HYMANS ROBERTSON

Investment Perspectives

Spring 2020

In this issue:

Welcome 2
Capital markets update 4
The purpose of stewardship 10
New funding code 12
RPI reform 15
Market returns to 31 March 2020 18

Welcome

Welcome to our 2020 Spring edition of Investment Perspectives.

A lot has changed in the three months since we published the last edition of *Investment Perspectives*. The coronavirus has quickly disrupted so many aspects of everyday life, including how we work. I am pleased to say that so far meetings with clients, whilst virtual, have been able to continue almost as usual, albeit with the delight of the occasional interruption by a young child or the inevitable lively dog joining the call, to remind us there is life beyond pensions.

There are of course some difficult numbers to discuss, as the impact on financial markets has been as invasive as the virus itself. However, these discussions are always to be within the context of the most dramatic numbers seen this quarter, which are the number of COVID-19 cases and sadly the number of deaths worldwide. The exponential scale of these figures has put human life in perspective and we are cognisant of this while we try to put the world of investments in perspective in the following articles.

So, while we recognise the human and societal challenges, and do not wish to ignore them, our focus here is on investing. Our capital markets update is, not surprisingly, focused on the impact of the coronavirus on markets. At some stage there will be opportunities to be sought, but for now the emphasis must be on making sure that your investment strategy and its implementation is fit for purpose however challenging markets and the economy become.

We are pleased by the extent and speed of response of governments and central banks across the world – the financial crisis of 2008 provided many good lessons that are being drawn upon; this has provided liquidity and function to core markets. However, we are surprised by the extent to which market pricing appears to be discounting pretty awful economic news and remaining so optimistic about corporate earnings. The impact on earnings may turn out to be not too bad, but long-term investing is about making sure you have enough chips to stay at the table.

Andy Green

Chief Investment Officer
andy.green@hymans.co.uk
0131 656 5151

Against this backdrop, we believe that the following areas within your investment strategy should be assessed in the short term:

- Strategic asset allocation and the appropriateness of your existing rebalancing framework;
- Portfolio liquidity and scenario testing of cashflow requirements in further stressed market conditions; and
- An understanding and look-through of your current managers portfolios including quality, diversification and constraints. In times like these, such a review could uncover some unintended consequences for the overall investment strategy.

While the coronavirus is still dominating the headlines, there are other areas that still require your attention within the investment governance of pension schemes.

In this edition, alongside our traditional quarterly market analysis we outline some key issues and the impact of new legislation:

- Simon Jones and Caoimhe Bain provide an update on stewardship following the recent revamp of the UK Stewardship Code by the FRC.
- Ross Fleming discusses The Pensions Regulator's new funding code and the investment implications for pension schemes and,
- Alen Ong provides an overview of RPI reform, the impact on market pricing and the implications for pension funds.

We would also like to take this opportunity to wish all our readers well and remind them that markets, like our daily lives, will one day bloom again.

William Chan

Head of DC Investment
william.chan@hymans.co.uk
0207 082 6357

Capital markets update

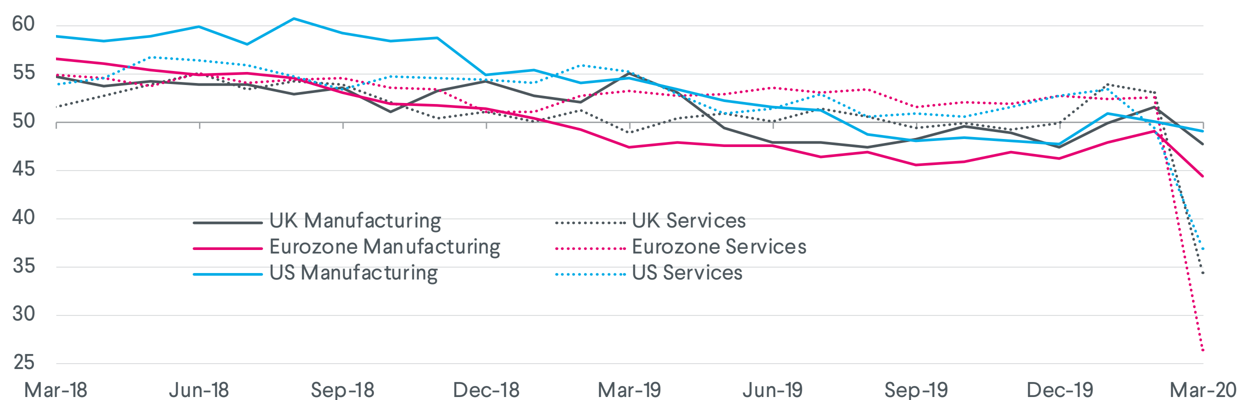
The start of 2020 was reminiscent of much of 2019. Bond yields drifted lower, consistent with the slowdown in global growth, manufacturing, and trade in 2019 and persistently low inflation. Despite the effect on corporate earnings – lacklustre growth and falling forecasts – and already-high valuations, global equity markets pushed even higher.

But no markets could ignore the likely economic effect of the outbreak and global spread of COVID-19, and on 20 February markets turned. The impact on supply and demand from containment measures adopted across much of the world will inevitably impact the rate of global economic growth in 2020 and beyond. Latest consensus forecasts suggest the global economy will shrink 2.1% in 2020, with the major advanced economies expected to contract more than during the Global Financial Crisis. The near-term environment will be extremely challenging, given the necessary halt in economic activity. Services Purchase Managers' Indices (PMIs) fell to record lows in the US, Eurozone, Japan and UK in March (Chart 1). Manufacturing PMIs fell less, but likely do not reflect the full extent of the contraction and may have been supported by a technicality of increased supplier delivery times, which in more normal circumstances suggest increased demand.

Forecasts point to a recovery once social distancing measures are relaxed, and monetary and fiscal stimulus combine with resumption in discretionary spending and production. The challenge of course is when this will be, and how quickly demand and supply will ramp up.

