

UK Equity

View from a Contrarian – Pension Deficits

November 2016

Pension fund deficits are a controversial topic for investors. With the issues at British Steel and BHS making front page news, there is almost universal negativity towards companies with large pension deficits.

PwC’s pension deficit index showed that UK pension fund deficits rose by £100bn in August 2016 alone, and data from the Pension Protection Fund (PPF) shows that at the end of September 84% of eligible schemes were in deficit on a S179 (or buy out basis) vs a long term average of 73%¹. It’s unsurprising that investors are concerned.

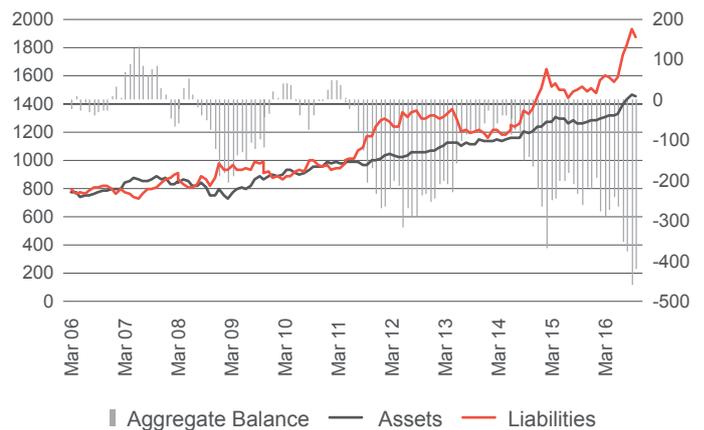
This hysteria may now be more than reflected in equity valuations however, and if bond yields continue to rise then we may already be past the point of maximum pain. In October 2016 IAG announced the results of the British Airways NAPS scheme triennial review, showing that as at March 2015 the pension deficit and cash contributions were broadly similar to the last review in 2012. IAG shares rose 5%² on the day because there was no ‘bad news’ despite the deficit equating to almost a third of the IAG market cap at the time and the data already being some 19 months old!

Additionally, the same PwC index that showed ballooning pension fund deficits in August recovered by \$60bn in the month of October.

Figure 1 illustrates that pension fund asset values have broadly trended steadily upwards over the last 10 years, driven by both asset value appreciation and substantial corporate contributions. Scheme liabilities have been far more volatile and are now around an all-time high suggesting the size of the pension deficit has more to do with the liabilities than the assets.

FIGURE 1: AGGREGATE UK PENSION SCHEMES

Aggregate Schemes

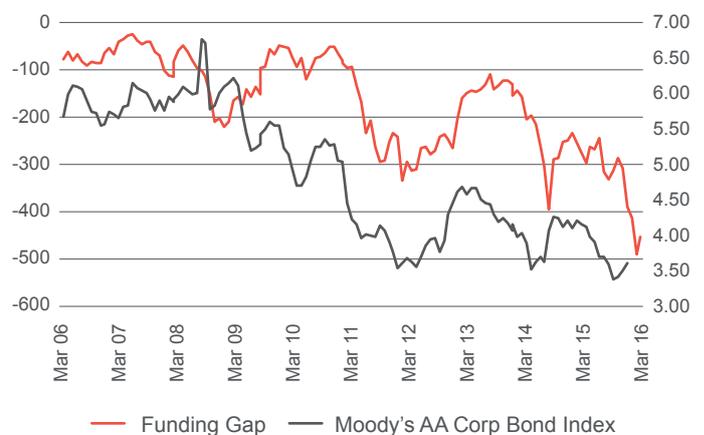


Source: Pension Protection Fund, March 2006 – September 2016.

According to the PPF the combined deficit of underfunded schemes is around £450bn. As can be seen in Figure 2, the size of deficit is strongly influenced by long term bond yields which in turn are at historically low levels.

FIGURE 2: UK PENSION SCHEMES IN DEFICIT

Deficit Schemes



Source: Pension Protection Fund, Bloomberg, March 2006 – September 2016.

1. Source: PPF, correct as at 15 November 2016

2. Source: Bloomberg, as at 26 October 2016

Valuing pension liabilities is an assumption-filled and rather theoretical exercise with no two schemes being the same. Key to all pension liability valuations however is the discount rate at which the future liabilities are returned to a present value. The discount rate used in the annual accounting calculation is based on (although not necessarily equal to) the long dated AA corporate bond yield at the time. Also important is the assumed rate of inflation.

