



## EPIC PERSPECTIVES

### Quarterly Investment Comment - Q4 2006

**London Office**  
22 Billiter Street  
London  
EC3M 2RY  
Tel: 020 7553 2307

**Glasgow Office**  
180 Hope Street  
Glasgow  
G2 2UE  
Tel: 0141 564 1638

**Lancaster Office**  
PO Box 785  
Lancaster  
LA1 9DB  
Tel: 01524 389326

**E-mail**  
[eia@epicip.com](mailto:eia@epicip.com)

**Web**  
[www.epicip.com](http://www.epicip.com)

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#### Economic Commentary

Third quarter reports have been correctly focusing on the pace and quality of growth over the next year. The 2007 consensus numbers (given overleaf) have barely changed over the last quarter; these forecasts - quite rationally - reflect a 'US soft landing', a 'mid-cycle correction' and a 'growth pause'. However, as the IMF tells us, **the risks to these forecasts have risen** - high oil, soft US housing, slowing industrial production, falling commodity prices, and

residual interest rate fears, if inflation figures worsen. Hence commentators are raising their chances of recessionary risk in 2007.

**Inflationary pressures are high and wage awards to date have been modest.** Public sector wage behaviour has been good. The CPI numbers are now recognised as being erroneous at best to fundamentally flawed at worst. Rising heating and travel costs will continue to crimp consumer expenditure, as

a rising tax burden in the UK will. The 2007 outlook for the UK at least - as the \$60-\$70 oil pig moves through the python - is dull at best. However, there are no signs of a wage push, which must remain the key inflationary catalyst, which would disrupt what looks like being another long, rolling economic cycle. The stagflation scenario does not threaten as yet.

The consensus economic growth forecasts are as shown in table 1 (*overleaf*).

### Welcome to EPIC Perspectives

I am sometimes asked the question - "What is EPIC Investment Advisers for?". The answer, very simply, is to provide independent and experienced advice to pension fund trustees in order to arrive at the best investment and governance decisions for their funds. In an increasingly conflicted world, where traditional consultants may want to move away from an advisory role to 'implemented consultancy' and where a number offer fully fledged investment management services, we believe there has never been a greater need for an independent, impartial and attractively priced advisory service.

EPIC Investment Advisers, which was launched three years ago, is owned by EPIC Investment Partners (51 per cent) and the major part of the remainder by its founding directors. EIA's staff consists

of 17 Investment Panel and Associate members, all of whom are highly experienced in pension fund trusteeship, governance and investment. This group has at its disposal over 500 years of experience, derived in the pension fund, pension fund consultancy and investment communities. The company as such offers an experienced, wide ranging and practical 'one stop shop' to the UK pension fund world.

EIA's team members are regulated by the FSA and have professional indemnity insurance cover. Surprisingly, this is frequently not the case for many individual pension fund advisers. We operate primarily from our offices in the City of London, but we also have representative offices in Glasgow and Lancaster, and we expect to open more offices in other parts of the UK.

We plan to publish 'EPIC Perspectives' on a quarterly basis to give our audience, first, a broad investment overview and how this might relate to asset allocation decisions facing trustees and sponsors and, second, an insight into interesting industry developments. I hope you find it stimulating. Please let us have any comments or feedback if you think EPIC Perspectives can be improved.

Yours sincerely  
Chris Edge  
Chief Executive



## Quarterly Investment Comment - Q4 2006 (continued)

The UK stands out as the one forecast that could be revised on the downside.

Table 1 (Source: DKW)

	2005 %	2006 %	2007 %
US	3.5	3.4	2.6
UK	1.9	2.6	2.4
Eurozone	1.5	2.6	1.9
Asia Pacific (inc. Japan)	5.1	5.3	4.6
Eastern Europe	6.0	6.2	5.3
Latin America	4.2	4.7	4.0
World	3.3	3.8	3.2

Aside from the stagflation, question, the key questions for markets going forward will be:

1. Will US growth trough out in 2007 and accelerate back towards trend 3-3.5% levels?
2. Is growth in the 'emerging' world, the driver of this cycle, secure?

