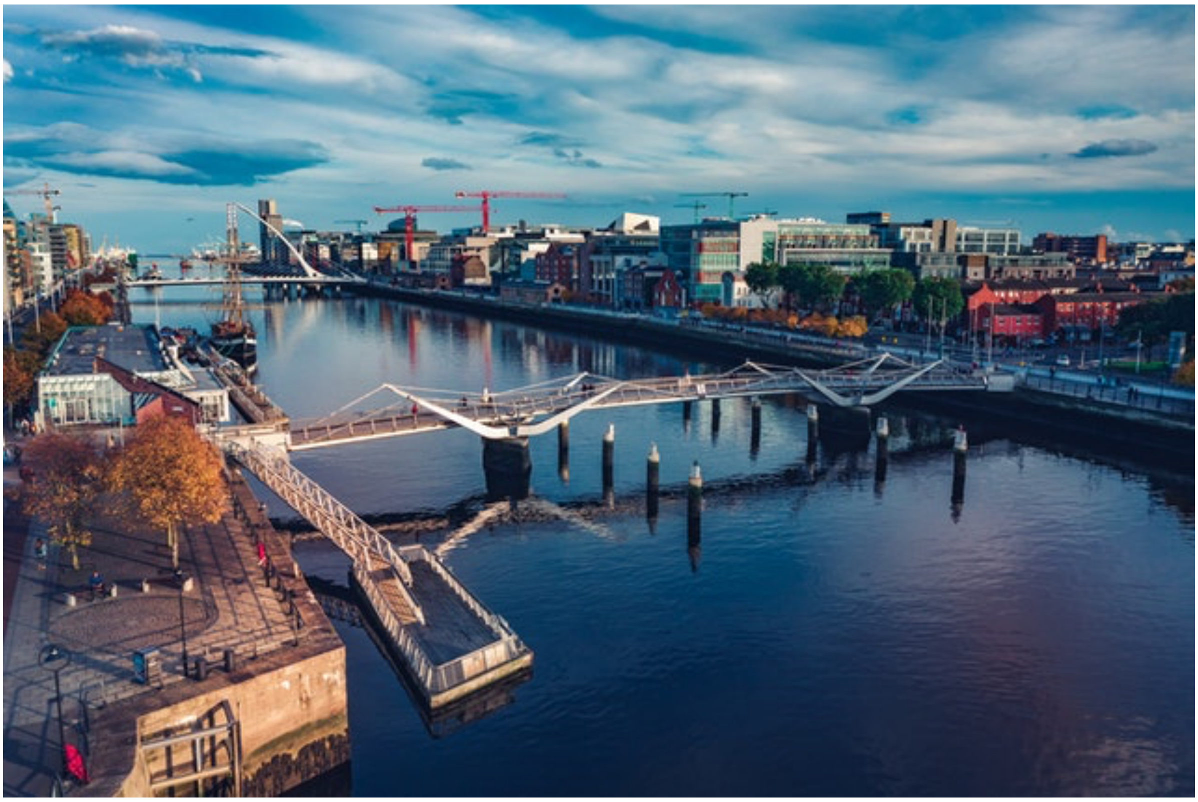
The FM Report

Sharing Experts' insights with Investors

# Showcase of articles from The FM Report 2021



E-book series 4

# Introduction

Welcome to our showcase for 2021 where we collate some of the best articles and what a year it has been. 2021 was full of record-breaking returns across all market led by the American behemoths.

The recovery from the pandemic has caught most commentators by surprise. Markets recovery has far outpaced the actual economic recovery with a wave of cheap money looking for a home and the only allocation providing welcoming returns were equities markets.

Inflation was the story of 2021 but largely ignored by markets and regulators as it was deemed transitory, caused by Coronavirus supple bottlenecks. While there is no fear of inflation now, I wonder how history will look back at this time?

On pension we had the introduction of Master trust bringing a new list of regulatory requirements and providing a death knell for Small Self-Managed Penson Schemes. These new regulations are a perfect example of how increasing regulations are reducing consumer choice and discouraging saving.

We hope you find the collection of articles by leading pension and investment experts of interest and beneficial.

Your Sincerely

Frank Mulcahy

Editor, The FM Report

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# INVESTMENTS

## The history and future of Ireland in Europe

January 19, 2021 By Cormac Lucey

Before 1916, nationalists in Ireland had sought to craft a better future for themselves within the United Kingdom (of Great Britain and Ireland, as it was then). After 1916, independence was the goal. And, after independence was secured a century ago, Ireland consistently availed of every opportunity to further loosen its bonds with Britain.

The 1937 constitution ended the role of the Crown in Irish public life. When Britain faced mortal danger in World War 2, Ireland remained studiously neutral. In 1949, the Republic was declared. In 1973, the state joined the European Economic Community (EEC), the forerunner of the European Union (EU). In 1979, Ireland sacrificed the 1:1 fixed currency rate between the punt and sterling on the altar of membership of the European Exchange Rate Mechanism, the forerunner of the euro. In 1999, Ireland went and joined the single currency, while Britain retained sterling. And, at the end of 2019, the UK departed the European Union while Ireland remained a member.

Ireland's continuing relationship with the EU can only be properly understood in the context of a century of history that has seen Irish governments, of whatever political hue, consistently opt to reduce our connections with the UK. So, now that Britain has left the EU and formally concluded its Withdrawal Agreement, what does the future hold for Ireland, as an EU member?

A Different Type of European Union

For starters, the EU is likely to be a different entity and to evolve in a different way now that the UK has departed. The founding six members of the EEC had each suffered grievously during World War 2 and wanted to ensure that nothing similar could ever happen again. They saw the new body as something transformational. That's what the commitment to "ever closer union" signals. They didn't merely set up a community to pool coal and steel resources. They set up that community as the first step on a long road that would only end with a European federal state. That Germany's eventual destination after its original components established a customs union in 1834.

The UK's attitude to the EU was essentially transactional rather than transformational. In response to its own decline from being one of the big winners of World War 2 to becoming an economic basket case by the early 1970s, it belatedly joined "the common market". It was only able to do this after the departure from power by Charles de Gaulle.

As French president, de Gaulle had blocked Britain's 1962 application for membership arguing that the UK "is maritime; it is bound by trade, by its markets, to the most diverse array of countries – and often the most far-flung". He added "It has a lot of industry and commerce but very little agriculture – and its habits and traditions are very different." Mrs Thatcher underlined Britain's transactional approach when she proclaimed "we want our money back" in the mid-1980s. As he struggled to win the referendum to keep Britain within the EU, David Cameron secured agreement to exempt the UK from aspiring to "an ever closer union among the peoples of Europe".

