Quarterly Investment Bulletin

September 2020

Introduction

Q3 2020

Welcome to the first edition of Capita's quarterly investment bulletin!

In it, you'll find information and data across a variety of investment markets, helping to keep you informed.

It also includes an article, written by one of our expert investment consultants, highlighting key issues that schemes are facing.

I have recently joined Capita as Head of Investment Consulting and I am excited to hear your views and ideas for future articles. So please get in touch.

Lydia Fearn

Lydia.Fearn@capita.com

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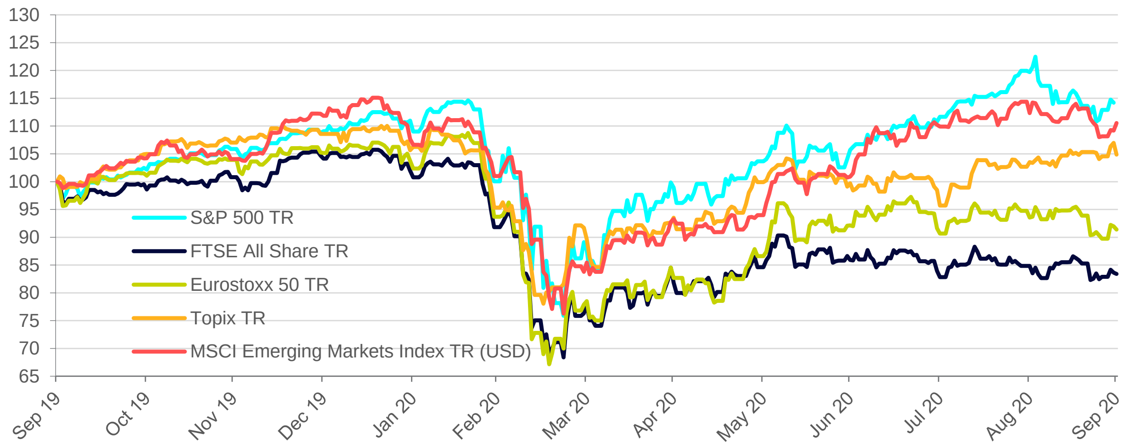
Global equities continued bounce back with another positive quarter

Figure 1: Equity market returns (rebased at 100) [1]



Source: Bloomberg, Capita

Equity Markets	Percentage Change				
Index	**30/09/2020 (Price)**	**1 Month**	**1 Quarter**	**YTD**	**1 Year**
S&P 500 (TR)	6,919	-3.8%	8.9%	5.6%	15.1%
FTSE ALL-Share (TR)	6,276	-1.7%	-2.9%	-19.9%	-16.6%
EuroStoxx 50 (TR)	6,908	-2.3%	-0.8%	-13.1%	-8.6%
Topix (TR)	2,536	1.3%	5.2%	-3.4%	4.9%
MSCI Emerging Markets Index TR (USD)	521	-1.6%	9.6%	-1.2%	10.5%

Source: Bloomberg, Capita | [1] Total returns in local currency

- Global equities generally made gains in the third quarter of 2020. Most major indices made positive returns over the quarter, except for the European and UK equities.

- US equities posted a strong quarter of positive performance, rising by +8.9%, despite a disappointing month in September. This means that the S&P 500 index is now up by +5.6% since the beginning of the year. This is a much-welcomed recovery following the Coronavirus pandemic, which saw the index fall by nearly 20% over Q1 2020.

- With continued domestic political and economic uncertainty in the UK, the FTSE All-Share index returned -2.9% over the quarter. The UK equity market is now at -19.9% since the start of the year due to the pandemic's significant impact.

- In the Eurozone, the EuroStoxx 50 index returned -0.8% over the quarter, showing that the Eurozone's economic recovery has slowed down in recent months. Much like the UK, European equities are still at negative levels since the start of the year, down by around -13.1%.

- In Japan, the Topix index made very strong gains over the quarter, returning around +5.2%. The Japanese equity market is down at around -3.4% since the beginning of the year; however, given the current economic climate, this is significantly better than some of their peers around the world.

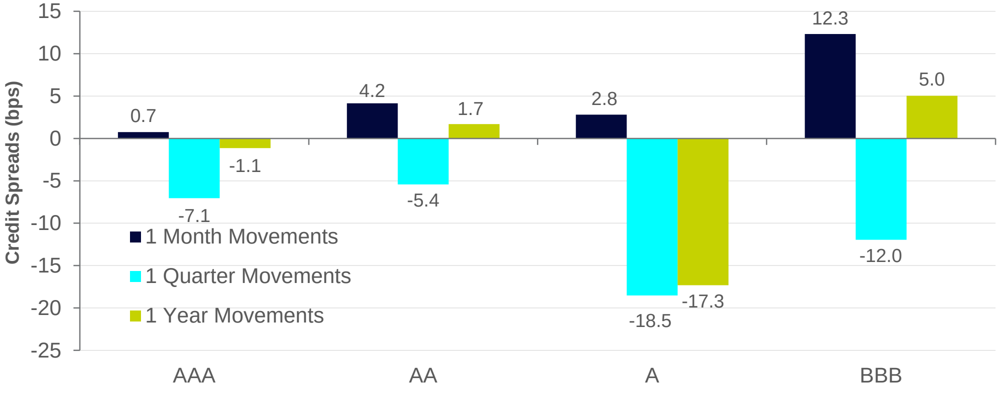
- In emerging markets, the MSCI Emerging Markets Index returned +9.6% over the quarter – the most of all major indices shown. However, year-to-date levels are still negative at around -1.2%.