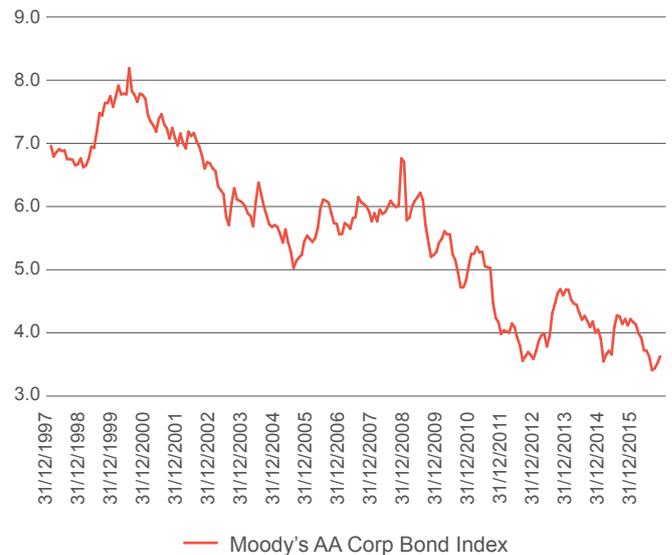
Pension liabilities often have a duration of more than 20 years and are only formally valued every three years via an actuarial review (using a completely different methodology than that used in the annual report). Arguably therefore, we should not be concerning ourselves with semi-annual or quarterly movements in the pension funding position, especially when the underlying assumptions used at a point in time may be far away from what might be considered ‘normal’.

It is generally accepted that equities should be purchased with a long term investment horizon in mind. Pension liabilities should be considered in the same context.

Compared to history, bond yields are now at exceptionally low levels and continued to drop materially to mid-2016. The average pension discount rate across the FTSE 350 was 3.8%³ at the end of 2015 compared to the Moody’s AA Corporate Bond Index’s rate of 4.2%. By June 2016 AA bonds yielded just 3.6% with pension discounts rates moving down in a similar fashion. For example the BAE Systems’ pension fund discount rate dropped from 3.9% in December 2015 to 3.10% in June 2016, and increased the pension deficit from £4.5bn to £6.1bn⁴.

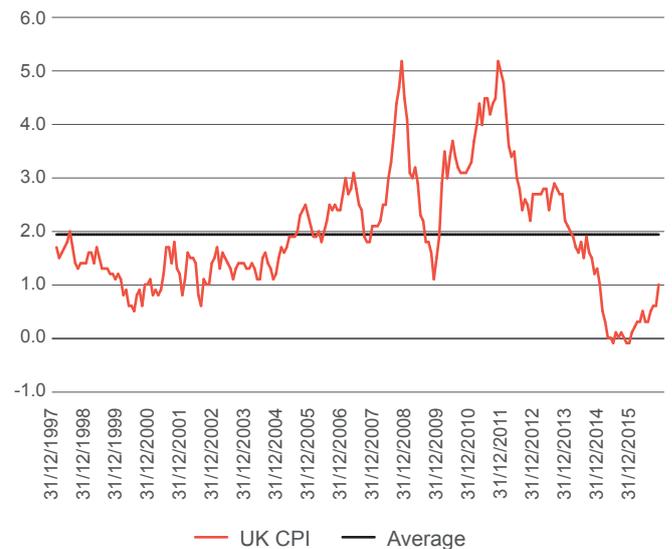
With inflationary forces now picking up in the UK (check out the price of Marmite), it seems that bond yields are more likely to increase than decrease. It is also worth noting that since the Bank of England was made independent in 1997 it has been targeting an inflation rate of 2%. Since then, the average rate is almost exactly 2%. It currently stands at less than 1%.

FIGURE 3: AA BOND YIELDS



Source: Bloomberg, 31 December 1997 – 31 October 2016.

FIGURE 4: UK INFLATION



Source: Bloomberg, 31 December 1997 – 31 October 2016.

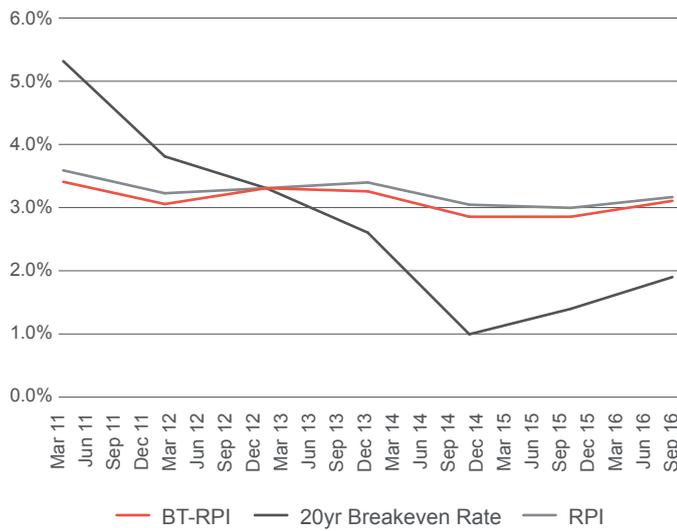
In the UK, inflation assumptions are informed by reference to the difference between the yields on index-linked and fixed-interest long-term government bonds, known as the “breakeven rate”. An important distinction here is between long-term implied inflation expectations and the RPI/CPI data that is widely watched and discussed.

