CIPS – London

Alternatives to gilt based valuations

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Complexity

- The world is complex, which leads to expertise
- Simplified models enable decision making

- The art of expertise is often not knowledge, but knowing what knowledge to omit

Summary statistics
The art of data destruction

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- Actuarial valuations:
  - Millions of data points compressed to just a handful of data points

- Easier to interpret
- Easier to understand
- Easier to explain
- Easier to make decisions

- But, summary statistics are only summaries

Inequivalence

- (10,10,10,10,10,10,10,10,10,10) ≠ 80
- £10 owed to Jack ≠ £10 owed to Jill
- 2 x £5 owed to Jack ≠ £10 owed to Jack

- A payment of £10 per annum for 10 years is not equal to £80
  - I wouldn't invest in gilts at these rates
  - I'm not required to pay
  - Funding, investment and covenant implications
  - Financial economics is neat, but not reality

Pensions Act 2004

- tPR and the PPF
- Lessons from the Pension Benefit Guaranty Corporation
- There was a regulatory need to choose a discount rate so it started out as the AA yield
  - this then morphed (although I am not sure how) into Gilts +
- The government assumed accountants knew something…

What do Accountants know?

- Income statement or balance sheet?

- IASB looks to the balance sheet and the income statement is where we wash everything out

- IASB was 6 people in Cannon St. in the mid 70s and now sets the accounting standards for the majority of the World (exc. US)

- David Tweedie and the IASB

What do Accountants know?

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- The IASB is not mandated by Government it operates on political will
- Key constituents are auditors
- AA suits auditors
  - Little focus on reality
  - Little focus on Trust Deed & Rules
- There may be a growing acceptance that the current system is not working
  - Interestingly, the PPF has a rather healthy surplus on an IAS 19 basis!

Different approaches

- Long-term valuation in finance
  - Adjust discount rate appropriately
  - Gilts plus x%, but so low that almost feels like risk-free
- Long-term valuation in economics
  - Take risk-free rate and adjust the cash flow to become certainty equivalent cash flow
- There is also a question about the variability of cash flow in here
  - How predictable are the cash outflows from a scheme?

Different approaches

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- Most people are happy with an NPV approach to project appraisal
- Discount rate is usually based on the WACC (asset mix)
  - Not without its issues as an approach i.e. asset pricing
- Why would pension liabilities be treated differently – investment in human capital?
  - DB pensions liabilities could be seen as something that shareholders have been able to dodge if we were to use the residual claimant view of the firm

What is the reality of the pension liability?

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- What is agreed?
  - Employer / employee contributions
  - Benefits to be paid
  - Back solve for the discount rate => investment returns required
  - Implicit rate of return
- This is a number we can actually use to make judgements on:
  - The optimism of what is being assumed;
  - The risk that is being run;
  - The ability of the sponsor to make good on underperformance.

What is the reality of the pension liability?

- Economics (and finance) post 1945
  - Increased quantification and use of mathematics and statistics
  - The cult of financial economics and physics envy
- Construction of social reality
  - Gilts
  - Gilts +
  - AA
  - Expected return on plan assets

Some other issues…

- How many firms will be here in 10 years?

- Focus should really be on the next 5-10 years contributions and contributions plus asset returns