Corporate bond spreads contract Q3

Corporate credit

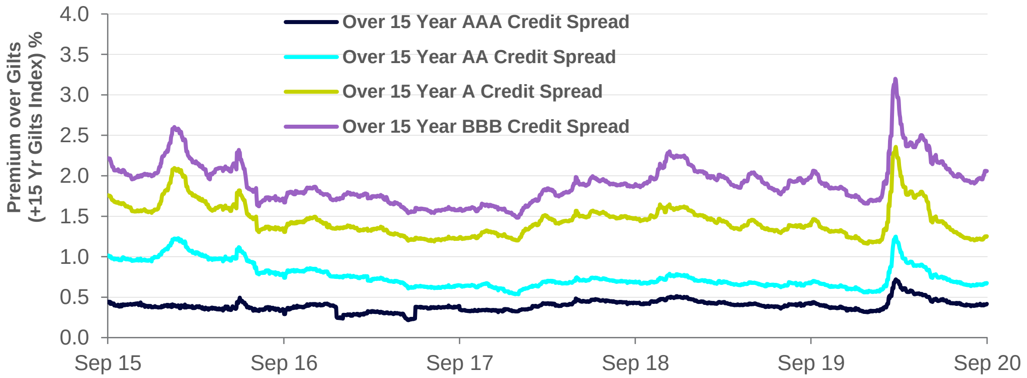
- UK corporate bond spreads narrowed significantly over the quarter for investment grade credit universe. This was particularly seen at the lower ratings.
- UK high yield continues to provide a more attractive rate of return compared to UK gilt yields. The drawback of using corporate debt for pension schemes, however, is that they tend to offer a lower duration than gilts, which means that they are less effective when it comes to liability matching.
- Decreased credit spreads on lower rated bonds over the past quarter may reflect investors moving from safer instruments into corporate bonds, as global markets and business / consumer confidence gradually picked up following the Coronavirus pandemic.

Figure 2: GBP corporate bond spreads over gilts by rating (change over month / quarter / year)



Source: Bloomberg, Bank of America Merrill Lynch, Capita

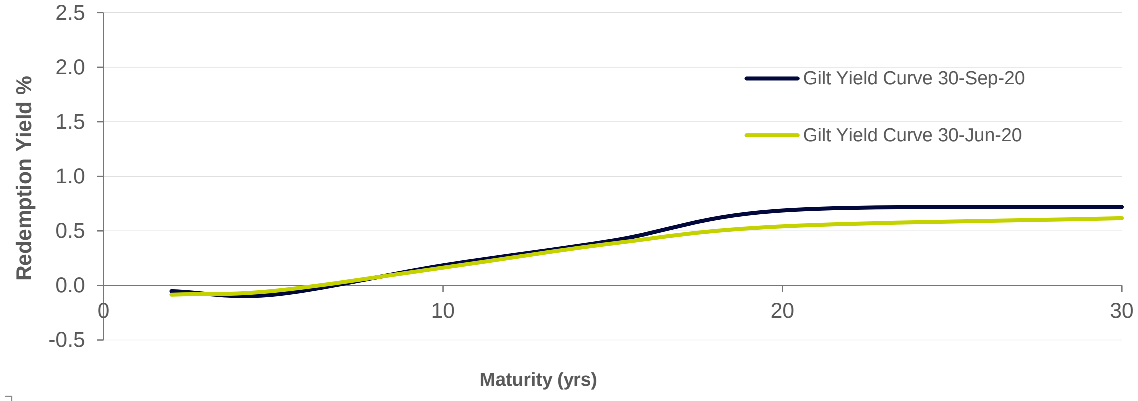
Figure 3: GBP corporate bond spreads over gilts by rating (historic)

