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Macroeconomic Effects of the Credit Crunch for Pension Plans .

Presentation for the Joint Meeting of the Faculty of Actuaries Student Society and Our Changing Future

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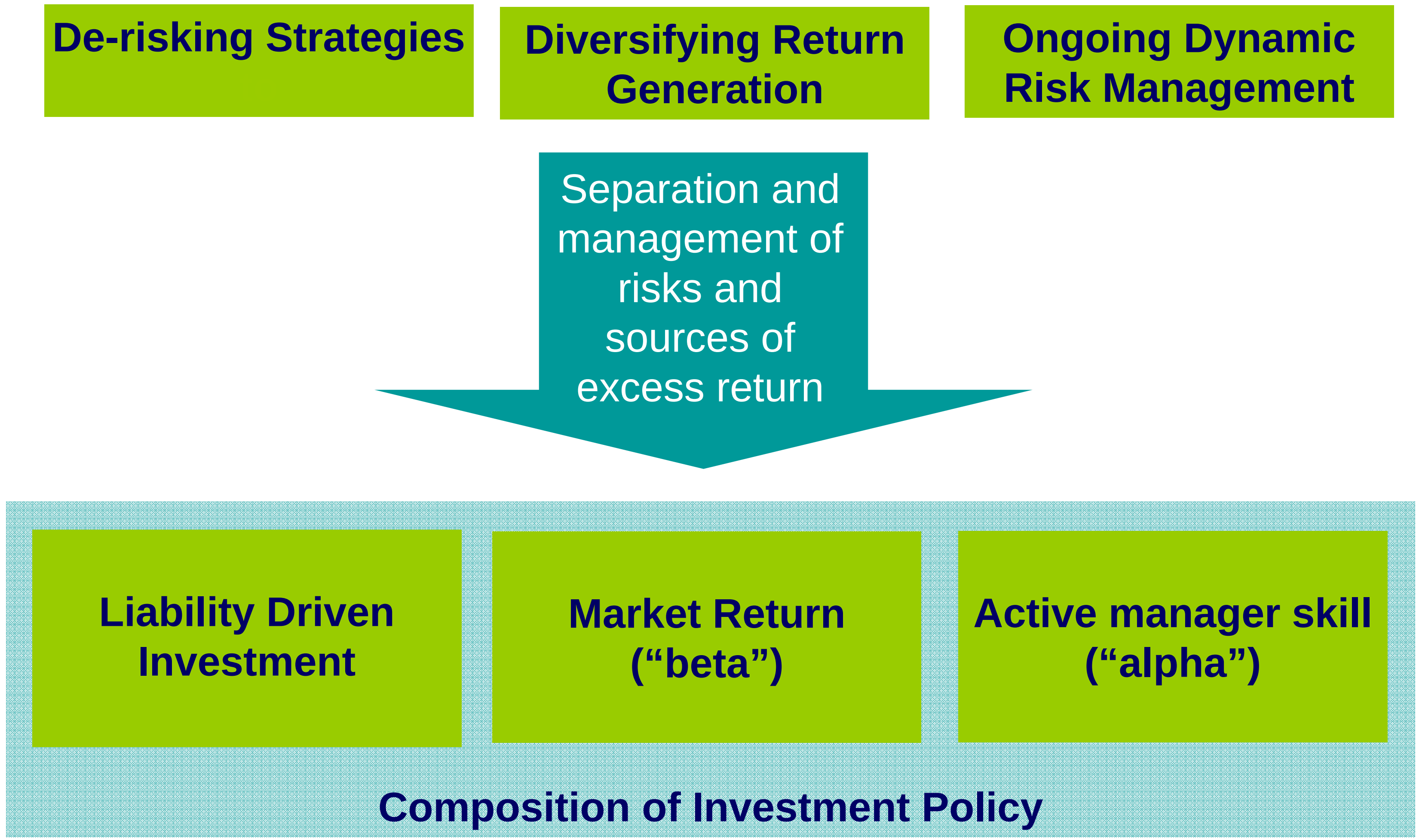
Summary

