Weekly Digest

Week ending **05 February 2017**

Is Outcomes based investing the answer to DB Transfers?

We are seeing increasing interest from the adviser community looking to use outcome based investments as a means to take advantage of pension transfers whilst not exposing their customers (or their advice business) to the unnecessary risks inherent in some market led strategies. This is an attractive route for customers and advisers because defined benefit pension pots are large, and thanks to low interest rates customers are keen to explore ways to realise that value and put it to work.

Last week, the FCA published a note on DB pension transfers expressing concern about transfers based solely on critical yield, which don't take into account the personal circumstances of the client and the 'likely expected returns of the assets'. Critical yield is a comparison between the expectations of the existing defined benefit pension scheme and an annuity purchased with the transfer value of the pension. Due to pension freedoms introduced by the previous Chancellor of the Exchequer, George Osbourne, the capital transferred out of a pension does not need to be invested in an annuity and this opens up some potentially interesting discussions about the investment of transferred out capital.

Annuities have some positive characteristics. Typically annuities pay an annual income for the rest of the purchasers' life. The amount is known in advance and as a result purchasers of an annuity should not get any nasty surprises. In today's low interest rate environment, annuity yields have inevitably crunched in and are, arguably, unattractive for many investors. Additionally, a quid pro quo of the guarantee of annuity returns and the protection they provide against longevity risk (living longer than expected) is that the annuity benefit dies with the owner and as a result savers may be put off by the combination of such a large upfront payment to buy the annuity combined with the lack of inheritance provision.

It was these sorts of concerns that led the then Chancellor George Osborne to introduce pensions freedom in 2014. Anecdotal evidence suggests that while some savers are opting to use these freedoms, few are blowing it on Lamborghinis and other inessential items like then Minister of State Pensions Steve Webb suggested in 2014. The point is that most people exercising their right to pension assets whether they are advised or not would likely do so as part of their long term planning rather than to do something frivolous.

Given most investors will not do something frivolous with their pension investments annuities are, to many, unattractive. What else could investors that want to transfer out their defined benefit pension invest in? We take the view that investors may want to look more closely at outcome based investing. Outcome based investment nestles neatly between traditional market investing and the guaranteed returns experience provided by an annuity. Traditional market returns worry only about generating returns and do so perhaps with one eye on a benchmark or a peer group as a way to validate the effectiveness of performance. The investment manager of the fund may be very skilled and does a good job against the benchmark, but the problem for investors is that the benchmark's returns are somewhat arbitrary and certainly do not speak to the needs of the customer. Annuities, on the other hand, provide certainty craved by customers but the predictability comes at the cost of returns and the ability to pass capital on to beneficiaries.

Outcome based investing bears some of the hallmarks of both approaches. For example, the performance outcome targeted is a return in excess of inflation through the cycle. While returns are not guaranteed, unlike an annuity, the fund manager's deliberate targeting of a specified goal is very far removed from old school investment 'product' that targets a benchmark that does not speak to customer needs. Additionally, outcome based investing focuses on making the journey to the outcome as palatable as possible. This provides a number of benefits such as reducing sequencing risk (the impact of poor performance on wealth, especially when the assets are at their largest) and perhaps more pertinently, the smoother the journey to the outcome, the greater confidence felt by customers which helps then to stay the distance to achieve their necessary investment goal. Outcome based investing also tends to exist in a risk rated environment and this helps investors to understand both at the outset and on a continuous basis the 'riskiness' of their fund and compare that to their risk appetite.

Ultimately, the FCA note highlights the dangers of investors losing themselves within the process of deliberation. Pension freedom has bestowed investors with choice. Pension transfers are not without risk. The choice does not have to be about chasing the largest potential return, or to replace one product with another, but taking the time to establish what a meaningful return truly is.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

The **Marketplace**

- US payrolls surprise on the upside
- Key central banks hold firm on policy
- Parliament backs bill to trigger Article 50
- European PMI data points to positive growth
- French election: Le Pen and Macron gain from Fillon scanda

Market **Focus**

US

- The latest payrolls report showed the US economy adding 227,000 jobs in January - well above the consensus estimate of 180,000. Figures also showed unemployment increasing from 4.7% to 4.8%, as the participation rate rose by 0.2% to 62.9%, while average hourly earnings growth was lacklustre, at +0.1% month-on-month versus +0.3% expectations.
- On Wednesday, the Federal Reserve Open Market Committee, in their first meeting of the year and their first under Trump's presidency, voted unanimously to keep the benchmark interest rate target range at 0.5-0.75%. In their statement following the committee, the members kept their cards close to their chest, giving no specifics on the timing of future potential rate rises.
- US equities gained 0.1% on the day and 0.2% for the week.
- Meanwhile US District Judge James Robart temporarily blocked the Trump administration's ban on citizens from seven countries with mainly Muslim populations from entering the US on Friday. A further request from Trump's team to reinstate the ban was rejected over the weekend.

UK

- On Wednesday the government took one step closer to being able to formerly begin the Brexit process, as members of Parliament voted by 498 votes to 114 to back the government's European Union Bill, which would allow Article 50 to be triggered. The bill now faces scrutiny from the House of Lords and in the Commons before it can become law.
- Sterling was 0.6% higher versus the US dollar on the day, but ended 0.6% down for the whole week at USD 1.248, while UK equity returns were flat over the same period.
- One noticeable sell-off in sterling came after disappointing Purchasing Manager's Index (PMI) prints for the construction and services industries, which both dropped in January compared to December. The indices came in at 52.2 and 54.5, representing continued growth, but below expectations of 53.8 and 55.8, respectively.

