PMI
Floor 20, Tower 42
25 Old Broad Street
London EC2N 1HQ
T: 020 7247 1452
F: 020 7375 0603
W: www.pensions-pmi.org.uk

Core Unit 4 – Financing and Investing for Retirement Provision

Assignment 4 Notes

(Parts 4 Investment Types and Part 5 Investment Strategy and Governance)
Recommended Time: 1 hour

1. **Briefly describe the distinction between ordinary and preference shares. Give an overview of the different types of markets available for trading in equities, commenting on:**

    - **UK and overseas markets**
    - **primary and secondary markets.**

10 marks

Within the UK market, there are various equity indices, measuring the fortunes of the stock market. The most commonly referenced index is the FTSE 100, which consists of the 100 largest companies by market capitalisation (total value placed by the stock market price on the shares in issue) quoted on the London Stock Exchange. These larger stocks are considered less risky investments than the shares of smaller companies ('small caps'), which are generally less well scrutinised by equity analysts, less liquid and, given their size, more susceptible to business failure.

UK equities make up only around 10% of the global stock market by market capitalisation, and so there are many opportunities to invest internationally.

It is worth remembering that a company may not choose to list its shares in the country it is headquartered, primarily for the reason that the major stock exchanges (e.g. London, New York, Tokyo) provide the company with access to a larger and wider base of investors. Shares may also be dual or multiple listed on two or more different exchanges.

Equities in developed countries are usually considered less risky than those in emerging markets and generally display less volatility. Meanwhile, investors should also be aware of the implications of currency fluctuations when investing in overseas equities. We deal with this aspect in more detail in Chapter 3.

Shares in publicly listed companies can be bought and sold on stock exchanges. The primary market is the market for new issues of shares that enable companies to raise new capital. This usually requires the approval of existing shareholders, as the new issue would dilute the value of their shareholding. The secondary market is where investors can buy and sell shares already in circulation.

The London Stock Exchange (LSE) is itself a publicly listed company, which provides a market place for shares to be traded. For the equity market to work efficiently, investors will only buy shares in the primary market if they can be assured that they can sell them on to other investors to realise their gains. Therefore, the secondary market is essentially a forum for the buying and selling of second hand shares.

As well as running the 'main market' for shares in larger companies, the LSE provides a marketplace for trading in the shares of newer and smaller companies. Known as AIM (Alternative Investment Market), this market has less stringent regulatory requirements than the main market for companies wishing to be listed on it.

The key systems used for trading on the LSE are SETS (Stock Exchange Electronic Trading Service) and SEAQ (Stock Exchange Automated Quotations System). Larger, or more liquid, stocks (generally FTSE 100 companies) are traded on

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SETS, which allows buyers and sellers to trade directly with one another. SEAQ is for more illiquid shares and involves two-way prices for market makers and broker dealers.

(The relevant sections of the Study Manual are Part 4, Chapter 1.1 & 1.2)

2. **Describe the different types of bonds issued by governments and companies.**

10 marks

Government bonds, issued by the central governments of countries (such as UK gilts, US Treasuries, German Bund), are traditionally considered the 'safest' type of bond, as they are backed by government guarantees and there is a very low risk of default, except for financially unstable countries.

Bonds issued by supranational agencies, such as the World Bank or the European Investment Bank, are considered as safe as those issued by central governments.

Bonds are also issued by lower levels of government (provincial, state or local authorities) and government agencies (such as the US Federal Home Loan Mortgage Corporation, also known as Freddie Mac). However, these are generally not considered to be as safe as government bonds.

Governments issue both conventional bonds, with a fixed coupon, and **index-linked bonds**, where the coupon and the redemption payment are linked to a measure of inflation (such as the consumer price index (CPI) or retail price index (RPI) in the UK). This provides protection for the original investment against the effects of price inflation.

In response to growing demand from pension schemes for assets to match their inflation-linked liabilities, the range of maturity dates has been expanded in recent years, with ultra-long dated bonds of a 50-year maturity now available.

Corporate bonds are bonds issued by companies. They are sometimes referred to as 'credits'. Corporate bonds carry a higher yield than most government issued bonds, as companies need to offer greater rewards to investors to compensate for the additional risk of default involved. However, a company's bond is still less risky than its shares because if a company becomes insolvent, bondholders rank above shareholders as creditors.

