

Stock Market Turmoil and Pension Schemes

A thought piece from Xafinity's Investment Team

"The stock market has forecast nine of the last five recessions"

Paul A Samuelson Nobel Prize Winner for Economics

You might find it hard to believe but up to a month ago, despite Japan's tsunami, the Arab spring, conflict in Libya, Hellenic meltdown and no more printing money stateside, the FTSE 100 remained above the level at the start of the year. What happened next and probably more importantly what it means for UK trustees and sponsors and the actions they should be taking is discussed in this thought piece.

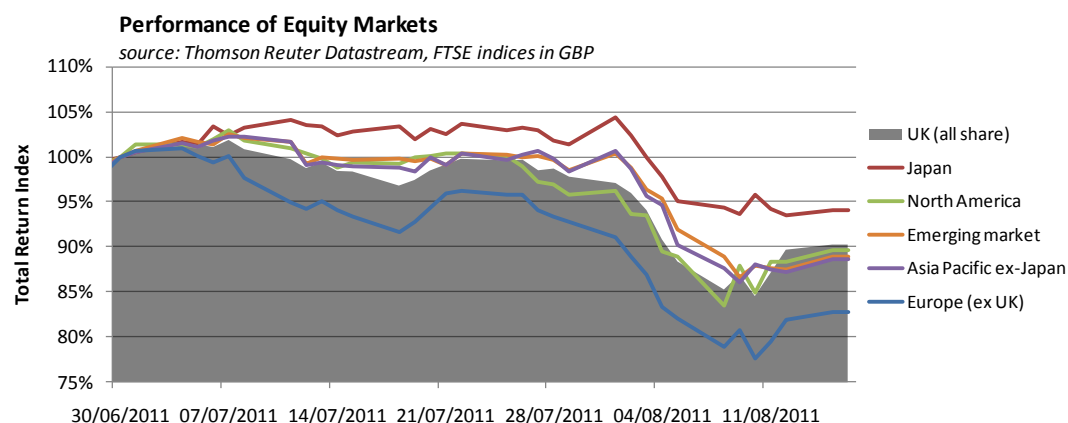
So what happened? In a nutshell, investors' confidence in the prospects for the global economy were dramatically shaken. The specific reasons for this are convoluted but relate to two main areas of concern namely:

- **The future economic prospects for the Eurozone.** There is the worry that the economic strength of the Eurozone "PIIGS" – Portugal, Ireland, Italy, Greece and Spain – will deteriorate further and that the blank cheque required to bail them out would be a sufficiently large sum to threaten the demise of the Euro, at least in its current form. In the event that the Italian and Spanish economies run into further trouble, the general consensus is that they are 'too big to bail out'. Even the credit rating of previously solid France has been questioned.
- **The future economic prospects for the US.** There are fears that the world's largest economy could fall into recession – the dreaded 'double dip'. There has been a string of poor economic data recently (e.g. relating to US unemployment, performance of the housing sector), which has fanned the flames, with these fears being compounded by high level of US government indebtedness (which led to the recent downgrade).

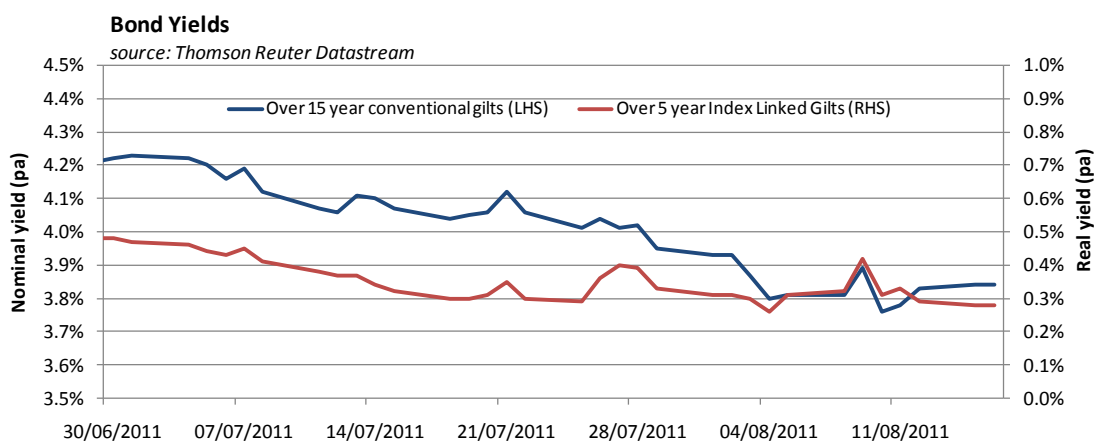
These concerns have had knock on effects to the whole global economy, including the UK where it is estimated that 60% of the income for FTSE100 companies is derived from overseas. There has also been a 'flight to quality' towards stronger sovereign debt issuances e.g. UK Government bonds (i.e. gilts) which has had the effect of pushing the prices for such instruments up.