The experience of China may provide a leading example for the outlook. February data revealed industrial production fell by 13.5% year-on-year, retail sales by 20.5% and fixed asset investment by 24.5%. Indeed, Chinese GDP was confirmed to have fallen 6.8% year-on-year in the first quarter. But, having plunged to a record low in February, the Chinese manufacturing PMI unexpectedly bounced back in March to a level consistent with expansion. A word of caution: this may just reflect more than half of the surveyed businesses having resumed production. A collapse in demand in the major advanced economies has the potential to hinder recovery in China and elsewhere, as of course would a second wave of the virus.

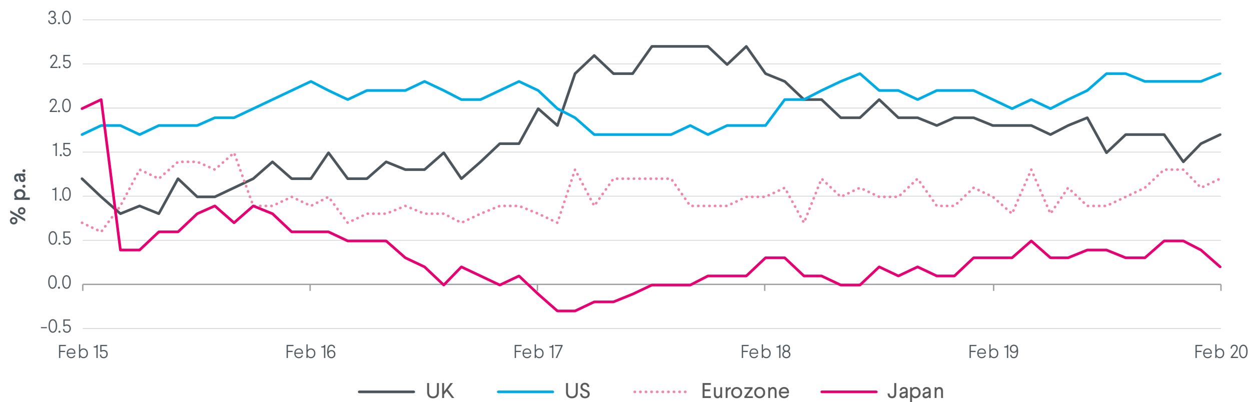
Chart 1: Manufacturing and services purchasing managers' indices (PMIs)



Source: Bloomberg

The immediate impact of collapsing demand globally and steep oil price declines are disinflationary. The slump in global demand for oil was compounded by a price war between OPEC (led by Saudi Arabia) and Russia. Even a subsequent agreement to cut supply, equating to around 10% of pre-outbreak global production, failed to provide much support, with oil prices still close to 60% below end-2019 levels. Global headline inflation is forecast to fall in 2020, with some economies in the Eurozone and Japan expected to enter deflation. Any inflationary effects owing to reduced labour supply, via widespread quarantine and sickness, and disruption to highly integrated global supply chains, for now, remain largely absent.

Chart 2: Core CPI inflation



Source: Datastream

Low realised (Chart 2) and forecast inflation reduced the risk of further action by central banks and governments at the start of the year. The US Federal Reserve (the Fed) and the Bank of England (BoE) cut rates to record low levels and the European Central Bank and Bank of Japan have joined the Fed and the BoE in announcing large expansions of their quantitative easing programs. The Fed's now unlimited purchases will, for the first time, include corporate debt.

Central bank actions are aimed at ensuring ample liquidity in the financial system and preventing financial conditions from tightening, but a simultaneous supply and demand-shock requires dual policy responses. Companies and households face a cash crunch as business interruption increases the risk of bankruptcy and unemployment. Aware of this, governments are making available unprecedented levels of fiscal support in the hope that near-term support may enable a return to business as usual when, what should be temporary, disruption is over. However, there are challenges as to the pace and breadth of the delivery of support.

Currency markets have been typical of a period of increased risk. The haven appeal of the dollar and yen was apparent particularly at the peak of market stress in mid-March and, in line with their less defensive reputation, emerging market currencies fell. Sterling also fell, following a period of strength that continued into the start of the year.

The depth and length of the global slowdown is unknowable at this stage. There are three key unknowns, which in time will provide more clarity for the direction and pace of recovery in markets:

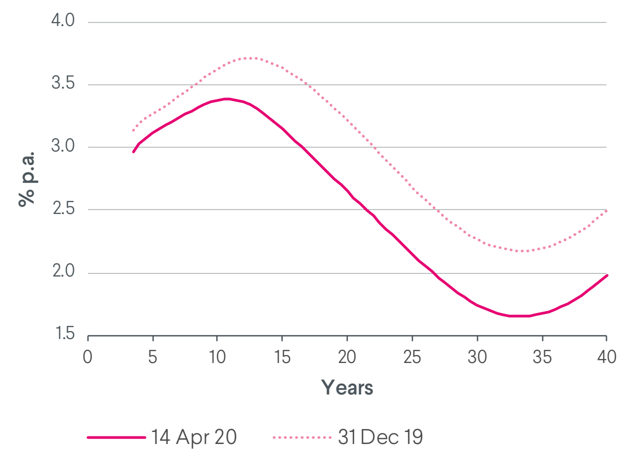
- Uncertainty over how long containment measures to restrict the spread remain in place. This is key, with markets looking at how well and how quickly the likes of China and Italy emerge from their lockdowns.
- The scale of monetary and fiscal policy responses has been enormous, but it remains to be seen how effective they are in limiting bankruptcies, unemployment and financial stress, particularly in the corporate and sovereign debt markets. Inevitably every day will bring news of companies that will not survive.
- Beyond that, there may be lasting effects on the health of businesses and individual wealth that affect the pace of recovery, individual spending patterns and government policy.

Government bonds

Despite starting from what were considered low yields, government bonds have delivered further positive returns as yields fell to new record lows. Downgrades to both growth and inflation forecasts lend technical support to nominal gilt markets in the short-term, at least. Yields are still well below our long-term notion of fair value but given the scale of current uncertainty, not only might the rise in yields be even slower than we might have previously envisaged, yields could still fall further.

UK implied inflation has fallen as real yields fell less than their nominal counterparts (Chart 3). While this fall coincides with the impending consultation on the reform of RPI, to which index-linked gilts are referenced, it is in line with the pattern in other markets where there is no comparable technical risk. The impact has been only modest returns from index-linked gilts over the quarter.

