Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

November 2015

Last Month in Brief

In October the USA and UK both saw weaker than expected growth announced for the period between July and September of this year due, in part, to a slowdown in construction and manufacturing. The UK economy grew by 0.5% over the period, lower than the 0.7% seen in the second quarter. The US saw a sharper correction with annualised growth of 1.5% in the third quarter compared to 3.9% in the second. Policy makers in both countries voted to maintain interest rates at their current record lows. The Eurozone also saw growth of only 0.4% over the period, as the region passed six months of its €60 billion a month quantitative easing programme.

The Chinese government set a lower annual economic growth target of 6.5% for the next five years, compared to 7% currently, in the aftermath of recent below-expectation growth and it's impact on the Chinese and global markets.

September UK CPI inflation, used to index state benefits (as well as a range of other public and private financial products) dipped in to negative territory, with growth of –0.1%. The UK, led by the Eurozone, have been faced with worries of deflation for some time, although markets and forecasters remain calm about the prospects of long-term, destructive deflation (see our past article from January 2015, as well as March 2015 and November 2014 for further reading on the impact and causes of deflation).

Chart 1: Equity Indices

Equity markets ended the month higher

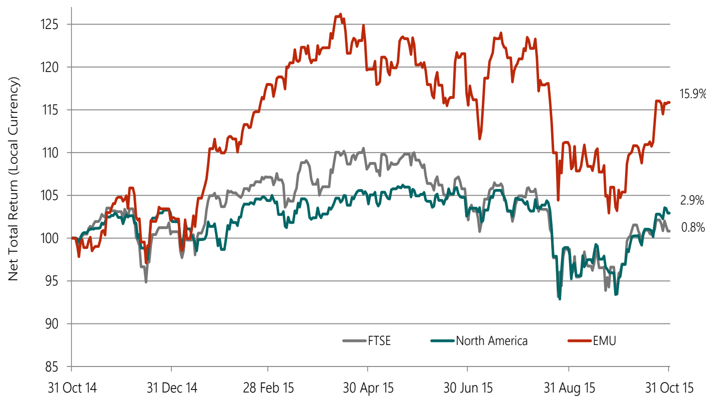


Chart 2: Sterling Credit Spreads

Credit spreads were flat during the month

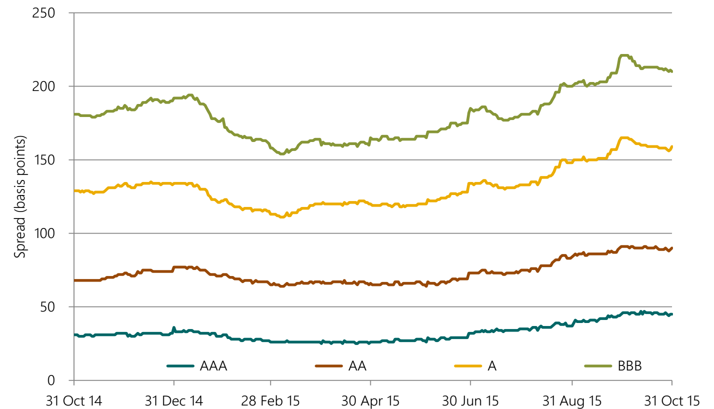


Chart 4: Gilt Spot Curves

Gilt yields rose during the month

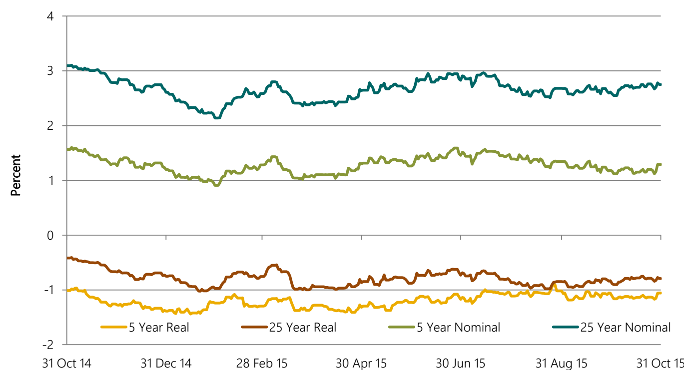
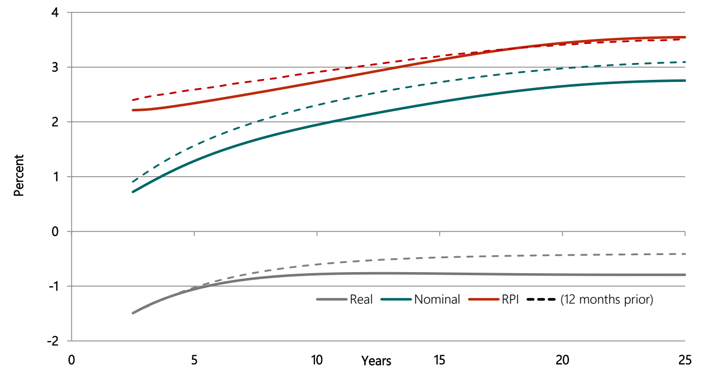


Chart 4: Gilt Spot Curves

Yield curves remain upward sloping



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

	Latest	Previous		Latest	Previous
CPI increase (annual change)	-0.1%	0.0%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	79.9%	81.6%	**$/£ exchange rate**	1.54	1.51
Halifax house prices (monthly change)	-0.9%	2.7%	**VIX (volatility) index**	15.07	24.50

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 funds: does size matter?