Although less secure than gilts, most corporate bonds are rated by independent credit ratings agencies to give some measure of the level of security that they can find in a particular issue. The main rating agencies include Moody's and Standard & Poor's. Corporate bonds with a high credit rating are called **'investment grade'**. The highest rating is AAA/Aaa ('triple A'), which indicates that a company is viewed as financially very strong and highly unlikely to default on its payments to bondholders. The lowest rating within 'investment grade' is BBB/Baa.

High yield corporate bonds cover the higher risk segment of corporate bonds, in particular those rated as non-investment grade. This segment includes bonds rated BB/Ba and below. High yield issuers have to offer greater rewards than investment grade corporate bond issuers, due to the higher risk of default.

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Emerging market debt includes bonds issued by governments and corporations of less developed countries. They tend to offer higher returns to compensate for the increased economic and political risks compared to developed countries. Some of the largest issuers in the emerging market debt segment are Brazil, Mexico and Russia.

(The relevant section of the Study Manual is Part 4, Chapter 2.2)

3. **What is meant by a derivative? Outline the key features of:**

- **futures**
- **forwards**
- **options**
- **swaps**

10 marks

Derivatives are a type of financial instrument that derive their value from the price of an underlying asset, such as an interest rate, equity, commodity or currency. Instead of having to buy or sell the underlying asset, a fund manager can buy or sell a derivative linked to the underlying asset, often at a lower cost, and still take advantage of movements in the underlying asset. Derivatives are not only linked to single assets, but may also provide exposure to a market or sector. Many different types of derivatives exist.

Futures are contracts where a buyer agrees with a seller to purchase an asset at a specified date in the future, at a price agreed upon today. This will be based on an expectation that the price of the asset in the intervening period will rise (from the point of view of the buyer) or fall (from the seller's perspective), thereby enabling them to immediately reverse the transaction and make a profit. Futures are standardised products, traded on an exchange.

Forwards are contracts similar to futures, but they are customisable and traded 'over the counter' (OTC) i.e. through private agreements rather than via an exchange.

Options are a type of derivative that gives the buyer the right, but not the obligation, to buy (a 'call' option) or sell (a 'put' option) an underlying asset at an agreed price on a specified future date. This is the main differentiator from futures, where there is an obligation to buy or sell. Another difference is that an option requires an upfront premium to provide the right to buy or sell at the end of the contract, whereas there is no upfront cost for a future contract apart from commission. A further difference is that future contracts generally involve much larger underlying positions than options and there are also differences in the way that the contracts are settled.

Swaps are contractual agreements where two parties agree to exchange (swap) either single payments or a series of payments in the future. While some swaps are highly complex, the vast majority of contracts involve the swap of a fixed payment for a floating series of payments. Swap contracts can be tailor made to each investor's specific requirements. They are not traded on an exchange, but OTC, like forwards. Financial organisations, such as banks and other money market institutions, are the main operators in the swaps market.

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The following types of swap are widely used:

- Interest rate swaps –In its most common form, a fixed rate of interest is exchanged for a variable rate of interest
- Index swaps – The exchange of one index return for another index return or for a variable interest rate
- Currency swaps – A pre-agreed amount of foreign currency is exchanged now and re-exchanged at a certain specified date in the future.
- Credit default swaps (CDS) - One party buys protection ('insurance') from another party against the default of a third party, usually a corporate bond issuer.

(The relevant section of the Study Manual is Part 4, Chapter 4.1)

4. **What are the objectives of an absolute return fund? Outline the main features of the following:**

- **diversified growth funds**
- **long/short funds**

10 marks

An absolute return fund aims to generate positive returns in all market conditions, along with some form of capital (or downside) protection. This contrasts with a traditional equity fund, which seeks to generate returns relative to the equity market. An absolute return fund will often have an annual target that it aims to achieve, or exceed, which is typically set at 2-4% above the cash rate, or above inflation. The cash rate in this case is usually measured by LIBID, the wholesale deposit rate.

Absolute return funds come in various guises. Some are based largely on fixed income assets, while others mainly invest in equities and equity derivatives. There are also those that use asset allocation methods to achieve their goals. This may be done through the use of alternative assets, including currencies.

To produce positive returns in all market conditions, the fund manager has to have the flexibility to use investment techniques beyond those used by traditional fund managers. In particular through the employment of derivatives, which can be used to hedge certain risks, add value to the portfolio and reduce trading costs.

Investors have long appreciated that diversifying a portfolio helps spread the risks associated with any one class of investment. . Funds that provide diversified sources of return are often called **diversified growth funds.**

Multi-asset or asset allocation funds seek to meet their objective by investing in a broad range of assets. In addition to the traditional asset classes, such as equities, bonds and cash, these products may invest from time to time, or on a structural, sustained basis, in commodities, property, currencies and structured products – often using funds or vehicles managed by other providers.