3. Source: Hymans Robertson
4. Source: BAE Systems, PwC, Bloomberg

It's important for two reasons:

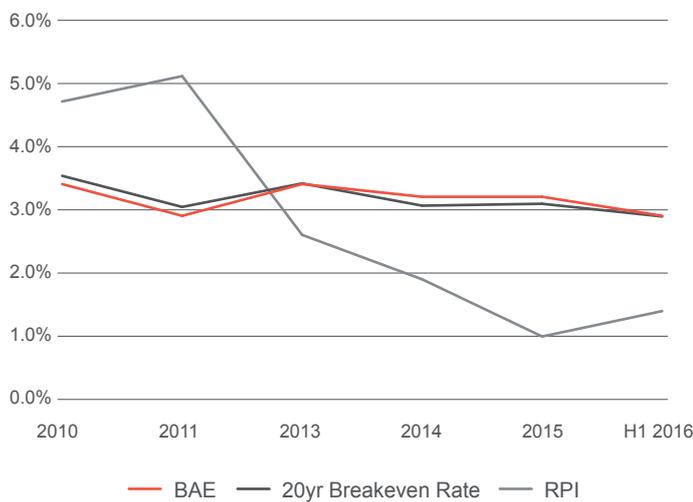
Firstly, as illustrated in figures 5 and 6, headline inflation data have very little influence on pension fund assumptions, whereas the 20-year breakeven rate is a very good proxy.

FIGURE 5: BT PENSION FUND



Source: Company data, Bloomberg, March 2011 – September 2016.

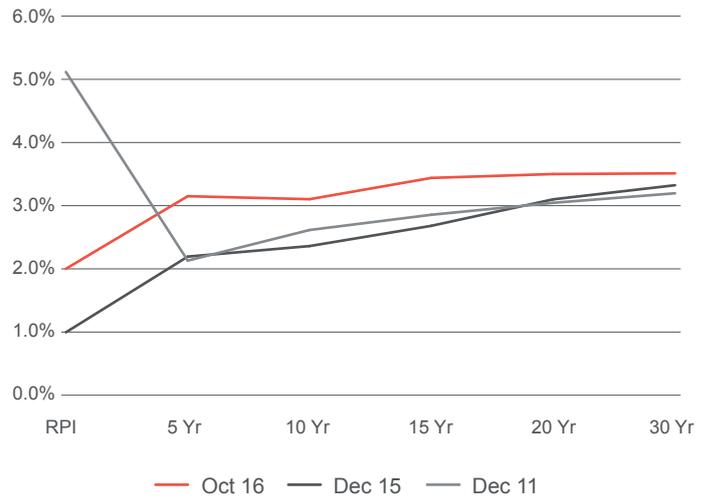
FIGURE 6: BAE PENSION FUND



Source: Company data, Bloomberg, 2010 – H1 2016.

Secondly, the long end of the inflation curve is much more stable than the short end. If we compare the current inflation curve with one from a period of much higher inflation, we see that 20 years out, implied inflation is similar.

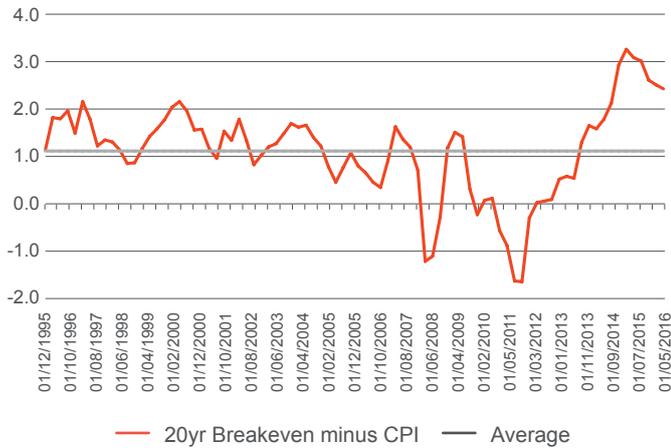
FIGURE 7: UK INFLATION CURVE



Source: Bloomberg, correct as at 31 October 2016.

Therefore a rise in inflation assumptions may not be as pronounced as a rise in headline inflation might suggest. UK RPI is just beginning to rise from historic lows yet the 20-year breakeven rate is around its historic average so the gap between the two measures is historically large. As illustrated in Figure 8, this gap is beginning to close. If this trend continues then the increase in the breakeven rate and therefore the inflation assumption will be more muted than the headline inflation statistics.

FIGURE 8: LONG TERM VS SHORT TERM



Source: Bloomberg, 01 December 1995 – 01 August 2016.

Taken together, the rise in bond yields (even if driven by rising headline inflation), coupled with a more stable set of long term inflation assumptions will lead to higher real yields when calculating pension fund liabilities.

In conclusion, if you believe that bond yields are about to rise from their low levels then there is every chance that the pension deficit issue will evaporate. Instead of concerns over dividend payments, the next round of triennial reviews may see pension top-up requirements reduce or even disappear. In aggregate, FTSE 350 companies contributed £15bn to their pensions in the 12 months to June 2016 (up from £13bn in the prior year).⁵ Without pension deficits this could be returned to shareholders or invested in value enhancing projects. This would be an unequivocal positive for UK equity valuations.

5. Source: Hymans Robertson

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John joined RWC as the founding portfolio manager in 2000. John has over 30 years of investment management experience, working across asset classes and at some of the most prestigious investment management firms in the UK. Prior to joining RWC John was Head of Institutional Business at M&G Investment Management since 1998 where he was responsible for \$6bn of funds under management.

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