Date: Monday 1 December 2008

Publication: Pensions Week

Pensions Week

Since the start of the credit crunch, how have pension funds changed in their views on fixed income?

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Peter Murray: There has been a general trend over the last five to 10 years for pension funds to use fixed income to moderate and control their risks. Schemes are becoming more mature, and fixed income becomes a more appropriate asset class. With the growth of mark to market actuarial valuations accounting, a way to control your funding volatility and moderate the volatility of your sponsor's balance sheet is to use fixed income. Schemes are now more sophisticated, with swaps for a proper liability-driven investing (LDI) approach to all or part of the liabilities.

In terms of what has happened over the last year, those who already have such strategies in place are relatively well-protected, and those who do not have such strategies in place are looking at potentially very large increases in their deficits. The bottom line is: get your protection in place before disaster strikes, rather than afterwards.

Adrian Grey: Buying an insurance policy when your house is on fire is never a good place to be. A number of years of benign conditions, where the volatility in inflation and economic activity became very low, has spawned a set of behaviours that involved investors extrapolating low volatility into investments, fixed income inclu-ded, and that in turn has set in train the process of people using more and more leverage to squeeze the last bit out of whatever risk premium was around. Risk premium across everything has been incredibly compressed, but that has now been scattered to the four winds. The dispersion between the best and worst credit is now extremely wide. Where we are left now is probably a situation where we are looking at the lowest level of risk-free yields and some of the highest risk premium there has been for a generation. That has all happened in the space of 12 to 18 months.

John Heskett: I think gilts have been very steady; it is the credit spreads that moved right in and now they are right out again.

PW: Andrew, as a fund manager, does this mean big changes in what you are offering clients, or is it too early to say?

Andrew Welch: In the main, no, but given that LDI is essentially a risk framework, one of the interesting things that has emerged over recent weeks is the extent to which schemes have been exposed to risks that few people paid attention to before. Money market funds were not news until a few months ago, but they are now subject to scrutiny. An ever greater focus on risk is emerging.

These conditions are also highlighting some interesting challenges around governance and decision-making. It is a natural reaction in these conditions to suddenly get extremely risk-averse, but there are now assets, including some fixed income assets, that on the face of it are offering very attractive returns for long-term investors, who can commit capital to such assets as senior bank debt, AAA-rated, asset-backed securities, and the like. These are offering very attractive returns above cash or gilts with the premiums at levels that are multiples of where they were only a few months ago.

Heskett: The focus on risk has been rising over the last 10 years since the 2002-2003 bear market so the pension fund community is probably in a much more robust state to take the analysis of risk to the next stage. Trustees are much better educated; they know what the playing field looks like, and a huge amount of work has been done to immunise plans, with retired lives more or less dealt with and understood. This leaves us free to focus on risk budgeting for the active and deferred lives. This is going to be a very interesting area, because there are a lot of valuation anomalies out there.

John Hastings: Do you think bonds are a complicated asset class for trustees to grasp? A quoted company has only one listed equity, but it could have 120 bonds with different maturities, covenants, and structures around how their income may be delivered. I just wonder if that adds an additional layer of complexity to trustees' understanding of bonds relative to equities.

Murray: Yield curves and duration are areas that some trustees have difficulty with. An equity manager can come in and talk about Vodafone, and everyone can have a discussion about that. Somebody comes in and talks about their bond strategy, that is more difficult; people do not empathise with that, they need training.

Marcus Whitehead: It is a case of starting off with the government-backed gilts being the lowest risk and then appreciating that the moment you move away from that, you are starting to bring risk onto the table and the reason why the anticipated returns are better is because there is a greater risk of loss. It is appreciating that as the market is developing, there are some very attractive yields; BBB paper is yielding over 9% a year. That is because a good proportion of the issuers could go under.

Welch: Are you seeing the influence of the corporate sponsor as compared with trustees coming through? Finance directors will be more familiar with different debt structures, risk profiles, hedging options and the like.

Whitehead: We are seeing a lot of the desire for change and greater control of risk coming from the employer side. There is greater financial awareness, especially from employers with a good treasury department. I know of a scheme where the employer was concerned whether the trustees would move promptly enough, so they put in place a corporate bond derivative outside of the pension scheme to cover their position. There is a greater awareness of risk control from employers, and generally trustees are quite sympathetic to that, at least to analyse and consider the position.

Murray: Trustees need all the help and advice they can get. They would be very happy to listen to advice from the corporate treasurer on areas where they have expertise.

