The Actuarial Profession
making financial sense of the future

Equity Debate
Simon Mayne, AonHewitt

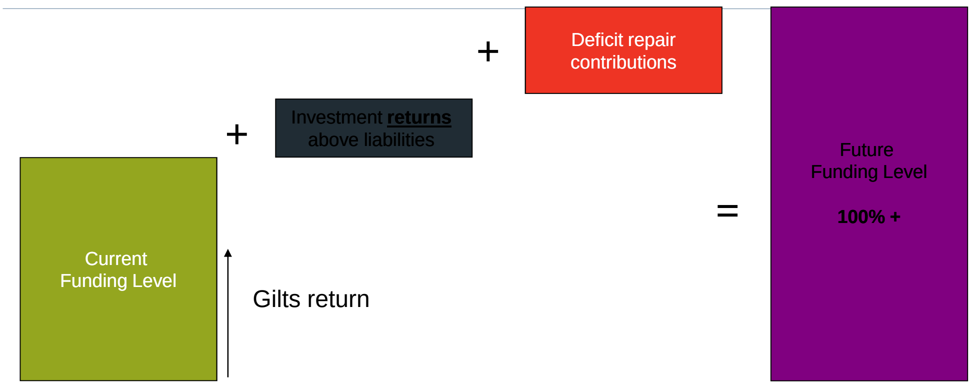
"This House believes that in DB pension investments we should not be bound by Bonds and that there is an opportunity for Equity."

15 March

Can't live with them, can't live without them!

- If we could afford to rely on gilts we would
- Why has the focus been on gilts
- The case for equities

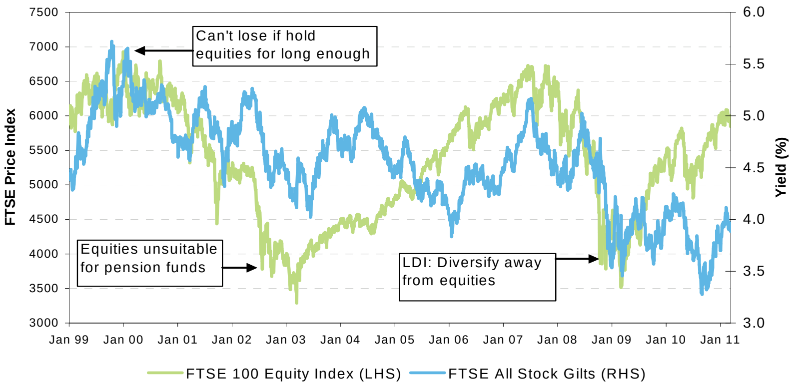
Funding



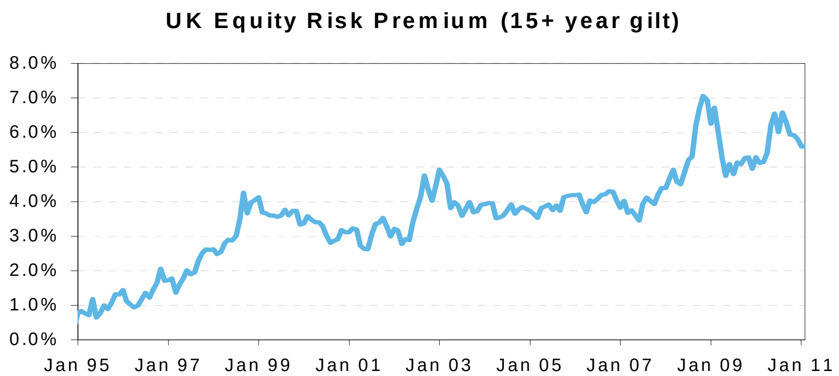
Equities will be around for a while

- Most schemes are still growing and away off maturity
- Equity
  - Can’t live without it
- Is there any more to say?

Pension fund advice has not always been quite right



Equity Risk Premium



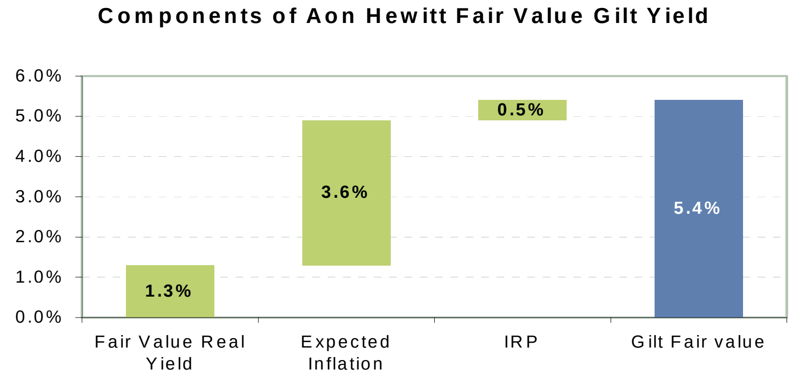
Think carefully about embedded advice

- Smoothed black box actuarial valuation techniques lose favour
  - Removal of ACT
  - “MFR broken before it started”
- Rise of the market led valuation
  - Changed focus to gilts

