Government Actuary's Department

# Investment News

## Monthly Bulletin from the Insurance & Investment Team

May 2017

## Last Month in Brief

On Tuesday 18th April Theresa May, the UK's Prime Minister, called for a general election to take place on 8th June 2017. The market reaction to this announcement saw the pound rise by 2.7% to $1.29. This gain reversed some of the downward pressure on the pound, present since the referendum on the UK's membership of the European Union in June 2016. Meanwhile, Emmanuel Macron, an independent centrist with a reformist agenda, was elected President of France in a runoff early in May. Markets had been largely expecting Macron's victory, although the euro rose following the official announcement.

The UK Markit/CIPS Purchasing Managers' Index increased to 55.8 in April, from 55.0 in March. Any figure above 50 denotes growth in the economy. This was the sharpest monthly increase in business activity since December 2016, largely attributed to strong performance in the services sector. Job creation also grew to a four month high, largely attributed to renewed pressures on operating capacity. However, according to the initial estimate from the Office for National Statistics the UK economy grew by just 0.3% in the first three months of 2017, the slowest growth rate since the first quarter of 2016. The weak growth was largely attributed to the impact of rising prices on household spending.

In April the NASDAQ stock market breached the 6,000 mark for the first time. The index, which is composed mainly of technology firms such as Apple, Google and Microsoft, has outperformed the broader S&P 500 so far this year.

Chart 1: Equity Indices

Equity markets were volatile towards the end of April


Chart 2: Sterling Credit Spreads

Credit spreads were stable over the month

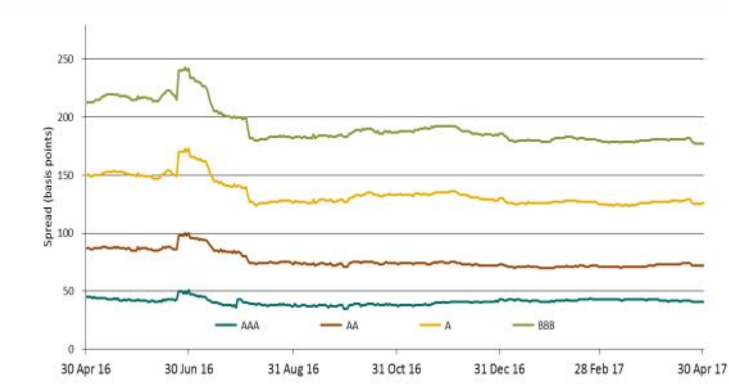



Chart 3: Gilt Yields

Nominal gilt yields were stable over the month

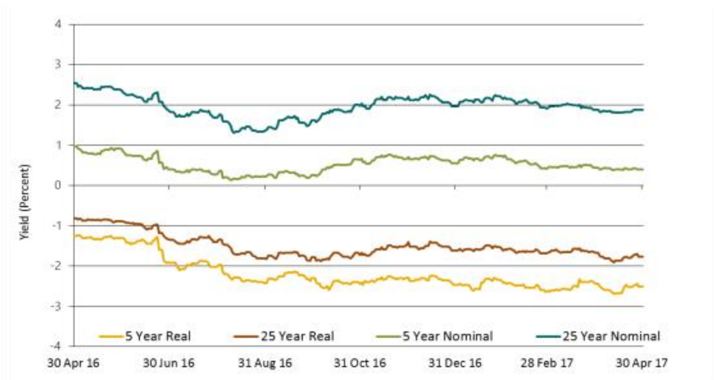
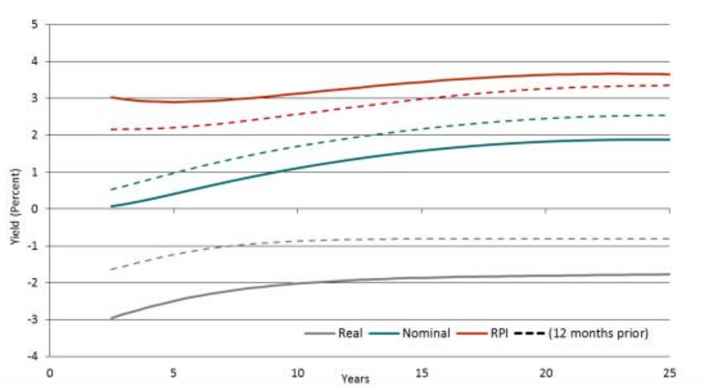