Market performance

In terms of numbers the impact of recent events, as can be seen from the graphic below, are stark. Since the beginning of the third quarter to 15 August, equity markets have fallen back with the UK, North America, Asia Pacific and Emerging Markets all off around 10 to 11% Continental Europe lagging at -17% with Japan suffering the least by losing (only!) 6% of its value.



On the other side of a scheme's balance sheet, there will be more pain as the 'flight to quality' reduced yields and consequently increased the value placed on a scheme's liabilities. The graphic below shows how nominal and real yields have fallen since the start of July, from 4.2% to 3.8% and 0.5% to 0.3% respectively. In rough terms for a typical scheme, this will have increased the value of the liabilities by around 5% in the last six weeks. The change is nearer 10% if the period extends to the beginning of the year.

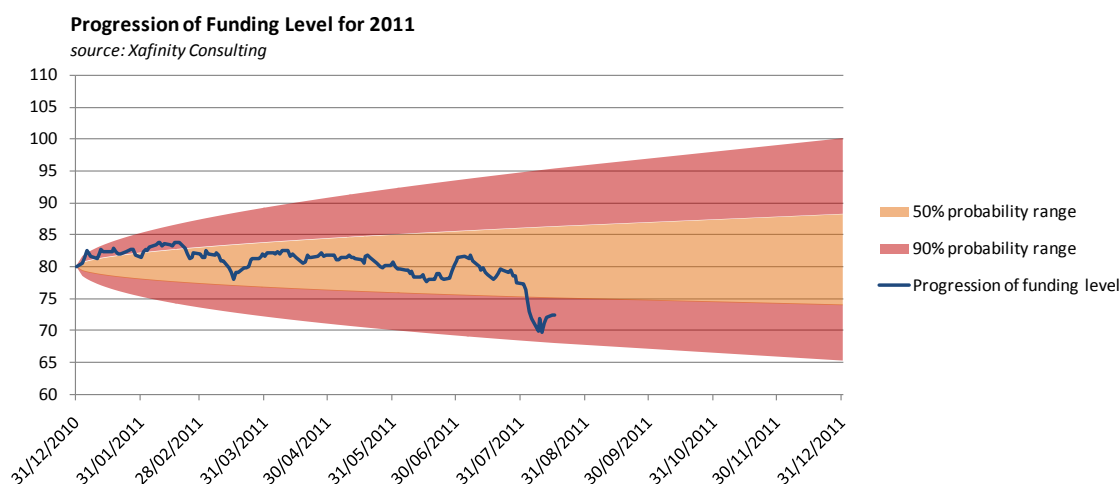


What impact has the downturn had on pension schemes?

The impact on funding levels is scheme-specific as each pension scheme has differing liability characteristics (e.g. proportions of fixed and inflation linkage) and has its own investment mix. Commenting generally however:

- **Not surprisingly, schemes with a high weighting in return seeking assets particularly equities will have experienced a weakening of their funding level.**
- **Less visibly but also damaging, schemes without a material element of bonds or their swap based equivalent will have suffered a funding level deterioration.**

As a further general illustration, we set out below a case study relating to a hypothetical scheme. The notional scheme has liabilities which are predominately inflation-related and its asset portfolio is invested 70% in global equities (half of which are in the UK) and 30% in corporate bonds. The blue line shows the progression funding level of the scheme since the start of 2011, assuming 80% funding on 1 January 2011.



It can be seen that the funding level of the scheme in question has worsened by some 8%, an increase of around £9m in the deficit from £20m to £29m assuming initial assets of £80m. It should be noted that such an outcome is at the more extreme end of the risk spectrum although is not totally unexpected. The yellow area shows funding level progression outcomes that might be expected 50% of the time (based on output from our investment model), and the extension to the orange area would be expected 90% of the time. As such, though such an outcome is poor, it can be considered to be within a range of outcomes that would fall within 'accepted' risk tolerances. Without putting too fine a point on it, if the impact of these risks cannot be tolerated, should potentially they have been taken in the first place?

Given the above analysis, it may be that trustees could consider what, if any, response is needed. Any approach to the sponsor for additional funding at this difficult time would have to be handled sensitively although trustees may elect to assess the impact of recent events on their ongoing funding level if only to have a better appreciation of what they mean for their scheme.

Trustees may also wish to look at their current asset allocation to assess how far away it has moved from the long term strategic mix and whether any rebalancing is required. It might appear counter intuitive but not rebalancing at some point does imply a level of de-risking that may be inconsistent with a scheme's overall objectives.

There are a number of techniques available to trustees seeking to dampen funding level volatility even though the current state and level of both the equity and bond markets may preclude action immediately. This does not, however, prevent trustees reviewing their arrangements and potentially agreeing levels of de-risking and establishing protocols that will transition the asset mix towards the new structures when conditions are 'right'.

