



EPIC PERSPECTIVES

Quarterly Investment Comment - Q1 2007

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The year end produced a rather complacent round of 2007 forecasts, centred around a reasonably certain chance of equity markets continuing to advance, albeit modestly, in the year ahead. The mean forecast for the FTSE 100 was 6650 or so, implying a return of just over 10% (cum dividend yield). The very broad conclusions at that time - which chimed in with our views in the last issue of EPIC Perspectives - were:

- Equities were more attractively valued than anything else
- Bonds offered little value, including index linked bonds
- Credit was expensively priced
- The easy money in commercial property had been made
- Sterling looked expensive
- There will be some bumps ahead but the case was there for riding through these.

Underpinning this approach was a very satisfactory outturn for equity markets (except Japan) in 2006. The central case is that another long rolling economic cycle is broadly in place and that the chances of this being threatened by inflation or stagflation is low. The chances of achieving long term returns on equities in 2007 are seen as reasonably good.

If economic and earnings growth is intact in the short/medium term, the problem is then valuing them. This depends, as ever, on bond markets and interest rate developments and these, in turn, depend on the Central Bank stance on inflation, the housing market, wage awards, credit and money supply growth, and so on.

At the year end, the UK market was relaxed and agnostic about these matters. It remains relaxed, despite interest rate surprises. The equity market sees the Bank of England

acting early in reining in inflation and, as a result, the bond market will have more chance of providing a secure backcloth against which the equity market can operate. This relaxed approach, while rational, may be tested because, on all inflationary measures - wages, house prices, money supply - the outlook is not particularly promising in the UK. So it is not surprising to see the forward interest rate curve suggesting rises in short rates to 5.5% - 5.75% in 12 months time - with no relief in sight. This is going to put pressure on the long end of the gilt market and the equity market should have contingency plans to value itself on a government bond yield of 5.25% - 5.5%, rather than today's 4.9%.

This may not produce such a headwind for the FTSE 100 - conservatively valued and very overseas dependent for its earnings; there may be more fallout in the FTSE 250 area

Cont (overleaf)

What is the True Value of your Investment Consultant?

Welcome to the second edition of 'EPIC Perspectives', our quarterly bulletin which provides investment-led commentary to pension scheme trustees, sponsors and other interested investors.

In this issue, John Heskett sets out EIA's assessment of the outlook for global economies and world securities markets. He also discusses our views on the relative valuation and

attractiveness of a wide range of asset classes, and how this might translate into trustees' asset allocation decisions. John has spent over 25 years in the investment business, principally with Baring Asset Management, where he was inter alia a founding director and head of fixed income investment, and now with Heartwood Wealth Management, where he is now Chairman.

Alistair Byrne, in addition to being an Associate member and DC specialist at EIA, is a lecturer in finance at Strathclyde University and a fellow of the Pensions Institute at the Cass Business School. Alistair describes the mechanics and practical aspects of devising a well governed DC pension scheme. All too often DC schemes are the 'bridesmaids' at trustee meetings,

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where returns have been inflated by takeover hopes. Hopefully we are talking about a UK phenomenon only, where an otherwise fair landscape is being muddied by significant tax increases, the possibility of accelerating public sector wage awards, planning sclerosis and government drift. Negative news on US rates would be just as serious, making the headwind more difficult to deal with.

Looking back at our last review, the principal change for the poorer has been the acceleration in UK wage push - to 4% levels - plus the accompanying 'drift' that goes with this. The combination of rising wage awards, rising inflation and an alert, possibly hawkish, Bank of England raises the chances of a UK hard landing. 2007 may well see interesting times for Sterling, bid up now on high rates but capable of correcting significantly if

rates were to go the other way.

On the positive side, oil prices have fallen back and the US dollar continues to survive slow, mid cycle domestic data, particularly as regards housing. This has led to significant reductions in forecast US 2007 GNP, but this slowdown is seen as short term. Long term low inflationary trend growth outlook remains reasonably secure as Tables 1 and 2 show.