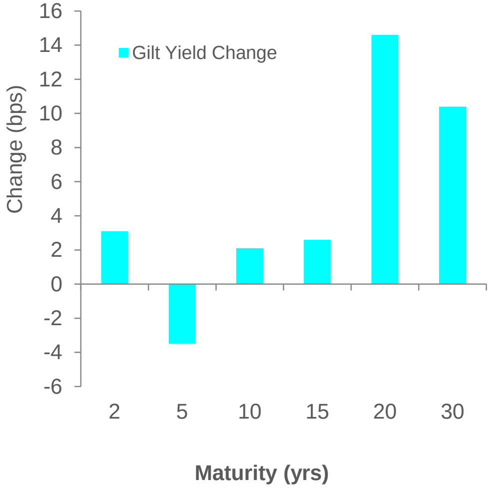


Source: Bloomberg, Bank of America Merrill Lynch, Capita

Nominal gilt yields increase across most of the curve

Figure 4: Nominal term structure of gilts





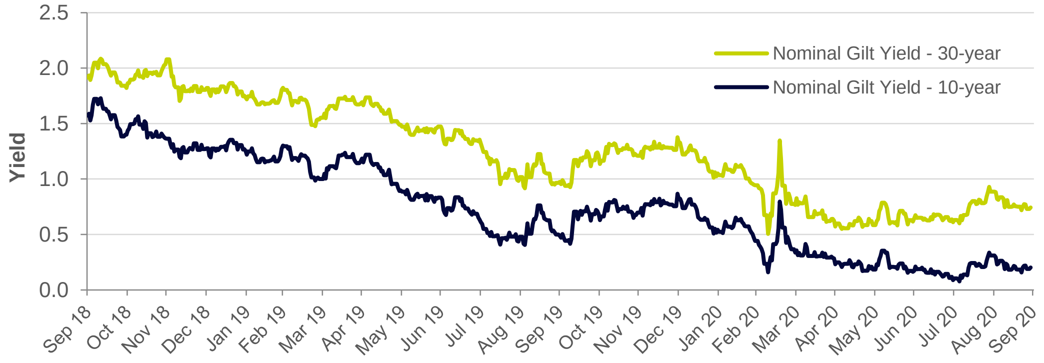
Source: Bloomberg, Capita

Nominal gilt yields	Maturity points (yrs)					
	2	5	10	15	20	30
Current % as at 30/09/2020	**-0.05**	**-0.09**	**0.18**	**0.41**	**0.69**	**0.72**
1 Month Change (bps)	0	-8	-13	-16	-7	-17
1 Quarter Change (bps)	3	-4	2	3	15	10
1 Year Change (bps)	-45	-39	-32	-31	-19	-25

Source: Bloomberg, Capita

[2] Gilt breakeven inflation has been calculated as the difference between nominal Gilt yields and real Gilt yields.

Figure 5: 10-year and 30-year nominal yields



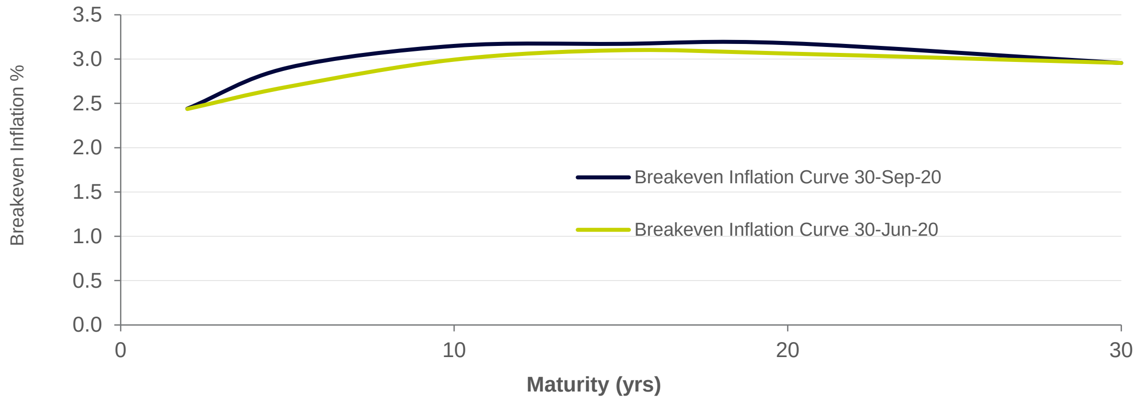
Source: Bloomberg, Capita

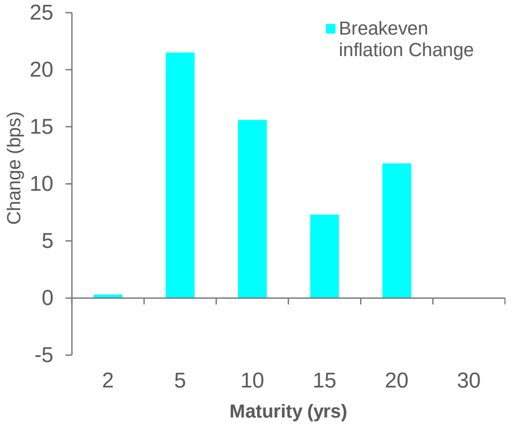
Nominal yields

- Nominal gilt yields increased across all maturities except five years, over the third quarter of the year.
- Yields remain below 1% despite recovering after the drastic decline. The recovery is welcome news for pension schemes, with funding levels being positively affected by a fall in liabilities.
- The current Bank of England base rate remains at 0.1% after being cut to the all-time low in March this year.

