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INVESTMENT OUTLOOK - GREY SKY THINKING

Dear Sid

If this summer felt depressing, then the outlook for pension fund managers returning to their desks is no more uplifting. Life expectancy is now at least 79, if not 150, and the UN is forecasting a return to global deflation even if economies recover next year - it looks like there are a lot more grey days to come.

Traditionally markets are subdued through Autumn and recover with the first signs of Spring. However the prospect of an election next year - we know there will be one, we just don't know exactly when - should ensure that UK markets track sideways at best till the middle of next year.

And then there's just the small matter of financing this Government's, or rather our, national debt and the unwinding of the vast cat's cradle of investments, some more toxic than others, still sitting in various investor portfolios and bank balance sheets.

Our recent survey The FTSE 250 and Their Pension Disclosures (for more details go to www.pensionstrategies.co.uk) highlighted the high rate of closures of FTSE 250 pension schemes, but simply "freezing" funds does not make the problem go away.

Transferring pension risk has been seen as "too expensive". However, as most schemes have had very poor investment experience over the last two years, self-administration doesn't look particularly attractive either; doing nothing though is certainly not an option.

- Pension scheme closures are more prevalent, but a good "end game" strategy is not
- Trustees and sponsors need more proactive management of assets and liabilities, embracing enhanced transfer values and early retirement programmes, targeted buyouts and contribution changes - and advisers who understand this new world.
- Trustees should focus on the "what" rather than the "how", not missing low risk investment opportunities under the pretext of good governance and "being strategic"
- Pension funds have valuable liquidity and should adopt a more rewarding tactical, transaction-led investment style

Equity and debt stakeholders should want their companies to increase revenues, reduce costs and manage their risks. Companies should focus on their core business though and not forced to be quasi-asset managers/ insurance companies to compensate for market shortcomings.

As our survey highlighted, many have liabilities greater than their stock market value and very little of this risk relates to current employees. Future corporate activity is hampered by need for trustee and Regulator approval - given the economic constraints already faced by companies, misguided governance and excessive red tape are the least welcome party guests.

As the pension fund is competing for limited and expensive corporate liquidity, companies must have an integrated enterprise risk management platform, profile and philosophy. Only with a common measurement of risk, capital and economic performance, can you hope to align financial objectives, and so reduce the impact on corporate strategy and growth and the strain on cash flow policy.

Pension funds need to adopt governance programmes consistent with the corporate calendar and management reporting in the "house style". This is a huge ask of "health and safety obsessed" consultant reports, full of information, but often short on practical, clear and usable advice. Only with clear and concise disclosure/ communications can we expedite transactions and optimise the appreciation of financial and non-financial benefits.

Traditionally schemes have maintained a high exposure to equities although, as our survey notes, this is falling dramatically. Such a strategy was justified under the guise of being a rewarded risk, implicitly accepting it did nothing to offset the interest rate, inflation and longevity risks inherent in future pension payouts.

Those bonds held were too short in duration leaving schemes exposed to changes in the level and shape of the yield curve; this is an unrewarded risk. This risk could be managed using derivatives and recent regulation has actively supported their use for risk reduction and efficient portfolio management. It has also engendered a host of new operational risks and counterparty considerations that few understand and even fewer can monitor.

Pension funds are left facing the same conundrums of Liability Driven Investment - how to control liability risks, but generate returns to make benefits affordable? This means getting cheap market exposure and consistent outperformance.

We should focus more on the "what", than the "how" - after all the proverbial opportunity of a lifetime only lasts for the lifetime of the opportunity. Recent examples abound - the expansion of credit spreads earlier this year for one - where schemes could have enhanced returns and de-risked, but missed out through excessive governance and due diligence processes.

Despite its lower cost, passive investment guarantees exposure to every market pitfall. Hence, we should see renewed interest in active management, but it's no easier to identify individual manager skill than the right market. We could see greater take-up of outsourced solutions such as fiduciary management; certainly we ought to see advisers being more direct, accountable (and so rewarded for) in the advice they give.

Trustees must never forget that they only have assets because they have liabilities and risks can be reduced by changing benefits or investment policy, but this may increase sponsor costs and have non-financial consequences.

Alternatively they can manage risks or transfer them to insurance or "non-insurance" contracts. A lack of affordable hedging solutions will probably lead trustees towards return-seeking, but stable, investments. Transparency and understanding are key, so alternatives such as private equity, credit and real estate become more attractive than hedge funds. Likewise public markets have disappointed and scared, so private transactions could offer innovation, security and returns. Pension funds have liquidity - they must not be afraid to use it and get well paid for it (and not be succoured into short-dated credit funds masquerading as cash deposits).

If there is a clear lesson from recent experience, then it is "don't always be strategic" - a tactical, transaction-led investment style can reap greater rewards. This means no longer being overly concerned with the history of asset classes, losing the belief that "possible futures" are a projection of that past and no longer being indifferent to purchase (and exit) price. PCS helps you manage your pension obligations now and through the end game, offering practical advice on, and innovative ways of, managing assets and liabilities, on effective communication with trustees and members and on finding the right funding solutions but avoiding trapped surpluses. Board rooms need now to be focusing on their core businesses, not playing at being quasi-insurance companies - being a FTSE quoted company too, we understand what you need and so can help you change both what you do and how you do it.

The old adage "once bitten, twice shy" would seem to apply more than ever now - although pension funds seem to have suffered a blight of bee stings in recent years, some of which were avoidable. Consequently the biggest challenge now is to be brave enough - the meek may inherit the earth, but we know who fortune favours.

Yours sincerely,

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