Blame it on the bonds

KERRIN ROSENBERG LOOKS AT HOW PENSIONS HAVE GOT INTO SUCH A MESS.

The average UK final salary pension fund has seen a 45% fall in the value of its assets compared with its liabilities over the past decade. It's a truly shocking statistic, especially when one considers that the combined assets of UK pension funds are in excess of £1 trillion.

Over the next four months we will look at how we got into this mess and what should be done going forward. In this first article we look at what's responsible for getting us here.

True, equity markets have disappointed, particularly relative to the inflation-adjusted returns of 5% a year that most actuaries expect. In addition, unanticipated improvement in life expectancy hasn't helped, although it's had less of an impact than many think.

However, the real culprit is declining bond yields. Over the past decade, long-dated real yields have fallen from 2.3% to -0.2%. This alone has caused the value of liabilities to increase by around 50%.

The impact on funding levels over the past decade has been as follows:

- declining real yields: –23%
- disappointing equity returns: –14%
- longevity surprises: –8%
- total: –45%

Yet many deny the relevance of bond yields. The liabilities of the pension fund are the payments it needs to make over the next 70 years. What difference do yields make? Since the amounts that will need to be paid are not affected by yields being 5% or 3%, in what way is the fund worse off if yields fall?

Purists respond that pension liabilities are a "bond-like" stream of inflation-linked cashflows and the best way to value them is with reference to long-dated index-linked bond yields.

A more intuitive argument is simply that when the 30-year gilt yields 3% (as it does now), this is, in large part, a reflection of a very gloomy outlook for economic growth. It makes sense to assume that the fund's assets will produce lower returns and probably cover only a lower proportion of the liabilities going forward.

But whatever one's philosophical perspective, one thing is clear – marking to market of liabilities is here to stay and bond yields will continue to affect the asset/liability ratio as far as accounting standards and funding valuations are concerned.

History shows that you ignore this at your peril.

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