CPI inflation falls to end quarter at lowest level since 2015

Figure 6: Gilt breakeven Inflation [2]





Source: Bloomberg, Capita

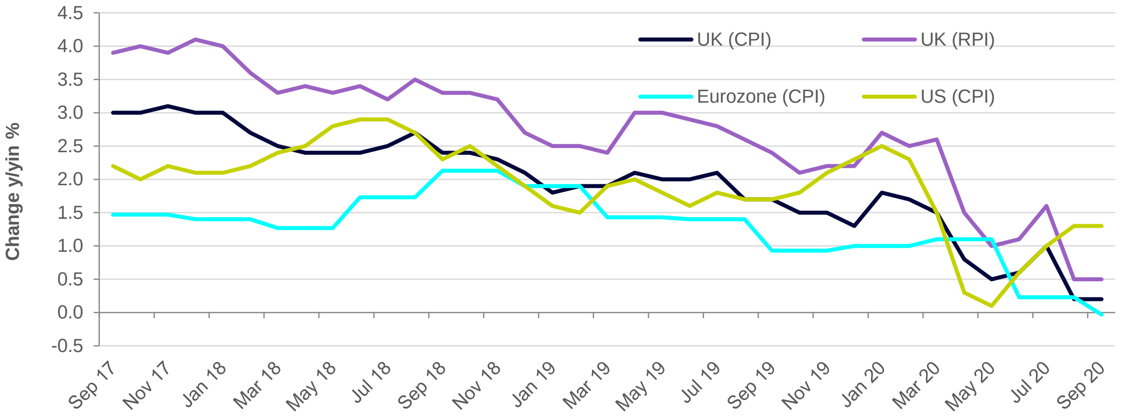
Gilt break-even inflation	Maturity points (yrs)					
	2	5	10	15	20	30
Current % as at 30/09/2020	**2.44**	**2.90**	**3.15**	**3.17**	**3.18**	**2.96**
1 Month Change (bps)	9	-9	-13	-4	2	-6
1 Quarter Change (bps)	0	22	16	7	12	0
1 Year Change (bps)	-39	-42	-35	-14	-13	-20

Source: Bloomberg, Capita

[2] Gilt breakeven inflation has been calculated as the difference between nominal Gilt yields and real Gilt yields.

Figure 7: CPI in the UK, US and Eurozone

Source: Bloomberg, Capita

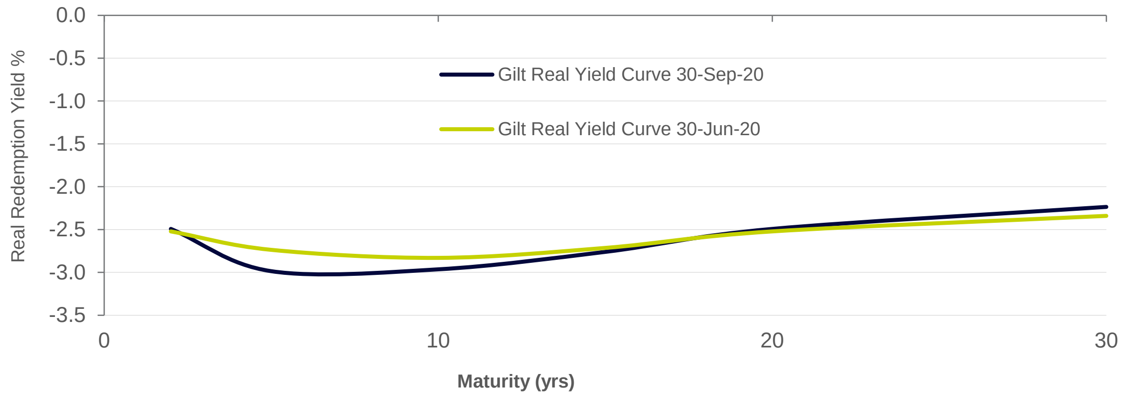


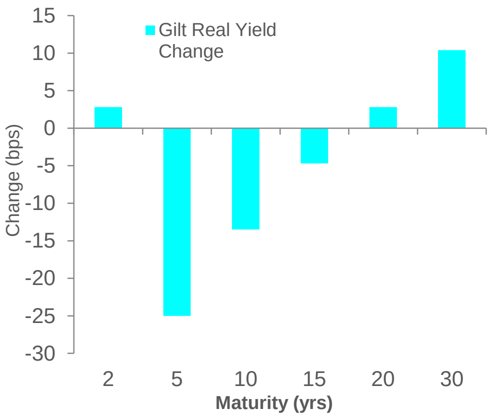
Inflation

- UK CPI inflation fell over the quarter from 0.6% at end of June to 0.2% at end of September. UK RPI was also down to 0.5%, compared to 1.1% for the end of the previous quarter.
- This is the lowest-level inflation rate the UK has seen since December 2015.
- Inflation expectations adjusted upwards across all maturity points 20 years and below, with the largest effect for the middle term, but are still lower than one year ago.

