XPS Pensions Group

XPS LIVE Special

23 March 2022

Ukraine crisis: Your investment questions answered

The XPS Live Special on the Ukraine Crisis webinar on 14 March discussed the key issues that pension scheme investors should be considering in response to the Russian invasion of Ukraine.

During the event we received a large number of insightful questions, a number of which we did not have time to cover on the webinar. Many were along similar themes. This document summarises some of the questions asked and Simeon Willis, XPS's Chief Investment Officer shares his thoughts in response to each.

Key questions covered include the following topics:

- Similarities with China/Taiwan
- The role of index exclusions
- Questions from scheme members
- Using scenario analysis
- Implications for tactical positions
- The investment outlook
- Actions trustees can take

Similarities with China/Taiwan

Q) To what extent should trustees be anticipating a potentially similar situation happening between China and Taiwan?

The impact of Russian asset values being written off will have been small for the majority of UK investors but if the same were to happen in China the impact would be many times greater with China at around 30% of the emerging market equity index (Russia was only 3%). For investors in emerging markets this needs to be acknowledged as a risk and we don't advocate disproportionate overweighting emerging markets within global equity portfolios for this reason.

That said, we do need to be mindful to avoid managing only the risks we can imagine or put a label on. The majority of the risks that cause the greatest turmoil are inherently unpredictable and often unforeseen, so sometimes the best approach is to acknowledge your overall exposure to risk, but not to be in any illusion as to the extent that you can control it. Where risk is considered too great the answer is often to reduce the overall risk exposure. Noting that this approach applies to rewarded risks only, unrewarded risks should be removed as far as is practically achievable. Taking an appropriate level of investment risk builds into a scheme's wider Integrated Risk Management (IRM)

For more on the topics of China, we covered this in more detail in our paper below:
www.xpsgroup.com/news-and-views/is-investing-in-china-and-emerging-markets-becoming-riskier

Index exclusions

Q) Should schemes that push the ethical credentials of their investment strategies pull out of companies with links to Russia also? Could we ultimately see pressure for index providers to offer an alternative version of mainstream indices excluding these companies?

Index providers' exclusion of Russian assets from mainstream equity and bond indices has been on the grounds of sanctions making them effectively worthless and uninvestable. It is therefore difficult to imagine index providers employing similar steps in mainstream indices in relation to companies indirectly linked.

However, there are a variety of indices already available that incorporate ESG considerations to varying degrees to exclude and tilt certain companies on the basis of ESG scores. There is a wide disparity across ESG providers' scores for certain companies, although this isn't entirely surprising given it is a highly subjective area. Providers may look to refine these more specialised indices to apply further criteria, in light of what has been learned in the last month.

That said, exclusion is a relatively blunt tool, and the general exclusion of energy sectors, nuclear and defence are going further than many see as being appropriate. This is because these exclusions also have implications for key issues such as transitioning to low a carbon economy and maintaining a secure political environment. In the face of complex questions it is appropriate that trustee boards have flexibility to find the approach that is right for them and their membership, as there is no single right approach.

Members' questions

Q) Have any members raised questions in practice yet? Could trustees have acted in response to this crisis more quickly?

Anecdotally, most of our discussions with trustees so far have been trustees pre-empting possible questions from their membership, rather than responding to a flurry of questions they have already received. Typical trustee concerns are around how much, if any, exposure there is to Russian assets and taking steps to review the ESG policy to ensure it is seen as adequate in light of the new situation.

A key potential area of criticism of trustees from members may not be what they have done to date, as investing in Russia wasn't previously something that they might have been expected to avoid. Rather, focus will likely be on what they do from here in light of the new information we have, and the greater emphasis on corporate stewardship.

There is a greater scope for criticism in terms of how they choose to respond, as the change in circumstances creates hazards that need to be approached cautiously. The greatest risk is acting inappropriately, rather than too slowly. Some of these decisions are complex and cannot be made immediately. Better to do the right thing more slowly, than do the wrong thing more quickly.

Forward looking Scenario analysis

Q) Is there anything we can learn in terms of understanding more granular information on holdings for any future scenario perhaps involving different countries?

