Government Actuary's Department

INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

01

04 August 2014

MONTHLY UPDATE

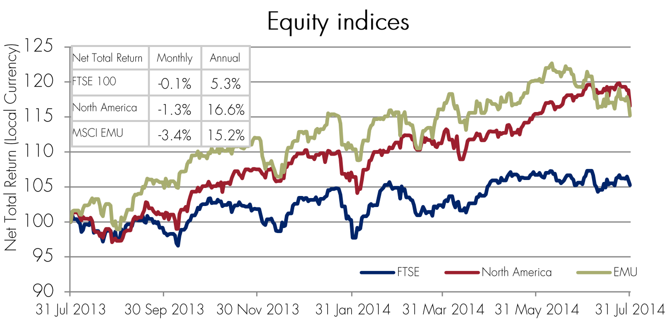
Overview

The UK reached a major milestone in its economic recovery, with data showing that, after 6 years, economic output had now exceeded its pre-crisis peak. Unemployment continued to fall with increasing numbers in full time employment. However, annual wage growth (including bonuses) slowed to 0.3%. In light of the weak wage growth, the Monetary Policy Committee voted unanimously to maintain the current level of interest rates. Surveys now suggest that the first increase will be in February 2015.

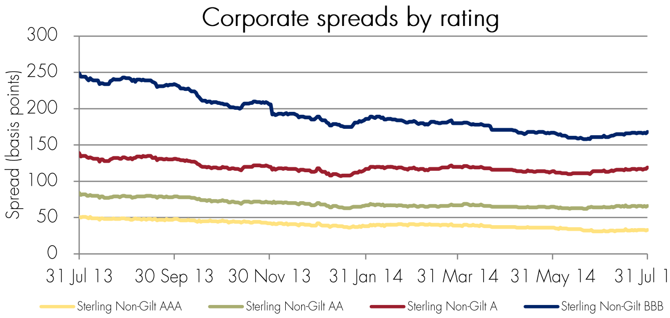
The US economy grew at an annual rate of 4% in Q2 spurring the Federal Reserve to announce that it will continue to ease back on bond purchases to $25bn from $35bn a month. In the Eurozone inflation fell still further to 0.4% in July. The ECB had indicated that it may take further measures such as a full scale quantitative easing programme if inflation continued to fall following the reduction in interest rates in June.

Argentina went into technical default after it was unable to reach a deal to repay $1.3bn to "hold-outs" - bond holders who had bought distressed debt at low prices shortly after Argentina's economic crisis in 2001-02 but who had refused previous debt restructuring.

Equity markets fell during the month



Credit spreads were largely unchanged over the month

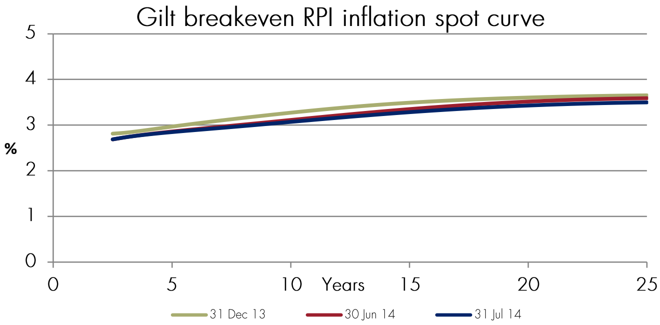


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase June (%y/y)	1.9%
Halifax house prices June (%m/m)	-0.6%
IPD TR property index June (%m/m)	2.1%
PPF 7800 funding ratio	91.5%
VIX (volatility) index	16.95
$/£ exchange rate	1.68

Numbers as at the end of month unless stated

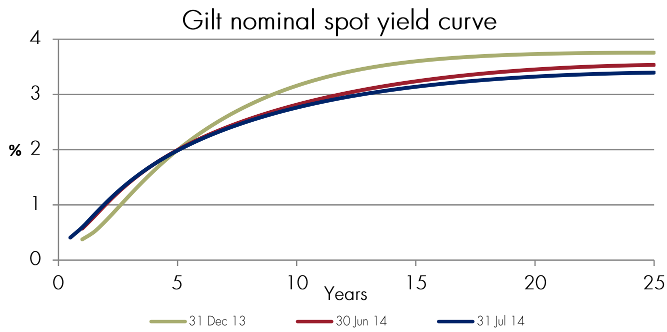
Breakeven inflation reduced slightly at longer durations



