

Note: on adjusting the regional equity mix

Summary

The Fund maintains significant exposure to non-UK equity markets as part of its diversified asset strategy. It is important to review the way these international assets are shaped (and how that shaping evolves).

The LPC reviewed the mix of overseas equities in 2015 and then updated that work in 2016. This process led initially to the re-introduction of Japan and, subsequently, to an increased allocation to that market. This note revisits the topic and proposes modest adjustments.

Background

There are at least five ways to set the neutral split of overseas equities:

1. *Peer group average*

Setting the neutral allocation equal to the peer group average is to follow the actions of comparable funds; the approach naturally lags rather than leads. It invites herd (lemming)-like behaviour based on data that, when released, could be considerably out of date. This can also lead to allocations that are wildly different from any recognised (or rational) norm.

2. *Market capitalisation*

This approach is the most common and biases the asset allocation to the largest equity markets and to momentum (the best performing markets attract greater proportions of capital) regardless of their valuation and outlook. As with the peer group average, this is an approach that lags rather than leads. This is the easiest benchmark to calculate and is based on live data. Currently, this approach produces a very concentrated benchmark weighted very heavily in favour of the US (see data on page 3).

3. *GDP weights*

Investment allocations are related to the size of each country's economy which, in comparison to the gyrations of equity markets, is relatively stable (which is fortunate given the lags by which GDP data is released and that the data is subject to revision). Issues with this approach include a) that large economies can have small stock markets e.g. China, b) that some markets are much more international than others e.g. the UK and c) some companies choose their country of listing for their best advantage¹.

4. *Forward GDP weights*

This is an extension of the GDP approach and is based on the latest GDP split and projected growth rates across the various economies and so, attractively, adds weight to the faster growing economies. While GDP forecasts are, like all forecasts, subject to error, these can be prepared internally and/or drawn from the World Bank and the IMF. Unlike any other approach mentioned, forward GDP weights attempts to capture future trends (although proponents of market capitalisation might argue that the stock markets that are performing best are doing so based on the relative strength in the corporate earnings outlook). The GDP approach, whether current or projected) produces a well-diversified benchmark.

5. *Set fractions*

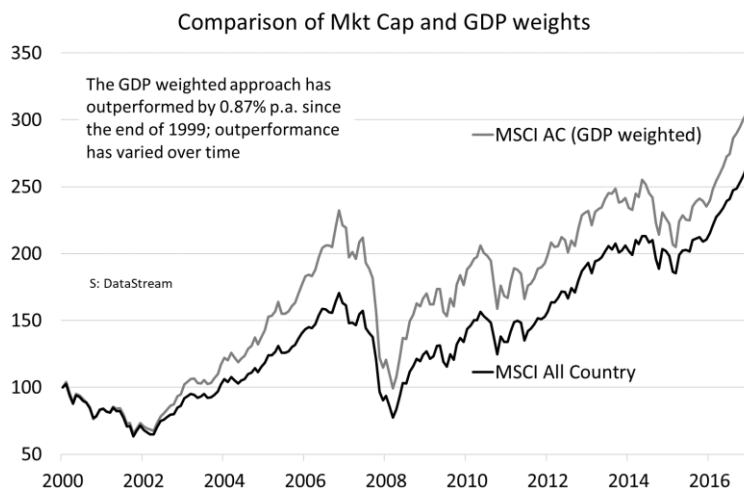
Depending on how emerging markets are treated, international markets can be split into three or four blocks. If three, they are North America, Europe (excluding the UK) and Asia; Asia is usually tilted in favour of Japan. Country weights within each block are usually based on market capitalisation. A common benchmark would assign one third to each block. Advantages seen in this approach include that it is simple, forces

¹ The bidding war surrounding the upcoming Aramco listing illustrates the distortions possible

diversification if the fractions are broadly equal and, perhaps most significantly, is distinct from the first four approaches mentioned. The principle disadvantage is that it lacks any financial or economic support.

Selected charts:

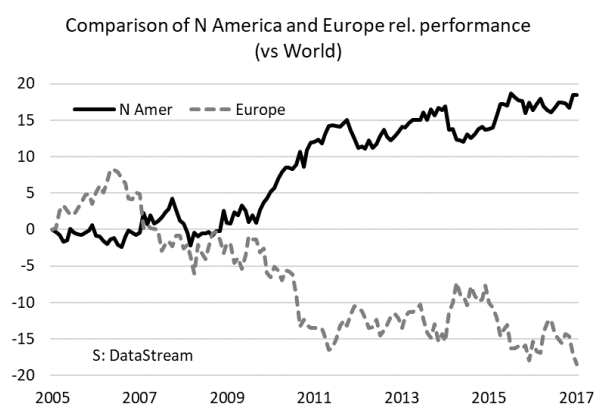
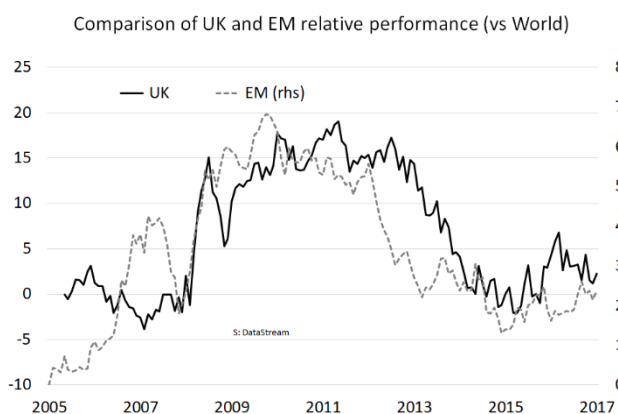
The chart opposite compares the compound achievement of the main market-capitalization weighted all world index as compiled by MSCI against the GDP weighted alternative. From the end of 1999, the GDP weighted version has outperformed the mainstream market-cap index by 0.87% per annum albeit with an inevitably higher level of volatility (consistent with the less mature nature of many of the countries involved). The more balanced GDP approach has tended to outperform unless growth in the world economy is being led by the US when its scale benefits the market-cap approach most significantly. At such times, the US\$ is invariably also strong and this compounds the concentration.



Below are two charts which compare the relative performance (vs. the market cap weighted world index²) of the UK against emerging markets and then of North America against continental Europe.

The UK equity market has significant exposure to companies that trade globally and which are heavily involved in commodities and energy. The first chart highlights that excess return (all data is in local currency) from UK equities has tended to occur when EM have outperformed (albeit that the degree of relative performance of EM is much greater). This close similarity should be remembered when setting target weights for the domestic market and EM. Crudely, three units of UK exposure have tended to generate the same excess return as one unit of EM exposure; this out-turn is consistent with the proportion of UK company earnings generated in emerging markets as mentioned in Hymans' 2015 review.

Since the GFC, the contrast in performance between Europe and US has been stark. This can, in part, be explained by several years of sluggish economic performance in Europe and ongoing political/ existential crises. It is interesting that despite significant strength in the EZ economies, European equities have failed to recover any ground (relative to the US and the World). The inference from this chart is that it is important to take the time to think about regional selection.



² For these charts, the data relates to FTSE indices

Selected data:

The table immediately below details the country constituents of the MSCI World (developed) and emerging market indices. The economies of the countries listed represent 90% of the world economy (GDP, in US\$).

MSCI ACWI					
MSCI World			MSCI Emerging Markets		
Americas	Europe and	Pacific	Americas	Europe, ME &	Asia
Canada	Austria	Australia	Brazil	Czech Rep	China
US	Belgium	Hong Kong	Chile	Egypt	India
	Finland	Japan	Columbia	Greece	Indonesia
	France	New Zealand	Mexico	Hungary	Korea
	Germany	Singapore	Peru	Poland	Malaysia
	Ireland			Qatar	Pakistan
	Israel			Russia	Philippines
	Italy			S Africa	Taiwan
	Netherlands			S Arabia	Thailand
	Norway			Turkey	
	Portugal			UAE	
	Spain				
	Sweden				
	Switzerland				

The current GDP split and that projected by the World Bank in 2022 are shown below along with the current weights in the world equity market. For those interested, the split across EM is given in the Appendix.

	% GDP of World economy x UK (current)	% GDP of World economy x UK (2022)	% of current Market Cap. x UK
DM	61.2	56.8	87.0
Americas	30.6	28.6	58.2
Europe (x UK)	20.2	18.7	15.0
Pacific	10.5	9.5	13.7
EM	38.8	43.2	13.0
Americas	5.4	5.1	1.5
Europe (x UK)	7.4	7.2	2.2
Asia	26.5	31.3	9.2
DM+EM			
Americas	36.0	33.8	59.8
Europe (x UK)	27.6	25.9	17.2
Asia Pacific	36.4	40.3	22.8

LCCPF approach

The Fund adopts a fixed fraction approach, periodically reviewed. The current % weights for the passive non-UK equity allocation are