Ireland has never really debated whether she sees her EU membership as transformational. We've certainly enjoyed its transactional aspects, no more than when Albert Reynolds returned from a 1992 summit in Edinburgh, having been promised £8 billion in structural funds. Now, rather than hiding behind British intransigence to protect us from hard political choices, we may have to rely on continental political exhaustion to save us from such dilemmas.

## Brexit and Northern Ireland

The most extraordinary aspect of Brexit is how it has ended up weakening Northern Ireland's position within the United Kingdom. The North's hybrid status whereby it remains part of the UK but is effectively within the EU's customs area requires checks of goods passing from Britain to Northern Ireland. While this status may boost the North's economic prospects, it does so by weakening its position within the Union. Furthermore, a majority of people in the six counties voted against Brexit: the quickest way for them to reverse it would be to vote to join the Republic.

The lack of coherent responses to the increased likelihood of a United Ireland is striking. At an economic level, nobody appears to have any idea of how a 32-county state would replace the, roughly £10 billion, annual British subvention to Northern Ireland. At a political level, the nationalist parties in the North may talk the language of reconciliation but expose themselves as practitioners of cultural apartheid when they refuse to take part in ceremonies marking the founding of Northern Ireland, something as dear to the hearts of unionists as 1916 is to nationalists.

## Digital tax

In her December 2019 mission letter to Margarethe Vestager (Executive Vice President of the European Commission for A Europe Fit for the Digital Age), Ursula von der Leyen (the Commission President) wrote "You will coordinate the work on digital taxation to find a consensus at international level by the end of 2020 or to propose a fair European tax." What might a "fair European tax" look like in 2021 and what impact will it have on us? It is hard to see that Ireland will be a net winner from such a development.

## Growing financial strains in the common currency area

While the single currency gave the advantage of much greater foreign exchange rate stability, it did so at the expense of importing greater instability into our domestic economy, courtesy of an interest rate likely to be inappropriate to our national circumstances. A second grave fault is that, by locking their currencies together in the euro, countries lose flexibility to devalue their currency to stimulate activity when the economy is doing poorly and revalue when the economy may be overheating.

One consequent area of instability is the rising Target2 balances at the European Central Bank (ECB). These record the financial balances between national central banks and the ECB. Countries suffering deposit outflows from retail banks, such as Spain and Italy, owe money to the ECB. That must be funded by countries with surplus cash, such as Germany and, increasingly, Ireland. The German central bank is currently owed more than €1 trillion, equivalent to more than €13,000 for every man, woman and child living there. Ireland is owed €45.4bn, equivalent to about €9,000 for each of us. Meanwhile, the Italians and Spaniards are both borrowing €9,000-10,000 per person. These balances — or imbalances — have been steadily rising over the years.

We can see a race between economic forces, tending towards disintegration, and political power pushing for integration. A crisis will be needed to force a decision as to the eventual destination.

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## Mind the gap: impact investing through public markets

January 19, 2021 By Tim Crockford

With a deadline of 2030, the United Nations Sustainable Development Goals (SDGs) are a comprehensive list of challenges, both environmental and socioeconomic, that we face as a planet. They aim to drive prosperity for all in a sustainable way, and encompass health, hunger, the natural world and much more.

When it comes to public equity markets specifically, we see a huge underserved need in companies that are helping the world, and can generate returns by doing so. Some SDG targets are best met by investors in listed equities. Take healthcare. To help fulfil the targets for SDG 3, Good Health and Well-Being, companies need considerable capital at an early stage of their life. They must often spend a great deal on research & development, long before they see a return on this investment. They also need to scale up production, to help solve global health problems. Listing on public markets can unlock that capital. And as we've seen in 2020, companies with solutions to our biggest health challenges are well-rewarded by the market, yet serve the needs of more than just their shareholders.

**Impact investing: keeping the core tenets**

In applying impact investing to public equities, we believe that the core tenets of impact investing, first established in private markets, need retaining but adapting: the search for investments with the intention to generate additional positive impacts, alongside a financial return. Unlike private equity investors, public equity investors do not control the businesses they invest in. For this reason, we must look for companies already on a clear mission to achieve a specific positive impact – they should be companies that already share our intention to contribute solutions towards the world's environmental and social challenges.

Impact investors also want to show that their investment creates an additional positive impact that makes a tangible difference to lives. We have to consider this "additionality" in a different way from private market impact investors. As buyers of equities in secondary markets, we cannot claim that our capital is solely responsible for the impact generated.

The first thing we consider, therefore, is how the company itself drives an additional measurable positive impact, through the product or service it sells to generate this outcome. We only back businesses that sell an innovative and differentiated solution to either an environmental or social challenge, rather than one which is easily replicable by other companies. This way, we can show that if the company didn't exist, nor would the positive outcomes they generate.

However, we should not underestimate our influence. If a critical mass of shareholders allocates capital based on a company's social and environmental impacts, companies are pushed to direct more of their capital to divisions of their businesses creating solutions. Moreover, we engage with companies to try and minimise specific negative impacts that result from their business. We therefore believe that the concept of additionality can and should be considered at both the level of the company as well as the level of investor. Listed companies are particularly well-suited to delivering research and development-intensive, innovative impactful solutions.

### The SDGs: a helpful framework

In seeking companies providing useful solutions, we need a proprietary framework to identify problems that require solving. This is where we find the 17 Sustainable Development Goals useful. We prefer to concentrate on the 169 targets linked to the goals, since they are more specific.

We call our framework the Regnan SDG Taxonomy. It seeks to identify products and services that exist to meet the SDG targets, to understand their scope to scale, and to learn about the companies that sell them. As a public equity investor, we might not have a seat on the board, however, we use our engagement to encourage management teams to improve disclosures about the impacts driven or enabled by their products and services.

### Our double mission

To conclude, the world needs impact investing in public equities to help deliver the SDGs. For this reason, we are on a mission to do two things. We want to preserve and adapt the concepts that evolved from the private markets, to maintain the integrity that gave birth to impact investing. At the same time, we want to provide a solution that allows additional positive impacts to be delivered at scale, through a platform accessible – and attractive – to any investor. We set the bar high for both the impact that our investments generate, as well as their returns.

Author: Tim Crockford Senior Fund Manager, Head of Global Impact at Regnan, the responsible investment affiliate of J O Hambro Capital Management. Contact your financial adviser to find out more.

## The Return of Inflation

February 16, 2021 By Brian S. Wesbury

Inflation is not dead. It is not gone. It has not been tamed. We know it seems like it, especially after the past few decades which generated in many an "inflation-complacency" that feels justified. After all, following the 2008 Financial Panic, many predicted Quantitative Easing would cause hyper-inflation.

