friday view

By Sebastian Cheek

We all have those things we don't like doing that don't give instant gratification but that we have to do. For me, it's usually cleaning the flat, sorting out bills or, and I'm not sure I should be admitting this, paying into an ISA/pension. If I can't immediately see the tangible benefit of it then how is it exciting and worth putting much effort into?

I guess the pension scheme trustee equivalent of this is dealing with liabilities which for most schemes far exceed their asset values leaving them with poor funding ratios. Of course, in an ideal world pension funds would be 100% funded but low gilt yields, low interest rates, high inflation and mark-to-market accounting standards have ensured this is not the case.

Meanwhile, difficult markets have meant lacklustre asset growth has done little to counteract this incessant escalation of liabilities. But, given the fact these liabilities are not due to be paid for several years down the line, it is no surprise many scheme trustees tend to spend the bulk of their time looking at the more immediate or 'sexier' stuff on the growth side of the portfolio, such as asset manager selection, assets that offer a yield and where the opportunities to invest are.

Trustee attention to this side of the portfolio has been further heightened by how they view the risks associated with the growth portfolio – equity market risk and active manager risk – which they see as posing the biggest threat to their funding positions. However, interest rate and inflation risk actually have a much greater impact on a scheme's funding ratio than asset risk does.

Indeed, as F&C director, client relations, Simon Bentley explained earlier this week, for a scheme with £200m liabilities, £160m assets and assuming a 50% weighting and an illustrative one-year move of 15%, equity market risk has only a 6% (£12m) impact on funding ratio. However, interest rate risk which has a 100% weighting has a 20% impact on the funding ratio (£40m).

So proof that liability risk does outweigh asset risk, but the difficult thing about liability driven investment (LDI) is timing it correctly, especially with market conditions currently so unpredictable. That is why schemes should act mechanistically and investigate triggers to address this unrewarded risk rather than jump into LDI wholesale.

As Bentley also said, the biggest risk is posed by not putting anything in place because "things move before you think they do". It may seem like a chore now but will surely pay off in the long run.

New push on pension charges disclosure

By Richard Saunders, chief executive, Investment Management Association

The opening of the party conference season usually marks the opening of political hostilities after the summer break, so expect the disclosure of pension charges and costs to come back on the agenda. My view, not only as a spokesman for the asset management industry, but also in my other capacity as a consumer, is that there is still urgent work to do on this.

Like many people I am an investor in a self-invested personal pension managed by a leading provider. I would like to know how much it is costing me, but even I – who ought to be able to find my way round the detail – find it difficult to work it out.

What is needed is not difficult: the costs of the underlying portfolio (in effect the average ongoing charges in the funds I invest in), plus the costs levied by the provider or platform, with payments to my adviser shown separately, all expressed as a percentage of my portfolio.

Why is this not standard practice already? One problem is fragmentation: trust-based and contract-based schemes, with different regulators and different rules. We need to find a way through this complex thicket if we are going to deliver something that helps consumers. A good starting point is the "ongoing charges" model that has been adopted under European rules for retail funds. This provides a single percentage figure which includes all charges levied as part of running the fund over the previous year. And it works – the number gives investors a clear picture of the cost of investing and enables consumers to compare different funds on a like-for-like basis.


Picture: stockphoto

This model needs be extended to other product types, including pensions. Recent proposals by the European Commission (the Packaged Retail Investment Products, or "PRIPs" initiative) seek to do that. But euro-legislation takes time and this measure is expected to run into strong counter-lobbying so we do not know how it will finally come out.

In order to move ahead more quickly, therefore, somebody needs to pull together the various charges – the ongoing charges on underlying investments, adviser fees, and the charges applied by the administration platform – into the sort of disclosure made in the funds world. This job naturally falls to the pension platform or provider, the entity facing the investor. They need to be under an obligation to do so in a prescribed common format. Meanwhile, other parts of the chain need to be under an obligation to make the necessary information available. The new IMA guidance on transaction cost disclosure can play a part here too.

So, how do we make this happen? It's not my usual solution, but this is an area where regulators need to be involved. Regulation has delivered a uniform charge disclosure regime for funds in Europe, and it ought to be able to do so for pensions. It needs the industry to pull together with the relevant regulators – the FSA, The Pensions Regulator and the European supervisory authorities. It's never easy to co-ordinate so many disparate groups. But it can be done and the prize of better consumer disclosure is a big one.

The case for emerging market bonds

By Greg Saichin, head of emerging markets and high yield fixed income portfolio management, Pioneer Investments

July was one of the strongest months on record for flows into emerging-market debt. What are the reasons behind this drive?

These flows were driven by the search for yields with a reasonable risk profile. Emerging market (EM) securities are no longer viewed as overly risky assets as was the case in the past. They remain sensitive to economic growth and are duly affected by investors' risk aversion when recession fears come to the fore. However, the long-running euro-debt crisis has shown the extent to which the credit standing of EM issuers has improved.

Market action is telling. Over the last five years we have experienced the sub-prime crisis, followed by a recession and then the euro-debt crisis. The JPM EMBI Composite Index fell dramatically in the wake of Lehman Brothers' collapse in 2008 and the ensuing recession but it maintained its position reasonably well during the euro-debt crisis. Throughout the period, it has outperformed not only the EMU Government Bond Index (dragged down by the performance of peripheral markets) but also the JPM Global Bond Index where traditionally the safest markets (US, Japan, Germany) account for a large proportion of the Index.

These crises have prompted investors to revise their risk profiles. There was a time when EM bonds took centre stage in past crises and even sparked crises themselves. Since then, EM governments have learned many valuable lessons and have become better than many developed countries at managing their own balance sheets. Financial markets are acknowledging their efforts, even in times of market volatility.