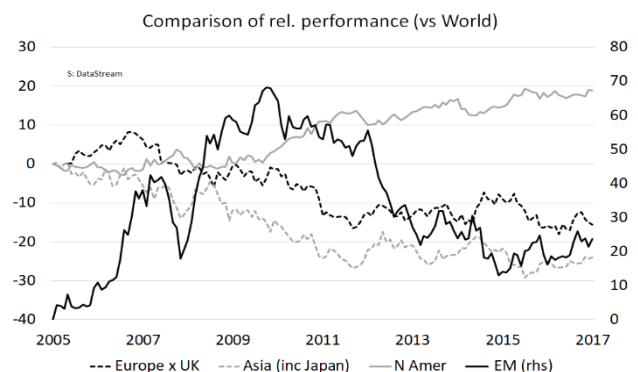
Europe x UK	N America	Asia x J	Japan	EM
5.7	13.2	2.8	2.8	2.0

Including the dedicated allocation to active EM equities (managed by Delaware) and combining Asia and Japan gives the following:

%	Europe x UK	N America	Asia	EM
of Fund	5.7	13.2	5.6	6.0
of regional equities (x UK)	18.7	43.3	18.4	19.7
World (x UK) mkt cap	15.0	58.2	13.7	13.0
World (x UK) current GDP	20.2	30.6	10.5	38.8
World (x UK) GDP (projected 2022)	18.7	28.6	9.5	43.2

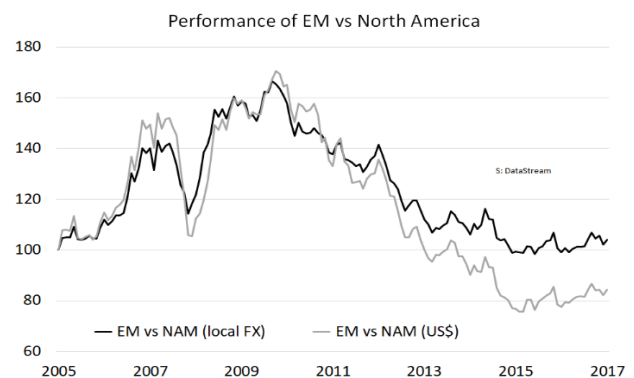
Comments:

A. A fixed fraction approach has merit if relative performance, across the major regions, is cyclical; if this is true then, as the chart (for local currency performance) opposite suggests, it is a very long cycle. As the world economy evolves then it seems reasonable that, structurally, equity markets should change in relative scale. The Fund adopts a discretionary approach, setting the fractions for the year ahead at the annual Strategy Review.



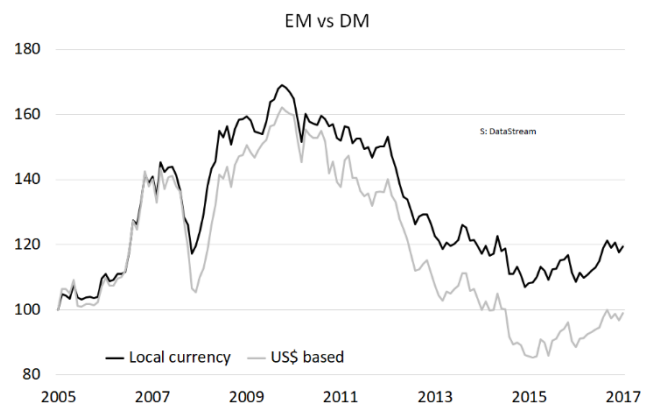
B. The size of developed economies is projected to fall relative to those in emerging economies and these economies are becoming more self-sufficient. While some will argue that this growth can be captured through holdings in developed market equities³, it seems reasonable that the neutral regional split should respect, by some means, this projection.

C. The most significant contrast between the current Fund weightings and those implied by either a GDP approach involves the US and EM. Adopting a GDP approach involves the US and EM. Adopting a GDP basis for setting the neutral allocation implies switching some 15% of non-UK equities from North America to EM. The chart opposite suggests, based on the past decade, that there has never been a better time to do this; the terms could improve.



³ Epoch – a global equity manager on the London CIV platform, hold no emerging market equities directly arguing that, through the likes of Unilever, Nestle etc, they get ample exposure to emerging economies without being exposed to the governance issues of owning EM shares directly. This stance suits the manager – they don't need to employ EM analysts!

D. Given the dominance of the US equity market in world indices it is unsurprising that developed markets overall have outperformed their emerging counterparts in recent years. This can, in part, be explained by the extra-ordinary policy conditions across developed markets (including ultra-low bond yields/ discount rates). Central banks, across developed economies, are now beginning to gently reverse out of their crisis policy setting. This partially explains some of the relative recovery in EM stocks over 2017; gradual rate hikes have taken the steam out of the US\$.



In thinking about possible changes to the current split for the year ahead, the following higher-level observations are relevant.