When the Fed boosted the Monetary Base by more than $3 trillion dollars during Quantitative Easing 1, 2 & 3, and the federal budget moved to a huge deficit, gold and silver commercials proliferated. So did predictions of a collapsing dollar. But inflation never came. Since the end of the 2008-09 financial panic, the Consumer Price Index has increased by an average of just 1.7% per year, falling short of the Fed's (conjectural) 2% target. So, what happened?

The answer: Boosting the monetary base is not the same as boosting the amount of money circulating in the economy. Milton Friedman taught us to watch the M2 measure of the money supply.

During the first period of QE, from 2008 to 2016, the Fed bought trillions of dollars of bonds, but also increased bank regulation and capital requirements. As a result, banks ended up holding excess reserves and the money supply remained calm, with M2 growing, on average, about 6% per year, similar to the growth rate in the 1990s. During the 2020 COVID-induced round of Fed money printing, instead of using QE to put reserves in the banking system, the Fed financed government programs to fund loans to businesses and direct payments to individuals. As a result, M2 has grown 26.3% in the past year, the fastest annual growth we can find in US history, and roughly double the pace of M2 growth the US experienced during the 1970s.

According to those who believe in Modern Monetary Theory – which isn't modern, and is just vaguely a theory – the US can increase real output enough to absorb it. In other words, they say that while inflation is "too much money chasing too few goods" – they expect the output of goods to increase enough to keep inflation low.

We find this impossible to believe. In fact, we think many are living in denial. Inflation is already on the rise. In the past six months, the Consumer Price Index is up 3.6% at an annual rate and if it rises a modest 0.2% per month between January and May, it will be up 3.4% over 12 months. Part of this is because COVID shutdowns led to weak inflation in early 2020, but we expect inflation to move higher in 2021.

But, in addition to M2 growth, incomes and savings have increased, while production has not. Demand is exceeding supply. All personal income combined – wages & salaries, employee benefits, small business income, rents, interest, dividends, and transfer payments – was up 6.3% in 2020 versus 2019. Total after-tax income was up 7.2% in 2020, the most for any year since 2000.

Combined, Americans saved about $2.9 trillion in 2020, more than doubling the previous record high of $1.2 trillion in 2018. As of the third quarter of 2020, the amount Americans held in checking accounts, savings accounts, time deposits, and money market funds was up $2.8 trillion from the year prior. Add another $1.9 trillion in federal government stimulus spending (borrowing from the future, to spend today) and the US is awash in cash, much of which is funded by Washington's money printing.

Unfortunately, in spite of a strong recovery in output, industrial production is 3.3% below pre-COVID levels, while real GDP is 2.5% below. In other words, demand is OK, it's supply that's still hurting – a perfect recipe for inflation.

We can see the impact of this affecting markets. The 10-year Treasury yield has risen from roughly 0.6% in May 2020 to 1.2% today. The gap between the yield on the normal 10-year Treasury Note and the inflation-adjusted 10-year Treasury Note suggests investors expect an annual average increase of 2.2% in the consumer price index (CPI) in the next ten years, and those expectations are rising. Bitcoin, while we doubt it will ever be real money, hit a record high today reflecting fears of lost dollar purchasing power. Commodity prices continue to surge.

All this money printing threatens to eventually create a sugar high in equities. We aren't there yet, but markets are floating on a sea of new money. In fact, it's more like a tsunami! Inflation hedges (real estate, commodities, materials companies) will do well. Traditional fixed income (long-term bonds) is at risk. The return of inflation because of misguided policy choices is a very real threat to the long-term health of the US economy.

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## Volatility: Friend or Foe?

June 17, 2021 By Eoin McBennett

The word volatility often has connotations of the unpredictable, or something potentially damaging that is out of our control. There is truth in this, but that is only part of the story. Volatility is an ever-present feature of stock markets that, in its essence, is a measure of risk. All investments encompass volatility, and the more volatility that comes with an investment, the more returns an investor should potentially receive.

For inexperienced investors, volatility can lead to irrational decisions, such as locking in losses by hastily selling when a share price has dipped. But all it takes is an understanding of what volatility is to turn it into a powerful investing tool. Given that investing is all about balancing risk and reward, the more you understand about volatility, the better able you will be to navigate the ups and downs and use it to your advantage.

**What is volatility?**

Strictly speaking, volatility is the measure of how much a security's price moves up or down during a set period of time. The higher the volatility, the greater the move. A less technical definition is the potential for markets to change rapidly and unexpectedly – often perceived in a negative way.

To put this into perspective, if a company share price is relatively stable and does not move very far in either direction, then it can be described as having relatively low volatility. The utility or telecoms sectors for example.

Conversely, a share with high volatility will display rapid and often erratic price movements that are unlike other companies on the stock exchange. For volatile shares, rapid rises are often met with equally fast falls as best illustrated by cryptocurrencies in recent weeks.

The hardest part of investing isn't necessarily finding a good stock to buy but navigating the inevitable fluctuations in price and emotions that will occur after you buy it.

**What causes volatility?**

Volatility can evoke strong emotions and strong emotions can lead to poor decisions. There are multiple factors that can cause volatility, and it can affect just one company, or it can affect stock markets as a whole.

Market-wide volatility is caused by a wide range of factors, frequently large-scale and global in nature. This can include major economic and political events, natural disasters, and extreme weather to name a few.  Although rare, periods of market-wide volatility occur frequently enough to be in the back of investors' minds when implementing investment strategies.

Volatility that occurs at a company level is typically driven by factors specifically affecting that business. This could be a rise or fall in profits, a corporate scandal, threats to business mode or a threat or crisis in its supply chain.

**How volatility affects your portfolio**

While your first instinct may be to avoid volatility at all costs, this is likely to cost you in real terms. Volatility is a normal aspect of financial markets that affects every type of asset. As noted earlier, securities with lower volatility, such as government bonds, often do not deliver big investment returns over the long run, while securities with higher volatility, such as equities, tend to perform better over the same period.

A savings account may be considered an investment with the lowest volatility.  However, as a result of monetary policy and the introduction of zero interest rates returns on cash deposits are non-existent at the moment. If your objective is to achieve a certain amount of capital growth, then it is necessary to accept a certain amount of volatility depending on your overall attitude to risk and your investment objectives.

We believe the best way for investors to protect themselves against volatility is to have a diversified portfolio that contains a mix of equities, bonds, and other asset classes, such as commodities, infrastructure, listed private equity and property. This approach reduces risk by blending assets that have different volatility levels and return expectations and respond differently to different economic developments, allowing you to ride out the peaks and troughs over the long term. In theory, a decline in one asset will be balanced by a gain in another, so your portfolio will, on balance, be working to your advantage. Remember that diversification cannot eliminate the possibility of a loss, and the value of your investments and fall as well as rise.