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Investment risk may be further diversified through varying investment across a number of regions. The manager is able to achieve a positive return in all market backdrops because the returns from these assets have a low correlation or are completely uncorrelated. This means the prices of these underlying assets do not move in tandem, for example a sell-off in equities might prompt a rally in bond prices, as investors seek safer investments. Meanwhile, commodity prices are linked to completely different supply and demand pressures from equity, bond or property prices.

Asset allocation funds tend to have unconstrained investment strategies, meaning that managers have complete freedom to move between asset classes to achieve the optimal blend of investments for different market conditions. Managers depend on a combination of market returns, asset allocation and management skill/timing to achieve their objective. These funds often have a predominantly long exposure, meaning that they are exposed to the direction of the underlying markets.

Long//short funds operate in a different manner. Traditionally, fund management has been based on identifying assets that are expected to appreciate in value (a **long position**), thereby realising a gain for the investor. However, as financial markets have developed, investors have devised new ways of incorporating disfavoured stocks into an investment strategy, either as a means of generating profit or hedging risk. This technique is generally known as '**short-selling'** or 'shorting', whereby an investor can use various techniques to benefit from a fall in an asset's value. A long/short fund combines long and short positions in individual companies' securities and thereby seeks to exploit both rises and falls in asset prices.

(The relevant section of the Study Manual is Part 4, Chapter 4.2)

5. **Lifestyling and target date funds are both used in defined contribution schemes. Outline their purpose and how they both operate.**

10 marks

A **lifestyle strategy** is a set investment strategy that automatically switches members' funds to what are considered to be lower risk asset classes as the member approaches retirement. It is commonplace for the default strategy to be a lifestyle strategy.

Lifestyle strategies are typically split into two phases. The **growth phase** typically lasts until between 5 and 10 years before the individual member's selected retirement date, at which point the **consolidation** phase begins.

During the growth phase, most or all of the contributions might be invested in different equities and/or diversified growth funds to offer the best opportunities for long term growth, as shares have historically outperformed other asset classes, such as bonds and cash, over the longer term.

Equities are subject to a higher level of volatility, which can make them a less suitable investment for holding as the member nears retirement and if funds are required at that time (to buy an annuity or withdraw cash), since any large falls would be difficult to make up over a short period. In such circumstances, during the consolidation phase, exposure to the risks associated with equities is typically reduced in favour of funds that offer safer and more predictable returns, in particular bonds (to provide for annuity purchases) and cash.

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This approach to the consolidation phase was prevalent before the abolition of compulsory annuity purchases in April 2015. For members wishing to take benefits as drawdown, the traditional lifestyle strategy may not be appropriate as the member will have a longer investment time horizon that stretches into retirement, and so many DC schemes have been re-designing their lifestyle strategies accordingly.

One benefit of opting for a lifestyle strategy is that the individual member does not have to manage the de-risking of their investments as they approach retirement – the funds are switched automatically within the set lifestyle matrix. This switching is undertaken by the administrator or provider.

As with any investment choice, members need to consider their attitude to risk – a lifestyle strategy may not be suitable for everyone. A member with a large fund and a wide portfolio of other investments may feel more willing to invest in higher risk asset classes when close to retirement than a member whose only source of retirement income is from one modest pension fund. With the new flexibilities introduced in April 2015, which no longer require members to purchase annuities at retirement, some members may instead wish maintain exposure to growth type assets in retirement.

Increasingly, trustees who provide a lifestyle strategy as the default strategy (with the aim of it being sufficient for the majority of members) may offer one or two additional lifestyle strategies with alternative fund allocations and risk profiles, so that members can select the strategy that best suits their own outlook on investments.

Target date funds (or 'life-cycle' funds) are an alternative to lifestyle strategies. They have most notably been adopted as the default strategy by NEST (the National Employment Savings Trust). Target date funds, like lifestyle strategies, are heavily invested in growth assets when the individual member is young, and progressively switch to safer assets, such as cash and bonds, as retirement age approaches.

Target date funds are individual funds rather than strategies. The fund is member-specific and targeted to the individual's retirement date. For example, a member retiring in 2030 would be invested in a fund that de-risks to 2030 with the investment manager having flexibility to determine the asset allocation in the intervening period.

(The relevant section of the Study Manual is Part 5, Chapter 1.3)

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