Scenario analysis is a powerful tool particularly to understand exposure to overall risk and exposure to specific factors. However, whilst scenario analysis at a granular level based on individual holdings is intuitively appealing it can be surprisingly complex to undertake when there are many different variables. This has been highlighted by the climate scenario testing as part of TCFD disclosure and wider climate risk management. The challenge is that you not only need granular information on holdings but also granular information on scenarios – i.e. what aspect are you stressing? For every additional variable you add to the scenario the range of possible combinations increases exponentially. Then you need to interpret the results and decide what you can do about it.

An alternative to scenario analysis is to slice a portfolio's holdings and exposures in different ways to establish whether there are concentrations of risk in any one particular aspect. This can be currency, geography, sector, active manager, top holdings etc. This can be a relatively simple yet powerful way to check you are not running unnecessary concentrations in any one type of risk exposure.

Tactical positions

Q) What are your views regarding managers holding Russian Roubles as part of foreign exchange positions?

This is a particularly challenging issue and one that boils down to the specifics of the situation. Pension schemes need to be very cautious to avoid being seen to take advantage of this situation. That means investments in either direction on Roubles or derivatives on Russian debt are shaky ground even if you are positioned 'against' Russia.

Buying Roubles via forwards or being short CDS could be thought of as supporting the underlying physical assets, which poses reputational risk. However being short Rouble or long CDS can also be seen to be taking advantage of the current situation which also carries distinct risk of reputational damage. Part of the consideration is the rationale for the position, which can be varied ranging from hedging through to synthetically selling assets that cannot otherwise be sold physically. The rationale is important in justifying positions that are entered into.

There is a further question as to whether indirect exposures, such as Nickel prices also sit in this category. Particularly as the market movements have disrupted the orderly functioning of those markets, and supporting correct functioning of markets is something that all responsible investors should encourage. This is therefore an area where particular caution is needed.

Investment outlook

Q) Have we seen the worst of the effects of Russian action on investments now?

It important to make a distinction between economic variables and investment market prices. Economic variables are current or backward looking, whereas market prices are forward-looking. It is widely expected that we are going to continue to see a deterioration in economic factors resulting from this war. These include disruption to global supply chains leading to higher energy prices and shortages of various goods.

However, market prices already reflect current news and expectations. Consequently, there is scope for markets to go in either direction, depending on whether the outcome is better or worse than expected, along with many other factors outside of the conflict. Looking at conflicts over the last 20 years, in the majority of cases markets have risen within 12 months from the first day of the invasion. An exception to this was the 11 September attacks in 2001 which prompted a sustained bear market. As investors we need to accept that situations can always get worse but in general investment markets offer a premium for taking risk.

Actions trustees can take

Q) What are XPS advising their clients to do?

We suggest the following investment actions for trustees:

- Ensure your current portfolio reflects your risk tolerance
- Assess your exposure to Russia and other assets affected by the sanctions
- Review your inflation hedging
- Review the robustness of your ESG policy
- For DC schemes, ensure your options enable members to reflect their views within their investment strategy.
- For schemes using a fiduciary manager (FM), ensure you understand what the FM is doing to monitor and manage the situation.



There are a broader range of actions that should be considered, as included in our Checklist which can be found here.

Find out more

If you have any further questions on this please contact Simeon Willis or your usual XPS consultant



Simeon Willis
Chief Investment Officer

t 020 3967 3895
e simeon.willis@xpsgroup.com

@xpsgroup
xpspensionsgroup

XPS Pensions Group

© XPS Pensions Group 2022. XPS Pensions Consulting Limited, Registered No. 2459442. XPS Investment Limited, Registered No. 6242672. XPS Pensions Limited, Registered No. 03842603. XPS Administration Limited, Registered No. 9428346. XPS Pensions (RL) Limited, Registered No. 5817049. XPS Pensions (Trigon) Limited, Registered No. 12085392.

All registered at: Phoenix House, 1 Station Hill, Reading RG1 1NB.

XPS Investment Limited is authorised and regulated by the Financial Conduct Authority for investment and general insurance business (FCA Register No. 528774).

This communication is based on our understanding of the position as at the date shown. It should not be relied upon for detailed advice or taken as an authoritative statement of the law.