1. EM equities have significantly underperformed their developed market peers in recent years with the latter boosted by extra-ordinarily accommodative monetary policies; that boost is now slowing down. The valuation of EM equities is much less stretched than in the west and EM economies continue to grow in global importance. Unless the US\$ becomes markedly stronger or, globally, inflation becomes a problem (neither is expected), EM assets should continue to re-rate. The case for implementing a structural increase now in EM weightings seems clear. Calibration of any adjustment should be done recognising the similarity in performance trends with UK equities.
2. China continues to move towards a domestically driven economy and policymakers there are tightening credit to avoid a repeat of the 'crunch' seen in the West in 2008/9; this should act as a headwind to non-China Asian equity markets.
3. The Japanese economy continues to perform well, the Bank of Japan shows no sign of tightening monetary policy and corporate earnings are growing well in Japan. Any reduction in Asia equities should not be expressed in the Japanese weighting. Global investors have considerable scope to add to their Japanese weighting.
4. The recovery in the European economy has been marked and this up-cycle should continue especially if, as expected, capital investment by European companies increases; a much stronger € would be a concern and political developments need to be watched. Valuations are more attractive than in the US. Global investors have still not fully rebuilt their weightings in European equities after the crisis-laden, post-GFC years. A cyclical lift in the European weighting is appropriate.
5. North America has been the place to invest for the past ten years. The policy response (to the GFC) was swift and powerful as was the corporate sector's reaction (early, sharp labour shedding which provided the platform for a recovery that has been sustained). The latest boost (from tax cuts) is increasingly being discounted and with economies elsewhere improving, given lofty valuations on US stocks and the prospect of US policy rates increasing further, the North American equity weighting should be reduced to fund increases elsewhere. Unlike everywhere else, valuation challenge from bonds is beginning to emerge.

These arguments lead to the changes enumerated over the page: increase Europe and EM, reduce Asia x Japan and more so the US, leave Japan unchanged. These adjustments move the mix in the direction of the projected GDP-weighted allocations in both EM (increase) and North America (reduction) and Asia (reduction).

%	Europe	N America	Asia	EM
Current Fund weight	5.7	13.2	5.6	6
Current % of non-UK	18.7	43.3	18.4	19.7
Suggested target % on non-	23.0	36.1	16.4	24.6
2022 GDP weights	18.7	28.6	9.5	43.2
Suggested Fund weight	7.0	11.0	5.0	7.5
Change	+1.3	-2.2	-0.6	+1.5

Summary

All decisions taking in the Fund should be taken with strategic objectives in mind. Reviewing how the regional (non-UK) asset allocation should be shaped, there are several approaches that can be adopted and these have been summarised in this note.

All of the approaches mentioned have their imperfections and selection is largely a matter of personal preference. The most common approach in Schemes akin to the LCCPF is the arbitrary fraction approach, periodically revised; this approach was adopted in a relatively recent strategy review. The author's preference is to have an approach which has an eye to economic trends; this should become more important as emerging economies mature (and are supported internally). The two approaches needn't conflict and can usefully combine with one offering to challenge to the other.

The Fund's approach sees weights reviewed once a year, the changes recommended for the year ahead are broadly consistent with, but not driven by, a projected GDP approach. The reduction proposed in the North American weighting reduces the concentration to this region.

It is recommended that the precise scale of the adjustments be left to Officers to reflect market conditions. Any finessing required could also usefully consider the tendency for UK and EM markets to move together.

There is scope to extend the detail of this note across the full asset mix of the Fund producing moderate adjustments reflecting market conditions etc. This is work that should be tasked to the ISC.

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Appendix

The table below details the relative size of each emerging market in terms of (US\$ based) GDP and of the current equity market capitalisation. The emerging markets listed are those defined by MSCI and data is taken from the World Bank and FTSE.

	% of World GDP (US\$)	% of World Equity Market
Brazil	2.6%	0.87%
Chile	0.4%	0.15%
China	16.2%	3.18%
Colombia	0.4%	0.05%
Czech Republic	0.3%	0.02%
Egypt	0.5%	0.02%
Greece	0.3%	0.04%
Hungary	0.2%	0.04%
India	3.3%	1.18%
Indonesia	1.3%	0.24%
Korea	2.0%	1.80%
Malaysia	0.4%	0.32%
Mexico	1.5%	0.37%
Pakistan	0.4%	0.01%
Peru	0.3%	0.04%
Philippines	0.4%	0.16%
Poland	0.7%	0.16%
Qatar	0.2%	0.07%
Russia	1.9%	0.43%
Saudi Arabia	0.9%	0.37%
South Africa	0.4%	0.90%
Taiwan	0.8%	1.33%
Thailand	0.6%	0.37%
Turkey	1.2%	0.13%
United Arab Emirates	0.5%	0.10%

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