Chart 3: Forward gilt-implied inflation

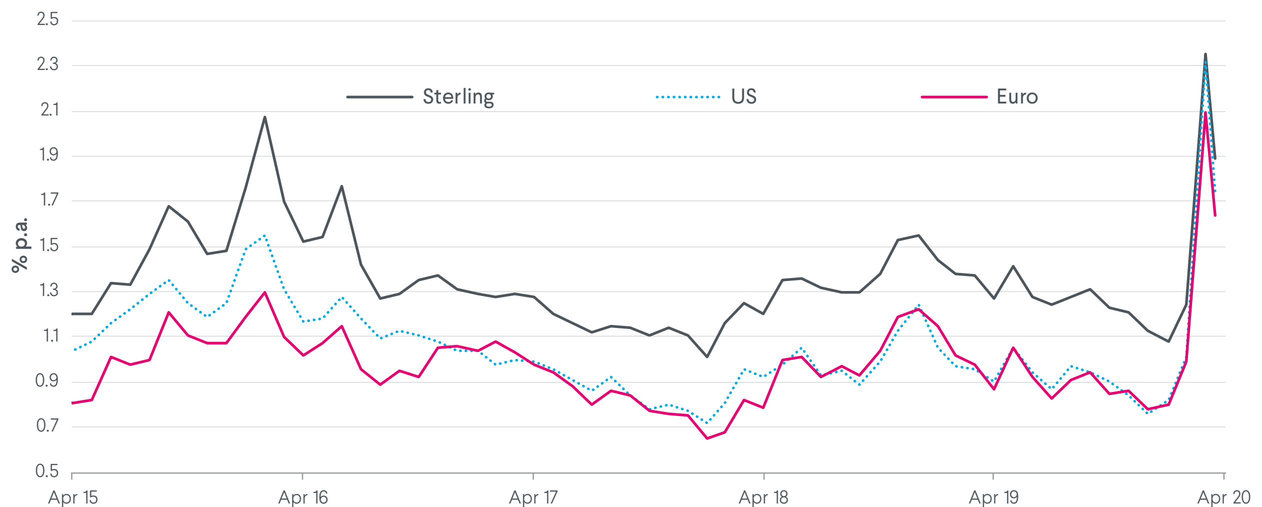


Source: Bank of England

Credit

Though sterling investment-grade credit spreads rose substantially above long-term median levels (Chart 4), falling government bond yields have cushioned the absolute fall in price terms. US investment-grade credit spreads widened more than in sterling or Euro credit markets, perhaps reflecting larger exposure to the energy sector in US indices, with the usual spread premium available in sterling markets versus US comparators disappearing as a result.

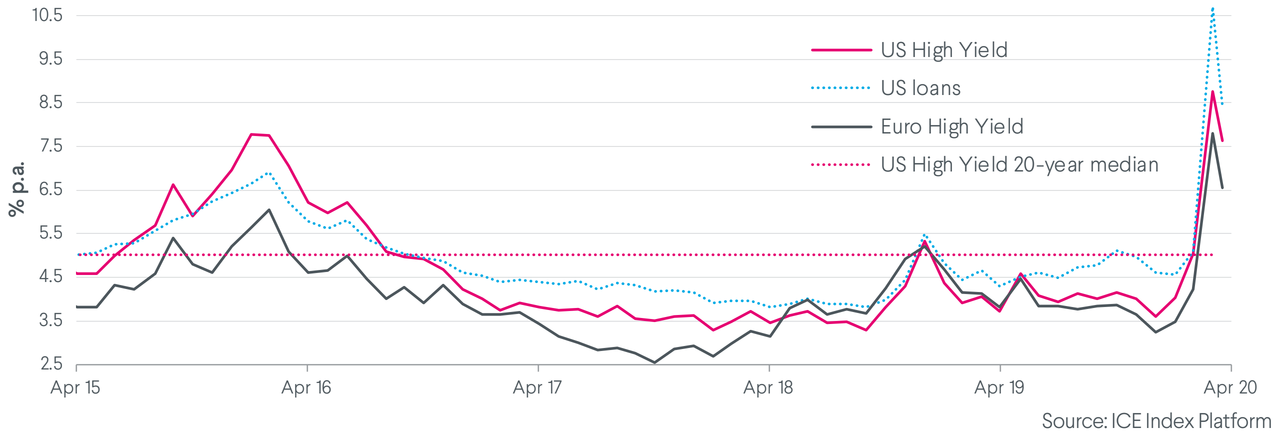
Chart 4: Investment-grade A-rated corporate credit yield spreads to 15 April 2020



Source: ICE Index Platform

Price falls in speculative-grade markets have been more substantial, moving credit spreads to levels which have historically represented an attractive entry point (Chart 5).

Chart 5: High yield bond and US loan yield spreads to 15 April 2020



Source: ICE Index Platform

We note that, a vertiginous rise in spreads in speculative-grade markets has been accompanied by a sharp deterioration in the outlook for earnings and defaults – Moody's expected default frequency (based on market values, liabilities and asset volatility) has recently indicated a potential high yield default rate as high as 10%. We are inclined to wait to see how the fundamental picture evolves. Constrained liquidity would make any significant investment in these markets challenging for the moment in any case.