The answer to both questions has to be, on balance, 'yes'. The chances of US recession, while they have risen, remain low. The problem will be basic growth, not inflation, and this will allow interest rates to fall in order that momentum can be maintained. So there is no reason why trend growth should not resume, without markets suffering undue pain.

As for the 'emerging' world, it is difficult generalising about such a complex group but many of the economies are now financially strong and economic policy is set to avoid any repetition of the mistakes/accidents of the 1990s. Economic momentum will ebb and flow but will remain relatively robust. There is no reason to expect a disruption. The only issue is that political risk is seen as low and this is very likely to change for the worse. A different out-

come to the knife edge election result in Mexico could have resulted in changed perceptions for this group.

So the conclusions are:

1. There are short term uncertainties impacting on 2007 growth;
2. Stagflation is low risk;
3. The long term picture is broadly constructive.

Finally, we should plan for a longer term change in economic leadership away from the US towards Asia. The US has retained its place as the World's growth locomotive through the Russian and Asian crises, the TMT collapse and the 9/11 trauma, primarily due to an enlightened and highly successful Federal Reserve policy on interest rates. Deficits notwithstanding, the dollar has survived. We now have a more conventional monetary approach, to the point where the worries relating to excess US growth should reduce. The trade deficit should stabilise and the dollar move onto a more stable footing.

On the Asian side, the current mercantilist approach should soften. This will entail some give on currency matters and stimulate domestic demand to move trade surpluses towards balance. All this will take time but will doubtless create interesting investment opportunities.

### Market Outlook

Given that some of these 2007 uncertainties should be

reflected in markets, it follows that we should be looking to increase the level of risk to which we are currently exposed. We can wait for logjams to clear - stagflation risk, slower growth than forecast - but this is the way we should ideally be facing. There is no reason to take a significant amount of risk off the table - not least because bonds are not a particularly safe haven.

Equities are cheap versus bonds and corporate earnings have been robust. For corporates, it cannot get any better than this. 2007 earnings growth will be increasingly questioned and we cannot look for upgrades versus downgrades to continue to move favourably as we go forward. This should increase uncertainty and raise volatility.

The latest figures from Dresdner Kleinwort are shown in table 2.

Table 2 (Source: DKW)

	2006 EPS Growth %	2006 PER	2007 EPS Growth %	2007 PER
US	17.7	16.3	9.9	14.8
UK	13.7	13.3	6.9	12.4
Europe ex UK	11.9	14.8	9.7	13.5
Japan	17.4	19.1	11.0	17.2
Pacific ex Japan	10.3	15.3	6.1	14.5

By reference to the three main drivers - valuation, growth and liquidity - real equity assets look reasonably positioned long term. The equity risk premium is still worth paying for, on the basis of reasonably stable bond markets forecast and on the basis that the 2007 earnings estimates are sensibly constructed. On a price earnings to growth (PEG) basis, markets look reasonably rated on long term earnings growth estimates of 7% or so. A soft landing on inflation/interest rates presages another relatively long growth cycle. This should be good for equities, with the derated US market standing out as interesting.

Lower bond yields and contracting credit spreads have conferred revaluation benefits, particularly on property and private equity. This is now over. There are endgames to be played in the quoted property sector in front of the introduction of REITs but it now a question of budgeting for a coupon return.

Today's anomalies are to be found in the bond market. Very low credit spreads are unlikely to narrow and are at risk of a slowdown. The long end of the conventional gilt market is subject to negative inflation surprise. Real yields in the index linked market, now exceptionally low by historical standards, reflect a shortage of supply in the face of an enormous desire to immunise by pension funds.

What about hedge funds? Difficult times continue, particularly in the aftermath of the Amaranth Advisors

fiasco. Extraordinarily, Amaranth's huge losses were the result of a single trader's bet on the natural gas market. That debacle and suspicions of malpractice at other funds has led to revised calls for greater regulation of the sector. More generally, an analysis of hedge funds performance tells us that results are moving more in line with financial markets generally, that drawdowns are becoming more commonplace and that the diversification factor is diminishing. The momentum of returns is falling while remaining satisfactory. There are excellent

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offerings out there but it is now a question of accessing these. The jury is out, as it is for commodities, which a number of major pension funds have made small commitments to and where research and debate continues.

