



## PENSION CAPITAL STRATEGIES

Innovative Alternatives

# THE PCS ALERT

## The latest in DB Pensions

### FAILURE TO INTEGRATE PENSION FUNDING AND INVESTMENT STRATEGIES CAN LEAD TO IRRECOVERABLE SURPLUSES, OR WORSE ...

*Dear Sid*

Too many pension schemes are destroying shareholder value by simply reacting to trustee and Regulator demands and failing to integrate funding and investment strategies into a long term "game plan", focused on company interests. The ideal strategy for many companies is to maintain a mismatched equity bias, to contribute to filling an existing deficit, but hedge out the risk implicit in such an approach as and when market movements mean the funding position is improved. Few schemes are successfully implementing such a strategy.

In particular, the management of many pension schemes is currently:

- leading to the possibility of irrecoverable surpluses;
- missing out on market opportunities for switching investments;
- creating unnecessarily expensive hedging strategies;
- failing to reflect market treatment of IAS19 surpluses/deficits;
- losing tax arbitrage opportunities; and
- resulting in inefficient management of PPF levies.

The recent PCS survey of equity analysts' views on pensions showed that markets now treat IAS19 deficits as company debt. However there is little evidence that markets treat IAS19 surpluses as a company asset. Indeed some analysts (and credit rating agencies) specifically exclude pension surpluses from any valuation of the company's assets. So increasingly companies need to manage IAS19 deficits and avoid IAS19 surpluses.

Tax arbitrage opportunities and the prospect of massively increasing PPF levies mean that for many companies running a pension deficit is inefficient and destroying shareholder value.

Also, too many investment strategies, driven primarily by trustee requirements, are failing companies' needs. They are often too complicated and involve expensive risk management strategies, which do not address the company's basic (and much simpler) need – to manage its IAS19 position.

Finally and most damaging, the trustee governance process means that decisions on investment switches invariably only take place on the infrequent occasions that the trustees sit down to meet. This means that opportunities to make investment switches in favourable market conditions are nearly always missed by trustees. The impact that poor timing of investment switches can make is dramatic, as illustrated below:



The above chart of equity prices vs. AA bond prices over the last twelve months shows that the difference between making a switch at the best time and making it at the worst time is a staggering 21%. Repeat this over a number of investment switches and it is easy to see how much value can be lost. Whilst it is not



PCSSolve  
from Pension Capital Strategies

**PCS is pleased to announce the launch of its new pension modeller – PCSSolve**

- Meets need to integrate funding and investment strategy
- Encourages the adoption of a long term "game plan"
- Reflects markets' treatment of pension surpluses/deficits
- Assists companies and trustees in not missing out on market opportunities to make investment switches

possible to predict the best time to make an investment switch (hindsight is always a wonderful thing in investment!), it is possible to improve on the random timing of normal trustee decision making.

PCS believes that companies should take control over the direction of the investment strategy. Value is arguably being destroyed by trustees who may not understand shareholders' interests. Most trustee discussion of investment strategy can be superficial, at best, and does not focus on the factors of key importance to the company and shareholders. 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.

### Striving for the optimum strategy

The first job is to set the long term goal and strategy. Optimum strategies will vary from company to company and from scheme to scheme (according to key factors such as tax, corporate cash flow, banking covenants, management of credit rating etc).

Any pension deficit must be met by a combination of funding strategy and investment strategy. The optimal management of tax and PPF levies will often determine the optimum funding strategy. Any residual deficit will then have to be delivered by the investment strategy. Many companies want to avoid locking in deficits by switching to bonds now, but would wish to implement a phased switch at times when markets make it beneficial.

In the current environment, the optimal long term goal for the company will likely be to seek to achieve 100% IAS19 funding for the pension scheme and then lock in to that level of funding, probably via an AA bond and swap based investment strategy which matches the IAS19 liabilities. This is likely to mean the gradual switching out of equities into IAS19 matching bonds and swaps.

### The new PCS modeller - PCSSolve

Like some other modellers, PCSSolve will help companies establish a long term "game plan" integrating funding strategy with investment strategy. Where PCSSolve is different is that it creates a series of trigger points for the automatic switching of the investment strategy.



By getting trustee agreement up front to the dynamic long term "game plan", the active monitoring of these trigger points allows the investment strategy to be switched without the continual need to go back to the trustees to get further agreement each step along the way. As well as making for a much more efficient trustee management process, this has the great advantages of reducing volatility and ensuring market opportunities are not missed. In addition it can even be possible to raise immediate cash from such a strategy by selling the option value of the upside investment returns that are not required.

It should be noted that whilst this alert highlights the example of a company wishing to achieve 100% IAS19 funding, the same principles (for a dynamic switching strategy) can be applied irrespective of the eventual funding target.

If companies are to avoid seeing trustees destroy more shareholder value, they need to take charge of the pension scheme investment strategy and then implement a dynamic strategy such as that outlined above. In our experience this is easily achieved - even with trustees' inherent control over investment strategy. Companies that fail to grasp this issue will likely be failing their shareholders in the management of one of the company's largest assets.

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 Peter Redhead on 020 7309 8198

Whilst all reasonable care has been taken in the preparation of this publication no liability is accepted under any circumstances by Jardine Lloyd Thompson for any loss or damage occurring as a result of reliance on any statement, opinion, or any error or omission contained herein. Any statement or opinion reflects our understanding of current or proposed legislation and regulation which may change without notice. The content of this document should not be regarded as specific advice in relation to the matters addressed.

Pension Capital Strategies Ltd. Authorised and regulated by the Financial Services Authority. A member of the Jardine Lloyd Thompson Group. Registered Office: 6 Crutched Friars, London EC3N 2PH. Registered in England No 5651461. VAT No. 244 2321 96.