Are EM-based companies as financially sound as EM governments?

Risk re-rating has already encompassed sovereign issuers, whose risk premiums have declined as a result, while corporate issuers are still widely viewed as somewhat less reliable in spite of the ongoing improvement in their financial management. Corporate issuers are increasingly part of the private sector and, unlike the past, have little or no relationship with governments (especially for energy-related companies). In a globally integrated world, the management teams of EM companies face similar problems to their counterparts in developed countries and have been compelled to act decisively during difficult times, such as the recession.

Not all management of EM-based private-sector companies can boast the experience of their US and European counterparts. However, the risk premium paid above sovereign bonds still seems excessive and when compared to underlying fundamentals. EM corporate bonds also pay a premium over EU and US corporates with the same credit rating. The small allocation in most portfolios, also as a result of a poor representation in most benchmarks, may be a reason for this cheapness. Market benchmarks should eventually reflect the increased issuance.

Is market liquidity still a problem?

The EM corporate bond market has grown dramatically over the last 10 years and based upon data from JP Morgan Chase the total tradable amount of emerging debt outstanding is currently about US$12trn. New corporate issues have dwarfed sovereign issues since 2005 and were worth almost three times as much in 2011. This pattern has added liquidity and has provided more options for bond selection. The private sector accounts for a large part of new issuance and has contributed to sector diversification. The correlation among different sectors is quite high and can often be affected by overall risk aversion, which is not an ideal situation for true stock pickers.

However, we believe that selecting well-managed companies can add value to a portfolio. Our team must also assess any legal risk, stemming not only on the bond's covenant but also from opaque solvency regimes in different countries. This may already be included in risk premiums, but it takes a specialised and well-experienced investment management team to provide a proper assessment.

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Reading the tea leaves

By Nick Gartside, international chief investment officer for fixed income, JP Morgan Asset Management

Well, was that it? The post 'QE infinity' rally seems to be consolidating already a mere two weeks after the big event. In reality though, this isn't altogether surprising. As we discussed at the recent quarterly meeting the move from central banks acting in a reactive, to a proactive manner, and pledging to 'do what it takes' has reduced the tail risk scenarios.

We reduced the probability of 'crisis' and 'above trend growth' to 5%, while increasing our 'sub trend' recovery base case to 80% leaving a 10% weight on the 'recession' scenario. Essentially, this puts the market focus back to where it was at the turn of the year and attempting to read the tea leaves around two key issues: the growth outlook and the eurozone.

The growth outlook does look worrying, just as it has many times this year. Our proprietary lead indicators point to a very pedestrian growth profile and the anecdotal evidence from credit analysts suggests increased nervousness from company management teams. Recent rhetoric, and actions, from central banks, however, reinforces that they are alert to downside risks and stand ready to provide more monetary policy accommodation.

Looking at the other pillar of worry, the eurozone, there's no cogent message from the tea leaves. We're back to trying to decipher summit communiqués as well as conflicting and competing versions of events from national policymakers.

The focus now is on the implementation risk. When will the fiscal compact be implemented? When will the plans for a banking union be advanced? And above all, when will the weaker eurozone countries move to request ECB assistance? The leaves are sadly unclear on all of these.

For fixed income markets this means a renewed focus on policymaker action (and inaction) which will fuel the usual risk on: risk off cycle and in turn create opportunity.

With the central bank put option in play, interest rates on hold for longer and cash cascading into bond funds, we're also inclined to look to buy corrections in risk assets.

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Infrastructure themes in the US

By Andrew Greenup, senior portfolio manager, Global Listed Infrastructure Securities, First State Investments

Face-to-face visits are a big part of the investment process, as they let managers glean valuable information about a prospective investment. First State Investments recently made a research trip to the US, visiting a raft of people from companies, regulators and across the industry. From the trip it became apparent that the US is set to benefit from structural growth stories such as increasing use of mobile data and investment in domestic rail. At the same time, market optimism is growing as the US economy slowly continues to recover.

A bigger bite of the Apple

The launch of Apple's iPad 3 in the US brought home to us a fundamental change taking place in the US wireless industry: people performing more data-intensive, everyday activities on their phones. Such activities use more data, irrespective of which devices (e.g. iPhone, Blackberry) or applications (e.g. Facebook, email, Google Maps) are popular at the time.

A direct result of US consumers using more data in this way is increased congestion of carriers' networks. For carriers to grow their businesses in a competitive market (with four nationwide players), they need to continue to invest in their network infrastructure, namely cell sites. Tower companies such as Crown Castle and American Tower Corp own the physical steel structure used in the cell site, meaning they are well placed to benefit from this trend. We own both companies in our fund. The outlook looks bright for the industry as consumers are expected to rapidly soak up the capacity that carriers are installing, forcing a continual cycle of capital investment (similar to the 3G trend).

From new technology to old: railroads

The North American railroad sector has enjoyed a renaissance in recent years, as pricing and returns have improved. This has allowed management teams to re-invest in their business to improve service (more sidings, better IT systems) and open new markets and volume opportunities (new, efficient terminals). With improving service, the US rail industry has a case for continued pricing gains. Our research trip reaffirmed our positive outlook for the US rail sector.
In the longer term, we believe that demand for infrastructure assets, underpinned by the chronic need for improvement in several areas globally, will support the asset class. As investors, we are conservative custodians of our clients' money, recognising that capital preservation is critical to achieving long-term capital growth. Looking ahead, we will continue to focus on quality infrastructure stocks that can deliver inflation-protected income and steady growth.

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Have a nice weekend.

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