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Industry Update

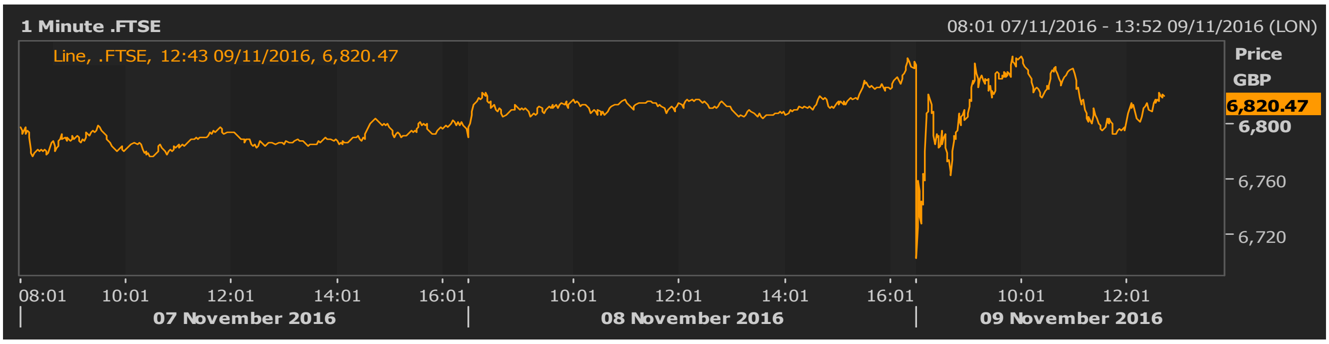
The immediate impact of the US presidential election result on trustees of UK defined benefit pension schemes

As you will be aware, early this morning it was confirmed that Donald Trump will become the next US President, with effect from January 2017. There will be plenty of speculation in the newspapers and elsewhere over coming months and years on the impact of this election result on global security, global financial markets and global trade to name but three.

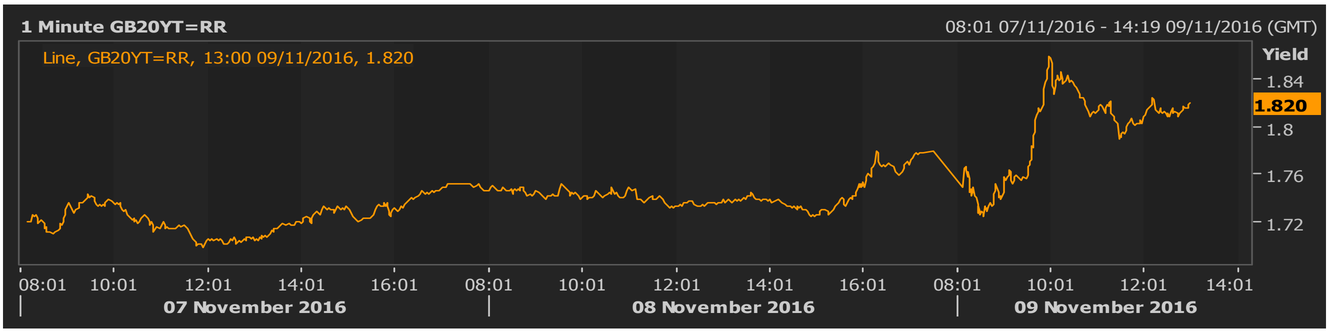
However, from the perspective of a trustee of a UK defined benefit pension scheme, should you take any immediate action in response? Any immediate impact is likely to be from financial markets and the effect these have on your scheme's investment strategy and funding position. However, in due course you may also wish to consider any impact on your scheme's sponsoring employer's covenant if the parent company is based in the US, or if it is reliant on significant trade with the US (although it would likely be prudent to wait for some specific announcements from Trump in the first instance).

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 Clinton victory. We show below the movements of the three key pension scheme risk factors for this week up to about 1pm UK time today.

The FTSE100, as an indicator for UK equities, fell 2% before recovering:



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), rose and slightly fell with the overall impact today so far being a c1% fall in the liability value:



£ Sterling/US$, which could impact the UK value of overseas assets and the value of the scheme's deficit in overseas currencies, strengthened by 1% before falling back:

Source for charts: Thomson Reuters

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 world now appears a politically more uncertain place than it has in the past few years, with the results of the UK's EU Referendum and the US presidential election being the two stand-out surprising political events this year. The Italian constitutional referendum on 4 December 2016 is another "known unknown" and could lead to a further surprise with potential adverse implications for the eurozone.
2. 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.
3. 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 etc) and within asset classes (eg multiple diversified growth funds for significant allocations)? Liability Driven Investment and diversified growth funds are two options which can help to mitigate and diversify these risks whilst still being relatively low governance for the trustees.
4. 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.

5. 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).
6. Check your ability to act quickly if needed: 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, 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.
7. 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.
8. 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). 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.
9. 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.

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