Given that volatility is unavoidable, we think the only way to approach is by keeping a level head and focusing on your long-term financial objectives. Warren Buffet summed it up nicely in his 1985 note to shareholders of Berkshire Hathaway when he said investment success will not come from arcane formulae or computer programs, but instead from good business judgement and an ability to insulate our thoughts from the emotions that swirl about in the market.

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# Into choppier waters

July 29, 2021 By Nikolaj Schmidt

It has been very smooth sailing for stock markets for six months or so now—or at least that's how it has appeared on the surface. Underneath, the crosscurrents are changing and tensions are starting to build. What does this mean for financial markets?

In my view, the strong performance of risk assets has been underpinned by two key forces. The first—and probably most important—is the fact that the economy is still early in the "expansion" phase of the business cycle. There is currently both pent-up demand (which facilitates rapid growth) and slack resource utilization (which means central banks are happy to accommodate that growth without tightening monetary policy). In other words, the current environment is very benign for risky assets. The shift to the next stage of the business cycle will not occur overnight, but as the economies reopen fully and as pent-up demand is gradually released, the transition will likely begin. At that point, fuller resource utilization will justify a tighter monetary policy stance.

The second force driving risky assets is liquidity: Over the past 16 months, markets have surfed a liquidity wave of unseen proportions. Unlike the business cycle, liquidity can change rather rapidly—and it seems to me that we are at the cusp of an inflection point. The U.S. Treasury has been on a spending spree over the past five months, which it has financed by drawing down its historically large cash balance at the Federal Reserve (Fed). This acceleration in quantitative easing (QE) has now reached a crescendo and will, over the coming months, begin to reverse in my view. However, as investors have been paying insufficient attention to the QE surge (perhaps understandably, given the number of distractions around), its reversal will probably surprise them.

The Fed Begins to Talk About Tapering

Another challenge to liquidity came when the Federal Open Market Committee (FOMC) indicated in its June meeting that it is time to discuss scaling back the Fed's official QE program. Of course, the Fed will not end QE overnight—it will most likely taper asset purchases through the whole of 2022—yet merely talking about tapering brings back the memories of the 2013 taper tantrum and can prompt some investors to take a more conservative view on the market for risk assets.

This is part of a global pattern. Over the past few months, central banks in peripheral countries have started to tighten monetary policy both by scaling back their QE and by hiking interest rates. Until now, these forces have had only a negligible impact on the financial market given that the core central banks—the European Central Bank and the Fed—have been resolutely dovish. However, a growing number of FOMC members have begun to voice concerns about the dovish posture.

These concerns reached an apex at the June Fed meeting, when several members of the FOMC indicated that they believed interest rates would be hiked over the next one to two years. My guess is that these hawkish individuals are probably not the key decision-makers in the FOMC, and in my view, they are overreacting to noisy inflation observations. I'm not saying that interest rates should remain on hold until the end of 2023—most likely, the economy will have recovered very substantially by then and rate increases will be completely appropriate. My point is simply that, when it comes to financial markets, talking about interest rate hikes has pretty much the same effect as actually tightening monetary policy—and the Fed has just dialed up the volume on the interest rate discussion.

Volatility Looms in the Autumn

So where does all this leave financial markets? I continue to think that the most important force—the business cycle stage—remains friendly to investors and that, therefore, the path of least resistance for equities is still upward. However, the change in the liquidity tide, and the discussion about when the Fed will raise interest rates and taper asset purchases, is likely to bring volatility back to the financial markets. My guess is that these forces will collide in the late summer/early autumn, and I anticipate an autumn that will be much harder for investors to navigate than the liquidity-pumped markets of the past few months.

Personally, I'm inclined to look to the currency markets, which are more jittery than equity markets, for any indications of a changing storyline.

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## Finding opportunities in an unloved market

November 29, 2021 By Michael Ulrich

The UK market is unloved and under allocated to, while at the same time the drivers of growth are changing in its favour. For those who are prepared to be selective, concentrated and absolute in their thinking, the UK is currently offering some fantastic opportunities for capital growth.

Like all chapters in history, investment cycles do turn. Tech re-rating, falling bond yields and vaccine beneficiaries are all in the past. We see the next cycle being driven by factors where the UK is well-represented and believe the growth being delivered will force investor perceptions to change.

**Beneficiaries of the green transition**

Mining companies like Glencore and Anglo American are dominant providers of minerals that are essential to a lower carbon future. Utilities such as National Grid and SSE have unique positions in building renewable and energy infrastructure. Engineering equipment companies like IMI are in a leading position to both reduce plant methane emissions and improve heating efficiency in our homes. Corporate demand for improved sustainability credentials has decades of growth ahead and this will benefit companies who have invested ahead of this rising demand such as WPP with its digital advertising solutions and Mondi helping to replace plastic with its paper based packaging solutions.

**Positioned to re-build the world**

Aggregates suppliers such as CRH, plant hire companies like Ashtead and urban design consultants like Wood Group are all set to benefit as Western governments seek to rebuild creaking infrastructure to boost economic growth.

**Well-invested digital platforms**

You don't need to pay up for US tech valuations or go up the risk curve investing in start-up businesses with no cash flows to gain exposure to digitally-enabled growth. Whether that is Next with its brand-gathering e-commerce platform or RELX with its solutions for pricing insurance or fraud risk, the UK is home to many well-established leading online platforms with high rates of growth, which are largely overlooked.

The UK index will look very different in 10 years' time and investors need to be backing funds investing in the winners of tomorrow. Investors who may have benchmark or income requirements are forced to hold large parts of the UK market where growth is low and the main form of return is a dividend. We don't have any holdings in banks or oil companies because we can't see the long term growth tailwinds for these sectors. We feel well positioned as a focused fund with around

30 holdings, highly engaged with the businesses we own, a long term time horizon and no benchmark constraints.

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# PENSIONS

## DC Investment: Always ask questions, just make sure they're the right ones!

February 16, 2021 By Ian Slattery

We are by no means 'out of the woods' in respect to the COVID pandemic, as a lockdown in Ireland, high case numbers, and ongoing vaccine rollout issues continue to dominate the new headlines. However, whilst volatility does remain somewhat heightened, we have entered a new Bull Market, stocks closed out 2020 on a high, and positive returns have continued through to 2021. COVID has also affected the pensions landscape in Ireland, not only through the impact of investments, but also on upcoming legislative arrangements. For example, the long-awaited auto-enrolment framework is still to be launched and the transposition and implementation of the IORP II is still to materialise. We don't know what the rest of 2021 may hold, but with 2020 fresh in our minds it's an opportune time to take stock and consider how we should appraise DC pensions.