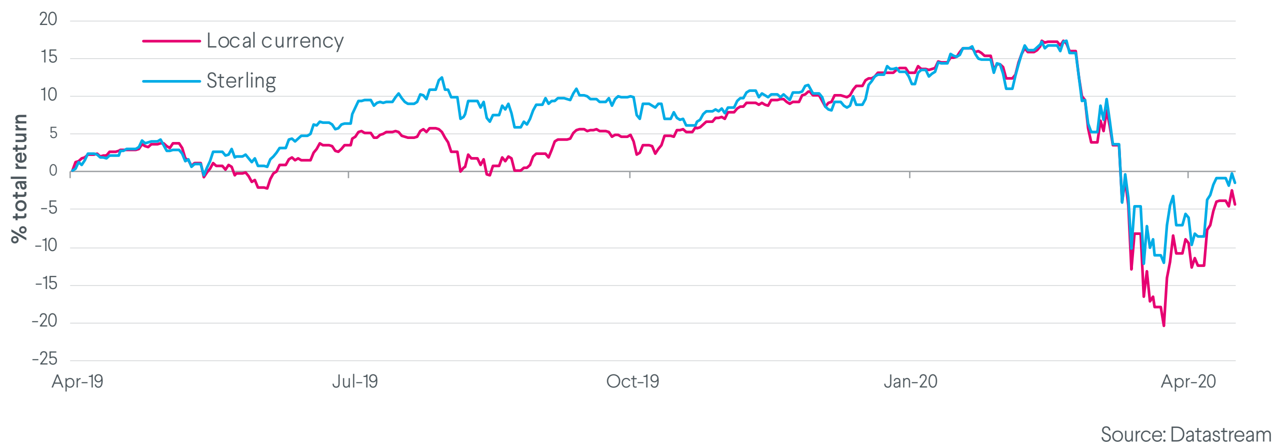
However, for both investment and speculative-grade debt, spreads have fallen substantially over April. This primarily reflects the expansion of the corporate credit purchase programmes of the US Federal Reserve (Fed). The Fed also took the unprecedented step of extending purchases to include non-investment-grade debt, both new issuance from companies recently downgraded from investment-grade (so-called "fallen angels") and the purchase of ETFs investing predominantly in high-yield debt in the secondary market.

Equities

Global equities moved higher at the start of 2020, even as expectations of last year's earnings growth continued to be revised down, before falling precipitously in March (Chart 6). Potentially boosted by signs that the daily number of new cases may be reaching a peak in some economies and consensus fall in earnings may be limited, global equities have risen over 20% above their March lows, although still 19% below February peaks.

Recent moves remove some of the apparent cheapness that emerged in March. However the large degree of uncertainty over the duration of shutdown across major economies means earnings visibility is non-existent, despite the impact of policy support measures, and current consensus estimates for 2020 of -7.8% may still be too optimistic.

Chart 6: Global equity returns to 15 April 2020



Source: Datastream

In the absence of viable exit strategies or earnings data, we treat current equity valuations with some caution, cognisant they may or may not yet fully compensate investors for the significant fundamental risks that equity markets face. Newsflow from the current US earnings season may at least provide some more information around potential impact, but cannot address the risk associated with an extended duration to the downturn.

Despite falls, the US remains at a premium to other regions, but the defensive characteristics of the market may mean it remains in favour in the short-term. The large technology exposure in the US market is also supportive - demand appears more insulated from the pandemic and demand for technological solutions has increased amid social distancing.

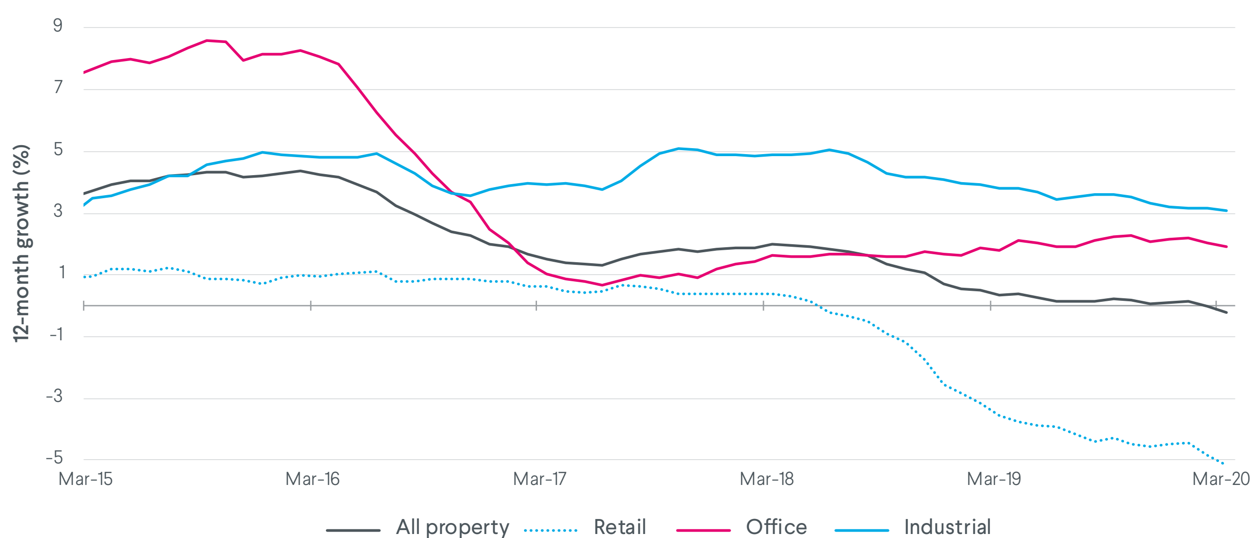
Property

Capital values fell during the first quarter of the year, with the post election bounce eliminated by the impact of COVID-19 on property markets. The current economic disruption is not fully reflected in property market data, but rental growth, which had already turned marginally negative prior to the outbreak, has fallen further (Chart 7) and is likely to remain on a downward trajectory for some time. Rents are likely to be most severely impacted in the retail sector and some alternative sectors, such as leisure and hotels.

Rent deferrals or tenants switching to monthly rent payments is now common, with rising vacancies inevitable as many businesses struggle.

With the property market effectively closed for the immediate future, a lack of post-outbreak transaction activity has led valuers to insert material uncertainty clauses into end-March valuations. The vast majority of property funds have gated redemptions due to the lack of a reliable market price. Secondary market activity in fund units has plummeted, although there is an increasing prevalence of discounts to the latest net asset value in indicative prices.

Chart 7: UK property rental growth



Source: MSCI

Conclusion

The rapid spread of the coronavirus will inevitably have a material impact on the rate of global economic growth in 2020 and beyond. It is important to note that, while growth is expected to take a severe hit in the near term, global growth and corporate profits will eventually enter a recovery. However, the timing and shape of any rebound is uncertain and depends on both the containment of the virus and the effectiveness of policy responses in preventing the widespread and material disruption to businesses and consumers causing permanent rather than temporary damage.