Pension funds come in all shapes and sizes, from small schemes with a few million pounds under management, to large schemes with thousands of members and billions of pounds under management. But which structure delivers better outcomes? For instance, do large schemes take advantage of economies of scale so that running costs are much lower per member? On the other hand, are small schemes more nimble and able to engage in active management?

Costs

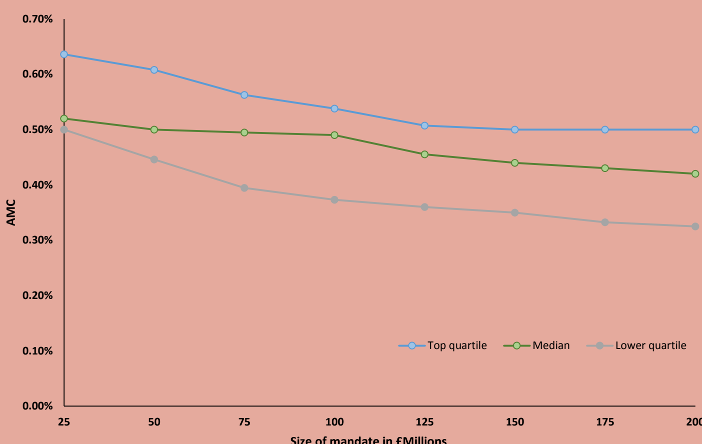
The first and possibly foremost issue is the cost of running the scheme. Management costs have long been maligned for reducing returns for investors. These costs comprise: administration, investment management, and other costs (i.e. actuarial & legal fees). 2014 research by The Pensions Regulator looked into the costs of 316 private sector defined benefit schemes. It found that the average running costs per member for very large schemes (5000+ members) was £182, whereas for medium sized schemes (100-999 members) it was £505.In particular the report found that larger schemes had significantly lower costs of administration and investment per member.

Box 1 highlights, in particular, the relationship between the size of the pension fund and its outlay on investment management costs - in particular we can see that larger funds benefit from lower investment management costs, likely due to economies of scale and increased bargaining power. Funds can find it difficult to compare and benchmark their investment fees as these are generally regarded as the least transparent cost area for schemes and there is a noticeable difference across different mandates and asset classes. However new regulation (MiFID II) being introduced in 2017 may address this by requiring more transparency in costs. When looking at costs it is also important to consider net returns. There may be an argument that higher fees are rewarded with higher returns, hence net returns can be higher despite the higher costs.

Box 1: Investment fees

The chart below shows that, for equities, larger mandates tend to be subject to lower investment management fees for similar investments. The chart looks similar for other asset classes.

(Source: LCP Investment Management Fees Survey 2015)



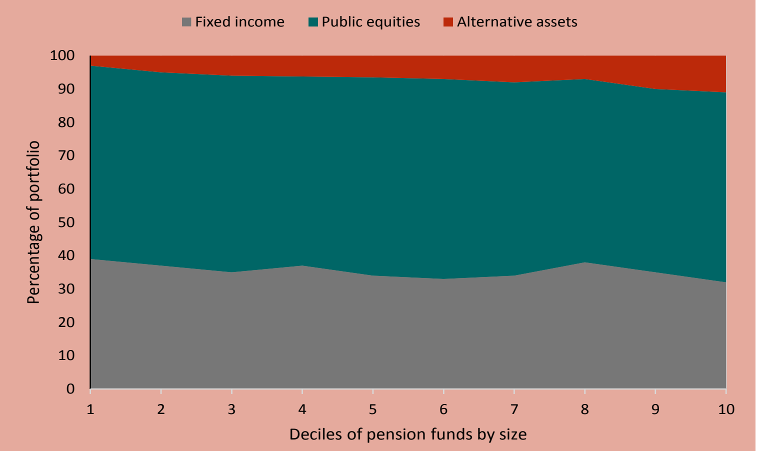
Access to financial products

Another potential issue for smaller pension funds is their ability to access certain alternative asset classes. Frank Driessen, CCO of Aon Hewitt Netherlands, says that “we don’t believe small funds have access to the same investment opportunities as larger funds”. This is generally the case due to smaller pension funds finding it difficult to diversify in asset classes with high average unit volumes or to justify the higher governance and access costs against potential benefit. This can harm small funds ability to diversify their assets.

Box 2: How does investment vary by scheme size?

A 2011 study by two University of Toronto academics considered this among other things. Using their data set of US, Canadian, European, and Australian/New Zealand defined benefit pension assets, they found that larger schemes diversify to a greater extent from fixed income and equities to alternative assets.

(Source: Is Bigger Better? Alexander Dyck and Lukasz Pomorski)



For instance alternative asset classes and derivatives may be used as part of a liability driven investment strategy. Larger funds are more able to have the resources and know-how to create a strategy tailored to their needs. Small pension funds have a comparative disadvantage here and may struggle to gain the precision needed to hedge effectively.

It’s not all bad for small funds though: a 2001 paper by Beckers and Vaughan (investment managers) attempted to quantify any disadvantages that large asset managers have. The paper found that diseconomies of scale can arise due to a lack of flexibility to implement certain strategies, difficulty trading in and out of large positions, and trade execution creating adverse price movement in the market.

The importance of good governance

There is evidence that points to the benefits of both smaller and larger pensions schemes. Ultimately, the performance of pension schemes is likely to be reliant upon good governance, and this can be found in large or small schemes. This entails a spectrum of controls aimed to ensure that risks are consistently identified, evaluated and managed effectively.

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