When looking at a Defined Contribution pension scheme there are three main areas to explore:

1. Governance
2. Administration
3. Investments

I'll focus on the third, as much has already been written in respect to Master Trusts and IORP II. However, it is worth noting the Pensions Authority's recent assessment of Master Trusts in Ireland, and in particularly that the structure may not be the panacea that some in the market claim. As often is the case, there may be lessons to be learned from the UK experience in this area.

Within the investment 'arena' we try to focus on three main areas:

1. Communication
2. Default Framework
3. Performance

Lessons from 2020

Within the context of the COVID Bear Market, it is easy to explicitly see the outcomes that providers across the market delivered under these three areas. For example, having a clear and flexible communication strategy in 2020 was imperative, a point highlighted by the unique nature of the COVID crisis in respect to not being able to meet face to face.

Communications should be tailored for different audiences – members, employers, trustees. For example, how you communicate with scheme members can play a key role in how people will behave when it comes to their investments. A communication strategy that keeps people informed during market volatility – perhaps covering topics such as basic investment principles and unit cost averaging can lead to positive behavioural outcomes. When we consider the switching experience for individual investors vs those in a DC scheme, we found that those in a DC scheme were less likely to switch in times of stress that those in an individual product, and even within a group scheme environment – those in a default were less likely to switch again. A fact that highlights the imperative need for a robust default framework.

Performance of course also plays a role here behaviourally, being invested in the funds that recovered quickest has a huge psychological advantage. This is without even extolling the well-established virtues of compounding, and the long-lasting impact of relative outperformance in a bear market on long term pension adequacy. Markets evolve, and change, but a consistent investment process should stand the test of time. This applies whether you are a fund manager, product provider, or financial advisor. And it is equally true of a DC Default Investment Strategy.

<u>Getting DC investment right</u>

There is often a conversation about investment styles in respect to a default strategy, and in my view, you can add value in three overarching ways:

1. Default Composition (Funds used, average equity weighting, glidepath timeline, transition mechanics, various options in retirement planning stage)
2. Asset Allocation (active top down, quantitative modelling, static, auto rebalancing,)
3. Single Asset Components (Passive, Active, factor tilts, bottom up, top down)

The Active v Passive debate always gets caught in point No.3. However, in my opinion the debate should encapsulate all the decisions that drive your investment performance. If you take that more holistic approach, points 1 & 2 are likely to have a larger influence on the outcomes for scheme members. Points 1 & 2 **<u>cannot</u>** be done passively. The need for a proactive approach is imperative.

<u>Value-for-Money</u>

Another subject that garners much attention in respect to all investment products, but particularly in the DC space, is that of costs. AMCs, OCFs, TERs, (amongst others!) are some of the acronyms that are discussed ad nauseum in the industry. However, a closer inspection of regulatory information (namely the Pensions Authority's DC Codes of Governance) reveals a much greater emphasis on 'value' rather than 'cost'. The two are often used interchangeably but there is a subtle, yet fundamental difference between them. For example, the right default composition and asset allocation can add 100bps per annum in performance versus other options in the marketplace (1,000bps in 2020 in some cases) whilst a focus on 10 or 20 bps at the scheme outset generates much more attention from scheme trustees and consultants. Being cost conscious is certainly prudent, but it is only one element of the decision.

## The current Economic Environment

Investment performance has always been the key driver of pension adequacy, and in my opinion, it is only going to grow in importance. In the current economic environment, business margins are as tight as ever and the propensity from a business and member perspective to increase contributions is reduced. In terms of more structural trends, the state pension is simply not viable in the long term in its current form, a fact accentuated by increasing time spent in retirement and the continuing demise of DB pension offerings. This all leads to a growing need for scheme members to actively take an interest in their pension and make their investments work as hard as they can for them – in order to ensure that they have the retirement they want and deserve.

In conclusion, there were lessons to be learned from 2020, but the main principles of DC pension investing remain intact. Consistency matters in terms of the overarching framework in place, as all schemes will see further Bear Markets and times of wider economic strife in the future. Therefore, it is important to appraise your scheme provider across the full market cycle and by the metrics that are most important to your scheme members. Unfortunately, there is no such thing as 'precedented times' – the world constantly changing and evolving and picking the right partner is imperative. There is of course plenty to debate in this subject area, with plenty of subjectivity – with that in mind it is important to concentrate the debate in the topics that really matter in providing pensions adequacy and cutting through the rest of the noise evident across the marketplace.

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# The Effect of IORP II on Single Member Schemes

May 13, 2021 By Eoin Hassett

The long-awaited publication of the IORP II legislation arrived on 27th April, 5 days after Minister for Social Protection, Heather Humphreys, T.D., signed document into Irish law. The new legislation will apply to all occupational schemes and trust Retirement Annuity Contracts (RACs), including one-member arrangements which previously benefited from a derogation under IORP I. It is important to note that this legislation only applies to occupational pension schemes and AVCs. A(M)RFs, Buy-Out-Bonds, PRSAs and PRSA AVC's are unaffected. Although the E.U. Directive on the activities and supervision of institutions for occupational retirement provision (IORP II) has been written primarily with group pension arrangements in mind, Minister Humphrey's decision not to avail of the single member scheme derogation, as the Government did with IORP I, means that these rules now apply to schemes where they seem inappropriate. The new rules affect single member schemes in two ways:

1. New governance and reporting requirements
2. New investment rules

Existing single member schemes have received a 5-year derogation from some of the new rules, but some important investment restrictions will kick in immediately. From the 27th of April, unregulated investments are now capped at 50% of the value of each individual occupational scheme. This means that a maximum of 50% can be invested in property. Furthermore, borrowing in an occupational scheme is no longer permitted. It is also important to note the restrictions limiting investment in property includes a look through to any property element in a managed or multi-asset fund. This last rule will make life quite difficult for pension providers.

There are also more general requirements placed on trustees. Trustees must now invest the assets in such a manner that the resources are properly diversified. This is to avoid excessive reliance on any particular asset, issuer, or group of undertakings and to avoid accumulations of risk in the portfolio as a whole. If assets from the same issuer *are* chosen, the trustees must invest in such a manner that shall not expose the scheme to excessive risk concentration. Environmental, Social and Governance (ESG) issues must also be considered when making investments. Schemes can invest in multiple investment types, but they must be properly diversified.

While the key tenets of these investment rules make a lot of sense, their application to single-member schemes is puzzling. During the financial crisis of 2008 a lot of pension funds were heavily impacted by investment losses. However, anecdotal evidence would say that an over-exposure to Irish banks was of far more concern than an over-exposure to ungeared property or unregulated investments. Furthermore, from a domestic investment point of view, restricting the ability of single member occupational pension schemes to invest in domestic property and domestic businesses, may direct investors' attention to foreign economies rather than our own.

