

Smart ideas about wealth

Barclays Capital Equity Gilt Study 2007

Published: 14 March 2007

We have now obtained our copy of this year's document, which makes, as always, interesting reading, being written as it is for institutional investors such as large pension funds.

Interestingly, considering that we did spend some time investigating the possible inclusion in our clients' portfolios of an index fund offering exposure to commodities as a diversifier but then rejected the idea, the study comments that the flow of capital into commodity index investments in the last couple of years has pushed up prices such that it has served to eliminate part of the prospective return that made the asset attractive originally.

Private equity is also addressed, with the comment that it is, as we have maintained ourselves, not a separate asset class from other equity but merely a variation of it (after all, its returns are still subject to the same factors as quoted equity). Indeed, the study highlights other issues with private equity, namely the illiquid (by definition) market which means that valuations are periodic and based on accounting updates rather than market prices which investors actually pay. The consequence of this is an apparent lower volatility than publicly quoted equity which is valued on a minute-by-minute basis in the market, although this is merely a function of the smaller number of data points. It can also appear to have good diversification benefits although this too is merely an artefact of the data. Given all this, we entirely agree with the assessment that private equity is simply public equity with additional leverage (i.e. more risk) and management fee structures which are several orders of magnitude more expensive (we would suggest that this represents additional risk for the investor, as it reduces the amount of net return available and thus the likelihood of achieving goals which depend on that return). As we point out in our Investment Methodology document, private equity exposure is really only appropriate for those clients who are happy that they understand the risk and other downsides of this asset class and even then, such exposure would be restricted to the 'ideas portfolio' as opposed to being part of the diversified long term portfolio

One of the consequences of the raft of regulations applying to private sector final salary pension schemes which have been enacted in the years since the Maxwell scandal has been an increased demand for long-dated government and corporate bonds as schemes seek to protect themselves against long term interest rate risk. However, as the study points out, this interest rate risk (the risk that long term interest rates will be higher than currently and thus future payouts will consume a greater proportion of the scheme assets) is really only an accounting risk and the real danger is one of increasing longevity of scheme members once they start to draw benefits. Unfortunately for such investors, there are no natural sellers of longevity risk and thus no perfect hedge, so the best option is likely to be to have a surplus of assets over liabilities and the best way to achieve this is to invest in equity so as to maximise potential returns. While this approach might conflict with the regulatory requirements for occupational pension schemes, private investors concerned with longevity risk (as most are, or at least should be) have no such constraint.



Smart ideas about wealth

Indeed, the authors suggest that a more appropriate yardstick for measuring the need for funding of such schemes would be the required return on assets necessary to meet the cashflow projections of scheme liabilities so that investor could then assess whether this rate were realistic given their risk capacity and expected future returns. Long term clients of Bloomsbury will be aware that we have been using exactly this approach for some years so it is encouraging to see a major institution agreeing with our rationale!

As to what these future returns might be, the study suggests a future risk premium for equities of around 4% over bonds, which coincidentally is the same assumption that Bloomsbury currently uses for broad equity market returns. As we explain regularly, this represents a reward to long term investors for accepting the higher systematic risks of equity investment compared to owning debt (i.e. cash or bonds). Although it is possible to hedge away some of this risk by the use of derivatives, as with many structured products, the uneven returns from equities from year to year tend to reduce long term returns to such an extent that the excess return disappears too – there is, as they say at the University of Chicago, no such thing as a free lunch. Without risk, there is no return. The study concludes that the best solution for investors is to create diversified portfolios of risky assets (the optimal mix being the same for all investors) and then to dilute that by replacing it proportionally with less risky assets such as cash according to each investor's required or desired risk and return parameters. Interestingly, that is exactly the methodology that we follow with our clients' portfolios.

Contacts	Telephone	Email
Jason Butler	07973 951107	jasonbutler@bloomsburyfp.co.uk
Carolyn Corless	07775 712969	carolync@bloomsburyfp.co.uk
Robert Lockie	07951 725880	robertl@bloomsburyfp.co.uk

Disclaimer

This document is intended for informational purposes only and no action should be taken or refrained from being taken as a consequence of it without consulting a suitably qualified and regulated person. It does not constitute financial advice under the terms of the Financial Services and Markets Act 2000. It is not an offer to sell, or a solicitation of an offer to buy, the instruments described in this document. Past performance is not an indication of future performance. Interested parties are advised to contact the entity with which they deal, or the entity that provided this document to them, if they desire further information. The information in this document has been obtained or derived from sources believed by Bloomsbury Financial Planning (BFP) to be reliable, but BFP does not represent that this information is accurate or complete. Any opinions or estimates contained in this document represent the judgement of BFP at this time, and are subject to change without notice.

BLOOMSBURY and the Bloomsbury Logo  are registered trade marks used under an exclusive sub-licence from Raymond James Investment Services Limited (RJIS). RJIS is a member of the London Stock Exchange and is authorised and regulated by the Financial Services Authority. Registered in England and Wales No. 3779657. Registered Office 77 Cornhill, London, EC3V 3QQ.

© 2006 Bloomsbury Wealth Management LLP