Recent positive market moves have reduced the apparent cheapness of global equity and credit markets, but the outlook for corporate earnings and defaults remains very uncertain at this stage, with sentiment likely to remain fragile through the first half of 2020. Even if lockdowns begin to be relaxed more widely as some economies pass the peak of infections, the sudden stop to global activity is now expected to generate the most severe recession in living memory and the restart is unlikely to occur quickly.

Furthermore, unprecedented fiscal and monetary policies may provide short-term liquidity and ease market stresses, but they may be unable to halt rising unemployment or prevent insolvencies in the deep downturn entered.

While the consensus being implied by the recent rise in markets may suggest something less than a severe downturn, the range of potential outcomes remains wide. Given the risks associated with this uncertainty, we advocate a degree of caution and holding more cash than usual, with a view to reinvesting with greater certainty at some point in future. There will also be investment opportunities to capture enhanced returns in some areas. Just as importantly, in a period when market activity could be depressed for some time, there is a need to ensure you can meet liquidity requirements associated with outgo as well as the collateral management associated with settlement of interest rate and currency hedging strategies and other derivative positions.

Chris Arcari

Investment Research Consultant
chris.arcari@hymans.co.uk
0141 566 7986

The purpose of stewardship

> “Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.”

This definition, adopted by the FRC in its recent revamp of the UK Stewardship Code, is perhaps broader and more far reaching than what many would consider to be stewardship. Yet it reflects two important goals: long-term value creation and a recognition that companies and assets exist within broader social and environmental systems. For long-term investors, the proper and sustainable functioning of these systems are as integral to the ability to derive return as the companies that operate within them.

Asset owners predominantly view stewardship through the lens of voting and engagement activity which, in many cases, is undertaken by asset managers acting as their proxy. Yet this lens is not particularly well focused, with some placing an emphasis on levels of activity, rather than outcomes, as measures of success. Consequently, there is a risk that asset owners do not properly engage with or understand the actions of their managers making it harder for them to be held to account.

One commonly considered measure is the extent to which asset managers vote against management recommendations. But is a manager who votes against management on 20% of occasions better or worse than a manager who votes against management on 30% of occasions? Without the context provided by an understanding of voting policies and the knowledge of individual resolutions, we cannot say.

We can, however, begin to explore trends in the data, for example, by considering whether managers are more or less likely to vote against management on particular issues. This provides greater insight and allows asset owners to develop their understanding of the stewardship activity that managers undertake on their behalf.

Voting against management at AGMs may be in line with policy, the recommendation of a voting adviser or the outcome of a failed engagement but this requires the manager to elucidate the reasoning for their vote.

Where managers engage with companies for the purposes of creating change, they are not just focused on routine governance issues such as executive remuneration, but increasingly on environmental and social themes such as climate change and human rights. In engaging on such issues, there is an implicit acknowledgement that companies have obligations to a range of stakeholders beyond investors. This responsibility to customers, employees, suppliers and communities as well as shareholders was recently recognised[1] by over 180 leading US companies who signed a 'Statement on the Purpose of a Corporation', outlining a new standard for corporate responsibility.

Commitments such as these chime with the definition of stewardship set out by the FRC yet the challenges presented by the current pandemic have served to highlight differing standards of corporate behaviour.

1 https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

Such promises depend on those who invest to hold companies to account which in turn requires asset owners, and their investment managers, to consider which practices are acceptable and which are not.

Pension fund trustees over the next 18 months will need to prepare Implementation Statements that reflect the execution of their voting and engagement policies. Rather than focusing wholly on quantitative assessments, the current situation offers a chance for trustees to reflect on the purpose of stewardship and the outcomes that they want to observe. By doing this, they can then hold asset managers more effectively to account.

Simon Jones
Head of Responsible Investment
simon.jones@hymans.co.uk
0131 656 5141

Caoimhe Bain
Responsible Investment Consultant
caoimhe.bain@hymans.co.uk
0207 082 6028

New funding code

Late last summer, our *Investment Perspectives* article 'A journey plan towards the ultimate destination' [2] provided a 'heads-up' on the new, more prescriptive DB code of practice on scheme funding that The Pensions Regulator (TPR) was busy working on and what that meant for schemes' investment strategies. At that time, I was heading off on summer holidays and the article provided a light-hearted analogy of setting a long term objective to planning a summer trip – for obvious reasons, planning the summer holiday this year feels less certain if March 2020 is anything to go by.

On 3 March 2020, TPR's first consultation on the new, more directive funding code was released[3]. This is the first of two planned consultations being run by the Regulator and focuses on their proposed approach, the principles of the new code and how these could be applied in practice. The new code is expected to come into force in 2021, with valuations submitted after that being subject to the revised code.