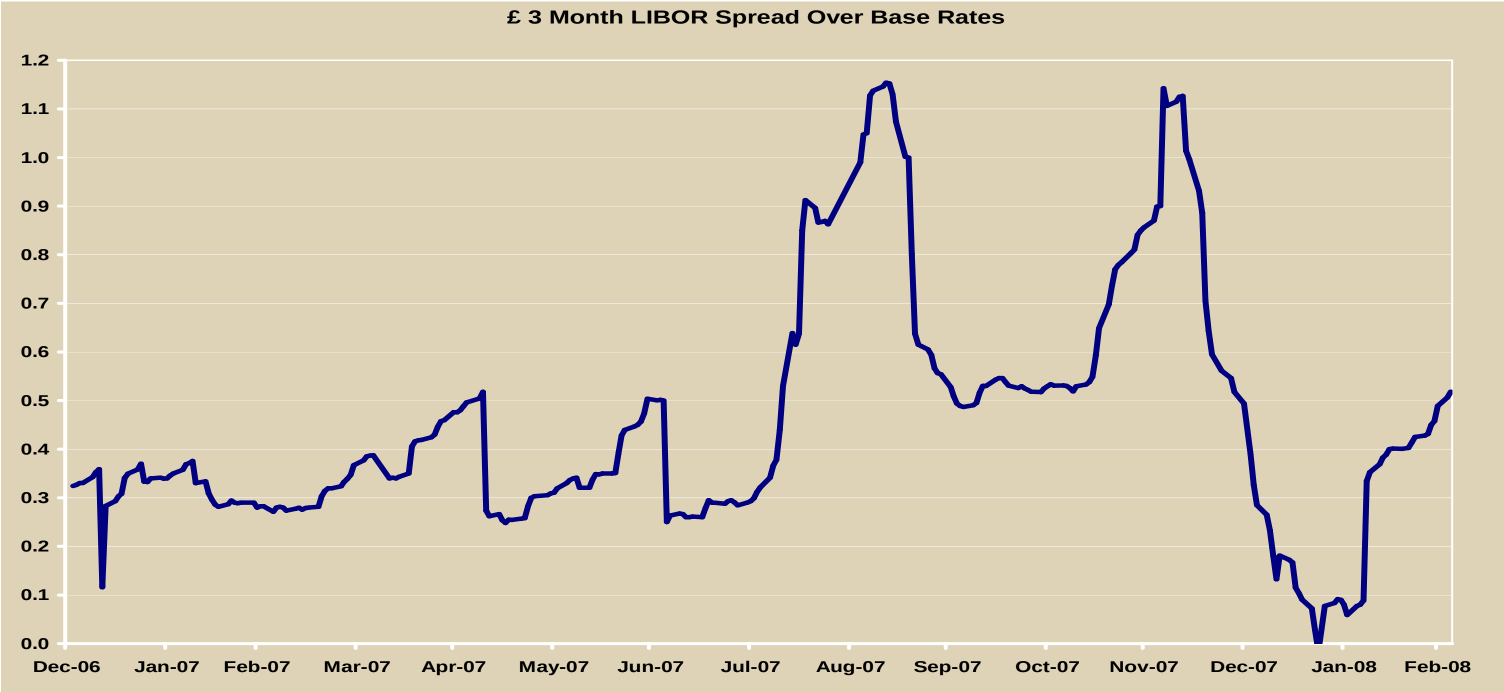
- Investment for defined benefit pension schemes
- Background
- Implications for hedging
  - Interest rate risk
  - Inflation risk
  - Credit risk
  - Liquidity risk
- LIBOR
- Conclusions

