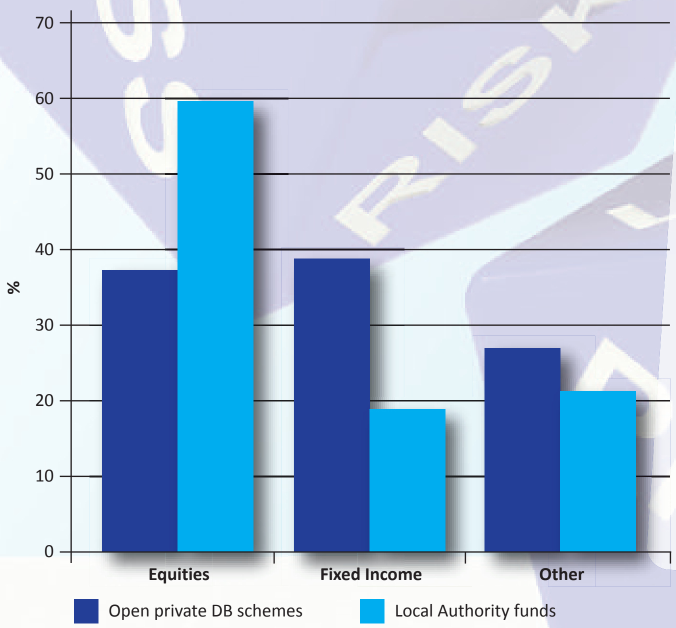
Investment Insight: Equities vs Bonds?

The Less Brave World of Low Returns

May 2013

Defined benefit: **Yes**
Defined contribution: **Yes**

Chart 1: NAPF Annual Survey 2012: Weighted allocations for Local Authority funds vs open private DB schemes*



** Percentage of assets across all funds (aggregated)*

What is the issue?

Our second edition of the Investment Insight series attempts to gaze into the investment crystal ball to consider the potential medium to longer term investment returns for UK pension schemes.

Prior to 2011 many of our defined benefit (DB) fund members had already been increasing their allocation into fixed income assets, particularly inflation-linked gilts, as part of their derisking strategies. Those schemes will have been relatively well positioned to benefit from rising bond prices as the UK's safe haven status and the effects of Quantitative Easing (QE) took hold during the financial crisis.

Since 2011 the prices of gilts have headed higher, making it increasingly difficult for other schemes to derisk. In recent discussions with our fund members, we have heard growing frustration that, partly due to the regulatory environment, pension schemes are forced buyers of gilts with low or negative real yields. Local Authority funds have consistently held around 60% of their portfolios in equities over the last ten years at a time when private DB schemes have shifted towards fixed income. (Chart 1)

Will the recent rally in the equity markets and a greater degree of flexibility from the Pensions Regulator encourage more DB pension schemes to hold onto or add to their equity holdings?

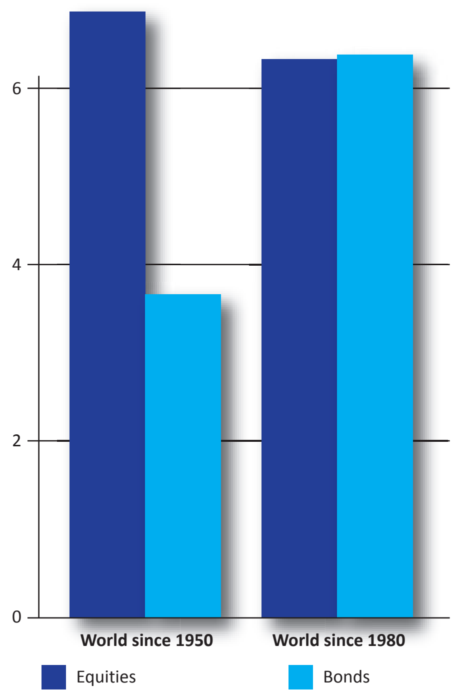
During the course of this analysis, we will also consider the implications for defined contribution (DC) schemes.

NAPF
Securing the future of pensions

What does history tell us?

