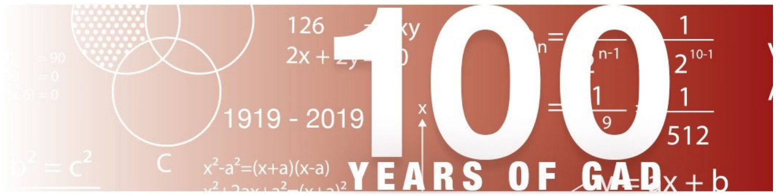
Government Actuary's Department

Investment News



Investment & Risk Bulletin

March 2019

Last Month in Brief

Global companies paid out record dividends in 2018 despite fears over global economic growth. Although many UK companies have seen their shares slip in recent months they continue to pay out high dividends. Yields are therefore running at an all time high but investors remain cautious amidst Brexit related uncertainty. At a basic level UK pay-outs rose 8.8%, ahead of the global average of 8.5%.

Corporate bond markets recovered from a short period of volatility after the Federal Reserve raised the possibility of a downward move in base rate, to produce their best start to the year in two decades. The Fed's change of position reflects rising concerns over flagging global growth, just three months after the central bank last raised interest rates. A popular high-yield bond index run by ICE Data Services has returned 5.6 per cent so far this year, its highest return since 2001.

JPMorgan Chase has created the first digital currency running on Blockchain technology to be backed by a major US bank. The introduction of a bank backed crypto-currency poses regulatory challenges and some question its purpose as it lacks the main advantage offered by crypto-currency of decentralisation.

Chart 1: Equity Indices
All markets generally continued to rise over the month, building on the gains from the previous month.

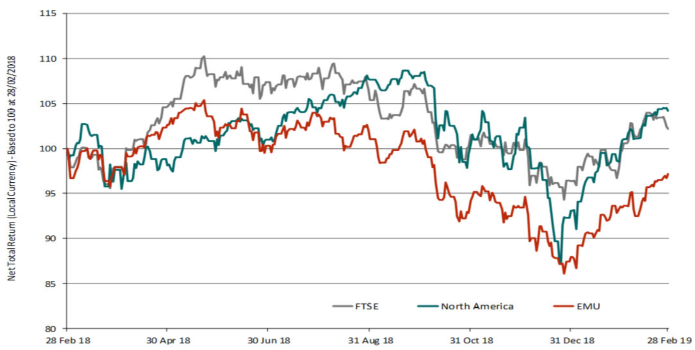


Chart 2: Sterling Credit Spreads
All spreads fell steadily over the month.

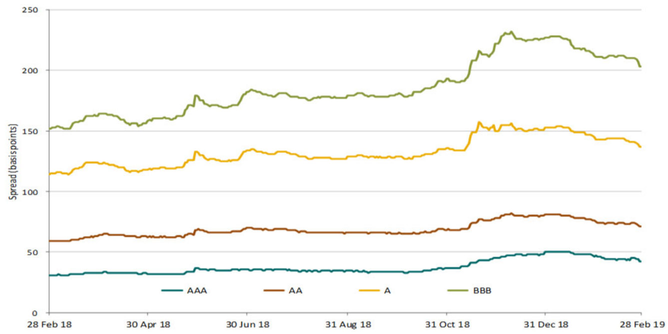


Chart 3: Gilt Yields
Real and nominal gilt yields for 5-year and 25-year bonds were mostly stable over the month before finishing slightly higher than the current month levels.

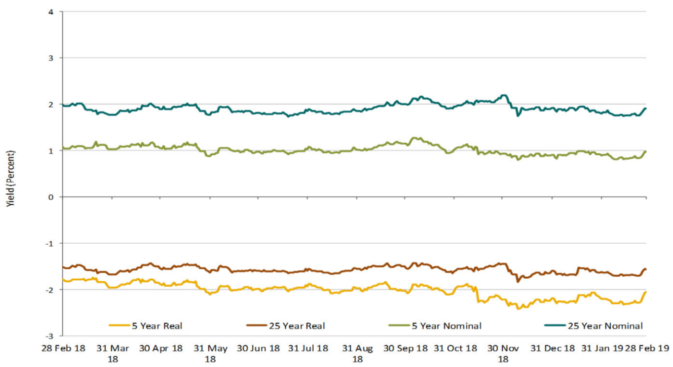
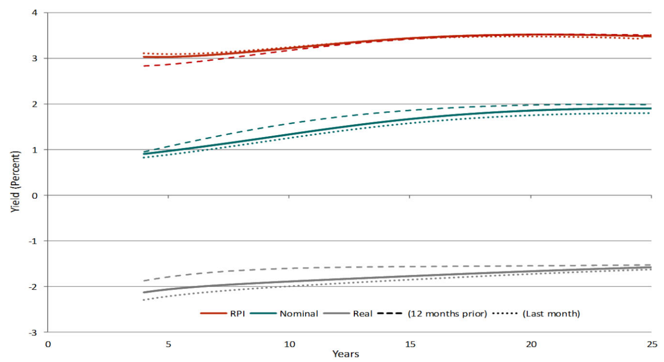


Chart 4: Gilt Spot Curves
The nominal and real gilt yields were generally higher than the pervious month over all durations.



Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous		Latest	Previous
CPI (annual change)	1.8%	2.0%	**Base rate**	0.75%	0.75%
PPF 7800 funding ratio	98.6%	98%	**$/£ exchange rate**	1.33	1.31
Halifax house prices (monthly change)*	+5.9%	-2.9%	**VIX (volatility) index**	14.78	16.57

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

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

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The decline of physical retail and the impact for pension schemes

Is Physical Retail dead?

Physical retail has faced a number of struggles over the past few years, with many top retailers now having to reassess their strategies in order to deal with multiple challenges. One of the major challenges faced by physical retailers is rapid growth of a major competitor, online retailers, in an industry which they once dominated.

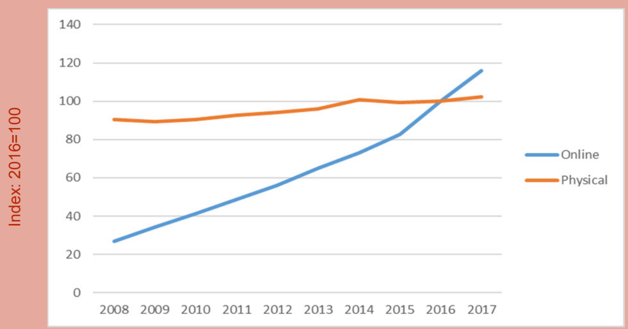
A fall in the number of new stores opening, the closure of existing stores and the growth in e-commerce have led to increased interest in how customers are behaving, with the aim of determining how physical retail can continue to compete.

What is causing this?

Challenges from online retailers, led by Amazon, have meant that the business models of retailers have had to be reassessed.

Even though 2017 saw a growth in sales for both online and physical retail in comparison to previous years, the online spending is growing at a faster rate. Online stores had an increase of £8.2 billion from the previous year – from £51.6 billion to £59.8 billion. Whereas physical retailers saw a 2.4% increase, of around £7 billion, from £299 billion in 2016 to £306 billion in 2017 (see Figure 1).

Figure 1: Annual store-only sales and online-only sales, non-seasonally adjusted



Source: ONS – Great Britain, 2008 to 2017

In addition, weak currency, liabilities of legacy pension schemes and outstanding debts have caused significant issues for retailers.

What are CVAs?

Company voluntary arrangements (CVA) have been used by some retailers in an attempt to prevent company insolvency. These are designed to help the company continue trading whilst ensuring that creditors are fairly repaid by means of an 'arrangement'. The CVA will offer an amount of debt to repay and a payment schedule.

To be eligible for this, a CVA must be submitted to the court and a shareholders and creditors meeting will be scheduled. The CVA is only valid if the proposal is approved by 75% of creditors and 50% of shareholders. For companies that remain at risk of becoming insolvent, options to try to rectify this will only be supported if they provide a solution rather than increasing any deficit or pension fund liabilities.

Mothercare and Toys R Us entered into CVAs to improve cashflow and relieve pressure from debts in an attempt to continue trading. Whilst Mothercare was able to restructure successfully, Toys R Us was unable to climb out of insolvency.

Considerations for pensions schemes

For trustees of pension schemes sponsored by retailers, the challenges faced and the speed with which fortunes can change reinforce the importance of assessing the strength and willingness of the sponsor to support the scheme.

However it's not just pension schemes sponsored by retailers that are likely to be affected by changing shopping habits. One of the most prominent debts for retailers is often the long-term leases that many physical stores are locked into. These 25-30 year leases were signed when it was viewed that retail would be perpetually successful, meaning that rent increases have become increasingly burdensome.

Landlords on these properties are often ultimately institutional investors—who view the long term inflation linked cashflows as a good match to the pensions they are funding. The risk of insolvencies and renegotiated rental agreements means that there is a real risk that returns on parts of their portfolio may be significantly impacted.

Is Physical Retail really dead?

In the midst of a transitionary period, retail itself is trying to adapt and restructure to modern day shopping habits. A combination of physical and online retail will drive the future of the retail sector.

For instance, the 'Halo effect' is the positive impact that a physical store can have on the surrounding environment. The opening of a new store can have a positive effect on both the store itself and those nearby; retailers with a smaller portfolio may see a significant positive impact in online sales as well as store sales as the awareness of the company is improved. In the long term, the more stores the company has the less beneficial it is to open a new store. However, the store itself will remain important in developing the brand image and awareness as part of the 'Halo effect'.

The retail industry both physical and online are both very much alive, with continued growth year on year. Whilst the physical and online retail industries are at different growth stages and therefore grappling with different challenges, over the longer term they are likely to be able to co-exist as they provide the consumer with different experiences.

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