

# BBS investment update

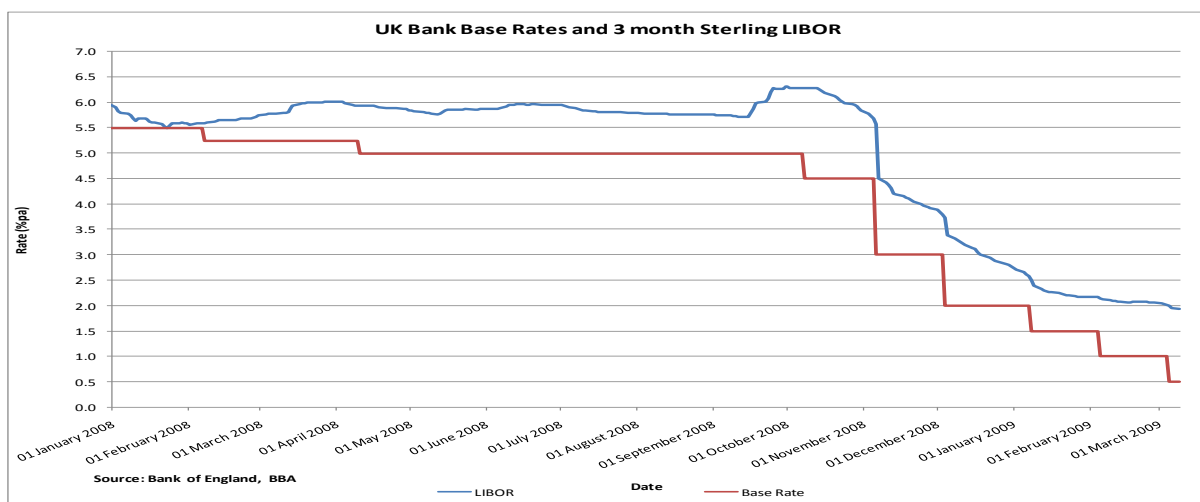
## Quantitative Easing

### Bank Base Rate Cuts

The fall-out from the global economic crisis has seen a succession of cuts to the UK Bank Base Rate over recent months. At their March meeting, the Monetary Policy Committee (MPC) agreed to make a further cut of 0.5%, so that the Bank Base Rate now stands at 0.5%.

In order to stimulate the amount of lending and economic activity, the normal approach for central banks is to cut interest rates. By cutting interest rates, businesses and individuals are encouraged to spend rather than save, but the impact of interest rate cuts usually takes some months to feed through to the economy as a whole.

The Bank of England has now cut the Base Rate from 5.0% at the beginning of October 2008 to an historic low of 0.5% in March 2009, so that there is almost no scope for further cuts to the Base Rate. The chart below shows the UK Bank Base Rate against the 3-month London Inter Bank Offer Rate (LIBOR) and suggests that the cuts to the Bank Base Rate over recent months have had a limited effect on the rate at which banks lend to each other and, by implication, to the business community.



As a result, the Bank of England has now decided that the money supply must be increased by 'creating money out of thin air'. This process is known as 'quantitative easing'.

### Asset Purchase Programme

At the time that the Base Rate cut was announced last week, the Bank of England announced that it was introducing an immediate programme of asset purchases of £75 billion financed by the issuance of central bank reserves. The Bank of England will be buying assets such as UK Government bonds (gilts) from financial institutions, for example commercial banks. The sellers will be credited with 'new' money in their reserves which should, in theory, be used to boost the money supply.

Economists expect the supply of 'new' money to stimulate the economy in two ways:

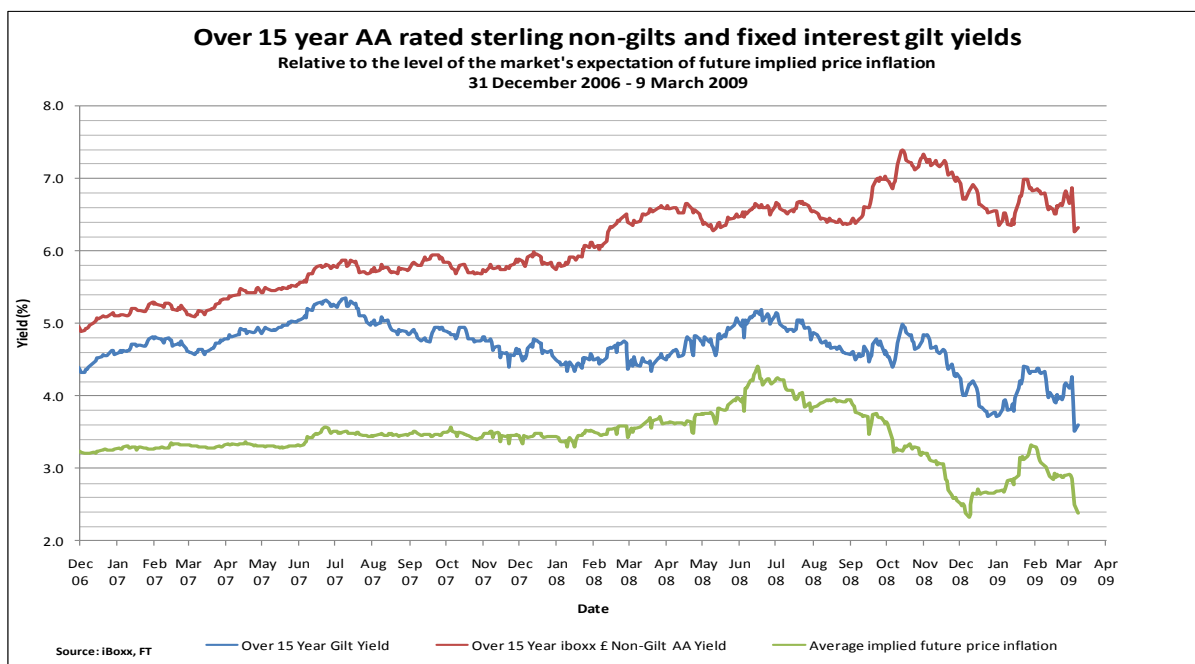
- As the commercial banks have more money in their reserves, the Bank of England hopes that this money will be used for lending to businesses and individuals and that economic activity will be kick-started.



## BBS investment update (continued)

- By buying gilts, the supply of available gilts is reduced and gilt prices should be expected to rise. As gilt prices rise, gilt yields fall thus making it cheaper for businesses to borrow over the medium and longer-term by issuing debt (the rates at which businesses can borrow are often linked to gilt yields).

The chart below shows the impact of the Bank's announcement about the quantitative easing programme. Gilt and bond yields both fell sharply on Thursday 5<sup>th</sup> and Friday 6<sup>th</sup> March, although yields have stabilised since the weekend.



The first asset purchase took place on Wednesday 11 March 2009, with the Bank of England offering to buy £2 billion of gilts with terms to maturity of between five and ten years. Further purchases are expected to take place on Monday and Wednesday each week over the coming months.

### Price Inflation

During 2008, there was a sharp increase in the level of price inflation, fuelled by rises in commodity prices. As commodity prices started to fall in the second half of the year, price inflation also fell. Inflation measured by the Consumer Prices Index (CPI) fell from its high point of 5.2% per annum in September 2008 to 3% per annum in January 2009. Inflation measured by the Retail Prices Index (RPI) also fell to just 0.1% per annum in January, the lowest level for the RPI since 1960.

It should be noted that the current level of CPI inflation remains outside the Government's stated target objective of 2% per annum. The Bank of England delayed cutting interest rates last year over concerns about inflationary pressures in the economy, but the Bank currently expects CPI inflation to drop to 0.5% per annum this year and that CPI inflation will then remain below its 2% per annum target for two years.

The falls in commodity prices and consumer and business spending mean that price inflation may well become negative this year ('deflation'). In the short-term, this may provide a boost to the economy by increasing consumers' purchasing power, but in the longer term it can cause serious economic problems. This is because consumers postpone spending as prices fall (the same item will cost less in the future), which reduces economic activity.



## BBS investment update (continued)

If the economy does experience deflation, RPI inflation seems likely to become negative first. This will be an item of interest when the inflation figures are released over the next few months.

By agreeing to a programme of quantitative easing, the Bank of England is increasing the money supply at a time when interest rates are at an historic low. If too much money is injected into the economy, and consumer and business spending does take off in due course, there is a significant risk that price inflation will then start to rise again in the future.

Rising price inflation can be countered by increasing interest rates, but the impact of interest rate rises will take time to feed through into the economy and bring price inflation under control. In the short term, the current deflationary environment suggests that price inflation appears unlikely to rise significantly in 2009. However, economists believe that price inflation is more likely to rise in 2010/2011.

The counter points of view for either an ongoing deflationary environment or rising price inflation caused by the quantitative easing programme are, of course, a matter of differing opinions.

### **Funding implications for pension schemes**

For many pension schemes, the starting point for their actuarial valuation will be the 'risk-free' rate of return available on suitable long-dated fixed interest gilt yields. As a consequence of gilt yields falling to their current levels, the value placed on the pension scheme liabilities is likely to have increased for many pension schemes. There may be additional consequences for liability valuations if the assumed level of future price inflation needs to be increased in due course.

There is also ongoing discussion about whether corporate bond yields remain an appropriate measure for actuarial valuations carried out for disclosure within company accounts and whether a gilts based accounting standard might be more suitable. However, changes to the accounting standards would appear unlikely in the short-term.

