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Knee-jerk levy raising is not the answer for UK's PPF

Sir, This month's announcement by the PPF regarding its potential liabilities – which have increased by 50% in little over a week – raises further concerns regarding the impact of current global market turmoil on companies' pension schemes.

It may well mean that many companies with UK defined benefit schemes could go bankrupt, as was the case with Lehman Brothers, leading to the Pension Protection Fund (PPF) having more schemes knocking at its door. This means that the PPF potentially faces a double whammy: More potential schemes entering the PPF at a time when the schemes are particularly poorly funded.

In addition, there has always been the potential for the PPF to trigger a vicious circle – if poorly funded schemes end up in the PPF, the first option is for it to increase levies. If the levy spirals out of control, then the burden on the dwindling population of DB schemes may become unaffordable, meaning more schemes end up in the PPF. In this extreme situation we would

Considering liability driven investment in today's market environment

Sir, there has been much discussion over the last several years about liability driven investing (LDI), including its merits, its definition and its applicability to a wide range of pension plan scenarios.

In its simplest form, LDI is an investment strategy designed to manage assets and liabilities in concert with the goal of lessening the volatility of a pension plan's funded status.

We would suggest that LDI concepts are fairly well known by now, but the actual uptake in managing assets and liabilities in this manner has been fairly slow.

The reasons for this are many, including a long education process for plan sponsors and trustees, interest rate environments that were deemed inappropriate and a reluctance to shift thinking around better plan management.

While LDI discussions were taking place, a market crisis hit like none we have seen in quite some time. Pension plans this past September and October alone saw precipitous declines in their asset valuations as a result of the great market upheaval.

Preventing pension plans' funded statuses from plunging further, at least temporarily, were corporate credit spreads

that had soared to historical highs.

Pension liabilities are typically valued by discounting their future values with high quality corporate credit curves, and with such widespread credit dislocation, the credit spreads of late are benefiting the liability valuations of pension plans by driving them lower.

Hence, temporary funded status relief has occurred as an unintended side effect of the market's turmoil as assets and liabilities plunge in tandem.

However, one must question how long these credit spreads will remain at these levels. Will this condition exist long enough for equities to recover or will they revert back to norms much too soon?

In the recent past, the credit discussion was not a large component of the LDI equation, which focused more on hedging interest rate and inflation risk.

The last half of 2008 has brought the issue of credit to the forefront and plans should consider the impact of credit on their funded status.

When examining the credit exposure of the plan in total, consideration should also be given to the credit component embedded in equities, as it can impact equity

valuations and, ultimately, a pension plan's funded status.

Vehicles to attain credit exposure range from physical bonds to derivatives such as credit default swaps, each with its own pros and cons to consider.

But, in a broader sense, credit itself should be a topic on the minds of pension plan sponsors as they manage through the current market environment and work toward managing assets in line with liabilities.

The current market environment and the challenges it presents should be a reminder to plan sponsors that a solid risk framework is critical to pension plan management success. Managing interest rate risk, inflation risk AND credit risk will go a long way towards dampening funded status volatility and ensuring the ongoing viability of pension plans.

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actually expect to see the PPF seeking government funding or reducing benefits.

It is also worth noting, however, that pensions are a long term business and only a small percentage of the PPF's pensions

obligations relate to payments needed in the next few years – much of what they have promised to pay is more than 20 years away, providing a long period over which market conditions can improve – even if there is

a higher influx of schemes into the PPF due to more company insolvencies.

It is important that the PPF resists the knee-jerk reaction of increasing the levy as this would only serve to exacerbate

problems for schemes in the short term, which could be solved over a much longer timeframe.

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In association with FTSE

Diversification drives development of benchmarks

Sir, I read with interest your recent article 'Turmoil creates ETF confusion' in the October issue of *Global Pensions*. The article, which sees ETF providers stating there is a need to educate investors rightly touches on an important issue in a market where Exchange Traded Funds (ETFs) have grown significantly to become a worldwide institutional investment tool of choice.

This trend is particularly evident throughout the Asia Pacific region and we see many

of the largest institutional investors moving away from traditional asset allocation models. These new approaches are perhaps best illustrated by sovereign wealth funds. Such funds are established by governments out of a growing urgency to fulfil future welfare liabilities which would generally equate a low tolerance for risk. However, the investment strategies employed are anything but conservative.

For example, the latest annual report for the Future

Fund in Australia reveals an increasingly aggressive approach with allocations to global property, private equity, and various other alternatives. Allocations to alternatives are expected to increase with a long term portfolio weighting of 15%. Furthermore, the Future Fund has invested 22% of its global equity exposure in non-market cap indices, which provides a further degree of diversification in the overall portfolio.

In Japan, the Government Pension Investment Fund,

the largest pension fund in the world, is in the midst of debating the five-year portfolio allocation strategy (due to be implemented in 2010). The current portfolio allocates nearly 80% to fixed income but there is critical discussion about the need for diversification in the face of the rapidly aging population. In fact, there are even voices within the Diet supporting the development of a more aggressively managed Japan sovereign fund to supplement or replace the GPIF.

Moving forward, it seems clear that despite the recent financial crisis, pensions and sovereign wealth funds clearly understand the benefits of increased diversification.

From an index provider's standpoint, we see this stimulating a need for transparent benchmarks covering an increasingly broad range of asset classes from infrastructure to RI, and customised according to specific investor objectives and tax positions.

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