

Baby boomers benefit

Shadow Secretary of State for Universities and Skills, David Willetts (aka "Two Brains"), highlights, in his new book on intergenerational inequality (*The Pinch: How the Baby Boomers Took Their Children's Future - And Why They Should Give It Back*), the extent to which those born between 1945 and 1965 have hoarded a disproportionate percentage of the UK's wealth. By benefiting from high inflation when in the red and low inflation when in the black, rising house prices and generous occupational defined benefit (DB) pension schemes, this 25% of the population owns 58% of claims on UK pensions, whilst those aged 35 to 74 own a gargantuan 88%.

Despite this, one in five people seeking to retire in 2010 will rely solely on the state pension and income from savings to fund their retirement. Research conducted by the Prudential shows that for these retirees the state pension of £95.25 per week is expected to account for an average 34% of income, occupational pension schemes 36%, with the remainder of income to comprise that from savings and investments, including personal pensions and equity release. This comes at a time when a combination of falling investment returns and lower annuity rates means that a contribution of £100 gross per month made over 20 years into an averagely performing balanced managed fund would produce an annual income of £2,452 from a resulting pensions pot of £40,749, against £8,998 from a pot of £103,914 a decade ago. In addition, as to the term over which this annuity would be received, a recent government-commissioned study suggests that health inequalities mean that the gap in life expectancy between the richest and poorest neighbourhoods in the UK is seven years.

De-risking on the rise

Hymans Robertson expects the volume of de-risking, or Liability Driven Investment (LDI), transactions undertaken by UK DB schemes this year to nearly double from £8bn in 2009 to £15bn in 2010, despite Mercer calculating the cost of a full scheme buyout currently costing 144% of a scheme's IAS 19 value. Within this £15bn, Hymans expects £10bn of longevity transactions, which protect DB schemes against the risk of their pensioners living longer than anticipated, to be executed. This forecast comes against the backdrop of £4.1bn of pioneering longevity swaps deals being engineered last year for Babcock International, RSA and the Royal County of Berkshire Pension Fund. Indeed, BMW alone is looking to offload nearly £3bn of longevity risk from its UK DB scheme. So as to cope with this increased demand for longevity solutions, a new industry body – the Life and Longevity Markets Association (LLMA) – has been created by the industry's largest longevity swap providers to promote common standards and a more liquid and innovative market to facilitate longevity transactions.

Separately, the UK banks are seething at a proposal published late last year by the Basel Committee on Banking Supervision that would oblige the banks to deduct their DB scheme deficits in their entirety from their capital provisions, thereby further constraining their ability to lend. If implemented, this could result in the banks being forced to de-risk either through the buy-in or longevity swaps market, rather than engineer a full buy-out.

DC funding suffers

According to adviser Punter Southall, based on a survey of 340 companies, 16% of employers in 2009 either cut or ceased payments to their defined contribution (DC) scheme or stopped promoting their DC scheme in an effort to stem its take up. Whilst consultant Aon found that the average employer DC contribution was a meagre 6%, separately Towers Watson reports that the average maximum sponsor contribution amongst FTSE 100 employers is 16.6%, up from 15.3% in 2009. However, this has been tempered by the news that a number of US companies with UK subsidiaries have begun to consider linking their DC contribution rate to their profits, as many companies already do in the US. In addition, as reported in January's Pensions Watch, the Association of Consulting Actuaries found that 24% of employers expect to "level down" their DC contributions to the 3% NEST (the National Employment Saving Trust – the new name for Personal Accounts) contribution level, while 15% suggested they may close their schemes in favour of NEST.