In addition, for the typical UK defined benefit pension scheme with exposure to UK and overseas equity markets, the value of the assets is also likely to have fallen significantly during 2008 and early 2009.

For schemes where the funding level has fallen substantially, there is likely to be pressure on sponsoring employers to increase the level of employer contribution to meet the funding shortfall. It remains to be seen what pressure, if any, will be applied by the Regulator, especially in cases where the employer covenant may have been weakened in the current market downturn.

One unexpected consequence of the quantitative easing programme may be that businesses that receive finance from the banks then come under pressure to use some of these funds to plug holes in their pension arrangements.

### **Investment implications for pension schemes**

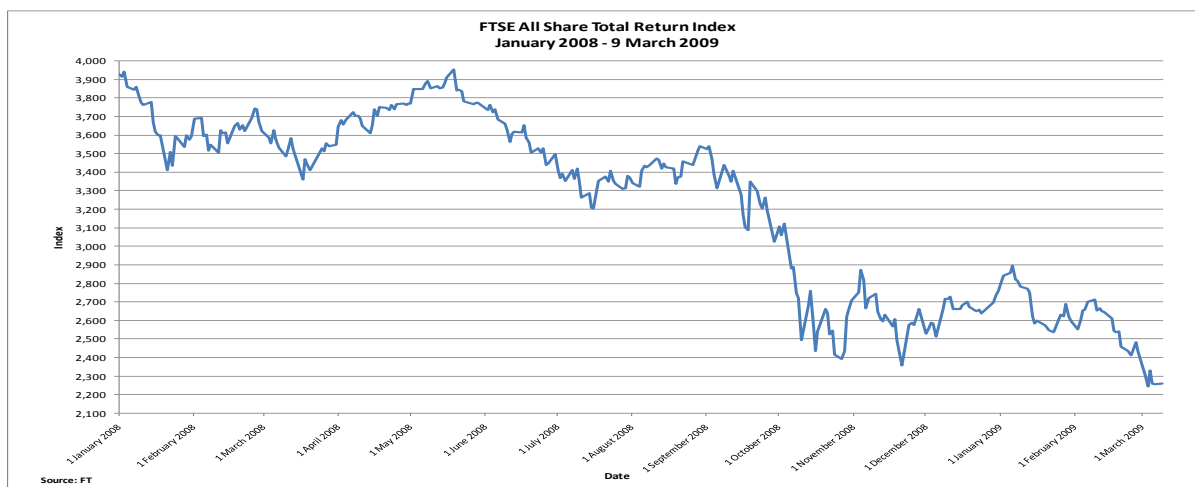
In our October 2008 Investment Update, we noted that pension scheme trustees remained long-term investors and are able to take a long-term view when setting their funding and investment objectives, subject to the continued long-term support of the sponsoring employer.

For schemes investing in equities, the UK equity market (as measured by the FTSE All-Share Index) has fallen roughly 14% in the year to date (12 March 2009) and 41% since 1 July 2007, just before the first signs of the credit crunch were highlighted by the demise of Northern Rock.



## BBS investment update (continued)

The chart below shows the falls in the FTSE All-Share Index since 1 January 2008.



At this time, it is extremely difficult for trustees to make informed judgements about setting a long-term investment strategy in the light of an economic background changing on an almost daily basis. In early 2007, it would have been almost impossible to imagine such a scenario within the UK economy where several leading banks have effectively been taken into state ownership, Bank Base Rates cut to a 300 year low, and the Bank of England 'printing money'.

As such, we would generally caution trustees and sponsoring employers about making significant changes to their investment strategy until the economic situation becomes clearer. When considering the performance of their managers, we would also generally advise trustees not to place too much emphasis on short-term performance (both good and bad) although a manager review may be appropriate if there has been a sustained period of underperformance in both benign and volatile market conditions.

One further consideration for pension schemes may be whether increasing asset allocations to fixed interest at the current yields is a prudent long-term investment decision. For any schemes considering a Liability Driven Investment (LDI) strategy involving interest rate swap contracts, we would also question the timing involved in implementing such a strategy, although we remain mindful that while gilt yields are currently at historic lows, they may still fall further!

### Annuities

The sharp falls in long-dated gilt yields will have a significant impact for members of defined contribution pension schemes reaching retirement and for members who have paid Additional Voluntary Contributions (AVCs) and now need to secure a pension by buying an annuity.

It appears likely that the falls in gilt yields will also result in falling annuity rates, and members will therefore receive a lower pension than they may have expected. Trustees may therefore wish to review the options for purchasing annuities on behalf of members to ensure that annuities are secured on reasonable terms.

If you have any immediate concerns about the implications for your pension scheme, please speak to your usual BBS Consultant.

**BBS Consultants & Actuaries LLP**  
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