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

26 March 2008

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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

- De-risking Strategies
- Diversifying Return Generation
- Ongoing Dynamic Risk Management

Separation and management of risks and sources of excess return

Composition of Investment Policy
- Liability Driven Investment
- Market Return ("beta")
- Active manager skill ("alpha")
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

![Chart showing asset class performance comparison](chart.png)

**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