Pension Scheme Valuations – Challenges and opportunities in 2015

Reviewing the impact of your pension scheme's Investment Strategy

The issue

How the assets of a pension scheme are invested is very important. For example, are they mostly invested in growth assets such as equities, or in more defensive assets such as bonds? The investment strategy and associated level of risk is the key driver of changes in scheme deficits, and therefore of company cash deficit recovery contributions.

Whilst setting the investment strategy is the responsibility of the trustees, it is the company that picks up the tab when things do not go to plan. The Pensions Regulator recognises that a healthy business is a valuable asset for the scheme, and so encourages the needs of the company to be considered when setting the investment strategy. The company is best placed to do this, and trustees tend to welcome the sponsor's involvement.

Companies should take a fresh and independent look at the investment strategy, to ensure it is appropriate for their corporate objectives and cashflow priorities.

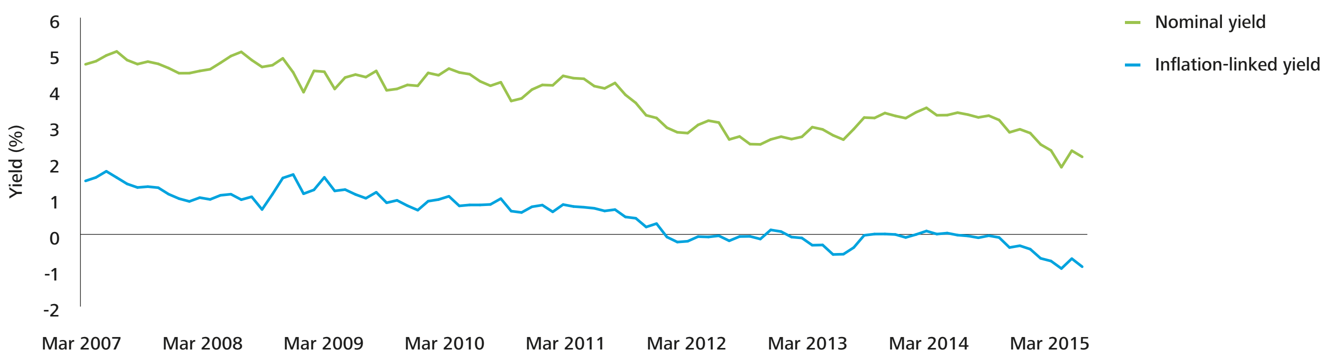
Introduction

In our report "Pension Scheme Valuations – Challenges and Opportunities in 2015" we highlighted the impact of falling long term Gilts yields on pension scheme valuations and 5 actions for companies to consider for their defined benefit pension schemes. In this paper we consider the first possible action: Reviewing the impact of your pension scheme's Investment Strategy.

Background

Asset prices have been volatile since the financial crisis, and central banks around the world have intervened in markets by lowering interest rates and undergoing large asset purchase programmes, such as quantitative easing (QE). The result is record low Gilt yields. Since pension scheme liabilities tend to be discounted using Gilt yields, the value placed on the liabilities has increased enormously. In many cases, the asset returns have not kept pace with the extreme rise in the liabilities, which has led to expanding cash deficits, more company cash contributions, and the need to review the investment strategy of the assets.

Figure 1. Change in Gilt yields since the financial crisis (20 year maturity)