These show a broadly constructive outlook. The key risks to confidence are:

1. Higher inflation
2. The US does not accelerate back to trend growth in 2008
3. The security of growth in the emerging world breaks down and markets add to risk premiums generally. This could result from higher inflation, deteriorating government finances, political instability causing currency flight. There is nothing to suggest that this could or should happen. The outlook for the 'BRIC' economies (Brazil, Russia, India, China), which underpins interest in the emerging world, is seen as positive but it might still provide unexpected surprises as has been the traditional pattern in the volatile emerging countries

Table 1 - GNP Growth %.
Source: Consensus Economics/Citigroup*

	2006 %	2007 %	2008 %
US	3.3	2.3	3.0
UK	2.6	2.4	2.4
Eurozone	2.7	2.0	2.1
Japan	2.4	2.0	2.3
Eastern Europe	6.3	5.6	5.2*
Latin America	4.8	4.2	4.0*
Asia	7.9	7.6	8.1*
China	10.3	9.8	10.7*
World	3.8	3.2	3.8*

What about equity value?

The latest figures from Dresdner Kleinwort Benson show reasonable value (see Table 3 - opposite page). This data should not encourage us

to take risk off the table. We are unlikely to have the benefit of a positive earn-

ings surprise in 2007, as we did in 2005/6. However, there is good profits visibility out there, although, at market level, one sector can depress - as oils do in the UK for instance. Equity risk premia gives no indication whatsoever of how an equity market is going to behave - but they remain reasonably substantial (in excess of 3.3% in the UK). The old 'rule of 20' sees the UK and Europe in a good position.

Not only does profit visibility remain, but value visibility is

What is the True Value of your Investment Consultant? (cont'd)

and risk suffering from a poor range of investment choices and inadequate member communication and education.

One of the conundrums of the pensions industry is that for many years trustees have critically evaluated the performance of their fund managers, but have not done so in any rigorous manner for their investment consultants. I see the evaluation and measurement of investment consultants' performance developing as a 'hot' topic in 2007, as trustees rise to the challenge of meeting the requirements of the 2004 Pensions Act.

The backdrop to this evolving debate is the extremely

concentrated nature of the industry in the UK - by far the most concentrated in Europe. According to Blacket Research, the market share of the top three consultants, measured by scheme liabilities, is 82% of all FTSE All Share Companies. Many trustee boards will have in place 'soft' or qualitative standards for measuring their consultants' performance - for example, the quality of verbal and written reports, communication skills and interpretation of new investment methods. However, there is very little evidence of 'harder' quantitative performance measures being introduced. It is a sadness that Blacket Research, which had developed a quantitative approach to consultant evaluation, has recently

ceased trading - hopefully only temporarily!

EIA believes that what is required is for investment consultants to be able to demonstrate to clients delivery against agreed key performance indicators, potentially set with independent input. Such performance indicators should reflect the risk adjusted returns delivered over, say, a three year period, relative to underlying market returns and the degree of risk employed. This is akin to the use of the 'information ratio' which trustees use to measure their fund managers' performance. Particularly in the light of the concentration of the UK investment consultant industry, trustees would be well advised to introduce regular

reviews of their arrangements as is now required under the Pensions Act. Best practice might suggest informal reviews annually, more formal reviews every three years, and full market-testing through re-tendering on a six year cycle. Not only would this encourage best practice delivery from incumbent consultants, it would also encourage innovation and different, perhaps superior, methods used by alternative providers.

Chris Edge
Chief Executive



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Table 2 - Inflation %.
Source: Consensus Economics/Citigroup*

	2006 %	2007 %	2008 %
US	2.9	1.8	2.3
UK	2.3	2.1	2.0
Eurozone	2.2	1.9	1.9
Japan	0.2	0.3	0.7
Eastern Europe	7.4	6.7	5.9*
Latin America	5.1	4.8	5.4*
Asia	3.4	3.2	3.9*
China	2.0	3.0	4.5*
World	2.9	2.4	2.6*

Table 3 - EPS and PER
Source: Dresdner Kleinwort

	2006 EPS Growth %	2006 PER	2007 EPS Growth %	2007 PER
US	17.6	17.1	9.3	15.8
UK	12.4	13.7	6.7	12.9
Europe ex UK	11.9	15.7	9.7	14.3
Japan	13.3	20.9	13.1	19.5
Pacific ex Japan	9.7	16.3	6.5	15.2

also in place. Deals continue to abound; equity prices rise to reflect private equity interest; private equity interest remains in place, however, because financing costs remain low and below earnings yields. This interest could be easily turned off, though, by higher interest rates and a widening of credit spreads, which reduce the benefits of balance sheet financial engineering, which is private equity's *raison d'être*. But we are not there yet.

