During 2015, the LGIM Pre-Retirement Fund (PRF) continued to be a popular component of clients’ pre-retirement investment strategies, representing a long-term, relatively cautious and transparent asset mix that evolves over time to reflect changing financial market conditions. Here we provide an overview of the performance of the fund over the year, an introduction to Solvency II and the impact of the regulations on annuity pricing.

Objective-driven performance

At LGIM, we believe the PRF - and similar strategies - are best measured against the level of retirement income achievable from annuities – i.e. focussing explicitly on member outcomes. Since the end of Q4 2015 we have started using the FTSE UK Level Annuity Index Series for this purpose, an independent and transparent source of annuity price changes*. We are proud to have collaborated closely with FTSE to launch the series earlier last year. Relative to this benchmark the PRF has demonstrated the closest or second closest match to annuity prices in 10 out of the last 13 months when compared to other typical pre-retirement strategies, as illustrated in figure 1 below.

This strong performance is also demonstrated by the tracking error of the Fund, where again the PRF clearly stands out over the past 13 months as consistently outperforming alternative strategies (see figure 2). While the investment strategy of the PRF is reviewed and updated regularly, providing a level of in-built governance, we use LGIM’s size and scale to take advantage of the opportunities to reduce the cost of changing the allocation of the Fund. As an example, the total cost of implementing changes to the strategy during 2015 was zero.

Figure 1. One month changes in purchasing power – PRF vs. alternatives – representative annuitant profile

*Prior to Q4 2015 performance of the PRF was measured relative to our internally calculated rate series.
Annuity prices reflected volatile interest rates and corporate bond spreads throughout 2015, however it is comforting that the PRF performance broadly followed the key trends, such as the peaks at the end of January and March, as shown in figure 3. Similarly, while there appears to be large under and outperformance in April and May, see figure 1, this is largely as a result of a delay, or lag, between market movements and insurers changing their prices in response. This is supported by the two months largely offsetting each other. The only significant deviation occurred during December, where we believe insurers increased their prices in advance of Solvency II coming into force. Changes in pricing driven by non-market related factors such as this impact all investment strategies equally regardless of asset allocation.

The impact of Solvency II

After a series of delays, the 1st January 2016 finally saw the introduction of the new Europe-wide regulatory regime for insurers – Solvency II. It arguably represents the biggest change in a generation in how insurers think about capital and risk. Below, we introduce the high level concepts and key points of Solvency II for annuity writers and our view on how insurers have responded to these changes so far.

An important step in our investment process for all the funds in the Pre-Retirement Suite is to determine and understand the drivers of annuity pricing, allowing for the regulatory framework insurers operate in. Given the move to Solvency II, we have also changed our proprietary model to incorporate insurers’ changing approach to capital efficiency and therefore annuity pricing, to ensure that the investment strategy remains appropriate to meet the objectives.

The ultimate aim of the new regulations is to create a level playing field for the European insurance market by harmonising the capital requirements, internal risk assessment and reporting of European insurers. From a capital requirement perspective, the move from Solvency I to Solvency II is seen as a switch from a relatively simplistic approach to the calculation of capital requirements to a dynamic, market-based approach reflecting the expected impact of a 1 in 200 year event across a range of risk types (with allowance for any diversification benefits).
Solvency II has been proven to be penal in terms of capital requirements, as can be seen from the reduction in free surplus in figure 4 on the previous page, especially when it comes to longevity risk (via the introduction of the Risk Margin). This resulted in a noticeable increase in the cost of an annuity during December last year of the order of 3-4% for the more competitive firms, which is expected to be a one-off step change. As a result our view is that insurers have increased their allocation to corporate bonds – see figure 5 – in an attempt to partially offset steeper rises in prices.

Figure 5. Changes in the Annuity Pricing Portfolio over time

Source: Market IBoxx, FTSE and LGIM own calculations

KEY CONSIDERATIONS AND RISKS

The Fund invests in fixed interest securities - usually corporate and government bonds. Investment returns are particularly sensitive to trends in interest rate movements. The Fund value is likely to fall when these interest rates rise (such falls may be more pronounced in a low nominal interest rate environment). The value of fixed interest securities which pay nominal coupons and/or capital payments may be eroded by the effects of inflation.

Following the global financial crisis (and consequential changes in regulation and capital requirements) inventories held by global financial institutions trading in fixed interest securities have fallen. There is therefore an increased risk that in times of, for example, market stress and/or significant redemptions by unit-holders that the redemption proceeds will be adversely affected and/or in extreme circumstances delayed.

The Fund invests in fixed or floating interest securities. The financial strength of a company or government issuing the security determines their ability to make some or all of the payments due. If this financial strength weakens, the chances of them not making payments increases and this will reduce the Fund’s value.

The Fund is designed to be used as part of a pre-retirement strategy by investors who are expected to purchase an annuity at retirement. The asset allocation for the Fund is based on an average of individual requirements/liability profiles appropriate to the specific pre-retirement fund objective. By considering the average, the Fund seeks to broadly mitigate the relevant risk(s) for a large number of individuals at an acceptable cost. The profile of the average investor cannot by definition be the same as for every individual and therefore there is a risk that the objective of the Fund will not necessarily match each investor’s liability profile and/or investment time horizon.

Any objective or target will be treated as a target only and should not be considered as an assurance or guarantee of performance of the Fund or any part of it.

Further details (including relevant risk factors and fund specific risks) are available in the Description of Funds document, which can be obtained from your usual LGIM contact or by visiting www.lgim.com/descriptionoffunds
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Important Notice

You may not get back the amount you originally invested. The return from your investment is not guaranteed and therefore you may receive a lower or higher return than you anticipated. Past performance is no guarantee of future performance. Our charges may change. Tax rules and the treatment of income and capital gains could change in the future. Inflation will over time reduce the value of your investment in real terms. There will be a variation in performance between Funds with similar objectives due to the different assets selected. The degree of investment risk depends on the Funds you choose. In extreme market conditions it may be difficult to realise assets held for a Fund and it may not be possible to cancel Units at short notice. We may have to delay acting on your instructions to sell or the price at which you cancel the Units may be lower than you anticipated.

The value of a Fund's assets may be affected by uncertainties such as international political developments, market sentiment, economic conditions, changes in government policies, restrictions on foreign investment and currency repatriation, currency fluctuations and other developments in the laws and regulations of countries in which investment may be made.

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