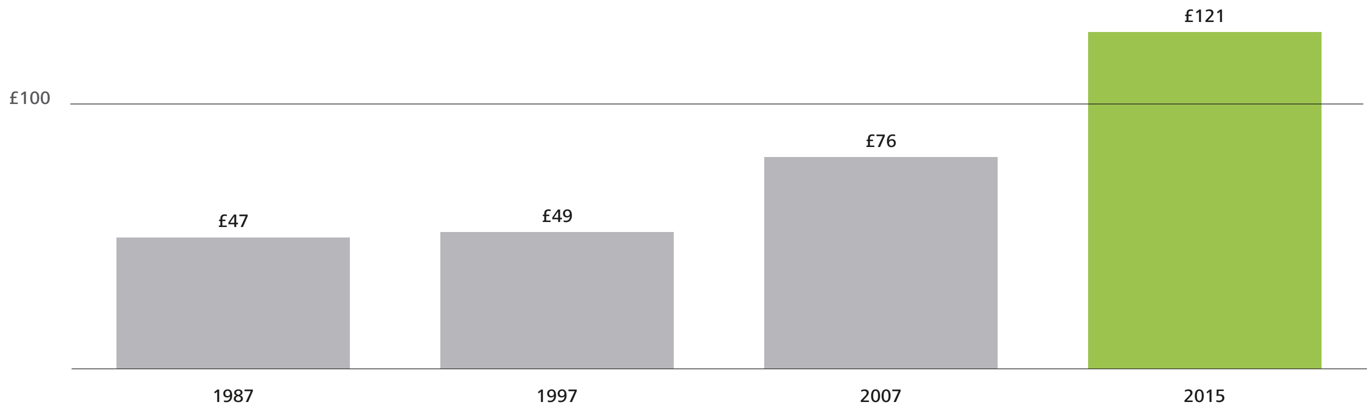
The Problem – record low Gilt yields

Let's take a closer look at the relationship between lower Gilt yields and the higher cost of money. To explore this we can consider something called the cost of money, or more strictly speaking, the cost of future money.

Take the example of owing £100. If you owe £100 at the end of the year, then you do not need all of it today. Instead, if interest rates are say 1%, then you need about £99 now, so that by the end of the year when all the interest payments have been made, the full £100 is available. In this example, you could say the cost of £100 in one year's time is £99.

Pension schemes typically owe money in about 20 years, and that money is linked to rises in price inflation. To secure that future cashflow today with a government guarantee you can purchase an Index-Linked Gilt (ILG). So what is the cost today of securing £100 of inflation-linked money in 20 years?

Figure 2. Cost of securing £100 of inflation-linked money in 20 years' time



In the 1980s, when ILGs were first launched, the cost was around £47. In 1997, when the Bank of England became independent, the cost was £49. A little more expensive but still less than half. In 2007, before the financial crisis, the cost was about £75. In February this year, the cost was a staggering £121. That means in order to secure a government guarantee, you must accept a 21% loss in real terms over the 20 year period.

Do you need to secure the government guarantee today? Can you afford to wait for a better price?

An alternative view

Whilst the liabilities have increased enormously when measured with reference to Gilt yields, in another manner of thinking, the liabilities have not changed at all. The workforce has not earned more pension benefits. They have not somehow worked incredible amounts of overtime or been given huge backdated salary rises. If you owed £100 in 20 years before, you still owe the same amount. It is the cost of the government guarantee that has increased.

There are other ways of investing assets to meet the cash liabilities as they fall due. Through understanding this distinction and taking appropriate advice, sponsors can be well placed to re-design the investment strategy of the pension scheme assets to better meet its liabilities.

What to do next – recovering deficits & the role of investment strategy

Markets have changed dramatically over recent times, upsetting funding levels, asset prices, and leaving many old investment strategies in need of review. Waiting for the formal triennial actuarial valuation before acting could be costly. Especially as investment strategy tends to be the main driver for changes in scheme deficits. Estimated funding updates are readily available, and they provide a useful snapshot from which to access the future funding requirements of the pension scheme.

For some companies a long term strategy of pursuing higher expected returns through equities may make sense, but the short term consequences need to be thought through.

Equally, the merits of hedging away interest rate risk at current market prices should be considered carefully. Doing so will remove any upside potential associated with a rebound in Gilt yields and effectively lock-in the recent deficits that have emerged.