Now, having considered the generalities of the legislation, let us look at the specifics of IORP II on pension investors who have single member occupational pension schemes. Firstly, some good news. All existing investments are exempt from these rules. This means that someone who holds unregulated assets or a property in their occupational pension has no immediate concerns. On the bad news front, pension investors who had investments in train but were not far enough through the process will have to change course. For example, if an investor placed a booking deposit on a property on the 28th of April having been in negotiations to purchase the property for the previous three months, it is very likely that this investment will be deemed as a new investment and will fall foul of the IORP II requirements. Should investors be determined to proceed with the purchase they will have to transfer their pension funds into a PRSA or a Buy Out Bond before closing the deal.

There are further complications for investors in unregulated assets that account for more than 50% of the occupational schemes' value. For instance, if an unregulated investment contains a roll-over option which a pension investor wishes to avail of this will not be possible for the investor to avail of it as it will be deemed as a new investment. In this scenario the investor has two options:

1. Choose an alternative investment
2. Close down the occupational pension scheme and move it to another pension arrangement that does not have the same rules attached.

Neither of these options will sit well with many investors. While I am on the subject of unregulated investments it may be helpful to clarify the difference between regulated and unregulated. For the purpose of the IORP Directive, only cash and securities which are traded on the main Exchange are considered regulated. In addition to this investment in a collective investment, investment in an insurance policy (subject to certain criteria) and investment in bonds issued by the government of any Member State are also allowable. Unregulated investments is everything else. It is hoped that more clarification around these rules will be forthcoming from the Pensions Authority in the coming days.

You may have noticed that I have glossed over the new reporting and governance requirements for new occupational pension schemes. There is a good reason for that, at the time of writing this article these new requirements require clarification from the Pensions Authority on how they are to be put into practice.  Indeed, there is even confusion in the industry as to whether the rules will apply to newly established occupational pension schemes or if they will have a grace period or a 5-year derogation along with existing schemes. The Pensions Authority are due to provide more detail on the new rules in the week commencing 10th May and hopefully we will have more clarity then. In summary these new rules, while not without merit, will not sit well with pension investors. I suspect in most cases it will prove to just create a heavy administration burden as assets move to other pension arrangements not effected by the legislation.

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# If you spray perfume on a turd does it stop it being a turd?

April 29, 2021 By Paul Murray

I have feared having to write an article with this title for a long time, sadly I've got the opportunity now.

Heather Humphreys, the Minister for Social Protection, signed a Statutory Instrument (*S.I. No. 128 of 2021 European Union (Occupational Pension Schemes) Regulations 2021)* into law on the 22nd April 2021.

This instrument imports the terms of the long debated IORP II Directive (*EU Directive 2016/2341 on the activities and supervision of institutions for occupational retirement provision (IORPs*) into Irish Law. This is being hailed as a 'once in a generation' change, a 'substantial directive' 'supporting positive reform', 'enhanced governance standards'. Is IORP II any of these things? Nah…….nah, it really isn't, it's a rehash of the 1st IORP Directive, if it was a 'once in a generation' change it'd hardy have II after its name!

Before I go on I'll say that if anyone has read anything I've written on The FM Report to date they will know I am for simplicity and good governance however…………………. the IORP II Directive is aimed at multi-member pension schemes, not single member pension schemes, in both words and intent.

There is significantly more governance required when someone invests funds on behalf of a group of unrelated people – that makes perfect and obvious sense. There should not be such onerous requirements when someone invests for themselves, as in a single member pension scheme. The Superannuation legislation actually defines a single member pension scheme as 'a scheme which is established solely for one person and for that person permanently to be the sole member and that member has discretion in respect of the manner in which the resources of that scheme are invested' and inserts this definition in to the Pensions Act. So why impose onerous multi-member rules on single member schemes? This is the first of many reasons why I'm angry with this triumph of bureaucracy.

Here are a few other reasons, while we're at it:

1. The 'derogation' for single member pension schemes is limited to existing schemes and only lasts for 5 years – so a 2 tier system will be in place going forward for these types of scheme, that should add a welcome layer of simplicity to the system
2. The 'derogation' is limited to existing schemes and existing investments, so if funds roll off an investment then its new investment rules that apply to the proceeds, and thus matured funds must invested 'predominantly' in regulated markets as will new contributions to a scheme
3. The 'prudent person' rule around investment doesn't apply to your own money

4. I’m still convinced a single member pension scheme cannot fall into the definition of an IRP anyway

But mainly I’m annoyed because we tried on multiple occasions to highlight to the then Minister Doherty and subsequent Minister Humphreys that limiting investment by single member pension schemes will impact the pension saver and Ireland’s economy as a whole.

We are in a period of economic uncertainty, for many individuals and also for the economy as a whole. Deposit interest rates are turning negative, unemployment is high, taxes will inevitably rise, national debt is the highest its ever been, traditional bank credit will become tighter and more expensive and this move by Government will hurt.

Cast your minds back to the financial crash of 2008 the Irish single member pension scheme regime stepped in when banks wouldn’t, they invested in Ireland in massive numbers in the likes of hotels, old folks homes, primary care centres, social and affordable housing schemes, indigenous Irish start-ups, commercial and residential property. Single member pension schemes currently have over €4B invested in Ireland.

These funds won’t be coming back into the Irish economy.

Currently our pension schemes hold over residential 8,000 residential properties in Ireland, over 20% of these are let to local housing authorities on long lets. Savers want certainty around returns, they want a balance between risk and reward – buying a property and renting it to the local authority for 5/10/25 years provided that certainty and the right balance of risk and reward. That certainty provided a pension saver a solid base on which they could build a portfolio around – while also providing a vital source of housing for the Irish State.

Will this increase pension coverage in Ireland………………I’m wagering no it won’t.

So where is the turd in all of this? The Directive isn’t the turd, it is drafted and worded to provide for proportionality and the derogation (exemption for smaller schemes) and aims to provide protection for pension scheme members. The turd is the decision making process, the lack of engagement and the determination, it would appear, not to listen to the voice of an industry who highlighted its negative impact.

The IORP II Directive is being used to kill off single member pension schemes for regulatory convenience and avoid accountability. When it goes wrong they’ll just blame the EU……..sure they told us to do it.

I made a mistake, it’s not actually a turd, its a bag of turds.

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## .The PRSA project success or failure?

October 28, 2021 By Eoin Hassett

The PRSA has come a long way since its introduction in 2002, becoming a core product in the pensions market despite its well documented flaws. The future for the PRSA looks to be even brighter with the possibility that the Buy-Out-Bond (BOB) may no longer be available to pension investors in line with the recommendation of the Interdepartmental Pensions Reform and Taxation Group.

