Investment Report

Hewitt

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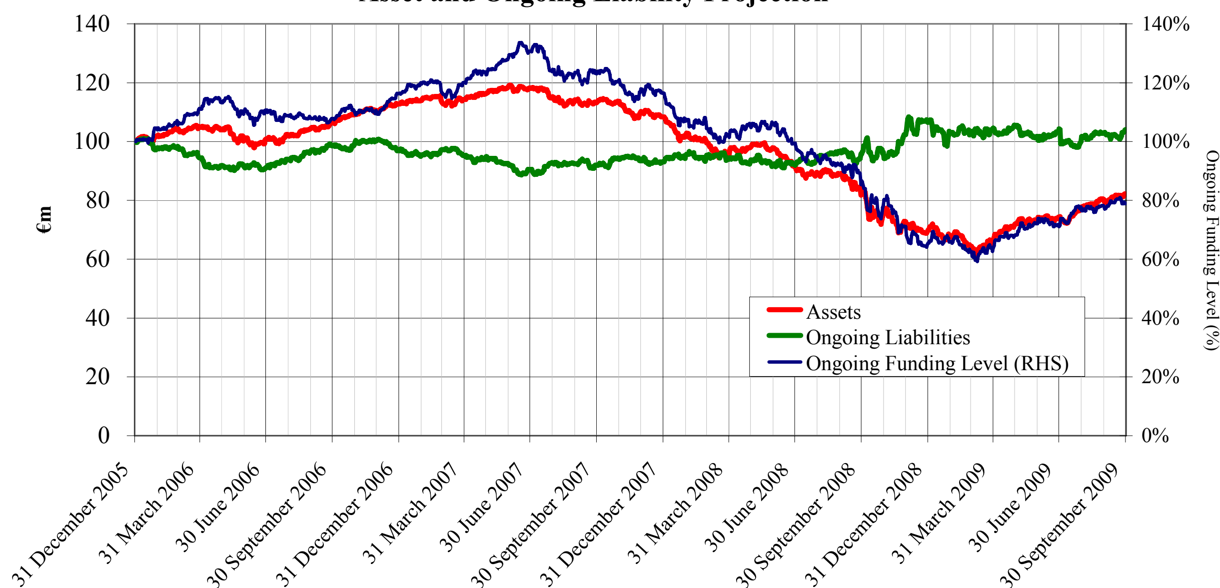
Defined Benefit Funding Shortfalls – The Full Picture

The collapse of equity markets in 2008 was seen as the main contributor to Defined Benefit (DB) funding difficulties. However while many equity markets have recovered over 50% in the last 6 months we have not yet seen the same degree of recovery to funding positions. This is because, for a defined benefit pension scheme, assets are only one side of the story.



Note: The above graph is approximate, and becomes more approximate as the projection period lengthens. It reflects approximate stock market movements and interest rate changes (assuming these occur uniformly along the length of the yield curve), but not client-specific factors, such as material changes in membership numbers or profile or changes in benefit scales. It is designed to give a broad picture of the direction of funding changes since the last actuarial valuation but does not have the same level of reliability as, and therefore does not replace the need for, formal actuarial valuations.

The fourth quarter of 2008 was memorable for all the wrong reasons with Managed Funds losing about 15% of their value during the 3 months. However, in what is now recognised as the second perfect storm in the last ten years, we saw funding levels drop by an even greater amount. This is because funding levels are driven not just by asset performance but by liability valuations as well - which are also proving very volatile in the current climate. During Q4 2008, bond yields fell significantly as Governments around the world slashed interest rates to try and save the financial system. This caused the liabilities of most pension schemes to increase by over 10% leading many to dub this period the second "perfect storm" in the last 10 years. As a result, pension funds saw their funding positions deteriorate by more than 20% in just 3 months. Nearly half of the decrease was due to liability movements with assets responsible for the balance.

Over the last five years, Irish Pension Managed Funds have returned an average of 1.2% per annum over the period ending 30 September 2009. Notably, for each of the individual years during the 5 year period, returns have varied between +21% and -26%, a range of returns of 47%. This is extreme but not unprecedented and in fact as recently as 2003 we experienced similar levels of volatility in 5 year returns.

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Most pension schemes in Ireland have run significant levels of investment risk. This was more appropriate when schemes were less mature and regulation allowed asset values to be smoothed through volatile periods. This is no longer an option as funding standards must be adhered to on an annual basis. It is therefore critical that short term investment risk is understood and addressed.

With many funding proposals due in the next 12 months, Trustees and Sponsoring Employers need to be highly aware of the investment risks within their pension schemes. As of 2005 EU legislation requires all Trustees to address investment risk in relation to the nature and duration of the scheme's liabilities and to specifically consider risk measurement and management. This is the first step for Trustees putting in place a plan to manage the way out of the current funding position and, once achieved, to take the necessary actions to minimise the risk of returning to the poorly funded positions many schemes currently find themselves in. Sponsoring Employers are beginning to realise that DB Schemes are becoming increasingly expensive to fund as schemes mature and longevity continues to improve. The appetite for investment risk is diminishing as Sponsors are being required to pump cash into what, over the last 5 years, seems like a bottomless pit. In signing up to a funding proposal Trustees and Sponsors need to be aware of the risk of the funding proposal going 'off track'. The consequences of going 'off track' are that even greater amounts of cash will be required as was the experience of many schemes with funding proposals in place over the last few years. Interestingly, a pension scheme with 70% of its assets invested in equities, carries an estimated 40% chance of going 'off track' in the next 3 years.

In conclusion we encourage both the Trustees and Sponsors to consider fully the price of certainty and, at a minimum, to put in place a plan to close out investment risk opportunistically as funding levels improve. The price of increased certainty should be considered in the context of the value of assets that are at risk.

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