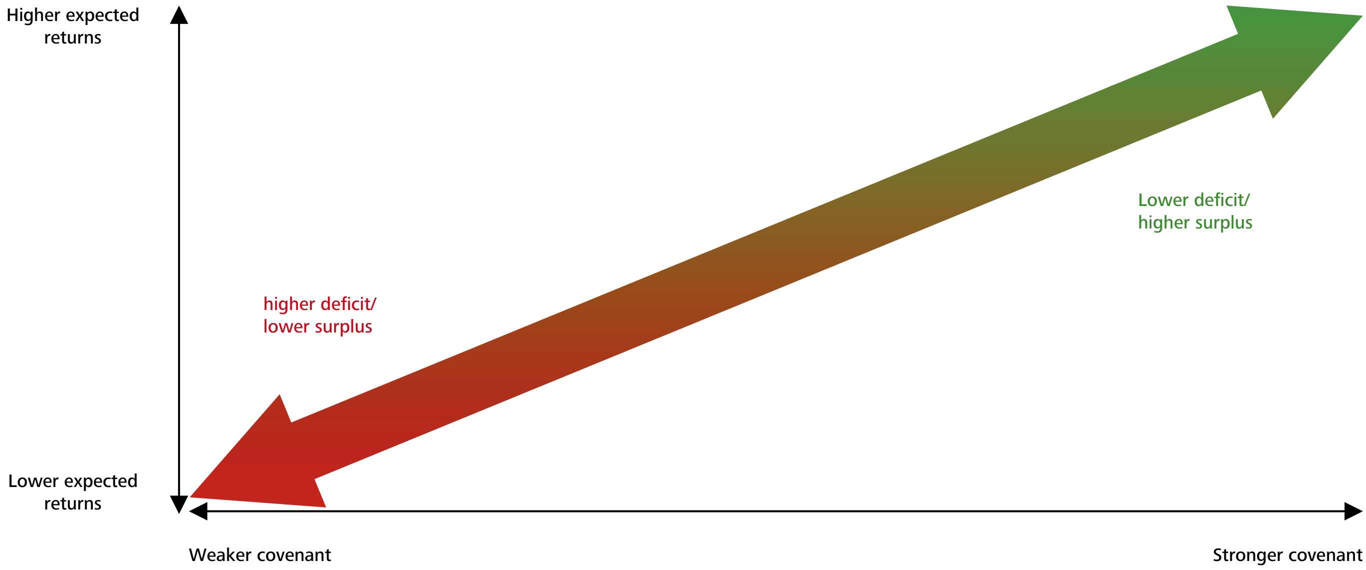
An optimal investment strategy pays due attention to the following key areas:

- funding requirements of the scheme;
- covenant strength that can be demonstrated by the company;
- cash flow needs of the business; and
- risk tolerance for short term shocks.

These factors drive the level of return the investment strategy should target, and in conjunction the level of cash contribution required to fund the cash deficit. The use of contingent assets alongside cash contributions can also play an important role, and potentially strengthen the covenant of the scheme.

These in turn have important knock-on effects on the way the liabilities are priced. Higher expected returns and a stronger covenant can allow the liabilities to be priced using a higher discount rate. This can lower the cash deficit, and make the investment strategy setting process iterative.

Figure 3. Impact of covenant and investment strategy on deficit



How Deloitte can help

Deloitte has experience and expertise to help:

- Understand pension scheme investment risk in the context of the company's business plans and cash constraints.
- Measurement of investment risk and design of plans to remove risk at opportune times.
- Create new solutions others may have missed.
- Holistic advice that brings together, covenant, investment, and funding.
- Market leaders in design of contingent asset solutions that can enhance covenant, fund deficits, balance investment risks, and pay in cash efficiently.
- Facilitate effective communications/negotiations with trustees.

Contact us to find out more about reviewing the investment strategy of the pension scheme assets, and give your company the best chance of funding the pension scheme, and avoiding nasty surprises.

Contact us

Deloitte has an extensive network of professionals working in an integrated way to bring cutting edge pensions advice and solutions to our clients. If you would like to speak to us about any of the opportunities raised in this series of reports or in setting and implementing a pension strategy please feel free to make contact with us using the details below or directly through your usual Deloitte contact.

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