Continental Europe

- The final January composite PMI for the Eurozone came in at 54.4 – maintaining a level reached in December, which is the highest point the index has reached since May 2011.
- According to IHS Markit economists, the latest reading is "comparable to GDP rising at a rate of 0.4% quarter-on-quarter, indicating that the economy is starting 2017 on a solid footing".
- Despite this, Continental European equities were down 0.5% over the week.
- On Sunday, the National Front's far-right candidate for the French Presidency, Marine Le Pen, laid out a 144 point manifesto which confirmed, amongst other proposals, her party's intentions to remove France from the Eurozone, hold a referendum on EU membership, impose taxes on imports, and limit immigration.
- Initial frontrunner, Francois Fillon, has become embroiled in a nepotism scandal which has resulted in Le Pen and independent candidate Emmanuel Macron taking the lead in most polls.
- The spread between the yields of French and German long term debt (now at 0.7%; its highest since March 2013) is reflecting the higher risk premium that investors are asking for in response to the increasing political uncertainty.

James Klempster (CFA) & Oliver Bickley

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Asset Class/Region	Currency	Currency returns			
		Week ending 02 Feb 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	-0.7%	0.1%	2.0%	21.7%
United Kingdom	GBP	-0.3%	0.5%	0.0%	25.5%
Continental Europe	EUR	-1.3%	0.6%	0.6%	12.9%
Japan	JPY	-2.2%	-0.7%	-0.5%	6.3%
Asia Pacific (ex Japan)	USD	0.3%	0.6%	6.5%	24.7%
Australia	AUD	-0.5%	0.4%	-0.4%	18.1%
Global	USD	-0.5%	0.2%	2.6%	19.1%
Emerging Market Equities					
Emerging Europe	USD	0.9%	0.8%	2.6%	38.0%
Emerging Asia	USD	-0.1%	0.6%	6.5%	23.3%
Emerging Latin America	USD	0.1%	0.8%	8.4%	54.5%
BRICs	USD	-0.3%	0.3%	6.6%	35.8%
MENA countries	USD	-1.4%	-0.4%	1.3%	21.9%
South Africa	USD	-1.7%	1.3%	4.2%	35.4%
India	USD	2.9%	2.5%	7.9%	20.0%
Global Emerging Markets	USD	-0.2%	0.7%	6.2%	28.6%
Bonds					
US Treasuries	USD	0.2%	-0.1%	0.1%	-1.4%
US Treasuries (inflation protected)	USD	0.2%	-0.2%	0.7%	3.9%
US Corporate (investment grade)	USD	0.2%	-0.1%	0.2%	5.8%
US High Yield	USD	0.2%	0.2%	1.7%	21.8%
UK Gilts	GBP	1.0%	0.0%	-1.8%	4.7%
UK Corporate (investment grade)	GBP	0.7%	0.1%	-0.9%	8.3%
Euro Government Bonds	EUR	-0.8%	0.1%	-2.0%	-0.6%
Euro Corporate (investment grade)	EUR	0.3%	0.1%	-0.4%	3.7%
Euro High Yield	EUR	-0.1%	0.1%	0.8%	11.7%
Japanese Government	JPY	-0.2%	-0.3%	-0.9%	1.0%
Australian Government	AUD	-0.2%	-0.3%	0.3%	1.3%
Global Government Bonds	USD	0.9%	-0.1%	0.8%	0.3%
Global Bonds	USD	0.8%	0.0%	0.8%	1.3%
Global Convertible Bonds	USD	0.5%	0.4%	2.6%	7.8%
Emerging Market Bonds	USD	0.9%	0.6%	2.0%	11.6%

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 02 Feb 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	-1.0%	-0.1%	-0.2%	11.6%
Australian Property Securities	AUD	-0.2%	-0.4%	-5.2%	0.6%
Asia Property Securities	USD	0.0%	-0.5%	5.0%	16.1%
Global Property Securities	USD	-0.1%	-0.1%	1.1%	12.0%
Currencies					
Euro	USD	1.0%	0.0%	2.5%	-1.2%
UK Pound Sterling	USD	-0.3%	-0.1%	1.6%	-12.9%
Japanese Yen	USD	1.6%	0.2%	3.8%	6.4%
Australian Dollar	USD	1.8%	1.3%	6.5%	9.0%
South African Rand	USD	0.0%	1.1%	2.4%	21.3%
Swiss Franc	USD	0.9%	0.0%	2.8%	2.8%
Chinese Yuan	USD	0.6%	0.4%	1.7%	-3.7%
Commodities & Alternatives					
Commodities	USD	0.5%	1.0%	2.0%	24.9%
Agricultural Commodities	USD	0.8%	1.4%	4.5%	8.2%
Oil	USD	0.6%	1.5%	-0.5%	72.9%
Gold	USD	2.3%	0.4%	5.5%	7.7%
Hedge funds	USD	-0.5%	0.2%	0.7%	6.4%

Source: Bloomberg

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