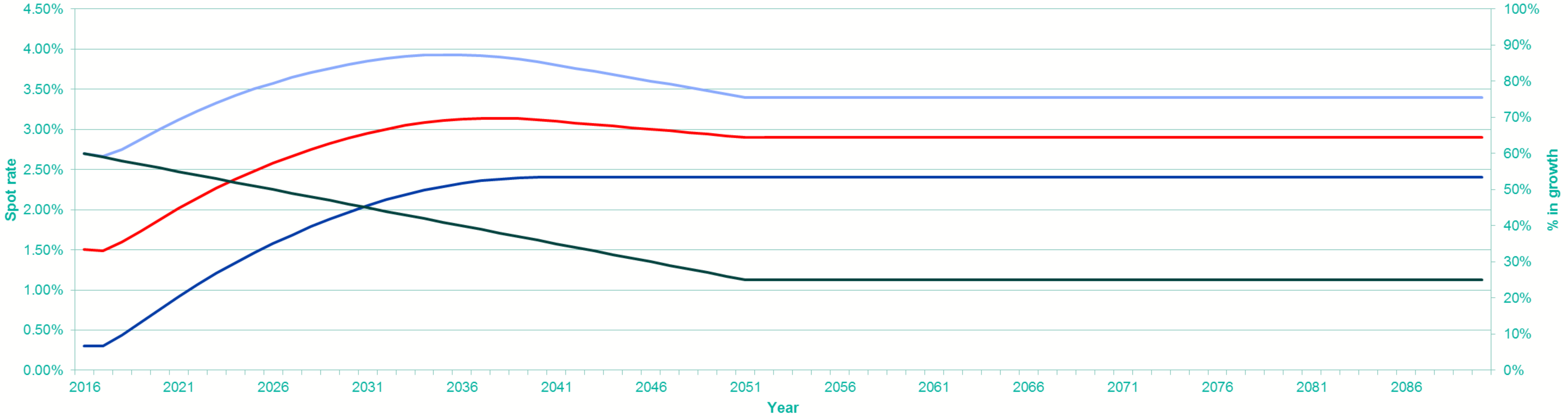
  – Not variable liability

- Focus on cash and return generation

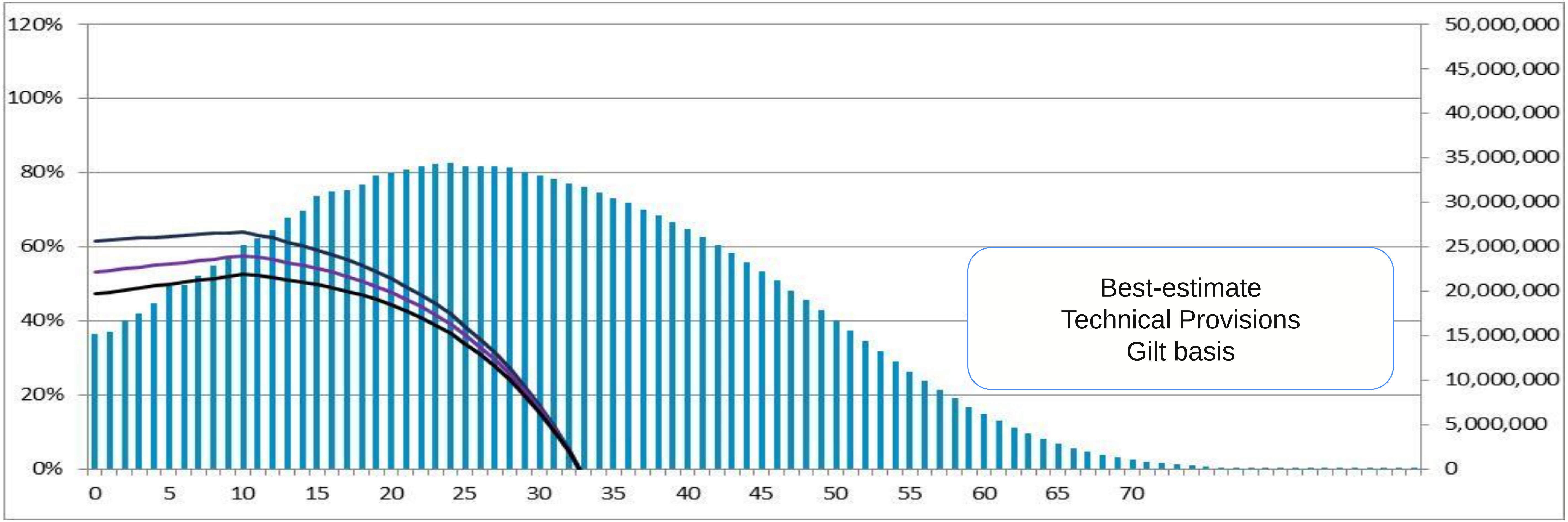
- Strategy and investment, not liability matching for
  – Regulatory concerns
  – Accounting concerns