Real yields continue to fall

Figure 8: Gilt real yield[3] term structure





Source: Bloomberg, Capita

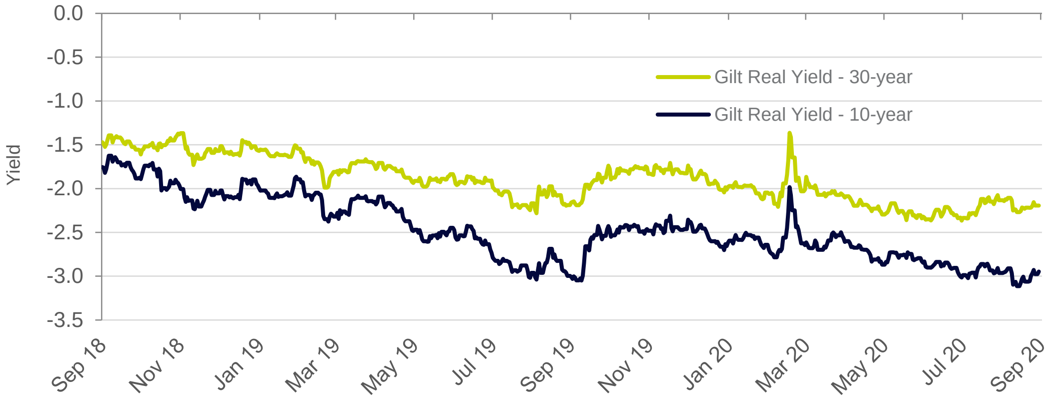
Real gilt yields	Maturity points (yrs)					
	2	5	10	15	20	30
Current % as at 30/09/2020	**-2.49**	**-2.99**	**-2.97**	**-2.76**	**-2.49**	**-2.24**
1 Month Change (bps)	-9	1	0	-12	-9	-10
1 Quarter Change (bps)	3	-25	-14	-5	3	10
1 Year Change (bps)	-6	3	3	-18	-6	-5

Source: Bloomberg, Capita

[3] Gilt real yield has been calculated as the yield on index-linked Gilts

Figure 9: 10-year and 30-year real yields

Source: Bloomberg, Capita



Real yields

- Real gilt yields remain negative for all maturities.
- Real yields and nominal yields increased for the majority of maturities, as inflation expectations also increased.

Asset class performance summary in local currency

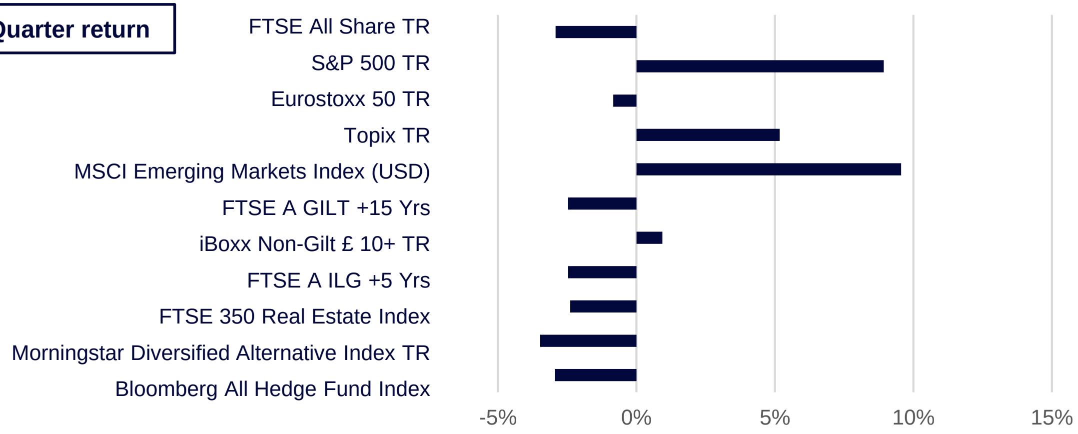
Asset class performance summary

- The charts below and the table to the right show the one-quarter and one-year performance in local currency of investments in major asset classes to the end of September 2020.
- Over the quarter, emerging markets equities was the best performing asset class.

