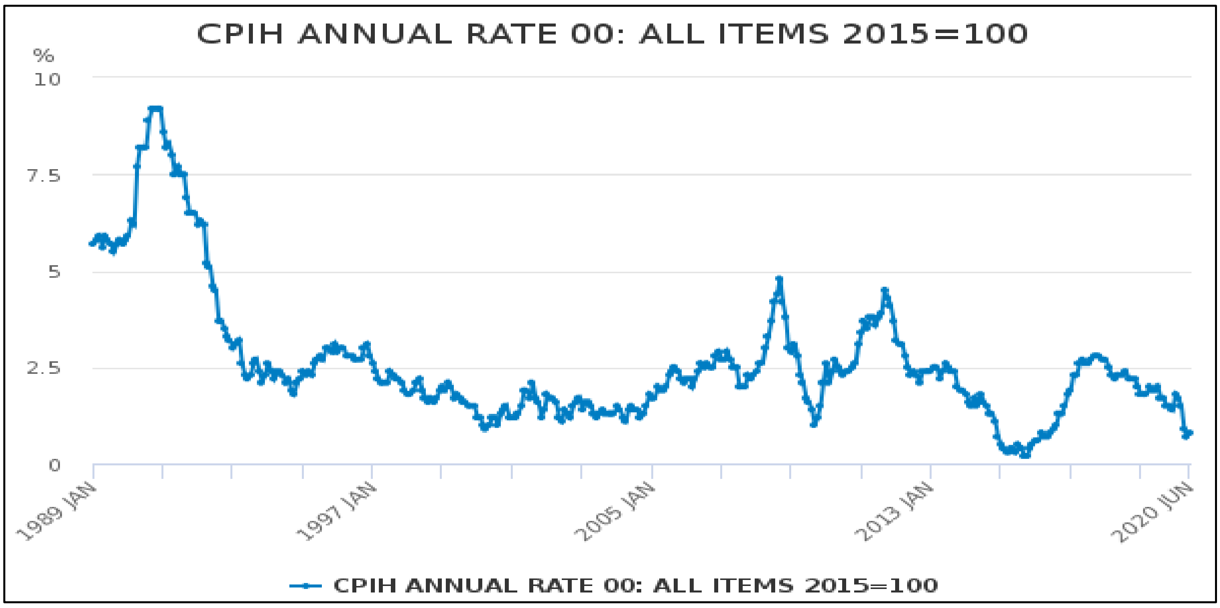
GROVE PENSION SOLUTIONS LTD

GUIDE TO:

INFLATION; ATTITUDE TO INVESTMENT RISK & VOLATILITY; CAPACITY FOR LOSS; GENERAL MARKET COMMENTARY

INFLATION

Inflation is the rate at which prices for goods and services is rising and reduces the purchasing power of money. If inflation is greater than pension investment returns, your pension pot will effectively decline in value over time. The rate of inflation in the UK, as calculated and presented by the Office of National Statistics, for the last thirty years is shown below;



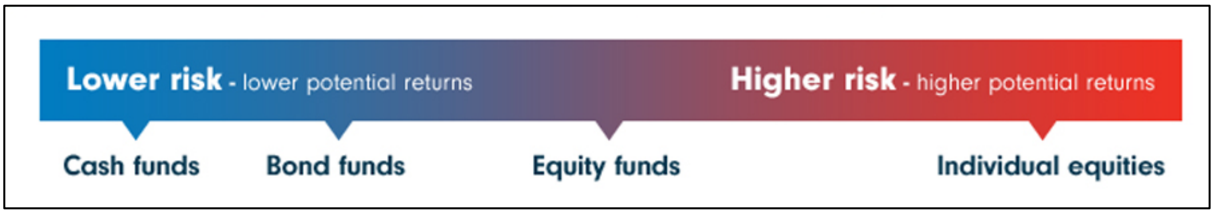
ATTITUDE TO INVESTMENT RISK & VOLATILITY

Investment risk falls into two main categories, 'systematic risk' and 'unsystematic' risk. Systematic risk applies to the market as a whole and an example of this would be the 2008 Financial Crisis, which caused negative returns across almost all investments.

Unsystematic risk by contrast only impacts a specific stock or sector, *not* the market as a whole. An example of this is the Volkswagen emissions scandal.

This is important to understand as a portfolio / fund might still have some *systematic* risk – since this is virtually unavoidable as markets will always go up and down – you can reduce the *unsystematic* risk by holding a diversified 'basket' of funds. Quite simply, the old saying 'don't put all of your eggs in one basket' still very much applies.

