

# Pensions Bulletin

## Fact Sheet 6

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### New investment strategy for Growth Plan

#### **1 Background**

- 1.1 The Growth Plan 2008 actuarial valuation revealed a deficit of £28.6 million and a funding level of 96%. The deficit is only in respect of Series 1 and 2 liabilities built up before 1 October 2001.
- 1.2 A recovery plan has been agreed and submitted to The Pensions Regulator. The plan aims to eliminate the £28.6 million deficit via investment returns over a period of nine year and ten months without the need for participating employers to pay additional contributions. In order to achieve this, the assets backing Series 1 and Series 2 liabilities must achieve an annual rate of return of around 9% per year.
- 1.3 In August 2008 the Trust capitalised on pricing opportunities in the buy-out market to replace the Growth Plan's government and corporate bond holdings, plus a share of its equity assets, with a bulk annuity provided by Paternoster UK Ltd. Effectively the policy with Paternoster provides a strong match to the pensioner liabilities in the Growth Plan.
- 1.4 Since the purchase of the bulk annuity with Paternoster, the assets backing Series 1 and 2 liabilities yet to come into payment have been invested almost entirely in equities, with a small allocation to property.

#### **2 New investment strategy**

- 2.1 The Trustee has been considering the future investment strategy for the Growth Plan as it is agreed that the current strategy carries too much downside risk. However, in order to repair the Plan's deficit over the longer-term, equity assets needed to be retained as part of the overall investment strategy.
- 2.2 Following consultation with the Growth Plan Employer Consultative Group (GPECCG) and advice received from our Investment Consultant, Mercer, the Trustee has agreed to replace the Growth Plan's physical equity holdings with a credit portfolio overlaid with equity options (this is a combination of 'call' options to obtain exposure to a range of equity upside financed by the sale of a 'put' option 15% below the current market level giving exposure to any equity market losses in excess of 15%). This is known as a 'synthetic equity collar'.
- 2.3 The new strategy is expected to provide an underlying yield on the credit assets of about 5% to 6% per annum, with the potential to participate in improvements in the equity market up to a certain level. It will also provide a degree of downside protection from a first tranche of any losses in the equity markets relative to current levels.
- 2.4 The rationale for the proposed strategy is:
  - to increase the probability of reaching full funding on a technical provisions basis by 2018; and



- to reduce the chance that additional employer contributions are required if equity markets do not deliver the expected level of performance over the medium term. In particular, the Growth Plan would be protected against the first 15% of falls in equity markets over the period to the next actuarial valuation in 2011, but would still benefit from out-performance from equities over the liabilities up to a maximum limit which is in excess of the rate of equity growth anticipated in the actuarial valuation.

2.5 The Trustee recognises that there are potential drawbacks in the proposed approach. In particular:

- If equity markets perform very strongly over the next two years, then the Growth Plan would not benefit fully from this. Performance in excess of around 9% pa would be foregone, in order to provide downside protection.
- Under the proposed structure the Growth Plan foregoes dividends on equities (and participates only in increases in equity prices) although the Growth Plan will receive interest income on the physical bond holdings to offset this.
- There are certain adverse circumstances when the strategy would perform more poorly than the current investment strategy. For example, if the level of defaults from corporate bonds was to be significantly higher than expected and equity markets fall materially.
- The equity market performance within the Global Equity Fund, through which the Growth Plan currently gets exposure to equities, is expected to be enhanced by out-performance from the active managers. Under the proposed strategy, the Growth Plan will not benefit from this, but will also not be exposed to any manager underperformance.
- There are transaction costs associated with implementing and managing the proposed strategy.
- The value of the 'call' and 'put' options (also known as 'derivative' contracts) are influenced by factors related to the time to expiry, the volatility of equity markets, changes in interest rates or dividend expectations and other factors in addition to being determined by changes in underlying equity markets.
- If the strategy needs to be unwound before maturity, there may be additional transaction costs and the Growth Plan may incur losses on the derivatives even though the equity market is above the levels at which any losses would have been incurred at maturity.
- Derivative contracts are subject to counterparty risk, although this is mitigated by exchange of collateral and by the type of exposure (in particular the Growth Plan is more likely to owe money rather than be owed money under these contracts in extreme downside events).
- The management of the bond portfolio may be restricted by the requirement to provide collateral for the derivative exposures which can move against the Growth Plan and in the event that a larger than expected amount of collateral is required there may be costs associated with reorganisation of the bond portfolio to accommodate this.

2.6 The Trustee looked at a number of different scenarios and whilst it is clear that there are risks attached to the new strategy, the Trustee believes that the risks associated with maintaining the previous strategy were even greater.

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