Case study

Investment strategy



Funding progression



Scenario 2

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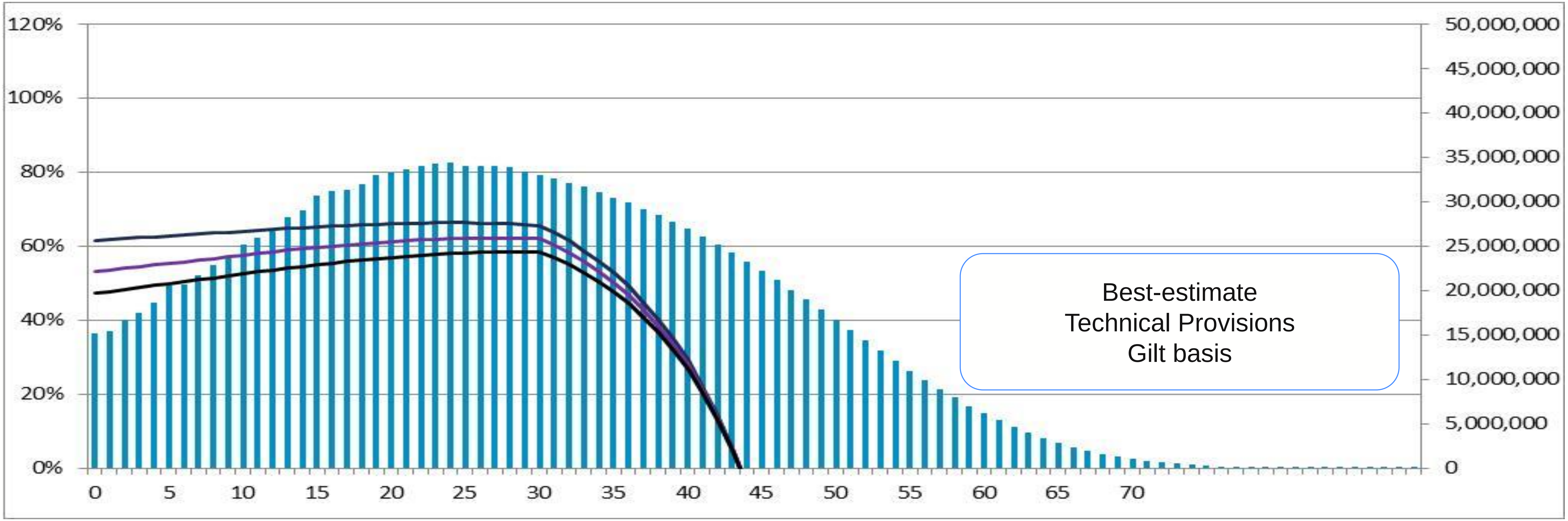