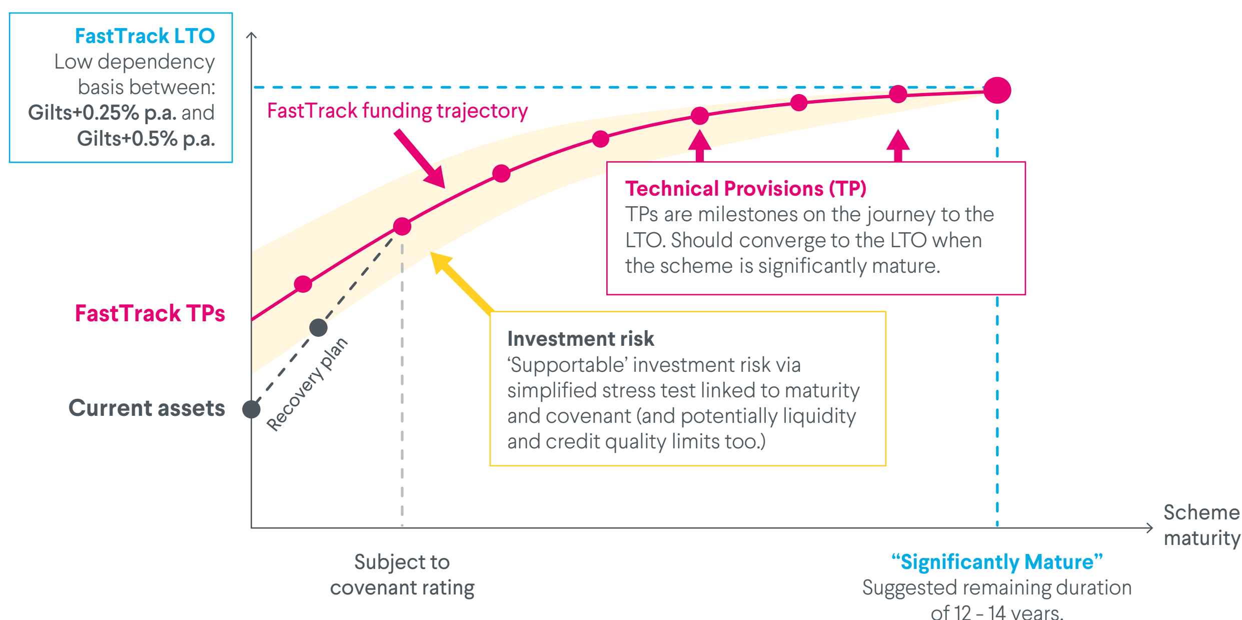
2 https://www.hymans.co.uk/insights/research-and-publications/publication/investment-perspectives-journey-plan-towards-the-ultimate-destination/

3 https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2020-press-releases/major-consultation-on-clearer-db-funding-standards-launched-by-tpr

The key principles of the code are summarised and illustrated in Diagram 1 below:

- A twin track compliance approach for valuations – 'FastTrack' vs. 'Bespoke'.
- More clarity on how sponsor covenant is allowed for within a scheme's funding plan and further specifics on appropriate recovery plans (shape and length) based on sponsor strength.
- The submission of valuations to TPR via a 'Statement of Strategy'.
- A requirement for schemes to set a Long Term Objective (LTO).
- Once 'significantly mature', schemes are expected to target full funding on a low dependency basis – this range is currently set at Gilts + 0.25% p.a. to Gilts + 0.5% p.a. under FastTrack.
- Technical Provisions (TPs) should be linked to the LTO with a clear journey plan for getting there and removing deficits over the short term.
- A more direct reference to investment risk, which should be supportable - the consultation sets out details of a potential stress test of the asset strategy, similar to that currently used by the PPF.

Diagram 1: Key principles of the revised funding code



So what does all this mean for investment strategy?

Setting the long term target... and the target investment portfolio

It's clear that trustees need to be able to articulate their long term objectives and the anticipated timeline. However, few may have articulated what that means for their target investment portfolio when their schemes start to de-risk or become significantly mature (possibly when the remaining duration is 12-14 years) and those that have will want to test whether this still remains relevant under the proposed FastTrack regime.

The consultation is pretty clear that TPR expect the investment strategy at the point of significant maturity to have a high resilience to investment risk and adopt a strategy broadly aligned with the FastTrack funding basis. However, TPR accept there is no single definitive investment strategy and there are many variants - they helpfully provide some examples:

1. **'Barbell' strategy –** majority of assets in gilts and LDI providing a good match for scheme cashflows and hedging liability risks, with the remaining small proportion of assets invested in a diversified 'growth' portfolio – 20% in growth assets is suggested as the maximum level of investment risk supportable.
2. **Credit-based strategy –** 100% invested in bonds, the majority of which are high-quality and liquid to generate some additional return over the funding basis to provide a buffer against adverse future experience – a strategy which includes a mixture of gilts, corporate bonds and including some illiquid and multi-asset credit is suggested.
3. **Cash flow-driven-investment strategy –** an extension to the credit-based strategy above, which invests in a portfolio of assets which deliver cashflows closely matching the liabilities – a strategy with more gilts, high-quality corporate bonds and other secure income assets is expected.

However, schemes may choose to adopt a different strategy and justify this through the bespoke route.

Why is maturity important?

Maturity is key because the more mature schemes are, the greater the impact of benefit outgo and the less time they have to recover from a fall in funding. Hence, the less resilient they are to downside shocks, so exposure to investment risk should reduce over time. Schemes mature at different paces, depending on their age profile and benefit structure and this may not be a smooth progression. A greater understanding of the emerging maturity in your scheme will give an idea of when the LTO should be targeted and sets the timescale for successfully incorporating any de-risking that is needed. This glidepath should also link in with the TP target, given that TP funding is to some extent a staging post along the way.

Investment risk considerations

To determine whether schemes remain within the permitted risk profile of FastTrack, TPR are consulting on the use of a standard stress test of the asset strategy (similar to that used in the PPF assessment), which will incorporate the scheme's maturity and strength of sponsor covenant. While a more mature scheme will be expected to run a lower risk investment strategy and may also be required to meet liquidity and credit quality criteria, a less mature scheme with a strong employer covenant is expected to be able to take more investment risk within the FastTrack regime.

Potential next steps

Areas where trustees should consider taking action include:

- Engaging with sponsoring employers to facilitate discussions on jointly suitable LTOs or reviewing whether any current LTO remains appropriate alongside the investment strategy path and funding support.
- Starting to map out a plan for how the investment strategy may be expected to evolve alongside the LTO path.
- Stress testing the plan, and thinking about contingent actions you would take; does this mean more money, more risk or more time is required to meet the target LTO.

For schemes which may be at risk of falling outside the FastTrack regime due to too much reliance on 'growth' assets or too little resilience to investment risk given their maturity and/or covenant support, trustees may decide to:

- Take no action because they have a genuine rationale for the bespoke route (which will be seen by TPR as equally compliant as FastTrack with suitable supporting evidence); or
- Begin to reduce the level of investment risk in their strategy and increase the resilience to adverse investment outcomes in order to meet the FastTrack criteria.

Incidentally there may be schemes which find themselves ahead of progress against the FastTrack criteria and there may be a temptation, at least on the part of some sponsors, to 'level down'. While TPR note that there is little to stop a levelling-down approach, their view is that schemes in such healthy (and enviable) positions, would be keen to maintain that additional cushion to withstand any future 'bumps in the road', such as the current market volatility from COVID-19.