Trends in defined benefit pension fund investing



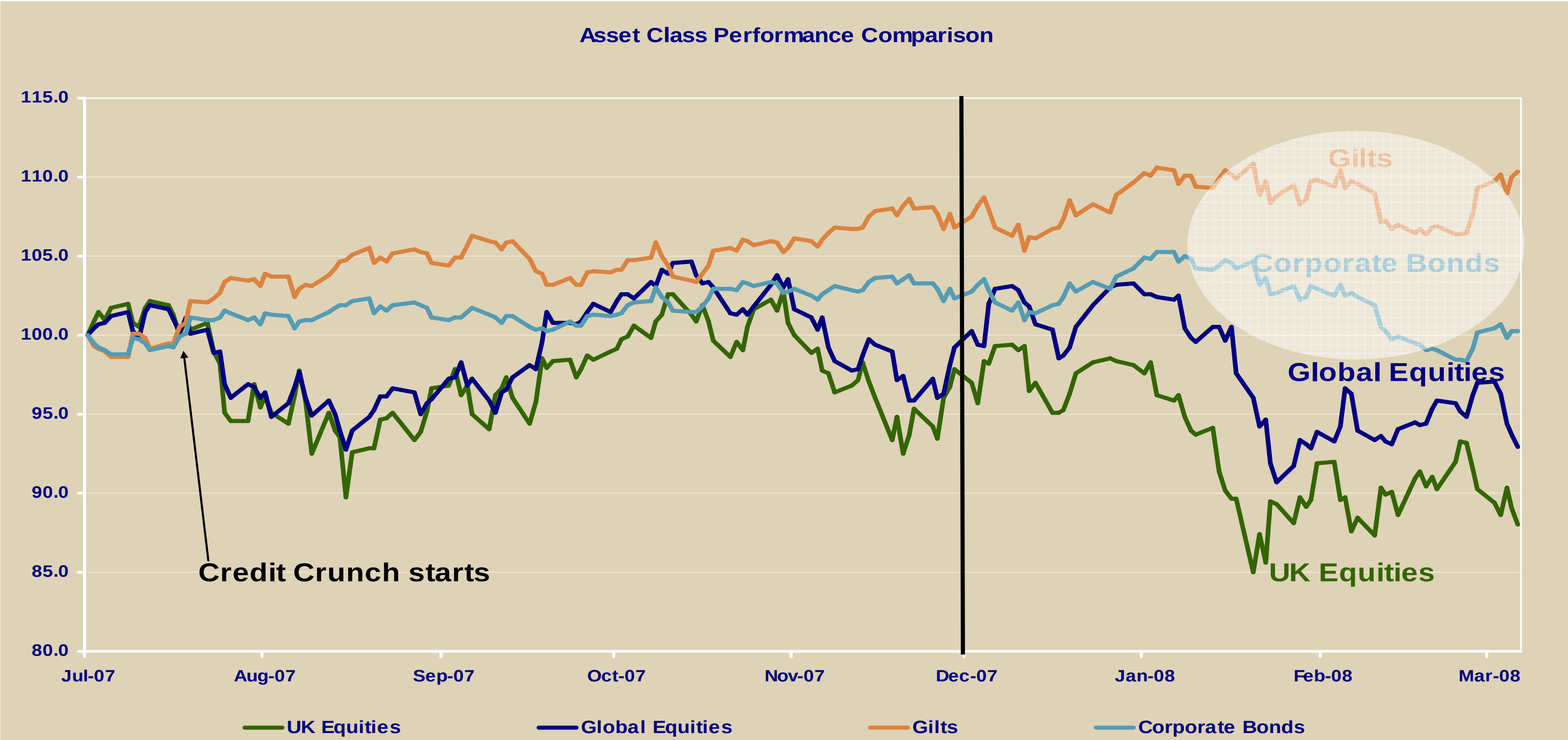
Background

- Trigger : US housing market
  - – US sub-prime mortgages are resetting to *much* higher interest rates
  - – US house prices peaked in 2006 and are now weakening.
- Credit concerns are far more wide-spread than US sub-prime:
  - – Uncertainty about how to assess credit risk = Increase in the **cost of borrowing**
  - – Banks have become very reluctant to lend to each other = Lower **liquidity**
  - – Forced selling of failed/distressed securities (especially structured credit)