Chart 4: Gilt Spot Curves

The yield curve remains upward sloping




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

| | Latest | Previous | | Latest | Previous |
|---|---|---|---|---|---|
| **CPI (annual change)** | +2.3% | +1.8% | **Base rate** | 0.25% | 0.25% |
| **PPF 7800 funding ratio** | 86.2% | 88.2% | **$/£ exchange rate** | 1.25 | 1.24 |
| **Halifax house prices (monthly change)** | +0.1% | -0.9% | **VIX (volatility) index** | 12.37 | 12.92 |

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

# Mergers and Acquisitions

In March, the European Commission officially blocked London Stock Exchange's merger with German stock exchange Deutsche Boerse. The £21 billion deal would have combined Europe's two largest stock market operators, with the market capitalisation of the exchange second only to the New York Stock Exchange. The EU competition regulator said the deal would create a "de facto monopoly in the crucial area of fixed income instruments". This is the third time that a proposed merger between the companies has failed.

The last couple of years have seen record levels of mergers and acquisitions (M&A) activity (see figure 1), but also increased concern about its possible negative effects.

## What are mergers and acquisitions?

Mergers and acquisitions (M&A) are the processes by which companies are consolidated. In a merger two companies are combined to form one, while in an acquisition one company is purchased and taken over by the other.

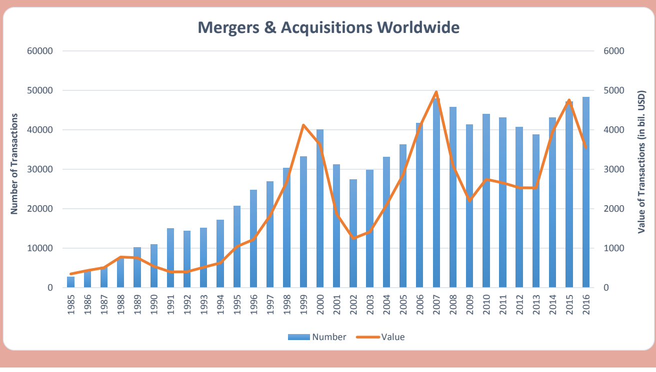
One reason for M&A activity generally given is that combining two companies together creates more value for shareholders compared to each operating individually. This can be attributed to increased cost efficiency through implementing economies of scale.

Investment banks and their client companies continuously seek new opportunities both directly and indirectly through M&A. They aim to capitalise on inefficient share pricing caused by perceived over- or under-reaction by the market to the announcement of M&A.

Research has shown as technology and banking processes have advanced, which make transactions more effective and efficient, mergers and acquisitions have become more frequent today than ever before.

**Figure 1: Growth in the M&A market**

Data Source: Institute for Mergers, Acquisitions & Alliances




## Risks of mergers and acquisitions

American International Group conducted a study into M&A deals and noted the frequency of claims against asset and liability misrepresentation has increased. This can be attributed to the increased likelihood of an unknown liability being present in higher valued M&A transactions. The study found that one in four policies written on deals with a value of more than $1 billion end in a claim.

A merger does not always generate success. Mergers can result in a loss of value because of problems that arise in the combining of forces. This can be through technological incompatibility, duplication of roles and more general inefficiencies.

Another risk associated with mergers is monopoly concerns. The European Commission, the United States Department of Justice, and the US Federal Trade Commission have the power to deny a merger in anti-trust cases that signal a monopoly or a negative impact on the market (see figure 2). Smaller business mergers do not necessarily share the same risks.

**Figure 2: M&A deals withdrawn or terminated**

Data Source: Bloomberg


Business acquisitions or takeovers share many of the same risks as a merger. There is the additional risk that the takeover may be perceived as hostile or unwanted by the target company's shareholders. During a hostile takeover the acquiring company may be forced to pay a substantial premium over the market value to force the deal, thus eradicating the value of the deal.

The target company may be forced to buy shares back at a substantial premium to prevent a takeover if the acquiring company has already bought a sufficient stake. This process is known as greenmail.

## Effect on pension schemes

Pension schemes are affected by mergers and acquisitions both as investors in companies affected by them, and also by their sponsor organisations being subject to M&A activity.

Potential suitors need to bear in mind that their purchases could trigger large employer debt payments to a pension scheme, as the M&A activity can trigger what is classed as the winding up of the original sponsor company - meaning that outstanding liabilities must be settled.

Concerns have also been raised recently that M&A activity has been used to help companies in minimising their pensions obligations. Lady Barbara Judge, ex-chair of the Pension Protection Fund, has said that The Pension Regulator should be given the power to block companies from closing deals that would harm pension scheme members.

The rising cost of pension liabilities and the complexity of associated regulations indicates the importance of this issue to potential M&A companies is likely to continue to grow.



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