Industry Update – 9 June 2017

The immediate impact of the UK general election on trustees of UK defined benefit pension schemes

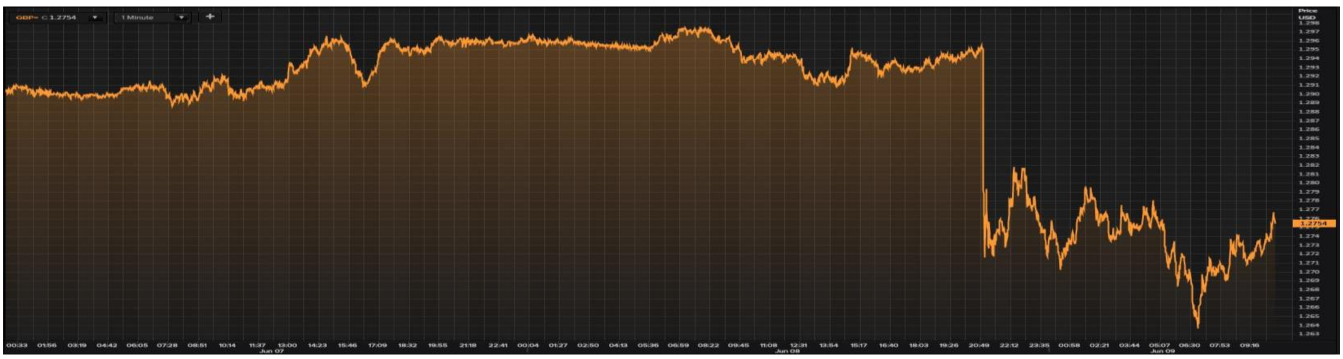
As you will be aware, early this morning it was confirmed that Theresa May's decision to call a snap general election only 7 weeks ago has backfired as the Conservative party has lost its parliamentary majority. The Conservatives remain the largest party and also the most likely party to govern, albeit either as a minority government or through some sort of coalition. There may well be a drift towards some of Labour's policies, for example higher government borrowing to fund more infrastructure spending (which may lead to higher long-dated gilt yields) or the introduction of a financial transaction tax (which could lead to investors favouring funds with a lower turnover of stocks). There will be plenty of speculation in the newspapers and elsewhere over the next few days and weeks on the impact of this election result on Brexit, financial markets and European trade to name but three.

However, from the perspective of a trustee of a UK defined benefit pension scheme, should you take any immediate action in response? With a hung parliament, comes extra uncertainty and financial markets loath uncertainty! Any immediate impact is likely to be from financial markets and the effect these have on your scheme's investment strategy and funding position. However, in due course you may also wish to consider any impact on your scheme's sponsoring employer's covenant, particularly if the parent company is based in Europe or if it is reliant on significant trade with Europe as plans for Brexit slowly become clearer.

Immediate reaction

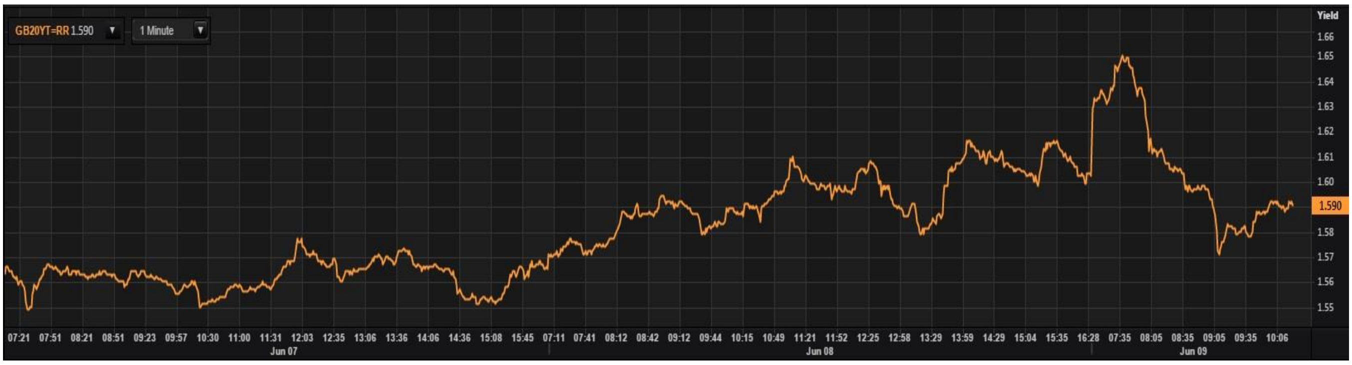
The immediate reaction of financial markets so far has been fairly limited – this is slightly surprising as the consensus was that the financial markets were expecting a larger Conservative majority. We show below the movements of the three key pension scheme risk factors for this week up to 11am UK time today.