Impact on asset prices

- Generally, prices of return-seeking assets have gone down and (risk free) matching assets have gone up

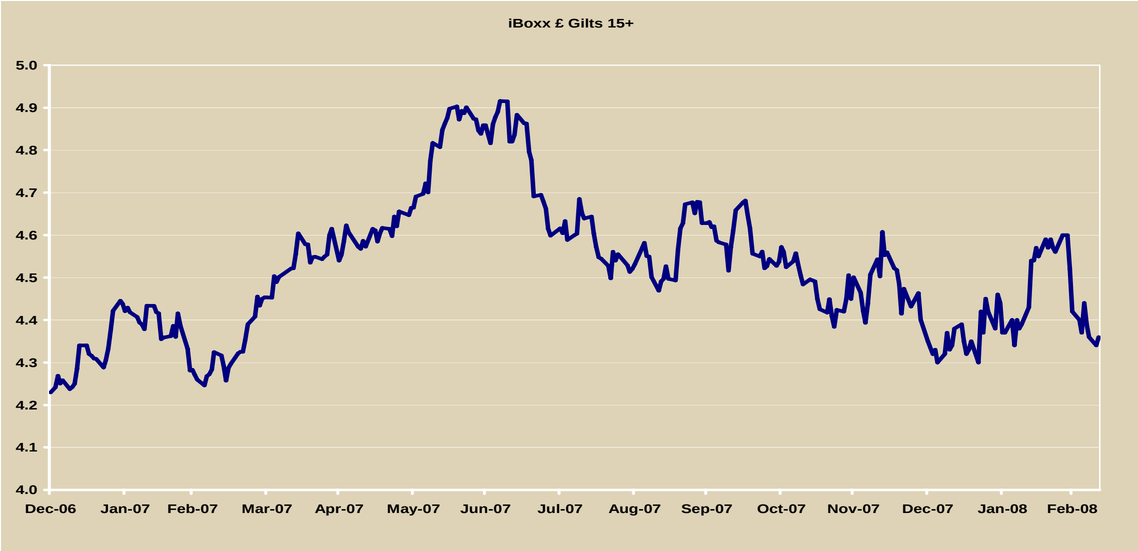


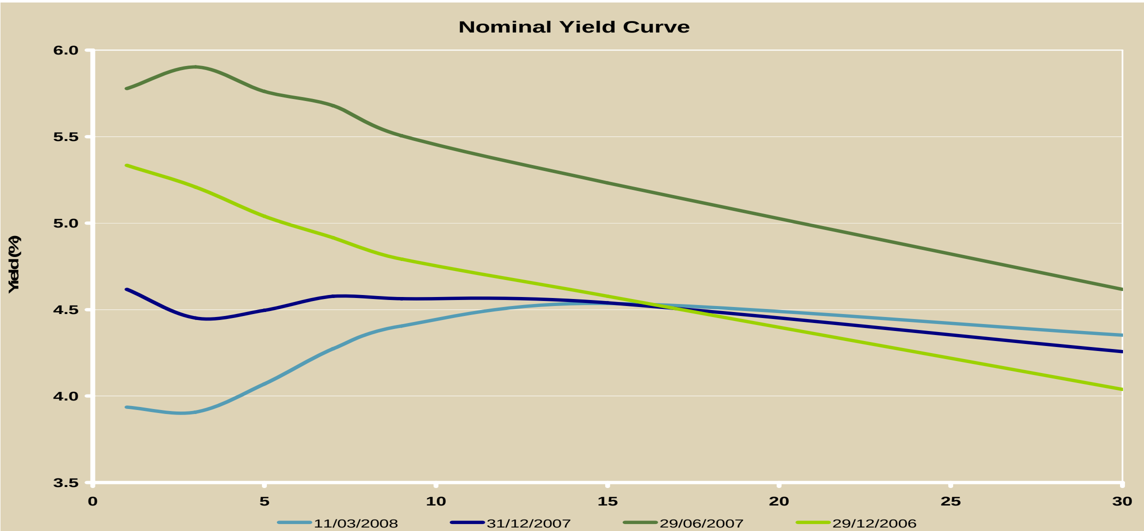
LOWER ECONOMIC GROWTH

UNCERTAINTY