Hastings: Talking about high beta availability from credit, trus-tees need convincing that they do not need to rely on equities to anything like the same extent. Credit is a much safer part of the corporate balance sheet; if it delivers the required rate of return, it is giving schemes adequate diversification for those funds still with a significant equity exposure. Admittedly, they would have to sell their equities at depreciated prices to raise corporate bond exposure, but if it still delivers the required return, then it is probably a good risk/reward trade-off.

Murray: One of the things trustees and sponsors need to bear in mind is that in their efforts to prevent the recession getting worse, governments are increasing money supply around the world at the most enormous rate. I would certainly have a concern that once things turned upwards, you would have a severe burst of inflation. I would have thought that one of the things pension schemes need to give some thought to rather quickly is getting some inflation protection in place before that happens, because it could really be quite bad.

Grey: The big bursts of inflation over the last century and a half have all been typically the result of fiscal monetisation caused by war. What is happening now is there is a significant fiscal impulse; quite how that will be dealt with in terms of monetising that fiscal impulse is still an open question. Our guess is that is probably one for the day after tomorrow rather than tomorrow.

Murray: It is the day after tomorrow, but if that is the case then put the inflation protection in place tomorrow. There is a risk of people getting complacent about inflation.

Welch: The other challenge is the governance around the speed of taking investment decisions, particularly big strategic decisions like that. I suspect most sponsors or trustee boards have a level in mind at which they would be willing buyers of protection against potential future rises in inflation. They would ideally need to have had that debate before those levels are reached, so that if and when such levels are reached, schemes are in a position to execute their strategies.

PW: Has there been a comparable event for fixed income before, where things have changed so much in such a short space of time?

Heskett: Yes, we have all been here before in terms of uncertainty. Uncertainty levels in the late 1970s and early 1980s were very high, but the circumstances were very different. There was a lot of inflation around, and, as a result the whole basis of the market was fundamentally unstable. Real yields were very high as a result, with resulting economic stress. You then had credit spreads widening out, so there was nowhere to go. When I started investing, there was nothing certain at all. At least, this time, you have got a reasonably solid government market.

Grey: What has been generally disquieting for people is that the whole banking system looked incredibly frail, incredibly quickly, which has a lot of ramifications. When big banks are staring over the abyss, it concentrates the mind.

Murray: What is different for trustees is that 10 or 20 years ago most UK funds were invested 70% or 80% in equities, and the rest in gilts, with perhaps a bit of property. When you had gilts you were not worried about credit spreads or defaults. This is the first credit crunch where pension funds are exposed to credit and a wide variety of other types of investment, such as hedge funds and private equity. Pension funds are also are being marked to market all the time, so they have a much shorter time horizon than they used to. Therefore it is more complicated for trustees to make sense of what is happening, and what to do about it. If we had gone into the present credit crunch with 80% in equities, then we really would be in trouble.

Grey: There has been an explosion of derivative use, which many people find a lot more difficult to get their heads around.

Murray: The place you will find these derivatives used most is in your bond portfolio. It used to be that I could look at a valuation list on a bond portfolio and it was a collection of bonds. Now there are some bonds in there, but the rest is a collection of derivatives, and I have to get people to explain to me what these are trying to do. The risk is that unless you get proper advice, and set up a proper derivative policy, then you may find that it makes transparency more difficult. Unless you have that policy and you have it written into your management agreement, you may find your manager is taking unintended risks. If we are looking for toxic assets in pension fund portfolios, we are most likely to find them in the fixed income portfolio, which is where trustees least expect to find them.

Heskett: Back in 1992 to 1993, in a strong market, lots of new kinds of paper were introduced. We [Baring Asset Management] were not buying derivatives ourselves, but caps and collars involving currencies and bond yields were being packaged up by Abbey National, and others of their ilk. We took them into portfolios to support an investment view and, under stress, they mispriced. We were all allowed to do what we did under the terms of our mandates, which, in retrospect, were loose.

It is very important to be absolutely clear what you are allowed or not allowed to do, because the fixed income market is very dynamic and inventive.

Welch: It is very important to understand what your managers are doing, and very important to define appropriately tight guidelines, commensurate with your performance objective and risk tolerance. Derivatives can be hugely useful risk management tools; they have a huge role to play in controlling risk within portfolios. If you think about a credit portfolio in recent months, there has been almost no liquidity in the cash bond market. The only place you could trade if you wanted to reduce credit risk within a portfolio was in the credit default swap (CDS) market. Portfolios where we have discretion to manage credit risk using derivatives are likely to fare better in those conditions then those that don't permit us to use them.