This piece draws on the annual long term analyses produced by Credit Suisse[1] and Barclays[2], which include data spanning over a hundred years. What we aim to do is summarise the key investment themes and place these within the regulatory context faced by pension schemes. Credit Suisse has compared equity and bond returns since 1950 and since 1980. From 1950 to date, the annualised real (after inflation) return on world equities was 6.8%, whilst from 1980, it was 6.4%. The corresponding world bond returns were 3.7% and 6.4% respectively (chart 2). Even cash gave a reasonably high annualised real return averaging 2.7% since 1980. Bond returns have been particularly high in the last thirty years. Since 1980, returns on world bonds just out-stripped world equities but, looking at the noughties in isolation, equities delivered real returns of practically zero, whilst real bond returns stayed at over 6% per year. What we may conclude from this analysis is that we should be cautious about allowing past performance to condition our aspirations of future returns. Bond returns, particularly in the last 13 years, have been extraordinary: will we have it so good going forward?

Chart 2: Annualised real returns on equities and bonds (%)



Source: Elroy Dimson, Paul Marsh, Mile Staunton, DMS database

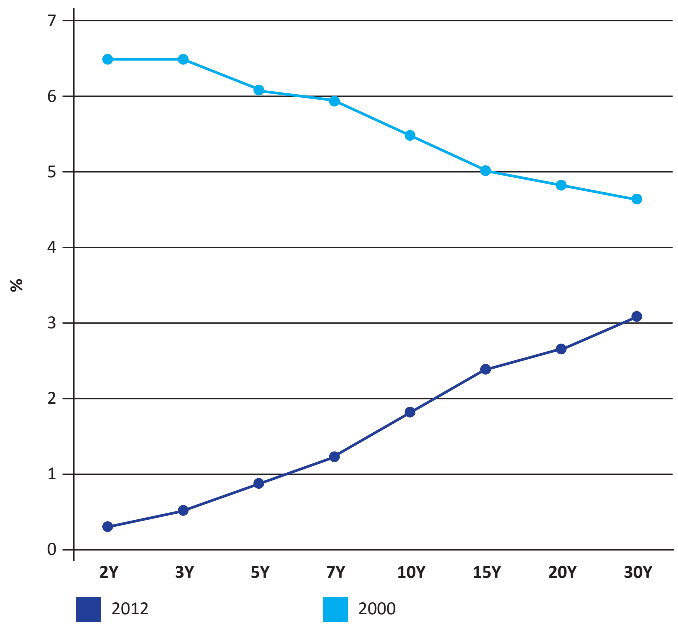
Where to next?

Government bond yields in many countries have fallen to all-time lows with real yields on inflation linked bonds in a number of countries turning negative. Since 2000 real yields have fallen by a staggering 4%. So what are bond markets pricing in for the future? We can perhaps glean some insight if we look at the shape of the gilt yield curve, which plots the yield for a range of different maturity bonds. In 2000 the UK yield curve up to 30 years maturity was downward sloping, believing future interest rates and inflation expectations were on a downward path. Today's gilt yield curve is a very differently shaped animal as 30 year gilt yields are around 3% whilst 2 year gilts stand at 0.3% (chart 3). This implies that the trajectory for future interest rate movements is expected to be up, but stopping short of the pre-2000 levels. Inflation linked gilts are however seeing negative real yields across the curve which suggests that real rates are expected to be near zero for many years to come. But given the kaleidoscopic investment world we live in, can we really predict where rates will be over the longer term, or even for the next few years?

[1] Credit Suisse Global Investment Returns Yearbook 2013

[2] Barclays Equity Gilt Study 2013

***Chart 3**: UK yield curve change*



Source: Bloomberg

Today's low yields reflect a number of drivers, some of which may prove temporary, but many, based on more structural factors, may well be permanent. Central Bank policies, the quest for safe haven assets, the lower tolerance for holding risk, regulatory pressures and demographics have all played a role in distorting and suppressing bond yields. None of these factors look likely to diminish: the threat of further regulatory pressures from Europe looms large; both public and private sector DB pension funds are maturing; demographic changes continue to drive an ageing population increasing the demand for low risk income producing assets; and the economic outlook at home and abroad remains uncertain. All of these factors are likely to maintain an underlying appetite for bonds.

There is a clear relationship between current real interest rates and the future real returns for both bonds and equities. The expected equity return is based on the expected risk free cash rate plus the required equity risk premium. Equity risk premia differ significantly across countries and vary over time frames: Credit Suisse concludes that investors should expect a future equity premium of around 3% above cash; whilst Barclays believes that the equity risk premium is higher at 5.5% over the medium term.

What does this mean for expected returns?