COMMODITY PRICES

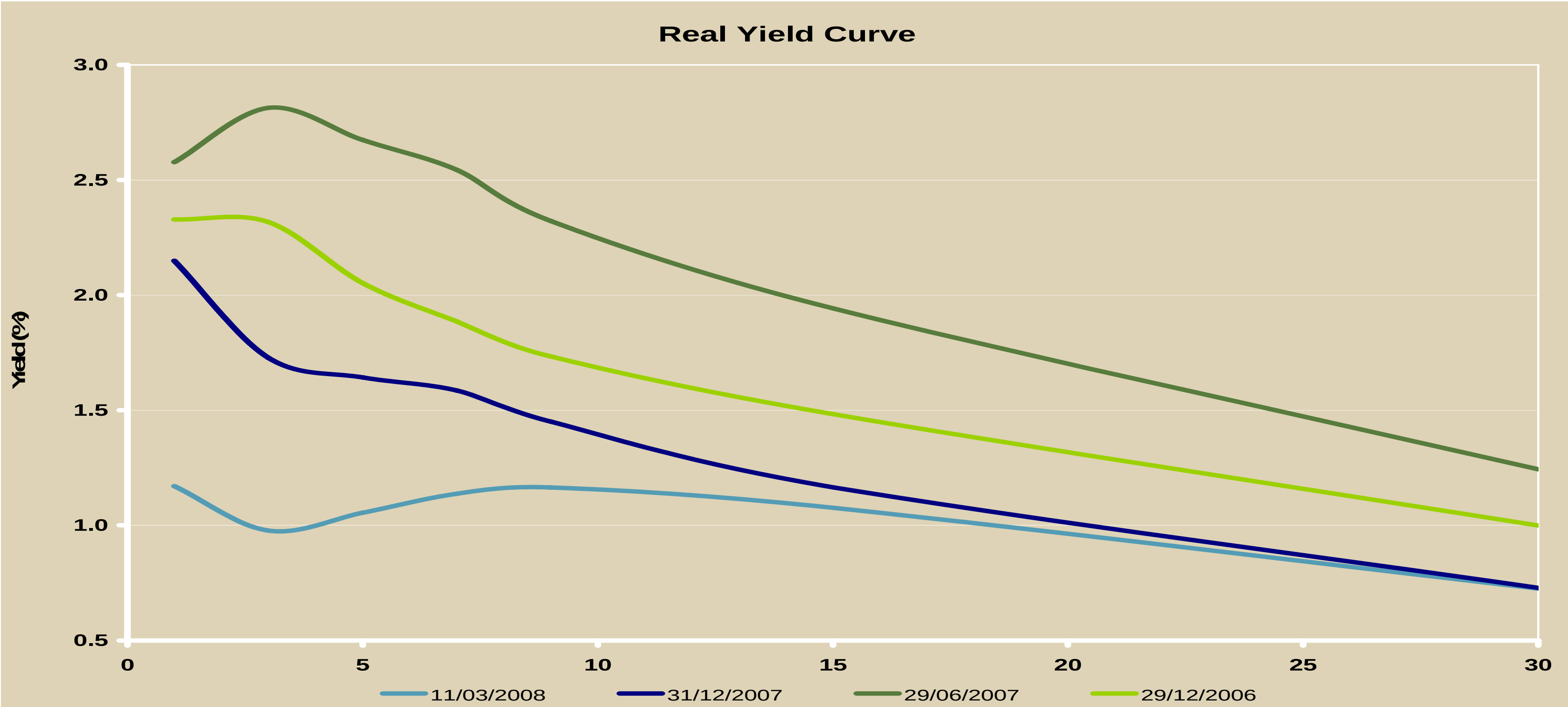
UK Government bond yields





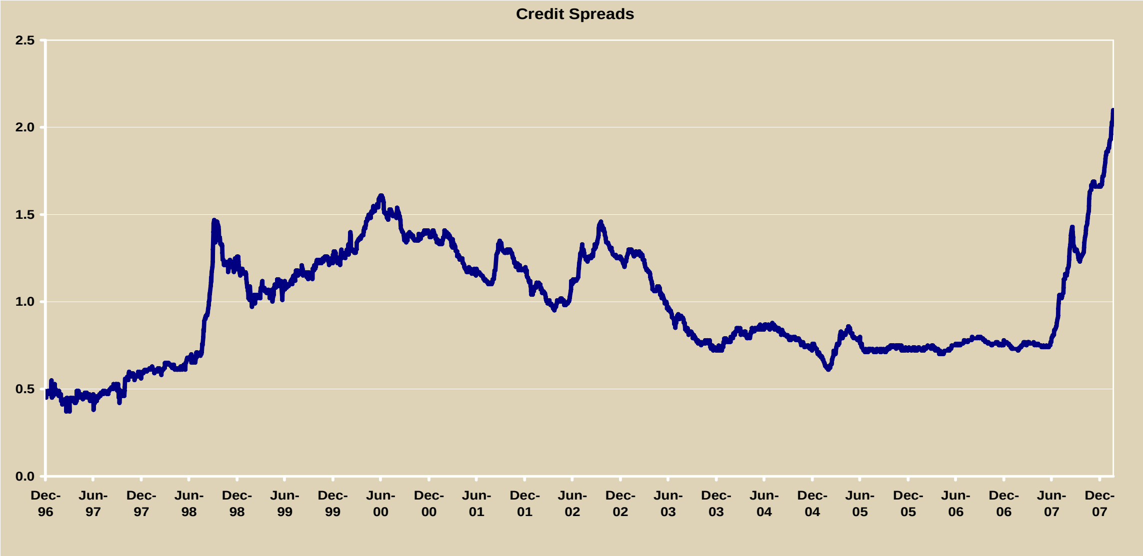
- Economic and credit uncertainty have led to a flight to quality, to (risk free) bonds and certain commodities (e.g. gold) . This has pushed yields back down across the curve, increasing the cost of hedging strategies
- Expectation of lower short term interest rates has flattened yield curve, reducing the yield drag cost of implementing hedging overlays