We recently hosted a client webinar which sets out some worked examples of the proposed new approach. Our special guest David Fairs (Executive Director at TPR) answered questions from many of our clients in relation to the consultation which can be found here.[4]

Further guidance from TPR acknowledges that some DB schemes may need to defer pension contributions in the current COVID-19 climate. Our follow-up webinar discussed the suspension of DB pension contributions and the impact this may have on schemes. The link to this is also provided here.[5]

4 https://www.hymans.co.uk/insights/research-and-publications/publication/webinar-replay-what-does-the-new-db-funding-code-mean-for-you/

5 https://www.hymans.co.uk/insights/research-and-publications/publication/webinar-replay-a-guide-to-deferring-pension-contributions/

Ross Fleming
Partner
ross.fleming@hymans.co.uk
0141 566 7693

RPI reform

Coinciding with the UK Budget on 11 March 2020, the much-anticipated Consultation on reforming the Retail Price Index (RPI) was released. The outcome of the Consultation may conclude many months of speculation on the future of RPI, initially triggered by the House of Lords Economic Affairs Committee's January 2019 report, *Measuring Inflation*,[6] which recommended that statistical deficiencies with the RPI be addressed.

Issues with RPI have been known for many years and some may recall a previous consultation launched in 2012 on a similar topic, which created a lot of uncertainty and eventually concluded with no change being made to the calculation of RPI.

Although many believe that reforming RPI is inevitable, exactly how this is done matters greatly because it could result in a significant transfer in value from index-linked gilt holders to the UK Treasury - or not. **Hence our view is that it is important that index-linked gilt holders respond to the consultation.**

Proposed reform

The reform proposed is to effectively replace RPI with CPIH. CPIH is the Consumer Price Index (CPI) adjusted for owner occupier housing costs. The proposed timescale for making this change is between 2025 and 2030. Timing is a key question in the Consultation as are the technical aspects of how to align RPI with CPIH.

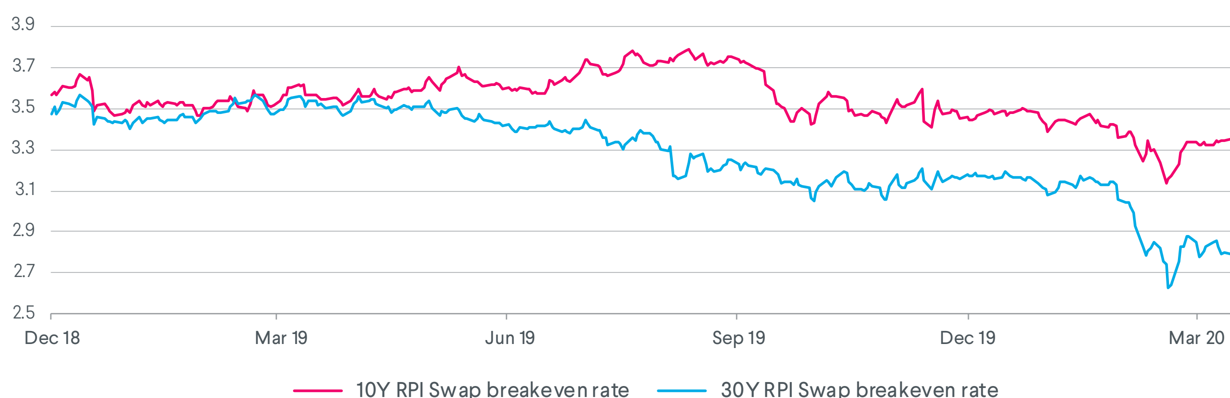
Replacing RPI with CPIH is expected to materially reduce the rate of inflation measured by RPI going forwards. The Consultation states that the difference in inflation between RPI and CPIH has averaged 1% per annum since 2010. The potential impact on index-linked gilts is therefore large. In simplistic terms, an index-linked gilt today with 20 years' duration would be worth 10% less if RPI inflation was reduced by 1% per annum from 2030 onwards and 15% less if the change is implemented from 2025.

Market pricing

The immediate market impact of key announcements on RPI swap breakeven rates has been reasonably muted (see Chart 8). The RPI swap breakeven rate is the rate at which the market is willing to exchange future RPI-linked payments for fixed payments i.e. an indicator of market expectations of the future rate of RPI inflation. The House of Lords report released on 17 January 2019 and a response by the then Chancellor, Sajid Javid, on 4 September 2019 both saw modest one-day falls in RPI swap breakeven rates. Against the background of other sources of volatility over the period (Brexit, General Election and Coronavirus), changes in RPI swap breakeven rates have not been very helpful in distilling market sentiment on RPI reform.

6 https://publications.parliament.uk/pa/ld201719/ldselect/ldeconaf/246/24602.htm

Chart 8: 10Y and 30Y RPI Swap breakeven rates (% p.a.)



Source: Datastream

The most direct way of observing the market view on RPI reform is to compare the pricing of RPI swaps and CPI swaps as set out in Table 1 (there is no market in CPIH swaps). The issue with this approach is that the market for CPI swaps is very small and illiquid, so the measure may be unreliable.

Nevertheless, if we take the prices we have at face value, it indicates that the market has now re-priced RPI assuming it will be aligned with CPIH with a reasonable likelihood from 2030 (with a significant likelihood this will happen between 2025 and 2030).

Table 1: Difference in inflation swap rates between RPI and CPI (% p.a.)

	Period covered	31 May 2019	18 September 2019	20 February 2020
5y spot	2020-2025	0.81	0.83	0.78
5y rate in 5 years	2025-2030	0.85	0.75	0.54
5y rate in 10 years	2030-2035	0.74	0.76	0.36
5y rate in 15 years	2035-2040	0.72	0.62	0.28
5y rate in 20 years	2040-2045	0.68	0.39	0.29
5y rate in 25 years	2045-2050	0.52	0.49	0.27
5y rate in 30 years	2050-2055	0.44	0.50	0.35
5y rate in 35 years	2055-2060	0.60	0.62	0.41
5y rate in 40 years	2060-2065	0.58	0.62	0.41

Source: Insight Investment, Hymans Robertson

What might be the eventual fate of RPI?