**Currencies, including sterling, continue to be an anomaly.** The US dollar has survived well, considering the widening of the current account deficit (from 3.8% of GDP for 2001 to 6.4% for 2005) and little or no interest rate support. Deutsche Bank tells us that the deficit widening would seem to result from higher oil and commodities, higher US growth relative to its principal trading partners, and the inability of the USD to depreciate against low cost emerging market countries. Excluding petroleum and China, the US trade deterioration (amounting to some \$350 billion in total) would 'only' have deteriorated by some \$100 billion p.a. or so in the period. Dollar depreciation has to date been focused on Europe/UK (where the trade deficit has widened by in excess of \$30 billion or so in the period), leaving a lot to be done in Asia.

In the UK, the oil factor, relatively high UK growth,

relatively high real returns, high competitiveness rankings and the desire to avoid a weak dollar have acted to support the currency. In terms of purchasing power parity, sterling is now estimated to be over 20% overvalued against the USD, over 30% overvalued against the yen and 7% overvalued versus the Euro. Against a basket of currencies, sterling is as strong as it has ever been. On the assumption of a more stable dollar against European currencies, this is a fair time to consider currency diversification away from UK assets on pure long term currency value grounds.

It is interesting in this context that Hermes has recently decided to reduce its UK equity percentage from 48% to 40% of its quoted equity exposure (planned to comprise 48% of the total fund), in favour of, principally, private equity, hedge funds and other 'unallocated' alternative investments. This must reflect a number of things - the profile of the fund, over-concentration in UK equities and a better balance of long term risk and reward in alternatives. The absence of undervaluation in sterling may have impacted on the decision.

**Conclusions & Questions**  
Trustees are primarily concerned about the

financial health of their pension plan, as advertised correctly or otherwise, by FRS 17 and IAS 19. The advice they will receive will probably be risk averse, focusing on immunisation and deficit avoidance. **The safest course for trustees to follow** (paying less attention to relative value and more attention to relative, historic risk) **is probably the most expensive course for sponsors.** Real assets - equities, private equity and commercial property - may offer short term volatility but they offer much greater long term value and, with bond yields where they are, are the only real immuniser for active lives.

So the extent to which trustees can retain an overall equity bias (to deal with active lives and the increasingly long cycle of retired lives) to expunge a pension deficit, should be a matter of debate with sponsors and consultants. Scenario planning - to gauge the likely short and long term impact of stagflation on a given deficit, for instance - will be important. These issues should form the backdrop for the meetings with fund managers where the stand out questions are set out below.

John Heskett  
Associate

### Did You Know?

EIA is a member of:

- The National Association of Pension Funds (NAPF)
- Pensions Management Institute Trustee Group (PMI)
- The UK Social Investment Forum (UKSIF)
- Institute of Business Ethics (IBE)
- The Society of Pension Consultants (SPC)



### 10 questions to ask your investment manager

- 1 What are the chances of stagflation?
- 2 The World seems to have coped with \$70 oil but if it rises to \$100, what then?
- 3 To what extent, if at all, should we rebalance our equity exposure away from the UK towards overseas, including Asia (including Japan)/Emerging Markets?
- 4 Commodities - should we get involved? And when?
- 5 Hedge funds - is there still scope for us to access these properly to give good risk adjusted returns over equities/bonds?
- 6 Commercial property - should we continue adding? And from where?
- 7 Is there any point in holding corporate credit? Should we not barbell between gilts and high yield?
- 8 Can bank equity re-rate? Are markets too pessimistic on the indebtedness point?
- 9 Should we be concerned about a 100 base point rise in Japanese bond yields? Will UK/US yields have to rise too attract surplus funds from Asia?
- 10 Private equity - what are expected long term returns now? Lots of money is flowing into fewer and larger more expensively priced deals.

# The Changing Face of Pension Fund Investment Advice

## New Names Arrive

In the three years since EPIC Investment Advisers was founded in June 2003, the world of pension scheme investment has continued to experience major changes. This is particularly true of the role of the investment consultant.