After taking account of inflation (expected to be around 2.5% over the medium term), Barclays expects cash to return -1.5% per annum, government bonds about -2% per annum and equities 3-4% per annum over the next five years. Credit Suisse expects, in real terms, a real cash return of just below zero, government bonds around -1.5% and equity returns of around 3% over the long term. If these returns come to pass, then Houston, we may have a problem…

Whilst many investors are hoping that returns revert to 'normal' over the medium term, the worry is that the last thirty years are unlikely to have been normal. According to Towers Watson, projected pension investment returns in the UK stand at a nominal 6% per year. With interest rates near zero, is this realistic?[3]

> "Assuming that growth and inflation recover, the major risk facing Pension Funds is that they are locking in the current low levels of yields and will face capital losses on their bond positions"
>
> ***Robert Parker***
> *Senior Advisor, Credit Suisse*

What about the regulatory pressures on DB funds, aren't they stuck between a rock and a hard place?

DB schemes have been under pressure across the globe and a number of countries, including the US, Sweden and the Netherlands have taken remedial action to soften the impact of falling government bond yields and associated low discount rates on scheme funding levels. In the UK, the Chancellor has recently announced a new statutory objective for the Pensions Regulator (TPR)[4] "to minimise any adverse impact on the sustainable growth of an employer". TPR itself has recently issued new guidance[5] for private sector DB schemes that might ease the perceived pressure on DB schemes to buy gilts to hedge away inflation and interest rate risk. For example, TPR's latest statement notes that 'Trustees can use the flexibility available in setting the discount rates… The assumptions made for relative returns of different asset classes may rise or fall from preceding valuations'.

3 Towers Watson 2012, 2012 Global Survey of Accounting Assumptions for Defined Benefit Plans
4 The Pensions Bill 2013
5 Defined Benefit Annual Funding Statement 2013, The Pensions Regulator.

The 2013 statement makes clear that trustees can use the flexibility available in setting the discount rate to calculate future liabilities (known as 'technical provisions'), based on the prevailing yield of the scheme portfolio and / or the yield on Government or high-quality bonds, to best fit their scheme circumstances.

What does this mean for the DC world?

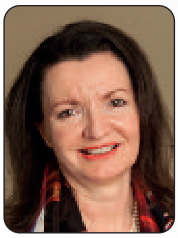
In many countries, regulators set guidelines for the claims that financial product manufacturers and distributors can make about what constitutes a plausible expected return. In the UK the FCA (previously FSA) currently stipulates projections based on nominal returns of 5%, 7% and 9% before costs for a notional DC product that is two-thirds invested in equities, one third in fixed income assets. From 2014 onward they will reduce these assumed returns to 2%, 5% and 7%. As part of the recent introduction of automatic enrolment for private pensions in the UK, the Department for Work and Pensions' analysis has previously assumed a return that exceeds the latest mid-range projections provided by the FCA[5]. So to achieve the same outcomes as the reforms originally intended, higher pension contributions may be required in future. Annuity rates have been falling in the UK, tied closely to movements in gilt yields, longevity improvements, rising costs and capital requirements. This has increased the interest in alternative income drawdown vehicles (other than annuities) that can hold at least some of the DC fund in growth assets in the run-up to, and beyond, retirement. Whilst many retirees will still have a strong appetite for the fixed, secure stream of income that an annuity provides, we would expect the interest in more flexible products to continue to grow.

Every cloud has a slither of a silver lining…

An interesting twist of a low return world is that fees charged by asset managers and consultants could also come down over time. The argument for this is that in a world of low returns a larger share of the gross real return will be taken up in fees unless these are moderated downwards.

To conclude…

Investing is hardly 'like watching paint dry or watching grass grow' (Paul Samuelson, economist and Nobel prize winner 1915-2009)[6]. Pension fund trustees are walking a tightrope, balancing the quest for investment returns and managing regulatory pressures. A strategy that is fast developing amongst our members is to diversify into assets that have a superior return to gilts or inflation linked gilts but have liability matching characteristics. We have seen a pick up in interest in such assets as infrastructure, social housing and ground rents. Trustees are doing their utmost to stay on the tightrope of this new world of potentially low returns.



If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our investment specialist: **Helen.Roberts@napf.co.uk.**

[5] DWP Security in retirement: towards a new pensions system. May 2006

[6] Samuelson quoted in P. Farrell "The lazy person's guide to Investing."