UK Government bond yields and inflation

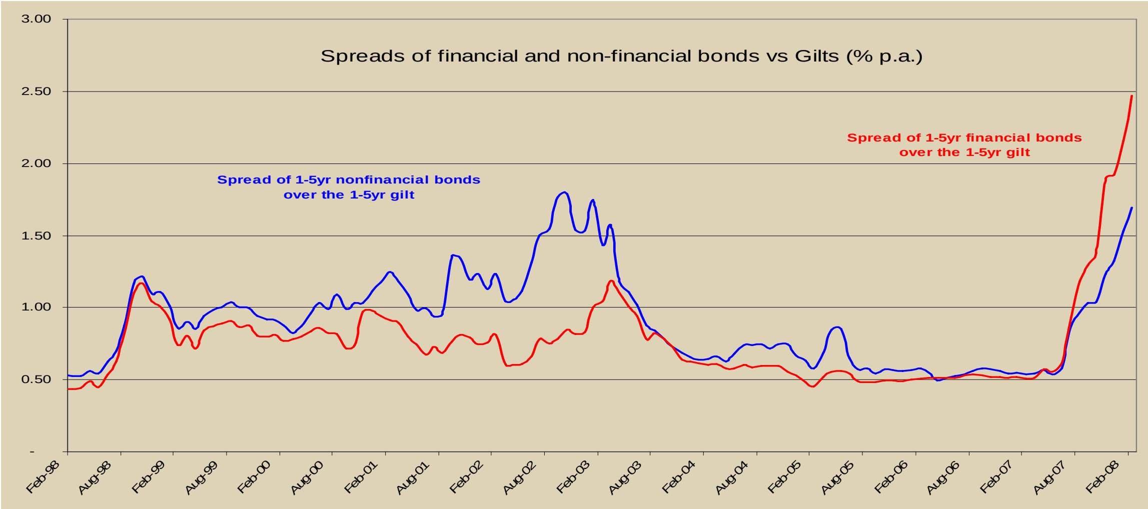


- Expectation of lower short term real yields has flattened real yield curve
- Inflation protection is now more expensive, for a combination of reasons:
  - Inflation risk premium
  - High demand relative to current supply at long end
  - Inflation expectations have risen – are we heading for Stagflation?

Credit market



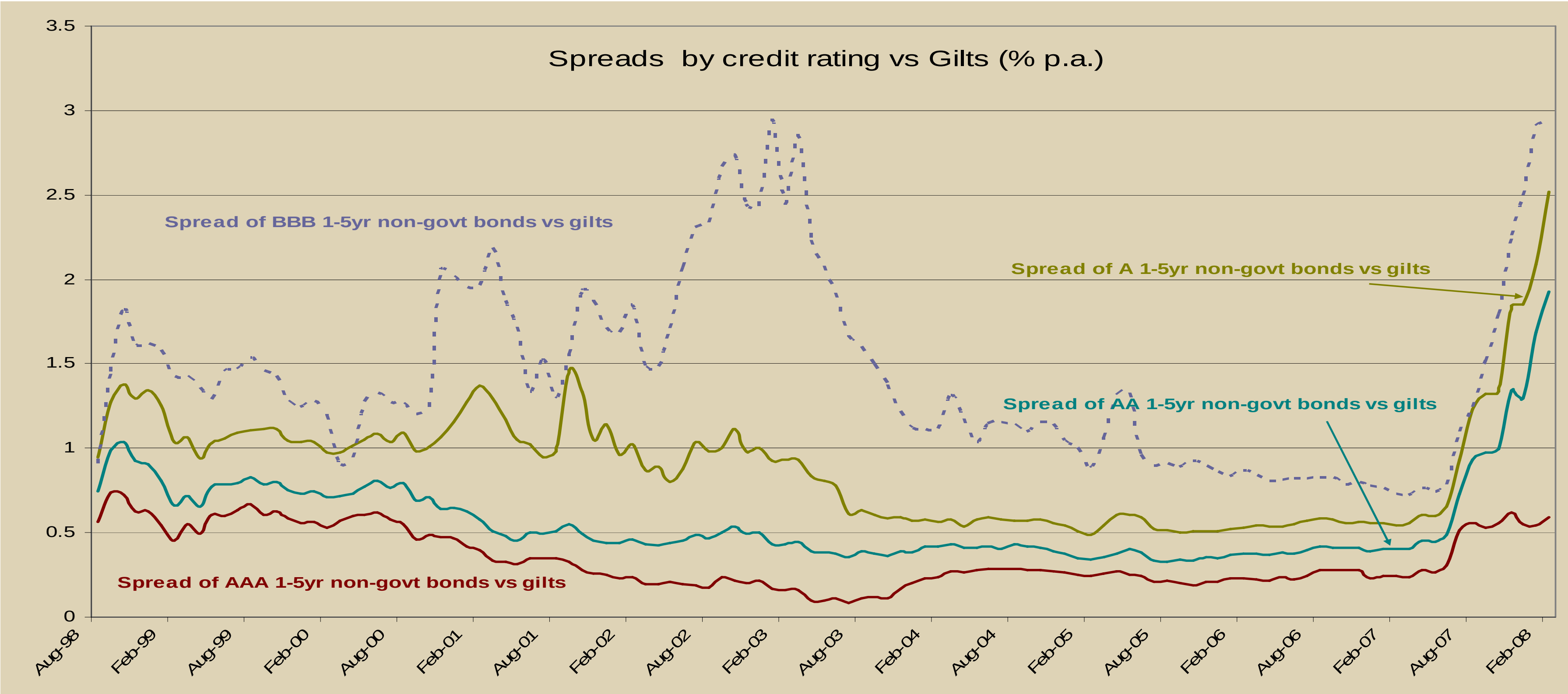
- Spreads have widened significantly
- Premium is compensation for credit (and liquidity) risk