Scenario 3

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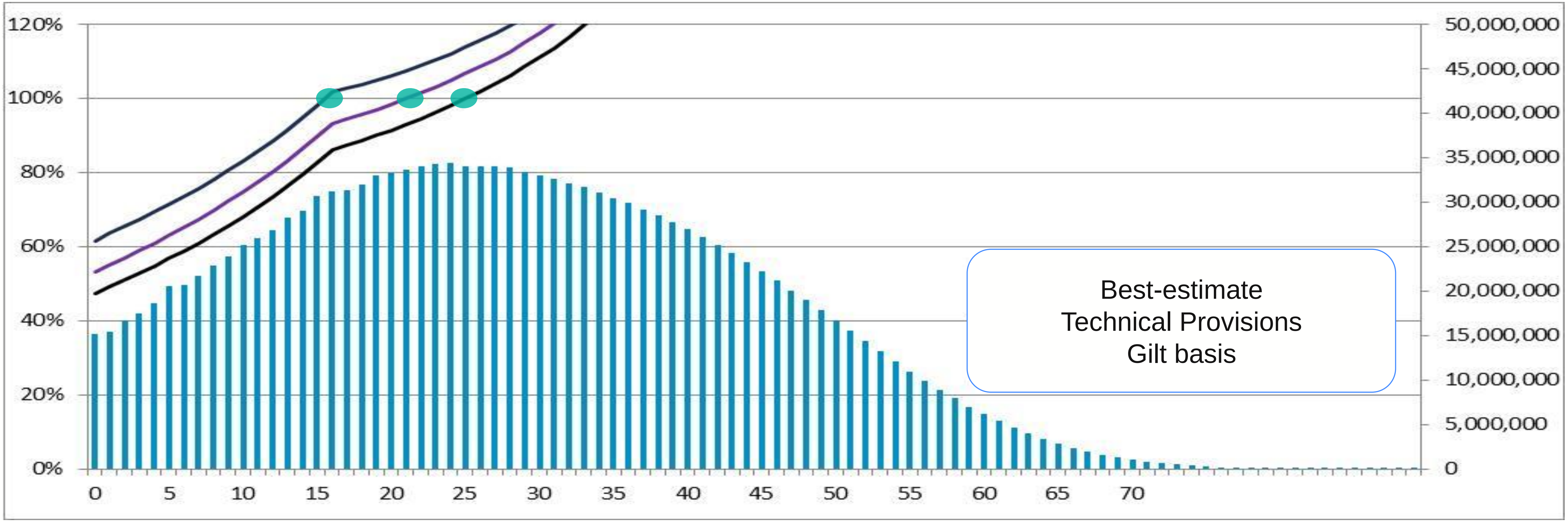
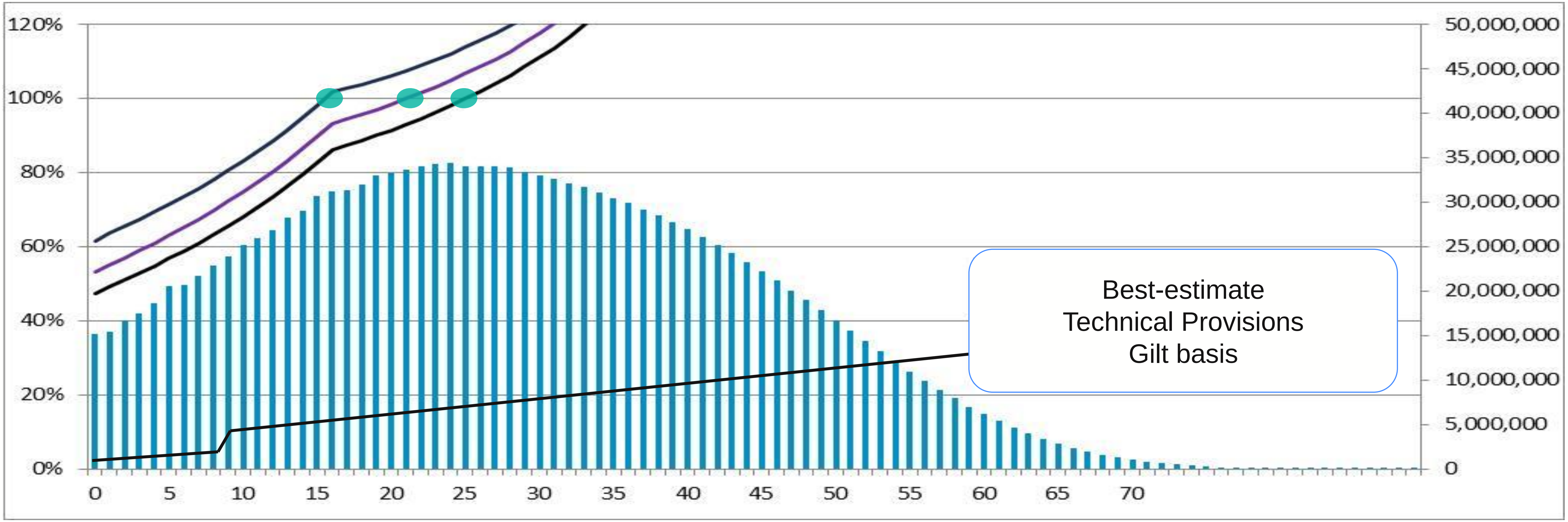


Insolvency probability



Thoughts

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FOR discounting

- Consistent across all schemes and meets a need
- If we can cope with it for accounting, then why not for a regulatory capital adequacy submission (aka triennial actuarial valuation)?

BUT

Funding and investment – don’t let the tail wag the dog.

Final thoughts
(musings from the ivory tower)

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The current approach is now skewing investment on a catastrophic scale

In a gilts+ World how big is the + allowed to be?

Quantitative easing has impacted the gilts part of gilts + … how exactly has this been accounted for?

The *'New Normal'* argument

The reality is that it has and is costing people their pensions in both the public and private

Until recently DB was been replaced by lackluster DC

Underneath all of this there are people and this has cost them dearly

Goodhart's Law

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When a measure becomes a target
it ceases to be a good measure

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