



PENSION CAPITAL STRATEGIES  
Innovative Alternatives

## THE PCS ALERT

The latest in DB Pensions

# NOW IS THE TIME TO LOCK IN YOUR PENSION SCHEME'S 'HIDDEN WINDFALL'

Dear Sid

Unless you were living in a cave, it would have been difficult to have not noticed the current problems in the financial sector. Even Osama Bin Laden mentioned the sub-prime crisis in a recent video message. Rather than adding to the endless column inches devoted to trying to understand what has happened, I want to point out a useful consequence of these problems that may have escaped your notice.

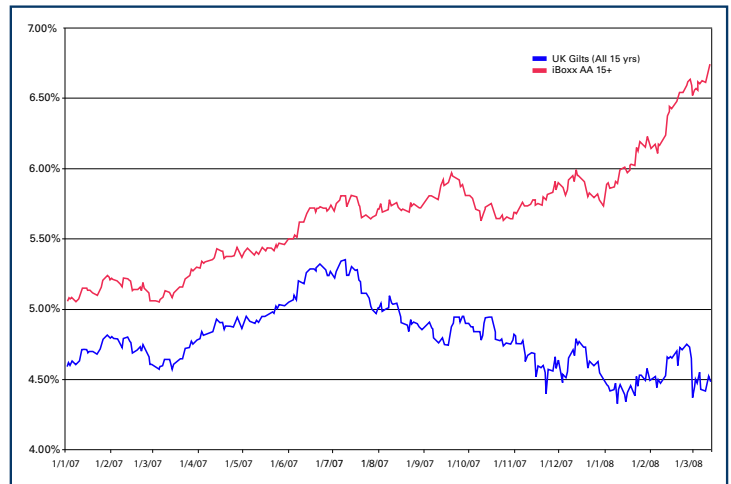
Investor sentiment is extremely risk-averse now. Prices of corporate bonds have suffered accordingly, especially when compared to gilts. So if your pension scheme had been holding corporate bonds then they would have lost money on those assets. However even if that were the case, your pension scheme will have almost certainly have benefited from the problems in the corporate bond market.

### The 'hidden windfall' for pension schemes

As the price of a corporate bond falls, the yield that will be earned for the remaining life of the bond increases. The chart below shows how high grade (AA-rated) corporate bond yields have risen recently even though gilt yields have fallen.

Under the IAS 19 accounting standard, the value of the pension liabilities in your company's accounts is calculated using the yield on AA-rated corporate bonds. The higher the AA bond yield, the lower the value placed on the liabilities, and the difference can be substantial.

To put this into context, the recent 1.5% increase in corporate bond yields following the credit crunch will have reduced the value of pension liabilities, and hence improved the funding position, by between 25% and 50% (assuming no other changes). This is some windfall.



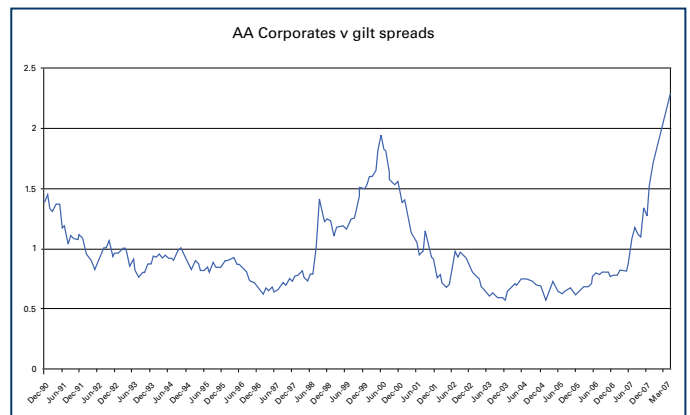
PCS believes that companies should take control over the direction of the investment strategy. Value is being destroyed by trustees who may not understand shareholders' interests. Most trustee discussion of the impact of investment strategy on the company and shareholders can be superficial at best. In particular a typical pension scheme ALM (asset liability model) study, which does not embrace key balance sheet and P&L metrics, can be worse than useless.

