XPS Investment

Investment briefing

August 2018

'No-deal' Brexit – what you can do to prepare

In brief

- Decision to leave the EU creates new opportunities for the UK
- But a no-deal exit is widely considered undesirable
- Impact on UK equity, property, credit and Sterling markets could be significant
- Liabilities may also be increased by falling gilt yields and rising inflation
- Overall impact on a UK pension scheme could be a material worsening of their funding position

Next steps

- There are a range of actions pension investors can take to strengthen their scheme's resilience to this uncertainty
- Contact your XPS consultant to discuss how we can help

The decision to leave the European Union creates new opportunities for the UK, the world's 5th largest economy, to redefine how it wishes to trade with the rest of the world in the future. But with it comes uncertainty, particularly in relation to the transition to the new normal.

A 'no-deal' Brexit is widely considered an undesirable outcome, albeit may be considered the best of a bad bunch depending on the path of negotiations over the coming months.

In this short note we look at what a no-deal scenario could look like in terms of the wider economy, pension scheme finances and the investment industry, and what, if anything, pension scheme investors can do to prepare for this eventuality.

Effect on the UK and global economy

A no-deal outcome has significant implications for the UK and European economy as a whole. It is easy to imagine how a loss of clarity over tariffs and regulatory structure could push the economy into turmoil. Many parts of our economy exist on finely honed 'just in time' processes, from car assembly to food and medical supply delivery, and even a short delay can compound to create havoc. Any detriment would not be limited to direct impacts of a supply chain, as there are also many secondary and tertiary effects which could be felt hard in our integrated society. You only need to look at the knock-on effects that the shortage of CO_2 created in June this year, from beer drinkers and food packing through to abattoirs, to appreciate the scale of the potential cost. After all CO_2 is a supply chain issue that many of us didn't even know we didn't know about.

Decision makers are conscious of these concerns but the scope for unintended consequences is huge, and the possibility of some key issues falling through the cracks is considerable. Therefore we are not complacent.

> A no-deal Brexit introduces uncertainty that cannot be avoided, but speculation on the outcome should be

Simeon Willis
Chief Investment Officer

Global markets – a no-deal scenario

UK pension schemes are fortunate, in that unlike the many thousands of businesses that trade with the EU, the management of a pension scheme is largely a domestic matter, governed by UK legislation and with benefits paid in Sterling. This insulates the industry to some extent, but by no means entirely. The knock-on effect of a volatile UK economy will feed through to sponsor covenant, investment returns and could affect fundamental cornerstones of pension investment such as access to investments.

We set out below an example of a plausible scenario that portrays the impact of a 'no-deal' situation on different investment markets, followed by the impact that this could have on a typical pension scheme:

1	**UK equities: 15% fall**	We look at the impact from two aspects: the impact on the largest 100 companies ('FTSE 100') and the impact on the next largest 250 companies ('FTSE 250') together with Small cap companies. The companies within the FTSE 100 generate the majority of their revenue from overseas earnings, therefore any depreciation in Sterling will result in an increase in their Sterling reported revenues. However, the uncertainty of a no-deal exit and potential operational issues will still likely result in an overall fall in values. The net negative impact on companies in the FTSE 250 is likely to be much greater as the majority of their earnings are domestic based.
2	**Global ex UK equities (currency hedged): 3% fall**	We would expect a no-deal exit to have a small impact on global equity markets, as European companies make up only c20% of the overall All-World Index.
3	**UK Credit spreads: 0.75% rise**	We would expect the economic uncertainty to result in investors needing to be compensated more for lending to UK companies, therefore we expect the credit spreads for UK companies to widen, meaningfully affecting bond prices and accounting liabilities. However, in a context of falling government bond yields the total corporate bond yield is likely to rise by less, reducing the negative effect on capital values. Underlying default risk could be expected to rise detracting from return expectations.
4	**Long dated gilt yields: 0.5% fall**	There are two conflicting drivers of yields here. Firstly, a flight to quality as risk averse investors move monies into safe havens such as UK gilts will cause the price of gilts to rise and the yields to fall. The counter to this is that the UK will be perceived a riskier borrower, due to the economic uncertainty, and as a result investors will expect to be compensated for taking more risk, e.g. a higher yield. We estimate that the impact of this will be a net fall in long gilt yields, as was seen in 2016 following the Leave vote. However, that fall in yields also comes with less confidence in the borrower, the UK government, to pay its debt.
5	**UK commercial property: 10% fall**	On the one hand, any fall in consumer confidence will place additional pressure on the retail sector, with a migration of employees from the city as multi-national companies establish a European base rather than a UK one putting pressure on the office sector. However, on the other hand, any significant depreciation of Sterling will make UK commercial property cheaper to purchase for foreign investors. On balance we would expect a material fall and expect some property funds to restrict outflows by either gating the funds or moving the pricing basis to deter disinvestments.
6	**Long term inflation expectations: 0.5% rise**	The effect on reported inflation is likely to take longer to materialise. With a depreciation of Sterling, import and input costs for domestic manufacturing are likely to rise but we believe there is scope for this to be priced into markets rapidly with a rise of 0.5%pa in long term inflation expectations. The ability of the Bank of England to control inflation may be hampered by the need for stimulus (i.e. interest rate cuts) to avoid recession.
7	**Sterling exchange rate: 15% depreciation**	The uncertainty caused by a no-deal Brexit could lead to a further notable depreciation of Sterling versus other developed market currencies, of a similar order to the impact that occurred post the result of the Brexit vote in 2016. It is plausible the GBP/USD rate falls as low as $1.10 and the GBP/EUR rate to parity.

