A challenging environment for investors

Purple Book reveals full extent of slump in pension funding levels

The comprehensive analysis of the UK’s largest defined benefit pension schemes has shown a quarter of them are in deficit. 

Source: The Actuary, Financial News, BlackRock, PPF

Pensions need some ‘regulatory relief’

The financial press has been full of reports of Pension Protection Fund (PPF) schemes going into the red, and high inflation.

Source: The Actuary, Financial News, BlackRock, PPF

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Why and how should a strategy evolve?

An evolving problem
- Assume you are targeting the correct return
- Does not go to plan – zero return
- What is the new required rate?
  - Implies higher risk, increased contributions, or extending the period to full funding.

Source: BlackRock/Bloomberg
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Why and how should a strategy evolve?

Cashflow profile
- For every year of zero return, the required rate of return increases.
- This is due to reduced time as well as increasing size of liabilities.
- Losses now disproportionately affect the required returns in subsequent years.

Small problems can snowball
Source: BlackRock/Bloomberg

Why and how should a strategy evolve?

Cashflow profile
- Portfolio has two bad years (scenario 1), 15% below expected return, and 10% below expected return (years 4 and 5).
- This reverses in years 14 and 15, but Plan will not get back to full funding.
- Reverse of the above example (scenario 2), now achieve full funding very quickly.
- How does a deficit feel compared with a surplus?
- How should a surplus or deficit change your view or approach?

Kicking the can down the road may be dangerous
Source: BlackRock/Bloomberg
Volatility: threat or opportunity?

Contributions to Asset Allocation Risk vs Liability Proxy

- Currency risk
- Infrastructure
- Commodities
- Hedge funds
- Private equity
- Real estate
- Emerging markets
- Foreign equities
- UK equities
- High yield
- Foreign inflation
- Foreign interest rates
- Investment grade credit
- UK swap spreads
- UK inflation
- UK interest rates


Note: Contributions to risk are based on rolling 104 weeks of index return data with an 8 week half life. Proxies are used where the relevant asset data is unavailable.

Opportunistic risk management

- Monitor funding level and adjust asset allocation as funding level triggers are achieved

Source: BlackRock
The very big picture – the theme of our time

- There have been multi-year themes in the global economy
- These themes have had a profound impact on market returns
- We are struggling to define a new theme for our times

Regime Shifts In Financial Markets

Multiple themes suggest a more complex and fragmented world

DELEVERAGING - DEBT REDUCTION
Varying speeds across countries and sectors

THE POLICY RESPONSE
What do policy makers want? What can they do?

SECULAR CHANGE
Demographics, globalisation, China

Source: BlackRock
**Market valuation rankings (relative to own history)**

![Market valuation rankings chart]

**Government bond yields?**

- Why are government bond yields so low?
- Dysfunctional economic environment – central banks have delivered low real rates
- Most likely catalyst for a bond bear market is higher policy rates - requires genuine cyclical recovery
- A good strategy must have more than a simple duration bet

**Not a bond bubble**
High risk premia or value traps? Digging into some themes

- Lower risk
  - Strong corporate balance sheets
  - Corporate credit
  - Financials credit
  - High yield
  - Higher yielding equities

- Higher risk
  - Emerging market growth
  - Emerging market currencies – local currency debt
  - Emerging market dollar debt
  - Global equities

- Short term Risk
  - Bonds and equity inverse return correlation
  - Fixed income
  - UK Property

- Long term Return
  - Diversification from corporate sector performance
  - Oil, food, gold

Emerging equities - part of the solution not THE solution

Why no outperformance from emerging equities?
- Valuations converge
- Greater integration into global equities

Outperformance of emerging Markets over developed markets

PE Multiples on Developed and Emerging Equities

Source: BlackRock/Bloomberg
IORP Directive and the holistic balance sheet

- Institutional Occupational Retirement Plans
- Objective: ensure level of security offered by all IORPS is similar

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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<tbody>
<tr>
<td>Financial assets</td>
<td>Excess of Assets over liabilities</td>
</tr>
<tr>
<td>Contingent assets</td>
<td>Risk buffer</td>
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</tbody>
</table>

- In principle Technical Provisions should be mainly covered by financial assets.
- Solvency Capital Requirement (SCR)
  1. Market risks
  2. Liability risks
  3. Default risks
  (Min Solvency Requirement = 35% SCR)

- Best estimates of liabilities
- Technical provisions
- Discounting
  1. Level A: Swap – 35bps

Where next?

- An asset only focus has failed
  - Liability focus and timescales are key

- Risk and the sources of risk should vary through time
  - A dynamic asset allocation
  - Funding level, risk allocation and return expectations

- Governance
  - Reacting to changing circumstances
  - Market themes

- Regulation
  - You can run but you can’t hide
Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.
The views expressed in this presentation are those of the presenter.