Murray: I advocate getting expert advice to devise a derivatives policy, so that derivatives are used only for efficient portfolio management.

Hastings: The reporting of the transactions involving derivatives is quite difficult. It becomes hard to work out what a manager is doing if they have invested in a Japanese bond with a currency overlay to bring it back to sterling, another derivative for duration shift, and maybe some CDS on top. Managers tend to report serially, making it very hard to unpick what they are trying to achieve. One sometimes struggles to believe the manager fully understands the complexity of all of the derivatives they have in place, and what the objective of the particular series of trades is trying to achieve. The poor trustee is going to struggle to see precisely what is going on in those circumstances.

Murray: There is no substitute for expertise; no one is expecting a trustee or even most consultants to be able to go through one of these things and understand everything that is going on.

Hastings: As this crisis has deepened, the speed and severity has caught us all on the hop. Managers may have done what seemed to be sensible, and were just too early, because no one expected that the conditions would deteriorate as much as they have done. For example, a manager might have invested early into financial corporates that already looked as if they had taken a lot of the pain with conditions priced in. But, with hindsight, this proved to be incorrect. Under those circumstances, when trustees begin to see underperformance, it is very difficult for them to retain the same confidence in the manager that they had before.

Murray: That does not necessarily have to be a very bad thing to have done. If you were early into buying financials, but you just bought senior paper from the best banks, then there would be a mark to market against you. But as a result of the UK government and other governments around the world doing what they have done, you would be more confident now than ever before that you would be getting your money back. However, if you had chosen to implement that trade by going right to the bottom of the capital structure, then you are toast. That is arguably an investment skill issue, rather than a market timing issue.

Grey: Credit went down the chute, but equities seemed to be doing fine until they woke up one morning and smelled the coffee and all hell broke loose. It comes back to liquidity; a relatively small imbalance in demand and supply now leads to an outsize movement in price, because of the lack of liquidity.

Welch: It is a measure of the challenge that trustees, advisers and pension funds are facing. How often in the past would you have discussed where in the capital structure of a bank it is appropriate to have your exposure?

Murray: The search for yield has driven investors, particularly pension fund investors, further down the capital structure then they would ever dream of going before.

Whitehead: That is where the banks got hammered. I suspect pension funds being prudent investors, and managed by well-intentioned, prudent lay people, did not dive into the collateralised debt obligation market in the same way.

Murray: The regulator has done a survey of pension funds in the UK, and his view is that the amount of exposure to toxic assets is limited. It seems that some of the more sophisticated pension funds on the continent and in the US have got involved to a greater extent than UK pension funds have done.

Heskett: Coming back to the risk budget, the prime focus has been traditionally on equities, with the bond side always managed within relatively tight limits.

Grey: Risk management techniques, like value at risk (VAR), which was originally designed by investment banks to monitor their overnight or weekly risks, suddenly became the modus operandi for pension funds with a time horizon of 20, 30, 40 years. VAR is like a car fitted with airbags that do not work in a crash.

Whitehead: The Association of British Insurers did a paper earlier this year, to which the key conclusions were just that; if we could have 20-year recovery plans, then everything would be so much better contribution rates on average would be lower.

Murray: The only snag with that argument is, of course, if the sponsor defaults in the middle of your long-term horizon.

Whitehead: There is a conflict of interest, because the Pensions Regulator has to ensure funds are suitably funded and that the legislation is adhered to, but they also have to ensure that funds, if they go under, have got enough money so they do not become a burden to the Pension Protection Fund (PPF). In an attempt to keep the PPF well-funded, there is a massive pressure to get money into pension funds that maybe does not need to be in there on a short-term basis. You cannot help feeling that there is an overreaction.

Hastings: In defence of mark to market, if you are ill, you want the doctor to conduct a proper examination. He might then say 'there's a virus doing the rounds, you are suffering a bit, but essentially you are healthy, and you will get through it'. Whereas, he might tell someone else 'frankly at your age, with your circumstances, with an already damaged covenant, you need care and some medicine.'

Whitehead: I totally agree. The legislation is fundamentally sound; it is the overenthusiasm with which the regulator is encouraging schemes to make good the deficits in three years. What is wrong with 10 or 20 years?

Murray: The sad thing about mark to market is that the rating agencies, if you show a large deficit, will factor that in to the credit rating of your sponsor. You simply cannot afford to ignore the short-term fluctuations in the accounting valuations.

Welch: We can argue the finer points of IAS 19 or FRS 17, but given that a pension fund deficit is a form of debt on the balance sheet, do you think it is wrong for it to influence the cost of capital of the sponsor?