The range of investment risk is broad, as shown below, and can range from a low risk cash holding giving a limited level of growth, up to direct equity exposure on the upper end, with a variety of stocks, bonds, property and other investment mixes in-between.



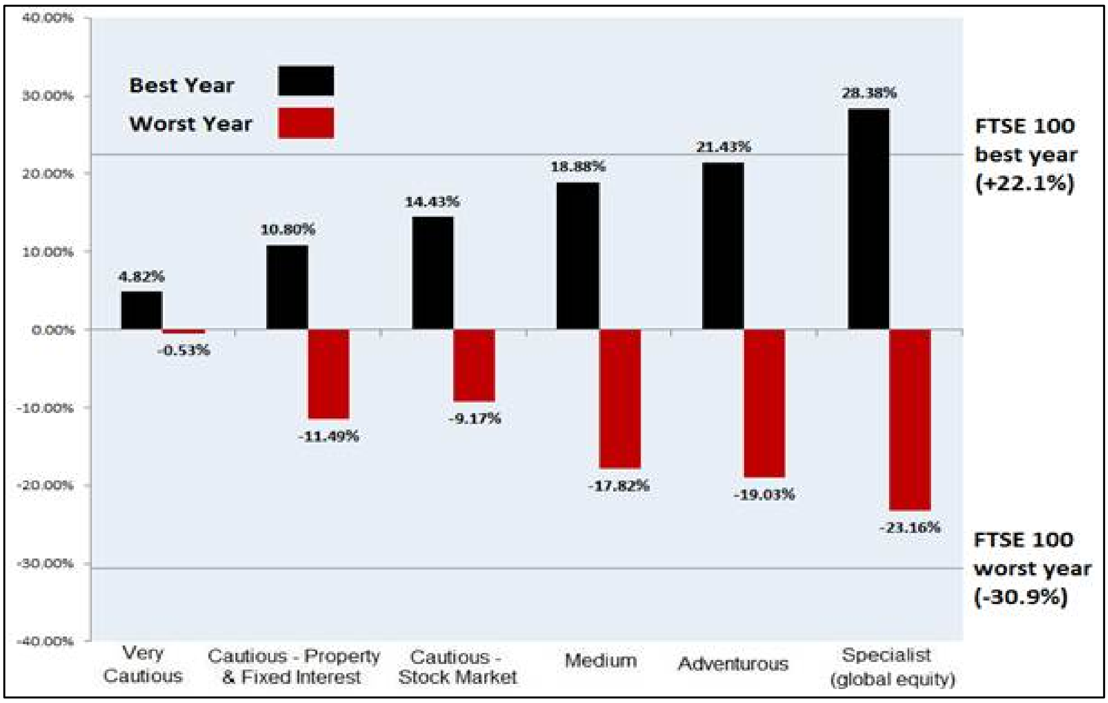
The different volatility levels incurred with various categories of investment risk can be most clearly summarised with the chart below.

The black and grey columns indicate the kind of returns that can happen in both the best and worst years in a range of investment funds with different levels of risk. It shows that in the best years, you can make very good returns, however, in the worst, you can also lose money. The columns also show the relationship between investing in a low risk fund, on the left of the graph, and the higher risk funds, to the right.

It clearly indicates that the higher the level of risk you are prepared to take with your investment, the potentially higher returns you could enjoy, however, the reverse is also true and these higher risk funds also have the potential for greater negative returns.

Conversely, the lower risk investments may not have the potential to give you such high returns, but that also means that if things do go wrong, they are not likely to go down by so much either.

By way of a bench mark, albeit over a different time period to illustrate an extreme example, the horizontal black lines at the top and bottom of the graph show the highs and lows of the UK stock market. It covers the period between 2008 and 2009, when the last financial crises occurred and markets fell by 30.9% but the following year recovered.



Source: Royal London, average annualised returns 2008 - 2018

CAPACITY FOR LOSS

This refers to the relative importance of this pension scheme, and the proportion of your retirement income it will comprise upon retirement. Put simply, how important is this pension to your retirement plans, and what can you reasonably afford to lose out on in a worst case scenario?

There are three factors to take into account; the level of retirement income needed, the value of your current provisions, and then your personal risk tolerance.

As an example, if you have significant other provisions for retirement that mean you are not likely to be dependent on this pension, you have the option to invest in a high risk fund, as a considerable loss wouldn't impact drastically on your retirement income. This doesn't mean you *have* to take on high risk if it doesn't line up with your personal risk tolerance, it just means you have the capacity to if you wanted to.

In contrast, if the above scenario was reversed as you have limited retirement provisions, then your capacity for loss would be greatly diminished as you don't have the ability to take on a lot of risk with this pension.

