48bn inflow to funds in 2013 bringing the total assets to around $156bn for funds focussing on US stocks. However the market for such funds is still relatively small.

There are a number of views on the benefits of smart beta tracking from investors and market commentators. Many suggest that the funds lack transparency when compared with traditional tracker funds as it is difficult to gauge performance relative to a complicated index. This can lead to unnoticed tracking error. Some suggest that the stocks smart beta funds will look to buy in defensive sectors are being targeted by many other 'non-smart' funds anyway. A further criticism of a smart beta approach is that higher charges and stock turnover than traditional tracker funds can diminish any additional benefits.

However, proponents of smart beta suggest that market-cap approaches are sub-optimal and alternative passive approaches can provide higher risk-adjusted returns or lower risk and volatility. They argue that a traditional market-cap tracking is unlikely to offer investors what they require in returns or to meet their liabilities, but using the correct smart beta approach can meet these needs without less uncertainty and cost associated with active management. It is also suggested that smart beta allows investors to better manage which risks they are exposed to.

Investing in Smart Beta

A number of large DB pension schemes are starting to invest a proportion of their assets in 'smart beta'. The challenge for investors is to find funds that match their risk and return targets including management charges, and to balance the limited downside risk with increased tracking error against less developed indices. Smart beta funds are generally considered to sit between active and passive investment strategies and investors should consider how this fits with their current investment strategy. In addition as these funds only have short, or simulated, track records it can be difficult for investors to analyse the future robustness of these approaches.

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