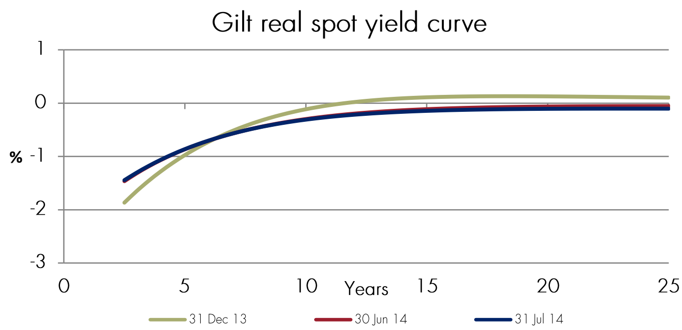
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	7th August
UK Trade	8h August
UK GDP (Q2)	15th August
UK CPI	19th August
Minutes of MPC meeting	20th August

Nominal yields fell slightly at longer durations



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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DC pension strategies - Budget Implications

The Budget in March announced that members of Defined Contribution (DC) pension schemes will soon have a greater level of flexibility in how they can use their pension funds at retirement. It is therefore expected that the number of people purchasing annuities is likely to decline as individuals use these new freedoms either to withdraw cash or to remain invested in drawdown type products. For those responsible for providing DC schemes, this means that consideration needs to be given to the investment strategies employed to ensure they are appropriate for changing member preferences.

What does this mean for investment strategies?

Although members of occupational schemes can usually choose their own investment strategies, few do—with 90% typically remaining in their scheme's default approach. The choice of the default approach is therefore very important in determining many peoples' outcomes. Currently schemes often use default approaches which have a form of "lifestyling". These commonly see younger members invested in growth assets before de-risking into 25% cash and 75% in long dated bonds as member's reach retirement (see Box 1). These proportions reflect the proportions which members have typically taken as cash and to purchase an annuity respectively. Although long dated bonds may be an effective asset for matching the changes in annuity prices, they will not have a stable value. Hence they may not be the best option for those who want more certainty about the cash value of their fund as they approach retirement.

Suggested approaches

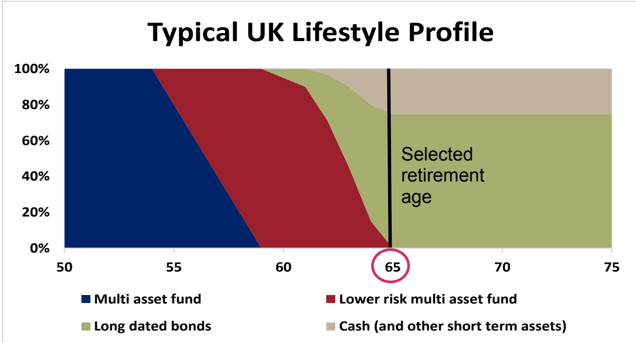
Given the increased flexibility, individuals will be able to make a much wider range of choices at retirement. It's therefore likely to be increasingly hard to provide a default profile which meets all members' needs. Furthermore, at this stage there is still significant uncertainty about what people will do once they have this new flexibility; will they take cash as soon as they can, remain invested or still value the security of a guaranteed income provided by an annuity?

There have yet to be many significant new product announcements in this area and it seems likely that, at least in the short term, lifestyling strategies (or target date funds which adopt similar approaches) will remain the most popular form of default investment strategy. In addition there are unlikely to be significant changes to the strategy used for individuals at younger ages (although the trend from equities to more diversified and lower risk funds may continue). Where changes are likely to be seen is the choice of assets as members near retirement. Here there is likely to be a reduction in long dated bonds held and an increase in the use of other assets. This may include retaining an allocation to equities with the fund remaining invested in some return seeking assets through the selected retirement date (as commonly occurs in US and Australian products).

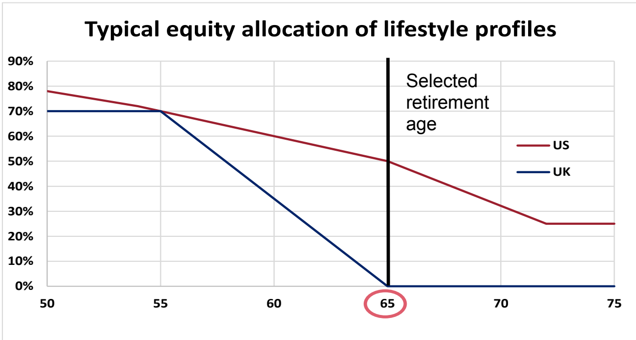
What is clear is that engagement will become more important than ever to ensure that the investment strategy reflects an individual's plans. However, given the difficulty in getting members to make active choices, alternative approaches are also being considered such as using alternative defaults for members with different sized pension funds to reflect the different retirement choices that they are likely to make. Those responsible for DC schemes will therefore need to consider the design of their schemes, taking into account the details of their membership which may vary significantly between schemes.

Box 1 — Lifestyling approaches

Lifestyle profiles automatically switch members' investments into less risky assets as they near their selected retirement age. Target Date funds adopt a similar approach - de-risking as the target



date is approached - but do so in a less prescribed manner. Approaches to de-risking in the US typically retain a higher level



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