£ Sterling/ $ US Dollar , which could impact the UK value of overseas assets and the value of the scheme's deficit in overseas currencies, fell sharply by 2% immediately after the exit poll was published and then stabilised to some extent:



The FTSE100, as an indicator for UK equities, rose sharply when the markets opened but has drifted lower since:

The generic 20 year UK gilt yield, as an indicator for the impact on a scheme's liability value (a higher yield reduces the liability value), is broadly unchanged since yesterday but showing reasonable volatility over what is a very short period:



Despite this fairly muted reaction so far today from financial markets, this may or may not last, and so trustees should check that they remain comfortable with their scheme's investment strategy:

1. **Check your overall investment risk/volatility**: The last year has shown more political uncertainty than in the previous few years. Is it time to reduce the overall investment risk/volatility? If the near future is expected to be more volatile than the recent past then, even if there is no change in the strength of the employer's covenant, a reduction in the overall investment risk may still be justified.

2. **Check your individual investment risk exposures**: Are the trustees still comfortable that they are diversified across both risk factors (eg equities, interest rates, inflation expectations, overseas currencies etc) and within asset classes (eg multiple diversified growth funds for significant allocations)? Liability Driven Investment and diversified growth funds are two key options which can help to mitigate and diversify these risks whilst still being relatively low governance for the trustees.

   Also check the nature of the scheme's protection assets. There may be some hidden basis risk (ie the LDI/bonds do not move exactly in line with the liability value). This may be acceptable from a governance perspective and to avoid spurious accuracy, but the trustees should be aware of it. If the protection assets were put in place some time ago then there are probably better options now available.

3. **Check your cash flow requirements**: Trustees may wish to revisit their cash flow policy if the default is to use a volatile asset class (eg equities) or assets which could quickly become illiquid or incur high transaction costs under stressful market conditions (eg property or corporate bonds). This is particularly the case on some schemes which have seen an increase in Cash Equivalent Transfer Values being taken by members.

4. **Check your ability to act quickly if neede**d: There is no one size fits all, but some of the ways we are helping our clients to be able to react quicker if needed (but not knee-jerk reactions and following considered investment advice) are: holding the assets on an execution only investment platform, implementing asset switching triggers to take advantage of short term opportunities, creating an investment sub-committee for quicker decision-making, ensuring there is a robust default cash flow policy in place, and discussing in advance how the asset allocation should change over time.

5. **Regularly monitoring your investment strategy helps you to better understand your investment strategy:** Many schemes review how their fund managers have performed against their benchmark, but this impact is usually negligible in the context of the strategic decisions made by the trustees (eg asset allocation and protection against changes in interest rates and inflation). Good monitoring is about being focused as well as doing it regularly.

6. **Remember to be strategic**: Even without these surprise events it is near impossible for the vast majority of trustees to successfully time financial markets. We encourage trustees to take a strategic approach and to delegate short-term market timing decisions (for example, tactical asset allocation changes to their diversified growth manager or monitoring strategic asset switching triggers). Therefore, do not take any knee-jerk decisions, speak to your investment consultant, and always consider your options in the context of your strategic objectives.

Please speak to Sam Roberts, Head of Investment Consulting (07917 897 460), or your usual Cartwright contact to discuss any of these issues further in the context of your scheme.

Source for graphs: Thomson Reuters (Tuesday 7 June to Thursday 9 June 11am)

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