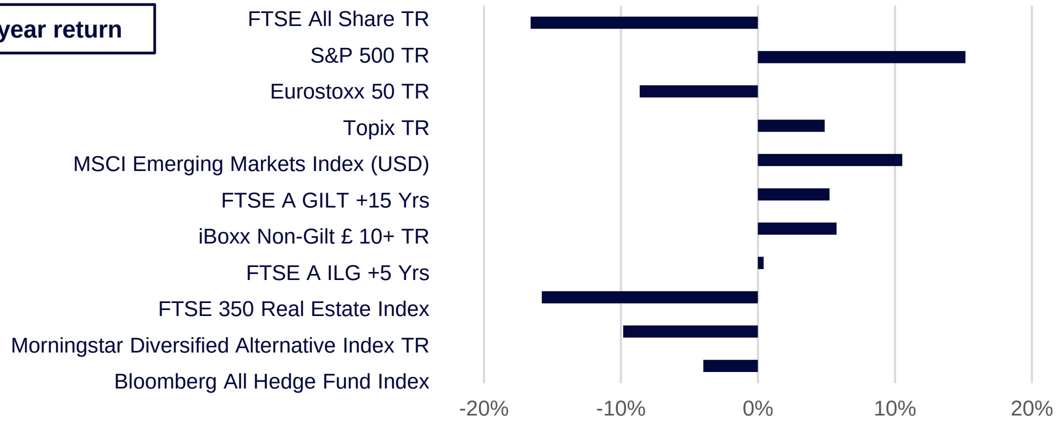
Asset class	Quarter return	1-year return
FTSE All Share TR	-2.9%	-16.6%
S&P 500 TR	8.9%	15.1%
Eurostoxx 50 TR	-0.8%	-8.6%
Topix TR	5.2%	4.9%
MSCI Emerging Markets Index TR (USD)	9.6%	10.5%
FTSE A GILT +15 Yrs	-2.5%	5.2%
iBoxx Non-Gilt £ 10+ TR	0.9%	5.7%
FTSE A ILG +5 Yrs	-2.5%	0.4%
FTSE 350 Real Estate Index	-2.4%	-15.8%
Morningstar Diversified Alternative Index TR	-3.5%	-9.8%
Bloomberg All Hedge Fund Index	-2.9%	-4.0%

Total returns in local currency | Source: Bloomberg, Capita

Quarter return



1-year return



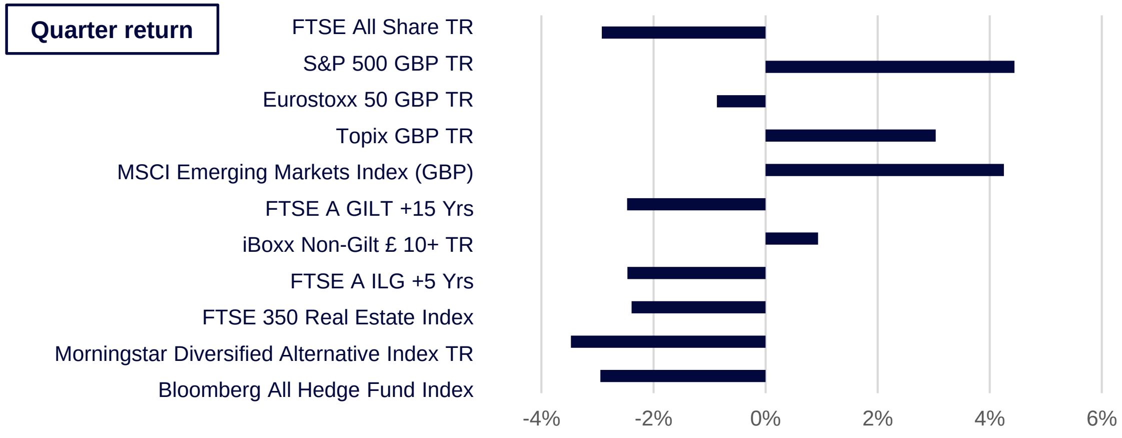
Asset class performance summary in GBP

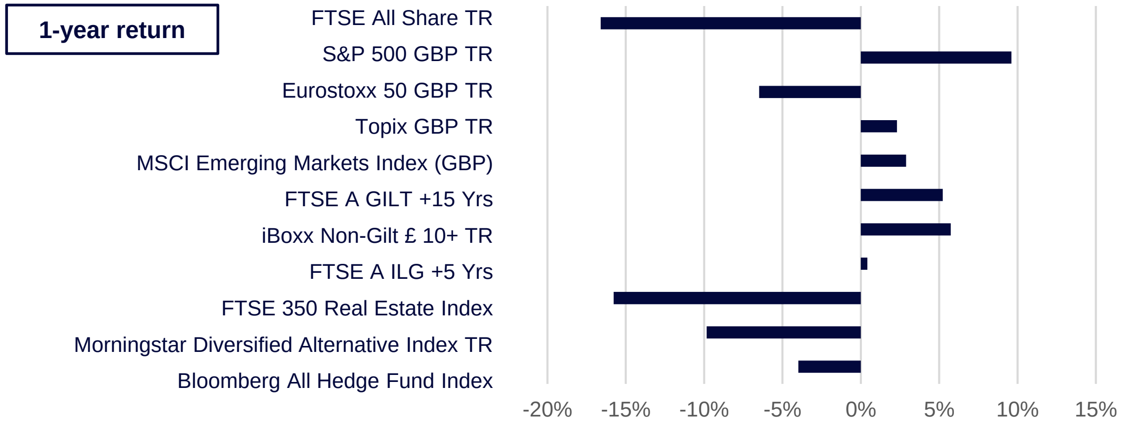
Asset class performance summary

- The charts below and the table to the right show the one-quarter and one-year performance of sterling-denominated investments in major asset classes to the end of September 2020.