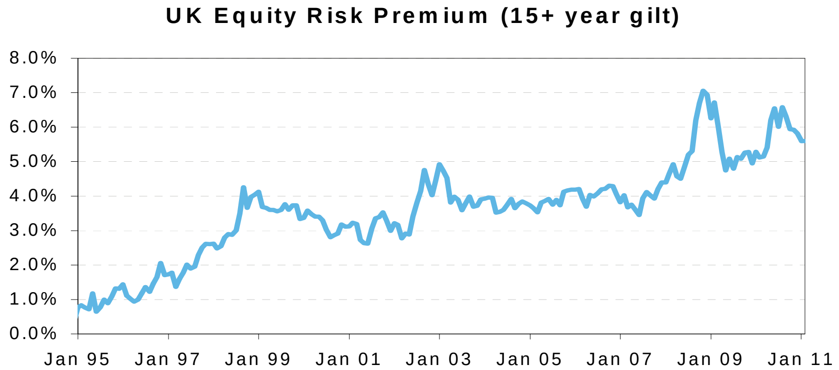
10 years later

- Wider horizons
  - LDI allows you to shift focus from risk / return v bonds
- Equity toolbox
  - Pure equity
  - Long/short hedge funds
  - Equity caps/collars/options

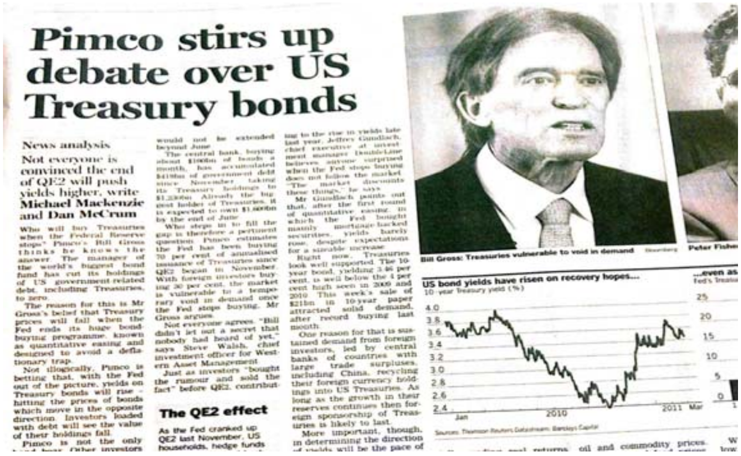
Aon Hewitt fixed income gilt yield fair value



Equity Risk Premium



FT – 11 March 2011



Pimco stirs up debate over US Treasury bonds

News analysis

Not everyone is convinced the end of QE2 will push yields higher, write Michael Mackenzie and Dan McCrum

Who will buy Treasuries when the Federal Reserve stops? Pimco's Bill Gross thinks he knows the answer. The manager of the world's biggest bond fund has cut its holdings of US government related debt, including Treasuries, to zero.

The reason for this is Mr Gross's belief that Treasury prices will fall when the Fed ends its huge bond-buying programme, known as quantitative easing and designed to avoid a deflationary trap.

Not illogically, Pimco is betting that, with the Fed out of the picture, yields on Treasury bonds will rise – hitting the prices of bonds which move in the opposite direction. Investors loaded with debt will see the value of their holdings fall.

Pimco is not the only

would not be extended beyond June.

The central bank, buying about [illegible] of bonds a month, has accumulated [illegible] of government debt since November, taking its Treasury holdings to [illegible]. Already the biggest holder of Treasuries, it is expected to own [illegible] by the end of June.

Who steps in to fill the gap is therefore a pertinent question. Pimco estimates the Fed has been buying 70 per cent of annualised issuance of Treasuries since QE2 began in November. With foreign investors buying 30 per cent, the market is vulnerable to a temporary void in demand once the Fed stops buying, Mr Gross argues.

Not everyone agrees. "Bill didn't let out a secret that nobody had heard of yet," says Steve Walsh, chief investment officer for Western Asset Management.

Just as investors "bought the rumour and sold the fact" before QE2, contribut-

The QE2 effect

As the Fed cranked up QE2 last November, US households, hedge funds

ing to the rise in yields late last year, Jeffrey Gundlach, chief executive at investment manager DoubleLine, believes anyone surprised when the Fed stops buying does not follow the market. "The market discounts these things," he says.

Mr Gundlach points out that, after the first round of quantitative easing, in which the Fed bought mainly mortgage-backed securities, yields barely rose, despite expectations for a sizeable increase.

Right now, Treasuries look well supported. The 10-year bond, yielding 3.46 per cent, is well below the 4 per cent high seen in 2009 and 2010. This week's sale of [illegible] in 10-year paper attracted solid demand, after record buying last month.

One reason for that is sustained demand from foreign investors, led by central banks of countries with large trade surpluses, including China, recycling their foreign currency holdings into US Treasuries. As long as the growth in their reserves continues then foreign sponsorship of Treasuries is likely to last.

More important, though, in determining the direction of yields will be the pace of

Bill Gross: Treasuries vulnerable to void in demand

US bond yields have risen on recovery hopes...

10-year Treasury yield (%)

Sources: Thomson Reuters Datastream; Barclays Capital