An interesting aspect of the swap pricing information is that it does not imply that RPI will be aligned to CPIH with certainty. Although alignment of RPI to CPIH still seems the most likely outcome, we have set out below some of the main permutations we think are possible:

- **Full alignment of RPI to CPIH:** In this scenario, we expect RPI after the implementation date to be 0.8% to 1% lower, index-linked gilts will further re-price downwards when confirmation is announced, although as the table shows, we assume material re-pricing has already taken place; RPI swaps will similarly re-price and underperform CPI swaps.

- **Implementation date of 2030:** We expect the majority of responses to the Consultation to express a preference for the most distant date on offer, as this reduces the impact of the change, but we do not rule out an earlier date being adopted. The current environment is placing enormous stress of the Government's finances – lowering costs will be seen as attractive.

- **Compensation for index-linked gilts:** Market pricing suggests this is still a possibility and we expect index-linked gilt holders to lobby for this in the Consultation. Given the complexities involved, it is the topic for a lengthier discussion, but the impact could be full compensation so that there is no loss in value to existing index-linked gilts holders and a beneficial reversal of re-pricing that has occurred to date. Depending on the mechanism used for compensation, other RPI-linked instruments such as RPI swaps could also benefit to a similar degree and outperform CPI swaps. Again, the outlook for Government finances is worth bearing in mind.

- **No change to RPI:** We include this because it was the surprise result of the previous consultation in 2012 and it would in many ways be the simplest thing to do. If this was announced, we would expect an immediate upward re-pricing of index-linked gilts and RPI swaps (similar to full compensation).

Implications for pension schemes

The overall financial impact of aligning RPI to CPIH on defined benefit pension schemes depends on the value of liabilities that are linked to RPI and the proportion of those liabilities backed by RPI-linked assets.

Liabilities and assets linked to RPI have already been re-priced downwards, and would fall further in value if RPI is set equal to CPIH (ignoring changes in interest rates and other factors), so schemes that would typically benefit most financially are those with a high proportion of liabilities linked to RPI and a low inflation hedge ratio. Schemes that have a high proportion of liabilities linked to CPI and a high inflation hedge ratio (achieved using RPI-linked assets) would typically be the most financially disadvantaged from an alignment of RPI to CPIH. All this assumes no compensation to asset holders.

Even though some schemes may not be materially affected or could even benefit financially from RPI reform, pensioners with RPI-linked pension increases would see the value of their pension incomes fall as a result.

Schemes that have not done so already should as a first step seek to understand the impact that the two extreme scenarios may have on their financial position: full alignment of RPI to CPIH and no change to RPI.

Appropriate courses of actions can then be considered given the uncertainties and pricing already built into hedging assets. Discussion with the Scheme Actuary to understand how they will change their funding assumptions is also important, so that investment and funding decisions can be integrated.

We are strongly supportive of schemes responding to the Consultation. This may be the only opportunity for schemes to have a voice in this matter. While other factors have to be considered, for index-linked gilt holders there could well be a significant value transfer away from themselves to the UK Treasury caused by aligning RPI to CPIH without compensation. In our view, responding to the Consultation is an important way for trustees of pension schemes to exercise good stewardship and engagement in the framework of being responsible investors.

Alen Ong
Senior Investment Research Consultant
alen.ong@hymans.co.uk
0207 082 6328

Market returns to 31 March 2020

	Yield % p.a.		Returns to 31 March 2020 (sterling, % p.a.)		
	31 Dec 2019	31 Mar 2020	1 year	3 years	5 years
Equities					
Global	2.4	3.0	-6.2	2.2	7.2
UK	4.1	5.5	-18.5	-4.2	0.6
Developed markets ex UK	2.2	2.8	-4.6	3.1	8.1
Emerging markets	2.9	3.5	-13.0	-1.2	3.6
Bonds					
Conventional gilts	1.1	0.7	9.9	4.6	4.7
Index-linked gilts	-1.9	-1.9	2.2	2.7	5.7
Sterling corporate bonds	2.4	3.1	0.0	1.8	3.2
High yield (US) *	6.0	9.3	-7.4	0.6	2.7
Emerging market debt	5.5	5.5	-2.3	-0.9	4.0
UK Property	-	-	0.1	5.6	6.4
Hedge Funds *	-	-	-4.3	0.4	0.2
Commodities *	-	-	-20.2	-6.7	-1.4

* Return in $

Source Datastream:

FTSE All Share
FTSE World Developed ex UK
FTSE All World

FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities

BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
MSCI Monthly Property Index

Credit Suisse Hedge Fund
S&P GSCI Light Energy

If you would like to find out more about any of the topics discussed in this publication, please contact your usual Hymans Robertson consultant or:

Andy Green
andy.green@hymans.co.uk
0131 656 5151

Mark Baker
mark.baker@hymans.co.uk
0207 082 6340

William Chan
william.chan@hymans.co.uk
0207 082 6357

HYMANS ROBERTSON

CLUB VITA

London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk

This communication has been compiled by Hymans Robertson LLP, and is based upon their understanding of legislation and events as at April 2020. It is designed to be a general information summary and may be subject to change. It is not a definitive analysis of the subject covered or specific to the circumstances of any particular employer, pension scheme or individual. The information contained is not intended to constitute advice, and should not be considered a substitute for specific advice in relation to individual circumstances. Where the subject of this document involves legal issues you may wish to take legal advice. Hymans Robertson LLP accepts no liability for errors or omissions or reliance on any statement or opinion.

This information is not to be interpreted as an offer or solicitation to make any specific investments. All forecasts are based on reasonable belief. Please note the value of investments, and income from them, may fall as well as rise. You should not make any assumptions about the future performance of your investments based on information contained in this document. This includes equities, government or corporate bonds, currency, derivatives, property and other alternative investments, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the full amount originally invested. Past performance is not necessarily a guide to future performance.

Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority. A member of Abelica Global.
© Hymans Robertson LLP.