- Financials v Non-Financials
- AA / A stocks have experienced significant yield widening.
- Darling Put

Liquidity is king

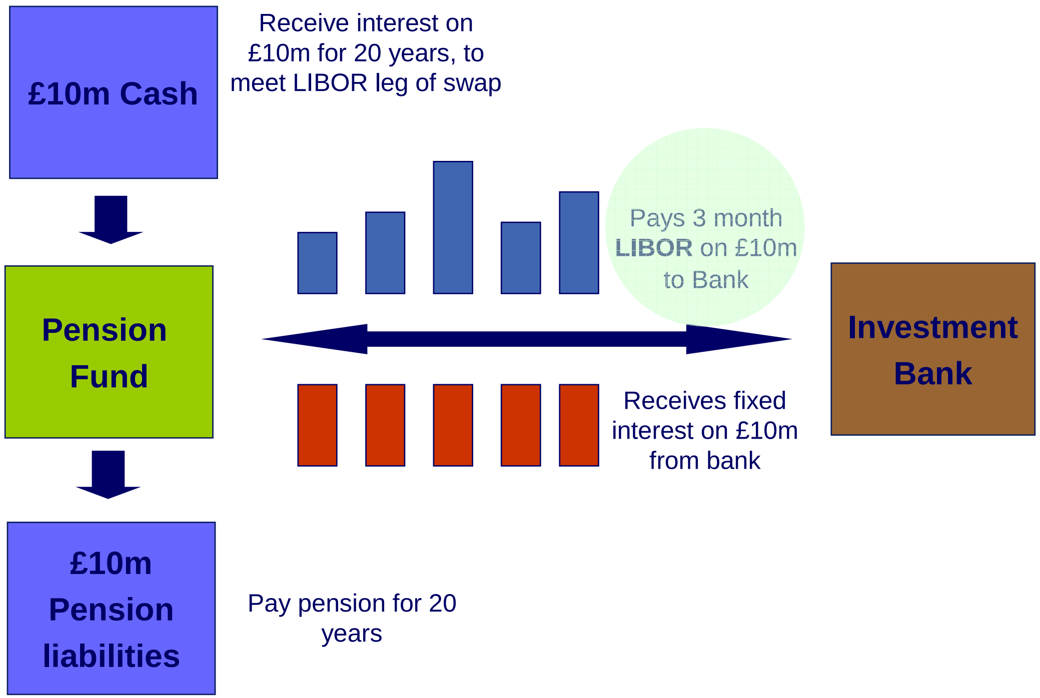
- Forced (distressed) selling and sharp value mark downs



- Pension funds are typically long term long only investors and have limited need for liquidity
- Liquidity demands a premium in the current environment

LIBOR generation

- Swap contracts used for hedging interest rate risk require investor to deliver 3 month LIBOR to the counterparty/bank



- 3 Month LIBOR is a challenging target – need to take **risk**
  - Credit risk
  - Interest rate (duration) risk
  - Currency or country risk
  - Liquidity risk

Conclusion

- **Interest rate risk**
  - Economic outlook putting pressure on (risk free) rates
  - Flatter yield curve means lower running cost of overlay strategies

- **Inflation risk**
  - More uncertainty about inflation, but demand remains high
  - High premium to hedge

- **Credit risk**
  - Spreads at a 10 year high – implies opportunity
  - Spreads may widen further before they revert
  - Outlook may vary by sector/rating
  - Opportunities for good active managers in this environment
  - Market timing and cost are critical

- **Liquidity risk**
  - Banks cautious about lending to one another
  - Banks need liquidity
  - Creates opportunities but also issues with running swap contracts – generating 3 month LIBOR

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