



Alexander Forbes

The Journey to Wind-Up

Investment strategy during the wind-up





Investment strategy during the wind-up

Scheme investment during the wind-up process

The decision to enter a managed wind-up fundamentally changes investment objectives and time horizons. Trustees and scheme sponsors cannot afford to jeopardise the ability to wind up by taking undue investment risk. Therefore, a different and more dynamic approach for dealing with investment strategy is needed compared to that required for an ongoing pension scheme, whether closed or open to accrual.

Most pension scheme trustees and sponsors do not fully appreciate how much a deficit could worsen due to market movements. To demonstrate the effect of volatility in markets (whether equity or bond related) the graph below shows how the funding level has moved for a typical scheme with a 70% equity and 30% bond investment strategy since 1st March 2007, allowing only for changes in market levels (i.e. pension payments, salary increases, mortality etc are in line with expectations).

The green line represents the expected funding level for a typical scheme assuming the valuation deficit funding plan had been borne out in practice, whereas the blue line shows the approximate funding level

based on actual market movements. As detailed, there has been in excess of a 10% movement in the funding level over the last year. A similar pattern is true for most pension schemes in this time period. The change of funding level for a particular scheme depends on the expected future pension payment profile and asset strategy, but is likely to be significant.

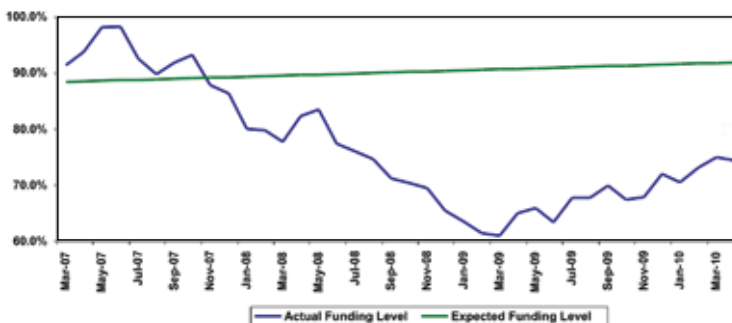
At a time when buy-out deficits are already large, scheme sponsors and trustees cannot afford the funding level to be as volatile as this during a wind-up process.

Managing the change in investment objectives

Alexander Forbes Consultants & Actuaries has developed an approach for dealing with investment issues in the managed wind up situation that reflects the change in investment objectives and shortened time horizons.

Our Investment Consulting approach means that we monitor asset allocation and investment markets on an ongoing basis, feeding real-time investment recommendations back to trustees. The focus is on providing relevant information which can then be used by trustees as a basis for key decision making. The ultimate responsibility remains with the trustees, with the Investment Consultant overseeing the implementation process.

Typical funding level progression since 1 March 2007



This service also identifies appropriate investment management (with access to funds across the whole market, in all asset classes) for the small to medium sized scheme.



The benefits of our approach

A successful managed wind-up process hinges on a whole scale reduction in investment risk levels and growth must be in a risk controlled way. The benefit from additional returns is unlikely to be significant in a short time frame, and the downside risk from an equity reliant strategy is significant in this situation. Our approach aims to increase the ability to buy-out if prices become affordable and protect funding profits that arise from liability management exercises, such as an enhanced transfer value exercise.

The risk reducing investments that are required are more sophisticated than the equities and bonds held currently by most pension schemes. Trustees can implement these sophisticated investment tools themselves at potentially significant cost (in addition to their own management time) or alternatively they can outsource the investment monitoring to an expert; we advocate the latter approach as it delivers the following key benefits:

- *Real time expert decision making*

Markets are volatile and as a result, there are expected to be opportunities to lock into a better than expected funding level or take advantage of attractive buy-out prices. These opportunities can be shortlived and unless a scheme is in a position to take advantage in real time, these could be missed.

- *Specialist knowledge*

The measures needed to deliver a fundamental downsizing in expected volatility involve sophisticated investment products. Quick advice by experts and timely decisions are crucial, especially when time is a precious commodity during the wind-up process.

- *Bridges the trustees' knowledge gap*

The risk reducing measures require new investment knowledge that can involve unfamiliar investment tools. Under our approach, trustees and sponsor have the reassurance that they are making decisions on the back of timely investment advice provided by experts.

However, for trustees it is still fundamentally important to understand the basic purpose of the investment tools being used and the key characteristics of each investment product.

- *Reduced costs*

Reducing investment volatility requires the use of several asset classes. Trustees could use a traditional consulting approach to implement risk reduction but manager selection and monitoring can be both time consuming and costly exercises. In the managed wind-up situation, every penny counts. Our approach allows schemes to outsource the monitoring, advice and judgement to experts at a much more competitive price than the traditional consulting approach.

Timely advice from experts and quick decision making by trustees are crucial, especially when time is a precious commodity during the wind-up process

Dealing with revised investment objectives in the managed wind-up process.

Typically, pension scheme investment strategies have been set with the long term in mind and tend to favour equities as they are expected to outperform the lower risk asset, Gilts, over the long term.

The managed wind-up situation changes these dynamics because the timeframe is significantly reduced. The intention is often to wind up the scheme as soon as it becomes affordable, and that means looking to structure the investments with a probable maximum 10 year outlook.

The focus moves to capital preservation and risk control while still looking for a degree of outperformance and the flexibility to adjust to changing conditions if necessary. This requires a completely different investment approach.

The shorter timeframe reduces the certainty of equity outperformance and holding significant equities could now compromise a scheme's opportunities to buy out in adverse stock market conditions. For example, it would be very painful to discover that assets had fallen 20% in a year at exactly the time when buy-out costs had fallen.

Our consultants will recommend investments specifically designed to reduce risk. Most clients will not have the luxury of being able to afford a 100% Gilt strategy that reduces investment risk close to zero, and will still need to seek growth in excess of Gilts. Our approach seeks this additional return in a much more risk-controlled way.



Reducing asset strategy risk

We have house assumptions on the expected return and volatility for each asset class, and the correlation of returns between asset classes. These assumptions are based on past experience with some sensible adjustments made to reflect future expectations. We can use these assumptions to calculate the expected risk saving benefits of diversification.



Summary

The investment mind set for both scheme sponsors and trustees should change significantly in the managed wind-up situation. Trustees and sponsors cannot afford to allow the investments to remain unchanged, as the potential downside in adverse market conditions is too significant. This downside could severely compromise the ability to wind up within the desired costs and timescales. The investment manager needs to be alert to the requirements of a managed wind-up situation and be able to provide the appropriate risk reducing investment tools. Our Investment Consulting service offers a leading edge solution, which caters for this exact situation that the small to medium pension scheme may face.

If you would like to discuss your pension scheme with our experts please call

North

Andrew Mobberley

0121 712 7900

07770 647169

South

Gordon Blum

020 8253 7826

07771 955191

Steve Johnson

020 8253 7883

07824 858513



Alexander Forbes Consultants & Actuaries
Leon House, 233 High Street, Croydon, Surrey CR9 9AF.
Tel: 020 8686 0660 Fax: 020 8681 4093 Web: www.alexanderforbes.co.uk

Alexander Forbes Consultants & Actuaries is a trading style of Alexander Forbes Financial Services Limited which is authorised and regulated by the Financial Services Authority. FSA Reference: 120975
Registered in England and Wales at 5th Floor, Leon House, 233 High Street, Croydon, Surrey CR9 9AF. Registered Number: 1804276

AFFS 0537/0410 03012



Alexander Forbes

CONSULTANTS & ACTUARIES