

# Current Investment Crisis Update Briefing Note

14 OCTOBER 2008

*Barnett Waddingham*

## Background

Barnett Waddingham issued a client briefing note dated 19 September 2008 covering the ongoing current investment crisis in markets. The note was placed on our website [www.barnett-waddingham.co.uk](http://www.barnett-waddingham.co.uk) under 'Press', 'Recently Published Articles' and 'Current Investment Crisis'.

This note is an update on the previous note. It aims to address a number of general questions that trustees may have in light of the financial crisis.

## Market Developments

There have been a number of market developments since 19 September 2008, the key ones being:

- Bradford & Bingley has been taken over by the Government
- Fortis, a large European Bank and Insurer, has been rescued by the governments of Belgium, Holland and Luxembourg
- Ireland now guarantees all deposits and senior debt issued by its banks until September 2010
- The UK increased deposit guarantees from £35,000 to £50,000 for individuals
- The US Congress agreed to make \$700bn available to buy 'toxic' debt from banks
- The main banks in Iceland were nationalised. There is a risk that many corporate depositors, including, local authorities may lose their deposits made with these Icelandic banks.
- The UK Government announced funds of up to £400bn to provide capital for banks and to guarantee a variety of inter-bank loans
- Equity markets worldwide fell by up to 25% in the week ending 10 October with falls of up to 10% on 10 October
- On 13 October the UK government announced financial support for RBS and Lloyds/HBOS which could result in the government owning 60% of RBS and 40% of Lloyds/HBOS
- Equity markets worldwide rose by up to 11% on 13 October 2008

## Pension Schemes

Pension schemes are likely to have suffered a serious deterioration in funding levels over recent weeks. The extent of the deterioration will depend on the type of assets held by the scheme and the funding measure (ongoing, discontinuance, FRS 17 etc) under investigation.

Trustees are likely to be considering what they should do with their investments. In reality, they may be looking for somebody to tell them which way markets will go, especially in the short-term. We do not know the answer to this. Anyone who claims to absolutely know the answer is somewhat deluded. Of course educated guesses may be made as to market direction...but they are still only guesses. Few people would have said at the start of 2007 that within 2 years much of the UK banking sector would have been partially nationalised, and that markets would rise on the news!

## Questions and answers

### *Have we reached the bottom?*

We do not know. Equities may look cheap in comparison to past values. However, there is a reason that equities and corporate bonds are cheap. Investors are scared, primarily of the banking crisis leading to global depression. These assets could fall again.

### *How long will it take to restore our scheme's funding position?*

This depends on a number of things:

- The future returns on the assets
- The level of contributions to be made
- Any changes in the valuation basis used to value the liabilities
- The timeframe under investigation

If you do not get the 'expected' investment returns assumed in your scheme valuations, contributions will have to be raised or a more aggressive investment strategy may have to be followed in order to close funding gaps.

### *Should we change the investment strategy now (strategic view)?*

In setting the investment strategy you take a range of factors into account. If any of these factors have fundamentally changed then the investment strategy should be reviewed.

*The investment strategy is often set taking into account the funding level. For example a higher funding level may indicate greater investment freedoms can be taken. Given that the funding level has deteriorated do we need to restrict these investment freedoms?*

The most important factor for schemes with sponsoring employers is usually the 'employer covenant'. One way of expressing this is having a view on the employer's ability and willingness to make additional contributions if risks undertaken in the investment strategy turn out adversely.

If the view on the employer covenant has changed, then there is a case for reviewing the investment strategy.

### *Should we change the investment strategy now (tactical view)?*

This situation may arise when there is a perception, for example, that equities have further to fall. Under this scenario it would be desirable to switch into other assets. There are potential problems with this approach, the key one being that the view may be incorrect, for example, equities may continue to rebound strongly.

### *Are markets likely to recover?*

In the short-term (up to three years) we do not know. In the long-term (over 10 years) we would hope that markets would recover. For example, one of the core philosophical investment views is that equities are expected to outperform bonds over the long term, due to their being an investment in business enterprise, rather than business/government debt, and that taking this 'risk' will be rewarded over the long term. We still hold that view.

Optimists will point you to the following:

- In 1974 UK equities fell by over 50%, in 1975 UK equities rose by around 135% (with assistance from high inflation)
- In October 1987 UK equities fell by almost 30%, but had regained their value in full by the summer of 1988

Pessimists will point you to the following:

- The Dow Jones Industrial Average took 24 years to regain its pre-crash highs following the Great Depression
- Japanese equities are still a quarter of what they were almost 20 years ago

## What should Trustees be doing?

There a number of actions that trustees should consider:

- Discussing or reviewing the current investment strategy
- Assessing how the pension scheme is affected by current market movements
- Assessing how the pension scheme is impacted by exposure to certain institutions
- Assessing the custody arrangements of the scheme's assets
- Assessing how the pension scheme invests its cash
- Whether rebalancing of assets should be suspended
- Whether one way switching mechanisms should be set up so that if funding levels improve, these improvements can be 'locked in'
- Considering LDI investments to protect against adverse movements in interest rates and inflation (...we have had the adverse asset movements)
- Considering Target Return investing to seek to reduce future downside volatility on the asset side of the balance sheet

## Conclusion

The current financial market crisis is likely to have had a serious impact on pension schemes' finances. There are a number of investment areas that trustees should be reviewing.

*If you have any questions or need advice in relation to this, please speak to your usual Barnett Waddingham consultant.*

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OCTOBER 2008

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