Scenario impact on pension schemes

Applying this impact to a typical scheme's portfolio highlights the scope for significant financial implications:

- Assets rise by 2% given poor asset performance offset by the positive contribution from liability hedging.
- Liabilities rise by 10% given the detrimental impact of inflation and yields on assumptions.

For an £80m scheme with a £20m deficit this would result in an increase in deficit of £7m to £27m.

Whilst these movements could hopefully be considered short term, whilst a deal is agreed, for schemes undertaking valuations, or companies going through turbulent times, simply riding out a ballooning pension issue may not be an option.

What you can do to protect your scheme:

- Understand the level of risk that you are currently taking using RADAR to monitor exposure.
- Ensure your risk exposure sits well within your tolerance, this is not the environment to be sailing close to the wind.
- Resist any temptation to engage in speculative positions such as increasing unhedged foreign currency exposure, or regional equity bets.
- Look to fully hedge interest rate and inflation risk to the extent that this is practical.
- Assess whether there is scope to reduce exposure to equities in favour of other more secure investments higher up the capital structure.
- Assess whether there is scope to reduce your target return and still meet your long term objectives.

There are a number of actions that a pension scheme can take to prepare, now is not the environment to be sailing close to the wind

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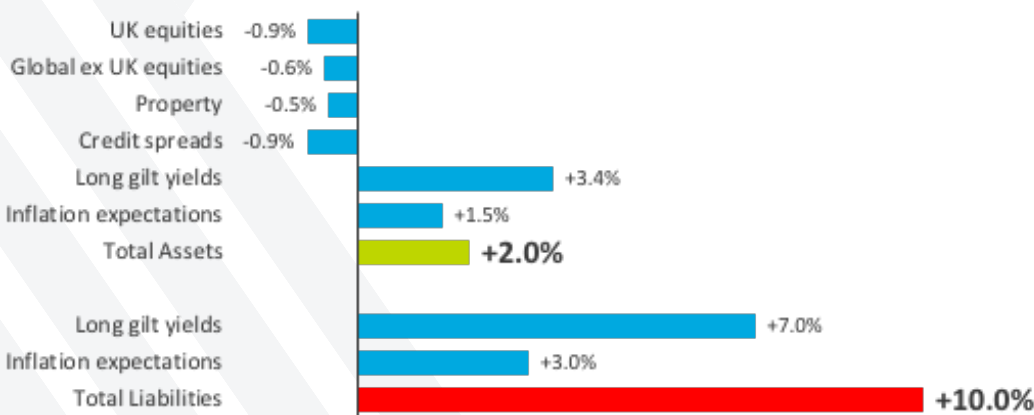
The chart below shows the impact of each of the items above, together with the resulting increase in scheme liabilities for a typical pension scheme.

No-deal scenario – impact on assets and liabilities



Source: Asset allocation of the average UK scheme as set out in the 2017 PPF Purple book, totals may not sum due to rounding. Liabilities approximated by a Gilts plus approach referencing the Purple book Section 179 liability's sensitivity to interest rates and inflation, assuming 49% of this is hedged in the asset portfolio as reported in the 2018 XPS LDI survey.

Investment industry impact

Beyond the face value impact on asset and liability returns there is a deeper and possibly more troublesome issue in terms of access and movement of capital across borders.

Many UK pension schemes invest through non-UK domiciled pooled funds, for instance funds are often domiciled in Luxembourg or Dublin. These benefit from tax efficient structures and EU compliant regulations enabling economies of scale from marketing across Europe. A no-deal scenario places a question over whether UK domiciled investors will be able to continue to invest via these structures and how income and any disinvestments will be taxed during a no-deal negotiation.

It is plausible that a situation will occur where trading and repatriating assets becomes difficult. Whilst intrusive, this situation is unlikely to significantly impact most UK schemes in the short term, given that the immediate cashflow requirements of schemes are typically low relative to the overall availability of liquid assets and we would expect the no-deal period to be resolved relatively promptly. It could present an issue for schemes with large cash demands, as well as those undertaking mergers, buyouts, or large transactions related to restructuring a portfolio.

All reputable investment managers will be making contingency plans for this event and should have a well documented risk management plan for various Brexit (and non-Brexit) related political risks.

As part of the UK leaving the EU there is a requirement for UK based investment managers to establish a European entity in order to market to EU countries after Brexit. This is an inconvenience for UK fund managers, many of whom are well down the track of making arrangements, but is unlikely to be affected by a no-deal scenario as it is required irrespective of the deal. This matter will not be an issue for most UK pension scheme investors given it relates to UK fund managers interacting with EU investors once the UK has left.

What you can do to protect your scheme:

- Plan to avoid any large disinvestments during Q2 2019.
- Target any planned asset transitions to take place before the end of 2018.
- Ensure there is a back-up source of cash to meet any foreseeable requirements, and that this is invested via a vehicle that will not need to be repatriated from an EU domicile.
- Maintain a slightly larger cash fund holding to weather any disruption but avoid using the Trustee bank account for this purpose due to the associated unsecured credit risk.
- Ask your fund manager to share its contingency plan in relation to your investment.

For further information

If you wish to discuss this further please contact Simeon Willis or André Kerr or your regular XPS contact.

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Important information: Typical scheme example has assumed asset allocation of 26% Equities, 5% Property, 56% bonds 13% Other with Liability Driven Investment overlay providing a total of 49% hedge on inflation and interest rates. The example scheme was 80% funded with an asset value of £80m.

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