We have to understand that, while contracting yields have conferred revaluation

benefits, on private equity and commercial property, some of this could be given back.

In commercial property, as anticipated, there have

been advances in the quoted sector in front of conversions to REITs but, with values now fully reflected in prices and with short and long yields drifting upwards, we should expect coupon returns only for this year.

Funds of hedge funds have come through a tricky year with reasonable returns, justifying their 7%+ returns forecast for them in 2007. They may provide a very effective bond substitute going forward.

Conclusions

What does all this mean in terms of slanting a portfolio? Are there any asset shifts

which suggest themselves? Notwithstanding possible first half tightening, it suggests that portfolios should be equity focused in looking to add value. Portfolios with low tracking error should be adding to equity risk on any downturn, rather than taking risk off the table. It is still an environment where buying the dips rather than selling the peaks should be rewarding. Volatility is bound to rise from today's very low levels but the background would suggest that, absent an exogenous, unforecastable shock, such volatility should not be onerous.

There are certain areas where valuations are stretched - index linked bonds look very expensive versus equities; credit spreads are low for emerging markets and corporate debt and, indeed, for commercial property; long dated gilts offer only modest returns over inflation. Risk/reward here looks suboptimal. As mentioned in the last issue, equities and commercial property look the only 'hedge' for active lives in pension funds.

A more equity centric approach brings with it a number of key questions - UK equities versus overseas; asset allocation by geography or sector or both; the use of differing manager styles or not? All these questions are asked to promote optimal

diversification and consequent risk reduction.

The concentrated nature of the UK market makes overseas diversification attractive. The current 'overvaluation' of sterling, discussed previously in Perspectives, adds to this attraction.

If equities are going to account for more of the risk budget overall, there is a good case for looking at varying manager styles comprising the active segment - combining high alpha with absolute return oriented approaches - to provide a defence against excess volatility, should it re-emerge.

Confidence generally has moved from very low levels in 2002/3 to very high levels now. These very high levels of confidence are seen in investment grade and high yield bond markets, with equities much more modestly rated. The three year equity bull market vaunted by some, can be seen as a recovery from excessive pessimism to normality, by others. 2007 will be a more testing year, but the maintenance of a real asset bias to reduce deficits should be rewarded in the long term.

John Heskett

In the first issues of Perspectives we gave a list of ten questions trustees should explore with their investment managers. Here is our updated list:

1. What are the chances of stagflation?
2. Would you agree with a \$55-\$65 oil price range for 2007?
3. To what extent should we be using sterling strength to rebalance our equity weightings away from the UK? How should this diversification be conducted?
4. Commodities - should we get involved? How and when? What about gold?
5. Hedge funds - what have we learnt about them in 2006 in terms of correlations with major markets/accessing of opportunities. Do they stack up better or worse than, say, two years ago?
6. Commercial property - when do we specialise to add value and yield?
7. Is there any point in holding credit? Should we not barbell between gilts and high yield?
8. Can bank equity re-rate? Is the market not too pessimistic on the bad debt issue?
9. If Japanese government bond yields rise by 100 basis points, would this have a knock on effect on other markets?
10. Private equity - currently what are the expected long term returns on this warrant on equity markets? It seems a lot of new money is chasing after fewer, more highly priced deals.

Governance of Defined Contribution Pension Schemes

What makes a Good DC Scheme?

Many employers now offer their employees pension provision via some form of defined contribution (DC) arrangement. This may be alongside a defined benefit (DB) scheme, perhaps closed to new members, or it may be the main form of provision for current employees. Much of the debate around the switch from DB to DC has been conducted along the lines that DB is good and DC is bad. That is clearly too simplistic and a more appropriate question is to ask, what makes a good DC scheme?