DC default funds

With reports of some US investors with 2010 target date funds in 2008 having suffering losses of up to 40%, despite retirement having only being two years away, owing to the funds having an average equity exposure of 57%, the search for the DC default fund panacea continues to gather momentum on both sides of the Atlantic. Drawing on the US experience, one UK pensions product provider is devising DC default funds that use DB-type LDI techniques that protect those who are making the transition from the accumulation phase to purchasing a retirement annuity against interest rate and inflation risks and dramatic equity market movements, whilst another is looking at the viability of incorporating a guarantee for its range of DC target date funds. In addition, the trustees of the Babcock International DC scheme have taken the initiative of converting the 100% equity strategy of the scheme's sole default fund to a range of better diversified and actively managed growth, moderate and defensive default funds for its 5,000 DC scheme members.

If the cap fits (Part 4)

In the August 2009 edition of Pensions Watch (“If the cap fits (Part 3)”) we reported that the Royal Bank of Scotland (RBS) was to cap pensionable salary increases for the 62,500 active members of the state-backed bank’s £14bn non-contributory DB scheme, to the lower 2% or the rate of inflation and reduce the lump sum payable to those who retire early. Against the backdrop of the recent dramatic rise in inflation expectations, the potential savings for the scheme, with its £2.7bn deficit, has now been estimated at £34,000 over their lifetime of each employee, with young higher flyers being hit hardest. This watering down of retirement benefits does, of course, contrast with the £17m early retirement package given to Sir Fred Goodwin, the former RBS chief executive, a part of which he later surrendered.

Alternatives back on the agenda

According to Towers Watson, last year UK pension assets bounced back from 2008 losses of 26.5%, posting average gains of 13.6% in 2009. Separately, Hewitt Associates report that in an effort to further recoup those 2008 losses, the number of pension schemes seeking to invest in hedge funds doubled in 2009 with Towers Watson confirming that most UK schemes are looking to make an average 15% allocation to the asset class. Although global inflows into hedge funds have only just recovered to pre-crisis levels, after 15 years of exponential growth, the very largest schemes such as CalPERS, the world’s largest, and the £28bn Universities Superannuation Scheme (USS), the UK’s second largest, have been busy conducting due diligence on 66 and 30 hedge fund managers respectively. This comes at a time when Lord Davies, the trade and investment minister, has suggested that “the big prize” for a cash-strapped government “would be to set aside part of the long-term pension industry and get them to invest in [the nation’s] infrastructure.”

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Wrong number?

With the deficit of the UK’s largest and most populous (at 241,000 members) DB scheme poised to exceed the sponsoring company’s £9bn market capitalisation, the BT scheme trustees have asked the High Court to rule on the scope of the “Crown guarantee” granted by the government when the company was privatised in 1984. Clarity around the guarantee, which BT believes covers about 75% of the scheme’s liabilities in the event of the company’s liquidation, would enable the trustees to adopt a less cautious basis to valuing the liabilities and so potentially reduce the company’s recently increased top-up payments of £525m per annum, escalating to over £600m per annum from 2014, over a proposed 17 year recovery period. This coincides with The Pensions Regulator (TPR) having expressed concerns about whether these top-up payments are sufficient, given that the scheme’s £9bn deficit has been calculated using valuation assumptions that are thought to have put it “at the lower end of reasonable estimates” and the length of the proposed recovery period.

As an aside, readers might recall from the December edition of Pensions Watch (“Dial L for levy”) BT is planning to raise the prices it charges its wholesale customers, who rent the landlines to sell phone and broadband services to consumers, by up to 4% per annum to supplement these top up contributions. In an attempt to prevent the levy being implemented, BT’s wholesale customers, in their submissions to Oftcom, the telecoms regulator, accuse BT of not having made adequate contributions to the scheme and having taken big risks with the scheme’s investment strategy.

And finally...

MATRESS?

Last month’s Pensions Watch reported that NEST – the National Employment Saving Trust – had become the new name for Personal Accounts: the government- implemented auto-enrolment pension scheme. However, since then a number of alternative acronyms have been suggested, of which MATRESS is one of the most novel: Making Arrangements To Retire Easier by Saving Salary. Can you think of another?

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Contact us at Aviva Investors Global Services Limited, No. 1 Poultry, London EC2R 8EJ.

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