Asset class	Quarter return	1-year return
FTSE All Share TR	-2.9%	-16.6%
S&P 500 GBP TR	4.4%	9.6%
Eurostoxx 50 GBP TR	-0.9%	-6.5%
Topix GBP TR	3.0%	2.3%
MSCI Emerging Markets Index (GBP)	4.3%	2.9%
FTSE A GILT +15 Yrs	-2.5%	5.2%
iBoxx Non-Gilt £ 10+ TR	0.9%	5.7%
FTSE A ILG +5 Yrs	-2.5%	0.4%
FTSE 350 Real Estate Index	-2.4%	-15.8%
Morningstar Diversified Alternative Index TR	-3.5%	-9.8%
Bloomberg All Hedge Fund Index	-2.9%	-4.0%

Total returns in GBP | Source: Bloomberg, Capita





Have we missed the boat on liability-driven investment? Insight by Israel Cohen

I was recently asked a question that has become an increasing concern for trustees during recent years: “Have we missed the boat on liability-driven investment (LDI)?” The questioner was clearly thinking about the current record low level of interest rates, and it’s very tempting to dive headfirst into a discussion about whether rates can go even lower, and how long before they start to rise. However, is this the correct way to frame the problem and address the issue? Taking a step back, what other questions should trustees be asking?

For those readers that can’t wait for the end of the article, my conclusion is that most schemes should hedge their interest rate risk, if they haven’t done so already.

What is the role of a trustee?
Pension scheme trustees work with the sponsor company to ensure that pension liabilities are paid when they fall due. However, with many schemes currently running significant funding deficits, trustees are left with the dilemma of solving the three-way payoff between trying to close the deficit without taking on too much risk and being mindful of the sponsor’s ability to step in if things go wrong.

What is the scheme’s ultimate objective?
Depending on the starting position, and the strength of the sponsor covenant, trustees should focus on a specific end objective, whether it be reaching self-sufficiency as an ongoing entity, an insurance-backed buyout, or even just meeting 100% funding on a technical provisions basis. With a clearly defined objective, and an agreed timeframe, the scheme sponsor is more likely to agree to a recovery plan of increased contributions or even fund a buyout.

How can trustees reduce a funding deficit? Pension scheme trustees have several ways of potentially reducing a funding deficit:
•Increased contributions
•Investment outperformance
•Maturing membership
•Liability management (buyout, PIE, CETV).

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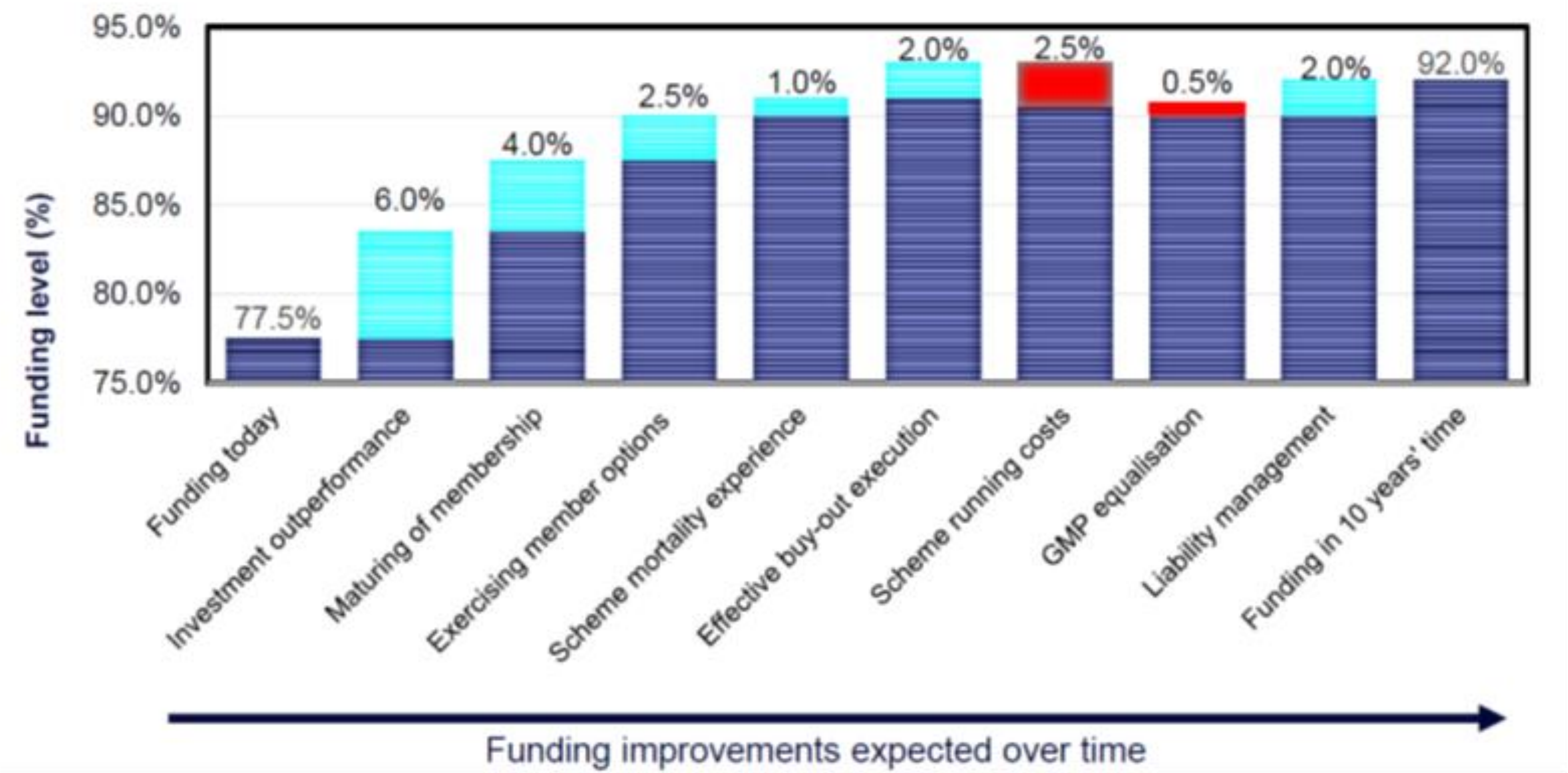