There isn't necessarily a right or wrong answer in these scenarios, as it's heavily dependent on the level of income required (which may even change considerably), but it is an important concept to consider, as capacity for loss is a key element when deciding on exposure to risk.

GENERAL MARKET COMMENTARY

Inflation Rate (CPIH)	Bank of England Base Rate	FTSE 100 One Year Performance	S&P 500 One Year Performance
0.8%/Year	0.1%	-15.99%	+15.48%

As at (06/08/2020)

CPIH is a comprehensive measure of the inflation rate in the UK. A low level of inflation is generally seen as a positive, with the Bank of England targeting a 2% inflation rate. As shown by the earlier graphic, inflation in the UK has remained low and relatively stable this century.

The Bank of England base rate is the interest rate that the UK's central bank charges retail banks to borrow money. It is therefore a good indication of typical interest rates on very low risk cash / deposit type investments. Interest rates have remained low since the 2008 Financial Crisis, as the economic fallout required dramatic policy measures. This has been further compounded by the economic volatility due to Covid-19.

The FTSE 100 is a stock market index that tracks the 100 largest UK listed companies, including big names like BP, AstraZeneca and Unilever. The FTSE 100 indicates the relative fortunes of the country's largest corporations and provides an insight into business prosperity and more generally the potential performance of equity investments.

The S&P 500 is a stock market index that tracks the 500 largest US listed companies, including household names like Amazon, Facebook and Nike. The S&P 500 is a longstanding and useful measure of the developed world's corporate 'health' and potential returns from US / Global equities.

EFFECT OF CORONAVIRUS

In March 2020 global markets were rattled by the impact of Covid-19. Significant falls in the stock market are uncomfortable for investors, but it's important to consider these against a longer-term historical context.

WHAT'S HAPPENED?

When equity markets fall, these can generally be put into two categories; corrections and crashes. As such, they happen fairly consistently and while uncomfortable, are a normal part of exposure to equities

Corrections tend to happen every year or two with a 10% - 30% market fall with recoveries generally taking about four months.

Crashes are clearly more serious, with greater losses and recoveries taking two years on average.

Whilst they feel bad at the time, corrections and crashes have happened throughout history and have many triggers, for example 1987 Black Monday, the Dot com crash and the global Financial Crisis in 2008.

There have been 26 market corrections since World War 2 (as of February 27, 2020). However, the average return in the 12 months following these losses was more than 16%.

It is important to note that 80% of corrections have not turned into crashes. While past performance is not a reliable guide to future performance, to date 100% of crashes in the UK and US have been followed by a recovery that more than recoups the losses.

When the Coronavirus became known in China in late January 2020, it was not initially anticipated to have a serious effect on the global economy, on the assumption that it could be effectively contained. However, due to the emergence and acceleration of the virus outside of China, it caused markets to respond as the realisation set in that the outbreak would trigger at least a short-term disruption of global economic activity.

Financial markets don't like uncertainty and global markets immediately tried to 'price in' the longer-term risks, meaning share prices reflect the *assumption* that the value of companies and profits will, on the whole, fall significantly. This often means that if / when these predictions occur, markets don't necessarily fall further.

The impact of the Coronavirus on the stock market has been felt heavily, with the S&P 500 dropping 30% in a month between 24th February and 23rd March 2020.

WHAT SHOULD YOU DO ABOUT IT?

While it is tempting to take action in a downturn, when you have investments in equities, often the smartest decision you can make is to continue as you are, as historically, academic studies have shown that attempts at 'timing' the market generally fail, and missing just a small number of the best days can hamper performance considerably. A good example of this is the fact that the S&P 500 gained 11.58% and 10.79% in two single days on the 13th and 28th of October in 2008, and 9.38% and 9.29% in two single days on the 24th and 13th of March this year.

If you are tempted to move your money into cash/deposit from an 'investment' fund, you need to be aware of that this is not risk free and inflation could erode the value of your money

It is difficult to tell when the right time to re-invest is – this is because the 'bottom' of the market will only be known in hindsight;

- Re-invest too early and you may be exposed to a further reduction in value
- Re-invest too late and you may have missed out on sharp recovery growth

WHAT NEXT?

Over the last 20 years (end 1999 – end 0f 2019), the FTSE All-World GBP has averaged an annual return of 7.5%, and this includes the crash of 2008. So, tune out of the short-term market fluctuations and noise of the headlines as much as you can. Know your time horizon and focus on your long-term investing goals.

Equally, if you are concerned about any of these issues and wish to speak to an adviser, please contact us.

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