Good governance is crucial for any pension scheme. It is important that the scheme is efficiently managed and meets the needs and expectations of the sponsor and of the scheme members. For corporate sponsors and pension scheme trustees familiar with DB schemes, an important issue is to understand the similarities and differences between effective governance of DB and DC schemes.

DC schemes put the investment risk of saving for retirement onto individual members, while typically giving them some control over how the pension contributions are invested. However, this transfer of risk and responsibility does not mean that effective management of the DC scheme is a trivial task from the employer or trustees' point of view.

From the [employee's perspective](#), there are four main decisions to make in relation to a DC scheme (see box in next column).

While these decisions are ultimately in the hands of the individual scheme member or employee, evidence suggests that scheme design can have a significant impact on the

Four main decisions

- Whether (or possibly when) to join the scheme
- How much to contribute to the scheme
- How to invest the resulting funds
- How to take benefits from the fund after retirement.

choices they make, for good or for bad. At EIA, we think it is important for trustees and corporate sponsors of DC schemes to consider carefully how members may perceive and respond to the arrangements in their scheme. For example:

Arrangements to consider

- How easy is it for employees to join the scheme?
- What guidance do members receive about how much they need to save to achieve a decent retirement income?
- Is the range of investment choice so narrow as to be restrictive, or so broad that it is likely to be confusing for members?

Investment presents one of the major challenges in DC (see box in next column).

Most scheme members are not particularly comfortable with investment issues and relatively few receive individual advice. As with DB, asset allocation is a key determinant of the investment outcome. Members need a growth strategy that will help them accumulate assets through their period of membership, but need to be careful to manage risk as retirement draws nearer. Lifestyle funds that switch from equities to bonds as the planned retirement date nears are a commonly used 'auto-pilot' approach to this problem but they are increasingly being described as 'blunt instruments'.

Key investment issues to address in relation to a DC scheme

- What degree of investment choice to offer to scheme members
- Whether to have a default fund for members who prefer not to choose their own investment strategy
- Whether to offer a lifestyle approach to asset allocation
- The roles of active and passive investment management
- The interaction between the investment choices in the scheme and other key decisions over joining mechanisms, contributory rates and annuity purchase
- How to communicate with members on investment issues and how to engage them in the choices they have to make

A key difference between DB and DC relates to the available form of governance. DB schemes operate under trust law, where the trustees are responsible for acting in the interests of members. Many DC schemes, especially large ones, also operate under trust and the trustees bear much the same responsibilities as in DB. However, a growing number of employees are opting for 'contract-based' DC schemes such as Group Personal Pensions (GPPs). In these schemes, the main relationship is between the pension provider - an insurance company - and the individual members. The relationship is governed by financial services regulation. However the employer typically chooses the provider and may play a role in shaping the menus of choices that their employees face. A key responsibility for the employer is in reviewing the ongoing suitability of the arrangements for their employees.

While most employers will be keen to ensure their DC schemes are well designed and well managed in order to maximise the chances of their employees enjoying comfortable retirement incomes, there are also important considerations about reducing the risk to the company of liabilities as a result of the DC scheme failing to live up to reasonable expectations. A well designed scheme with appropriate governance

arrangements will stand a better chance of meeting expectations and allows the employer to show 'due diligence' in the event that investment performance or other circumstances lead to members being disappointed.

Alistair Byrne

At EIA, we are able to provide ongoing advice to trustees of DC schemes & to pensions managers and governance committees responsible for overseeing contract-based DC schemes. We also undertake one-off consulting projects for DC schemes including conducting 'audits' of the efficiency & effectiveness of existing DC investment arrangements, & provide tailored training for trustees responsible for DC schemes. The latter is particularly suitable for trustees who are accustomed to overseeing their company's DB scheme and need to understand the different challenges that a DC scheme presents.

To discuss EIA's DC services in more detail, please contact Chris Edge (07740 928797) or Alistair Byrne (0141 564 1638).