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The trustees (with the sponsor) should agree a holistic journey plan, determining which levers they will use and how much they expect each to contribute to reducing the funding gap, and monitor progress along it.

How to set an investment objective and risk budget
Once the various options have been assessed, trustees may be surprised to learn how little they need to earn from investment performance in excess of the liabilities (maybe 1% or 2% p.a.). Besides understanding the return objective, they have to determine how much risk the scheme can take on. An acceptable risk level is driven by the sponsor's willingness and ability to make additional contributions should the funding position worsen if the investment strategy fails to perform as expected. The answer to this question essentially defines the investment strategy's 'risk budget' and is often measured in terms of VaR (value at risk). Notice that just like return, risk is also measured relative to the liabilities. Once the risk budget is agreed, it is the trustees' duty to make best use of it to maximise the probability of achieving the target outperformance levels.

How to use the risk budget optimally

Pension scheme risks can be split into three categories:

- A Those that are expected to be rewarded
- B Those that are not expected to be rewarded and can be mitigated
- C Those that are not expected to be rewarded but cannot be mitigated.

Given a limited risk budget, it makes sense to take on many diversified Category A risks, and limit exposure to Category B risks.

How to translate an investment objective into an asset allocation
Return targets (outperformance) and risk limits (underperformance) can both be measured relative to the liabilities in terms of their impact on funding level. Therefore, the 'neutral asset allocation' can be defined as the one with no liability risk, that is zero interest rate and inflation sensitivity. Beyond this neutral position, the trustees can take incremental investment decisions that are expected to outperform the liabilities, thus reducing the funding gap over time.

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Why does investment diversification help?
It can be mathematically proven that investing in a portfolio of multiple investments that have imperfect correlations will have lower risk than the individual investments themselves. For example, a portfolio of four uncorrelated investments that have similar risk and return expectation will have half the level of risk compared to investing in just one of those investments alone. Or put another way, a fixed risk budget can accommodate an increased target return when invested in a diversified portfolio.

What is wrong with concentrated ‘bets’?
A trustee may have a strong conviction in a particular trade. However, any significant move away from the neutral asset allocation would be taking a ‘bet’ that this decision will pay off. Furthermore, it should be recognised that these tactical trades a) have a very poor historic track record of success, b) may take longer to play out than i) was originally expected and ii) the investor can afford to wait, and c) they forego increased diversification in the meantime. These ‘bets’ consume a disproportionate amount of the risk budget, and therefore, should only be undertaken if the strength of conviction is such that they are expected to be rewarded, and the expected outperformance justifies all of the negatives listed above.

What is LDI?
For any pension scheme that has not put in place a hedging programme, interest rate risk is usually the single largest risk, often followed by inflation risk. These risks are likely to consume most of the risk budget and preclude allocation to more rewarding investments, which represents an opportunity cost. Constructing a portfolio of secure payments that closely match those of the liabilities can remove the sensitivity to those risks and is known as liability-driven investment. Utilising an LDI approach, but hedging anything less than 100% of the liabilities, will leave some risk exposure, and an investment consultant can guide on the appropriate hedging level. Any remaining assets can be used to target the required outperformance in excess of the liabilities.

A late adopter of LDI will undoubtedly have missed the benefit of long-term interest rates falling from 2.5% to around 0.6% over five years. However, not incorporating LDI into your investment strategy unwittingly represents a huge binary bet, and a significant opportunity cost. In general, an LDI portfolio, overlaid with a diversified portfolio of assets and investment strategies, will provide higher probability of meeting your funding level targets with lower risk.

The views expressed in this article represent those of the author and do not necessarily reflect the views of Capita Employee Solutions. Israel Cohen is a Senior Investment Consultant at Capita Employee Solutions.

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The information provided is based on our understanding of current law and taxation.

HMRC policy, practice and legislation may change in the future

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