Before looking at the advantages of a PRSA let's first examine whether it has fulfilled the role it was introduced to do. The answer to this is a resounding no. The PRSA was introduced to make the pensions industry easier to understand, however it has had the opposite effect. It hasn't replaced any of the pre-existing pension products but instead added yet another layer. The PRSA has become perhaps the most complicated product in the market with many rules attached to it that are difficult to understand. For instance, an employer can contribute to a PRSA but any contribution which exceeds the personal contribution limits will be taxed as benefit-in-kind, meanwhile a company pension plan can, in some circumstances, contribute multiples of an employee's salary without any adverse taxation issues.

From an investment perspective the PRSA has more bewildering rules, for instance a PRSA cannot invest in a passive investment fund with a Total Expense Ratio (TER) of 0.25% including a performance fee of 0.10% of returns above its benchmark. The same legislation allows for a PRSA to invest in a fund with an Annual Management Charge of 3.00% (the TER could be much higher) once there is no performance fee. It is difficult to see how this benefits the pension investor. While we are on the subject of charges, the PRSA was intended to be a cost-effective pension solution with firm rules controlling its costs, however, while market forces on other products have pushed pension costs down, the excessive cost to PRSA providers of running the highly regulated PRSA means it is now probably the most expensive pension contract in the market, especially at the lower values.

Unfortunately, that is not where the unusual rules end. A personal pension plan can transfer to a PRSA, but a PRSA cannot transfer to a personal pension. A PRSA can transfer to an Executive Pension and an Executive Pension can transfer to a PRSA but only if the member has been in the pension scheme for less than 15 years, thankfully this rule is being relaxed, but not removed, in January 2022. From January members with more than 15 years' service can transfer to a PRSA when leaving service or on scheme wind up. There is no requirement for a Certificate of Benefit Comparison to transfer out of a PRSA or to transfer from a Personal Pension to a PRSA but there is if you want to transfer from an Occupational Pension arrangement to a PRSA, unless the scheme is winding down, as is the case with all single member schemes.

Having looked at many of the problems the PRSA brings with it, let's look at some of the benefits of the PRSA. The PRSA's popularity has shot up since the much-maligned transposition of IORP II into law on the 22nd of April. We have seen a huge outflow of funds from Occupational Pensions into PRSAs as clients look for more flexibility in their asset allocation.

Investments aside there are several other areas where the PRSA has benefits when compared to the other pension products:

**Death in Service:** According to Chapter 10 of the Pensions Manual, on death in an Occupational Pension scheme “a lump sum not exceeding the greater of €6,350 or four times the deceased employee’s final remuneration may be provided.” Any funds over this amount are required to purchase an annuity. With annuity rates so low at present this may constitute very poor value for the receiver.

Chapter 24 of the Manual which deals with PRSA’s states “Where an individual dies before benefits are taken, the fund passes to the estate of the deceased” thus avoiding the four times salary problem.

**Forward Funding:** While the PRSA doesn’t have the same funding advantages as an executive arrangement, it does provide pension savers with the option to future fund by making a large contribution in the current year and spreading the tax relief over any amount of years in the future.

**Split Retirement:** Benefits from an Occupational Pension scheme relating to the same employment must all be drawn simultaneously. In many circumstances this is not an issue, however some clients will have a preference to only retire a portion of their funds for various reasons, most commonly when a client has a pension fund threshold issue or needs access to some of their retirement-lump-sum but not the full 25% of their fund. PRSAs can be retired at different times allowing for planning and potential further growth.

**UK Property:** As HMRC does not recognise non-life assured A(M)RF’s as a pension, there is a tax leakage for such projects. A Vested PRSA however is fully recognised by HMRC and enables pension savers to invest in UK property free from income tax on rent and CGT on capital appreciation.

**Breaking Link With Employer:** As with a BOB the move to a PRSA ends an employer’s relationship with an Occupational Pension scheme. This avoids problem of people entering retirement having to locate trustees of a company they worked for many years previously to allow the retirement to be processed. For employees of SME’s this can be very complex if the company has been sold or wound up.

Despite the many flaws of a PRSA it could still be the future of individual pensions. It currently has many uses in the financial planning process and a single portable pension product that you can carry with you for your entire working life is still a great idea, we just need the rules to be simplified and made more practical.

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# The investment implications of IORP II

November 29, 2021 By Ian Slattery

The slow march that has been the implementation of the IORP directive in Ireland has been the subject of many a recent webinar and article – indeed with a number here in the FM Report. The Pensions Authority recently published the Codes of Practice for Trustees, which is to complement the primary text of the directive and can perhaps be seen as a 'playbook' for practitioners in the industry. The bar in terms of trustee requirements and obligations is certainly being raised and the industry looks set to continue the inexorable shift towards Master Trusts or a Group PRSA arrangement, as the landscape for smaller schemes and one-man arrangements continues to be eroded by increasing scheme regulatory complexity and cost. The purpose of this piece is to look at some of the investment related points in the draft codes and hopefully provide some further insight into the implications of the information included in Chapter 4 of the Codes. Ultimately the Codes of Practice for Trustees aims to put a greater focus on the standards of pensions management. The full impact remains to be seen but here are some of the actions you can begin to implement now to demonstrate compliance.

**Improve record retention**

One point that is clear, is that going forward there will be a requirement for a lot more record keeping in relation to investment selection, governance, and ongoing oversight. Much of the work in this area is already being done, but perhaps not to the level of formality indicated by the new Codes of Practice for Trustees. A common theme evident throughout the consultation period was the concerns surrounding proportionality and the risk of duplication. This is also true in respect to investments with the new 'Statement of Investment Governance' a clear example. Just to note, this does not replace the existing Statement of Investment Policy Principles (SIPP) and is a distinct and separate requirement.

Included in new 'Statement of Investment Governance' will be items such as:

- Investment objectives
- Number of fund choices
- Strategy
- Risk tolerance applicable to each choice
- Consideration given to ESG factors

Whilst the ESG consideration under IORP II, is distinct to any classification under SFDR, it would certainly be prudent to consider both aspects simultaneously.

**Regular reviews and potential pitfalls**

One interesting aspect is the concept of investment manager review frequency, including 'under what circumstances would they be subjected to an immediate review'. I think it will be important that such guidelines don't leave trustees susceptible to a knee jerk reaction as a result of market shocks. The history of investment markets is littered with examples of when doing nothing was a perfectly acceptable, and indeed preferable, course of action.

**The potential for increased duplication**

The concept of potential duplication rears its head once again under the heading of 'investment contracts' which appears to cover many of the same topics in the aforementioned Statement of Investment Governance. Viewed through the lens of an insured arrangement it could be argued that much of the requirements in this particular piece are already covered by existing contractual and trusteeship instruments.