Legally and properly, the investment strategy is in the control of trustees, who must ensure that members' interests are protected. However, in the large majority of pension schemes the reality today is that the investment strategy has little or no impact on members' benefits. All the risk (and reward) from the investment strategy falls to shareholders and it is therefore the shareholders (and hence companies) who must take control.

### How can you 'lock-in' the windfall?

A simple (and possibly intermediate) step would be to switch any gilts held in the pension scheme into comparable investment-grade corporate bonds. This would 'lock-in' that part of the windfall which arose from the widening spread between gilts and corporate bonds.

This chart shows how the additional yield (the "spread") of AA rated corporate bonds over gilts has changed over time. At the moment long-dated AA bonds yield about 2 to 2.5% per annum more than gilts. The only other occasion in recent years when AA spreads reached these levels (in the middle of 2000) they very quickly fell back to longer term norms.



This additional yield is due partly to the level of anticipated corporate default. The question here is whether the premium paid to invest in default risk free government gilts is greater than the default risk being removed. We have undertaken research to estimate how much of the extra return that corporate bond holders receive compared to gilt investors is lost due to defaults and downgrading. For AA rated bonds our 'best guess' estimate (based on historic default rates) is that only 0.06% per annum of the return is lost due to defaults and downgrading. Even on our conservative basis we estimate that the loss is just 0.32% per annum. This is substantially below the typical 0.6% to 0.7% yield premium available, let alone the current 2 to 2.5% spread.

The main factor underlying the increase in spreads is a large increase in liquidity risk i.e. the risk that the cost of borrowing money is going to increase and put further downward pressure on bond prices. However, for a pension scheme where the IAS 19 liabilities are measured on a corporate bond basis, any future reduction in corporate bond prices would also reduce the IAS 19 liabilities. Therefore corporate bond investment reduces the risk of changes in the IAS 19 funding position compared to investment in gilts.

#### **Is now the right time to switch into corporate bonds?**

Unfortunately we cannot know, but even at 'typical' market levels (with AA bonds yielding 0.6% to 0.7% above gilts) there is a compelling strategic case for investing in corporate bonds rather than gilts. At current market levels there is an opportunity to lock into substantially higher yields

- By locking in now, you would potentially be missing out on any opportunities of investing in corporate bonds at even higher spreads. But your IAS19 funding position will not be adversely affected by this. It is just an opportunity cost.
- If you do not lock in, and corporate bond spreads narrow back in, then part of the "windfall" your pension scheme has just enjoyed will be lost.

Added to this is the latest accounting interpretation IFRIC14 which may mean that whilst companies have to treat pension deficits as debt, they may not be able to treat pension surpluses as assets. All of this means that we believe that for very many companies now is the right time to switch into corporate bonds.

#### **Summary**

It is not possible to say what the markets will do in the future and therefore only hindsight will tell whether now is the most opportune time to move into corporate bonds.

However it is a fact that IAS19 funding levels have improved recently due to the increase in credit spreads. Therefore any risk reduction undertaken now would lock in some of these recent windfall gains.

Companies should be entering into a dialogue with their pension scheme trustees on the subject of investment strategy. With prices of corporate bonds currently low compared to gilts, now would be a good time to review investment strategy. PCS is ideally placed to assist companies in such a review, with asset liability analysis and tools that specifically integrate company and shareholder interests into pension scheme investment strategy discussions.

For more information on how PCS might help please contact Steve Barker on 0207 895 7907 or Charles Cowling on 0161 242 5388.

Yours sincerely,




For further information on the services PCS can offer you, please email us at [solutions@pensionstrategies.co.uk](mailto:solutions@pensionstrategies.co.uk) or visit our website at [www.pensionstrategies.co.uk](http://www.pensionstrategies.co.uk) to register your interest. Alternatively call Charles Cowling on 0161 242 5388 or Rob Dales on 0113 203 5883.

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