Murray: As the chairman of the National Association of Pension Funds at the time when Sir David Tweedy was consulting on FRS 17, I had many discussions with him on the subject, and my point was that whatever answer he came up with, if it was volatile, it was wrong. He did not take that advice, and we now have a very volatile accounting system. The problem with that is that nobody knows whether a scheme is in surplus or deficit. Aon publishes an excellent report every month. It takes the top 200 schemes in the country and estimates the total IAS 19/FRS 17 surplus/deficit. In August 2008 it was a GBP16bn deficit, then the next month it was only GBP1bn, and the next month it was a GBP6bn deficit.

Clearly, this result is just silly, so what is the point of it? I have no problem putting assets and liabilities on the sponsor's balance sheet, but please could we give a little bit more attention to trying to ensure that these figures are meaningful.

Hastings: Mathematically the problem with a surplus or deficit is that it is the difference between two large numbers, and it is inherently going to be volatile.

You spoke about the expansion of credit beta and the expansion of risk premiums everywhere. Given that you can buy beta cheaply and risk premiums are so high, why do you need alternative asset classes, which tend to be incredibly expensive to manage? Can trustees not just exploit a range of credit beta that's much cheaper to manage?

Hastings: It comes down to the history of trying to get more out of assets than assets can deliver. If credit spreads are really low, it is telling you something about generic risk premiums in every asset class.

Heskett: All these alternatives were supposed to behave in different ways, they were supposed to diversify, and then it all blew up. Hedge funds were supposed to behave a little bit differently, but in extreme stress they did not.

Murray: I do not want to go overboard in defence of alternative assets, but if you invested sensibly in private equity over the last 20 years, you would have had a very substantial premium over the FTSE. If you had gone into commodities about 10 years ago, you would have had a return that was comparable with that of equities, and did not correlate with it particularly closely. Alternatives provided some diversification. Again, if you look at hedge funds, yes they are down, but they are not down as far as equities.

Heskett: I am not saying that they have completely failed, but the fact is that traditional assets are now offering something really quite attractive. What do we do now? Hedge funds have done a fantastic job over the last 10 years, with their finest hour in the last bear market rather than this bear market, but that does not mean that they do not remain valid.

Murray: The very last thing that those pension funds invested in equities should do right now is to panic and rush into other asset classes. Provided the trustees have sufficient risk tolerance as far as their funding levels, the employer has a good covenant and has a certain amount of risk tolerance about his balance sheet. I would normally advise trustees and employers to think about rebalancing their equity/bond allocation back to their original strategic asset allocation, because eventually, I would expect a rebound in equities. If you reduce equities now, you will have locked in part of the loss, and that will have to be made up by sponsor contributions. Do not pull out from equities without thinking carefully about it.

PW: For pension funds in the short term, presumably the discount rate will not be too bad for them in valuing liabilities?

Whitehead: For scheme funding, the regulator is looking at what margin above gilts you are looking to take. The gilt return is 4.5% or so, with an unusual bump to it at medium terms, and the regulator is looking at that these gilt yields. Actually, there has not been a huge amount to help the scheme-specific funding liabilities.

Heskett: Gilts plus two, or one and a half, something normal.

Whitehead: It depends upon the circumstances of the scheme and the employer, but the regulator has said it believes the regulations are sufficiently robust to deal with it, which in my understanding says that there is some wiggle room. Maybe the regulator is happy with longer recovery periods, as the legislation is sufficiently robust. Otherwise, there is a fear that if you have all these deficits coming up on the scheme valuations that the trustees will say, 'we will have that paid off over three years please'.

Murray: The regulator has emphasised that the best guarantor of pensions is a solvent, strong employer. His latest announcement has suggested to trustees they need to take a reasonably long view and bear in mind the position of the employer, which seems to me to be eminently sensible.

Hastings: If you put the regulator to one side and 'kitchen sink' pension funding levels by putting them on to gilts funding basis, you are likely to only see improvement going forward. That approach would be the way a new chief executive at a company would initially give the worst possible base level so he could move forward from there.

Whitehead: That is the line in the sand funding position. Maybe if you get an employer who can say, 'my starting position should be all in gilts, how much would that cost me, over what time could I spread it, could I afford that, yes or no', that determines whether you are forced to take risk, or whether you choose to take risk.

Murray: If I was asked a year ago if it was likely that Lehman Brothers would have disappeared, my answer would have been "probably not next year but possibly over the next 30 or 40 years". Trustees also have to take a view of the long- term viability, not just the short-term viability, of their employers.