**Selecting an appropriate benchmark**

The concept of benchmarking is mentioned a number of times in the codes and is also directly addressed in the Pension Authority's response to the consultation submissions. Several submissions recommended the concept of peer group averages and reference benchmarks as opposed to absolute quantitative risk and return metrics. The Authority notes that such an approach 'creates the risk of encouraging herd behaviour'. Again, this seems like a logical approach for larger schemes with economies of scale and significant in-house expertise. For those of a smaller scale, comparing the chosen investment fund with the direct alternatives available in the marketplace would appear to be a much more practical, and indeed logical approach. It remains to be seen how trustees will implement some of the proposals in respect to performance evaluation. The idea of assigning expected return values to funds and asset classes on an 'ex-ante' basis is open to justified criticism.

**Establishing an Investment Committee**

We have spoken on these pages previously in relation to the concept of an Investment Committee and some of the regulatory 'push' the industry is experiencing is creating these in all but name. In terms of next steps, it is prudent for all advisors and trustees to familiarise themselves with the codes in their entirety. Overall, there are potentially at least a dozen new policies or statements to be constructed across all the main areas and the initial work for trustees and advisors will be significant.

Whilst the codes are indeed prescriptive, the Pensions Authority do note that they are looking to implement a minimum standard for the processes in which decisions are made, but not necessarily appraise the decisions themselves. I think this remains an important point for trustees and ultimately their advisors. 'Paralysis by analysis' is not the aim here, and it should not be the outcome. Trustees and advisors who have always made good decisions, within a good governance framework will continue to do so.

**Principles and Practicalities**

The practical implications of the codes of practice will become more apparent in the coming weeks and months, and there is sure to be some unintended consequences for advisors, trustees, and ultimately scheme members. However, at the very least it should serve as a ‘call to action’ in the marketplace with a significant amount of work and resources needed in order for pension schemes and their trustees to fully comply.

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## The complex world of pension funding

November 29, 2021 By Eoin Hassett

As with everything pensions related, nothing is straight forward. That being said, funding a pension is a great way to reduce current tax liabilities while also building a war chest to maintain your lifestyle in retirement.

From a pension funding perspective, the world is split broadly into two categories, the Self-Employed and Employees (including owner directors). The dichotomy in pension funding options between the two groups is vast.

Firstly, looking at the simpler of the two options, self-employed taxpayers are entitled to make an annual pension contribution up to the limits listed on the table below in any one tax year.

| Age | Limits of remuneration/net relevant earnings |
|---|---|
| Up to 30 years | 15% |
| 30 – 39 years | 20% |
| 40 – 49 years | 25% |
| 50 – 54 years | 30% |
| 55 – 59 years | 35% |
| 60 years and over | 40% |

In addition, section 790A of the Taxes Consolidation Act places an overall upper limit on the amount of remuneration/net relevant earnings that may be considered for tax relief purposes. The earnings limit is €115,000 since 2014. So, what this effectively means is that a 50-year-old self-employed person who earns €150,000 can make a maximum pension contribution of €34,500 (€115,000 x 30%) as the earnings limit applies.

While the self-employed have the benefit of a simpler method of calculating their payment, their ability to contribute large sums tax efficiently into their pension scheme in the years close to retirement is limited, which is when the majority of pension funding occurs.

It is important to note that the self-employed person can make contributions into a PRSA that are above their personal threshold in any year and gain tax relief on those contributions at any point in the future when they have the relevant income tax liability. This allows the contribution to be offset. This can be very beneficial to individuals whose income fluctuates from year to year.

Moving on to employees, most people are familiar with the standard group pension scheme, typically a defined contribution scheme as private sector defined benefit schemes are quickly becoming a thing of the past. In this scenario the employee usually pays a set portion of their annual salary, say 5%, and the company will match that contribution with a payment of their own. This is a simple way of funding for retirement and for people lucky enough to be in such a scheme for 20+ years. For example, a 30-year-old earning a salary of €40,000 who makes a monthly contribution of 11.5% that is matched by their employer could have a pension pot capable of providing an income of 66% of their pre-retirement income, assuming they are entitled to the full state pension. While 11.5% seems like a large portion of an employee’s income it is important to remember that tax relief is granted at the client’s marginal rate of tax. It is also important for members of group pension schemes to remember that they can make additional voluntary contributions to bring them up to their personal maximum pension contribution, however it is extremely likely that these additional contributions will not be matched by the employer.

From this point on, contribution capacity gets more complex as owner directors who have the capability to make very large contributions can avail of very generous allowances. When a company owner wants to make a substantial contribution from their company into their company pension scheme, there are a range of factors in determining how much can be contributed:

- Salary
- Age
- Marital Status
- Chosen Retirement Age
- Previous / existing pensions
- Potential Service / Years of service with the current employer

Effectively the contribution limit calculates the shortfall between the current pension provision and the provision that would currently be required to give you the maximum pension allowable on your chosen retirement age. This calculation is unique to each individual as it is based on all the factors above plus additional information such as assumed investment growth rates and annuity rates. Generally speaking, the longer the service, the higher the salary, the lower the current pension provision and the shorter the time to retirement, the higher the pension contribution can be.

For example, a 55-year-old married female business owner with a salary of €40,000, a retirement age of 60, 20 years’ service and no pension provision could make a maximum once-off lump sum to provide for back service of €640,000 in addition to an annual contribution of €40,000. Should the same person decide to increase their salary to €100,000 and not make any contributions to their pension pot until immediately before retirement, then they would be able to make a back funding contribution of €2,000,000.

While it can seem that owner directors are being treated more favourably than employees by the Revenue, that is not the case. Employees have the same funding entitlements as their employers, however they typically do not have the same influence on the company's finances as their employers do. Unfortunately, as we have seen, self-employed pension savers definitely do not have the same allowances as those who are employed. That being said there are some additional options available to the self-employed. For instance:

- Some self-employed individuals can employ their spouse and fund their spouses' pension in the same manner as an owner director
- Some self-employed people could incorporate turning them into owner directors
- Some self-employed people can create service companies of which they are an employee allowing them to benefit from the owner directors' options with the surplus cash in said company

Overall, the ability to contribute and the tax relief around contributions can be quite complex. For example:

- While a self-employed individual's contribution limit is quite clear, that contribution can only be offset if there is a relevant tax bill accrued (notwithstanding the ability to roll forward)
- For directors who own more than 20% of a company the salary used to calculate their maximum contribution should be sustained for a period of at least 3 years (assuming the client is within 10 years of retirement)
- Pension contributions made by an employer to account for back service may be required to be offset over a number of years

For this reason, it is advisable to speak to both your accountant and financial advisor in order to ensure you are getting the most out of your pension.

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