The emergence of scheme deficits has led to a re-evaluation of investment strategies which now focus on seeking to match scheme-specific liabilities as opposed to 'peer-group' benchmarking. This has in turn led to a progressive move away from the balanced investment mandates, which prevailed during the 1980s and 1990s, towards strategies based on the appointment of specialist managers for specific asset classes. This has led to a very significant increase in the costs of manager research for the traditional investment consultancies as they have been obliged to increase their coverage of managers away from the relatively small universe of balanced managers.

The need to at least match liabilities in an environment where inflation is low and the expected returns from traditional asset classes are generally forecast to be lower than hitherto is also leading trustees to explore new investment styles and alternative asset classes. Everyone needs to take notice when BT, the UK's largest pension scheme, cuts its allocation to UK equities by nearly a third and more than doubles its exposure to alternative assets. The objective is to increase exposure to assets which can produce above market returns in exchange for little extra risk.

Where the BT pension scheme and other larger funds tread, including many local authority schemes, others will surely follow. The average exposure to UK equities across all funds is today around 35 percent, down from 48 percent three years ago, and the overall weighting to all global equities is about 62 percent by comparison with 68 percent in 2003.

Recent research published by the Bank of New York and Casey, Quirk (a consultant) found that in the US, the 100 largest schemes are assuming an 8.5 percent average annualised return to meet their liabilities. However, the Congressional Budget Office estimates that the expected return from a typical portfolio mix of 60 percent equities and 40 percent bonds, will be only 5.7 percent per annum. The gap between the required and forecast returns when compounded over a long period is enormous. This situation is replicated in the UK and explains the growth in interest in alternative investment techniques and asset classes.

However, the commitment to alternative assets across all pension schemes remains incredibly small - according to Mercer, a mere 0.7 percent of all assets are now in hedge funds, with only 7 percent of funds making any allocation at all to date. For private equity, only 6 percent of trustee boards have made any commitment so far, with the

average allocation at a mere 3 percent of total assets.

Although, as yet, the exposure to newer asset styles is very modest, there is a huge and ongoing proliferation of new products and providers. This is massively increasing the research costs of those investment consultants who seek to offer a waterfront manager research coverage. No longer is it acceptable to advise trustees that newer asset classes are too complex to be considered!

These developments combined with corporate ownership changes, have put great pressures on the

business models of the traditional actuarially-based investment consultancy practices. In future, the issue is whether the traditional structure of a small number of large consultancies who cover all actuarial and investment areas to some degree of depth will continue to prevail, or whether there will continue to be a growth in smaller specialist firms covering specialist subject areas in greater depth.

The UK pensions market is the most consultant-led in all Europe. According to Mercer in the UK 95 percent of pension schemes use external consultants. This compares with 75 percent in France and Germany and only 40 percent in Spain. In terms of market share, the three leading consultants, Mercer, Watson Wyatt and Hewitt account for 65 percent of the entire market in the UK, but only 55 percent in France, 50 percent in the

Netherlands and 25 percent in Germany. On the other hand, the respective market shares of the top three firms in the Irish pension fund market is 80 percent and, in Portugal, 100 percent.

Some of the global consultants are also treading the path previously adopted by Russell and SEI in developing their own multi-manager style offerings, mainly for smaller clients who have become less profitable as research costs have escalated. Together with the need for schemes to improve their governance structures, there is an increase in specialist consulting and advisory practices, either working alongside the major consultants or, in other cases, supplanting them. These include Bfinance, a specialist quantitative research consultant with a different charging model to the typical time-based structure which has generally prevailed in the past.

As well as the clear need for trustees to seek skilled and genuinely independent investment advice, the provisions of the Pensions Act have led to an upsurge in demand for the services of independent trustees. The fundamental requirement is for trustee boards to review, establish or improve their governance structures and operational risk procedures. By working through this process, several essential cross-checks should be carried out - for example, are investment advisers regulated by the FSA, and do all external service providers have adequate professional indemnity insurance arrangements in place?

Chris Edge  
Chief Executive