De-Risking in troubled times

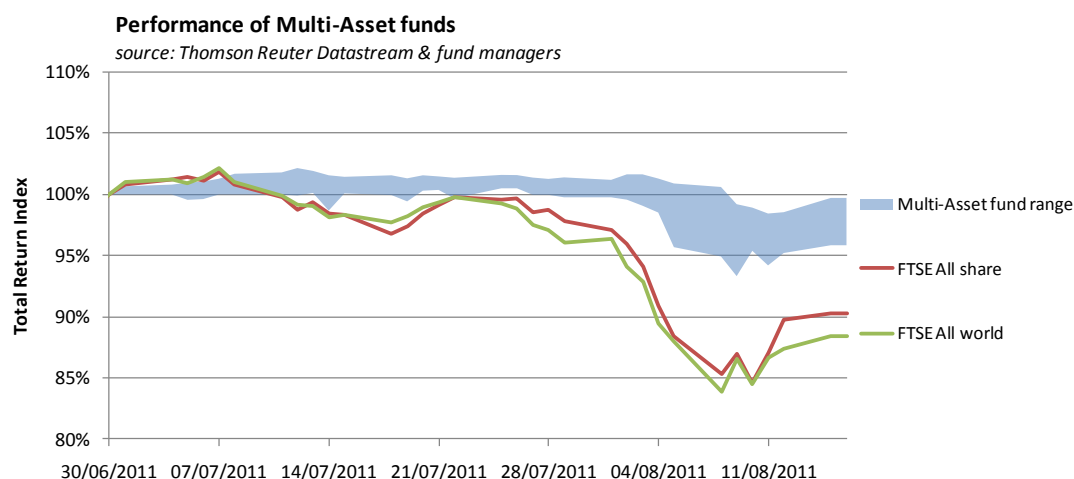
It is possible to reduce funding level volatility using various techniques.

- **Restructuring the bond portfolio in order to make these investment 'behave' much more like scheme liabilities** (i.e. reducing the scope for assets moving 'the wrong way' relative to liabilities and causing a deficit to arise).

By designing a bond portfolio whose characteristics (e.g. the term of the bonds as well as the nature) mirror or at least closely match those of the liabilities. In such circumstances, the investment would be expected to move in value with a good degree of commonality with that of the liabilities – thus creating a 'matching' asset which has useful de-risking properties.

- **The introduction of good quality multi-asset mandates** (i.e. reducing reliance on equity and introducing additional 'diversifiers').

The chart below shows the range of performance of a number of our preferred multi-asset funds since July (shown in blue) and also plots the performance of UK and overseas equity markets. It can be seen that they have protected well against the recent downturn.



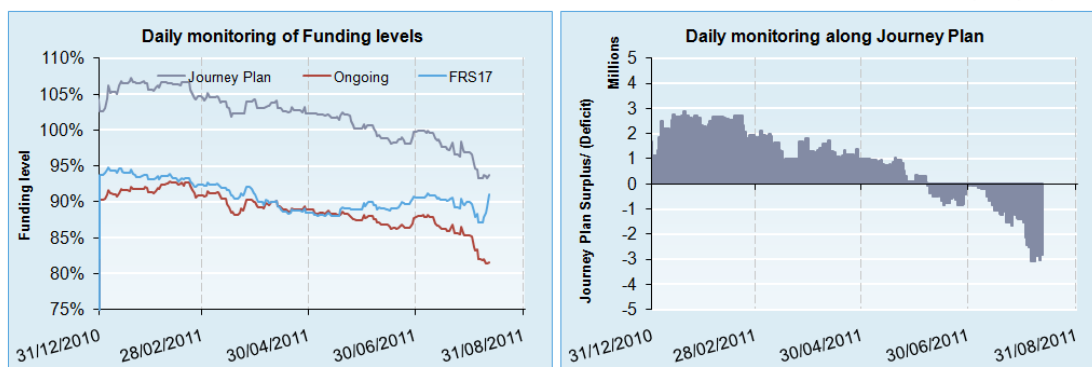
In many cases, material reductions in risk can be achieved while maintaining a level of expected investment return that would not impact adversely on the actuary's valuation basis – that is, **funding level risk could be reduced without any expected impact on the level of investment return nor the level of sponsor contributions that need to be made.**

- **Dynamically de-risking over time**

Trustees can **consider how their scheme's investment strategy should develop over time in advance** – so that they are in a position to act quickly when the time is right. One approach is to monitor the scheme's funding level on a daily basis and our dynamic de-risking monitoring tool is designed to assist trustees with this task.

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What can be done now?

With uncertainty pervading through most markets and with bond yields at historically low levels, now might not be the appropriate time to be making fundamental decisions about your scheme. Investment can be all about timing and there are some specific areas that can be considered and decisions made for implementation when the time is right.

- **What impact have the recent market movements had on the scheme's asset allocation?** Should you be rebalancing now or possibly initiating a temporary benchmark suspension?
- **Is the current level of risk to which your scheme is exposed appropriate?** We have tools that can help you quantify these risks and mitigate them through de-risking techniques.
- **Consider the options relating to the progression of investment strategy over time.** In particular when the time is right, trigger related protocols can capture upturns in both the equity and bond markets that will assist trustees move towards a fully funded position in a more controlled and determined manner.
- **Authorised Signatories.** If nothing else, check your list of authorised signatories is current and that you can move quickly if needs be.

As always, your Xafinity consultant will be happy to provide guidance and should be contacted if you have any queries. Alternatively, for more information please contact

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