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Introduction



Welcome to the latest edition of our Pensions Briefing, my third as head of Chantrey Vellacott DFK's Pensions Group. These are brought to you to provide an update on issues facing pension Trustees and their advisors. My thanks to each of the contributors and especially to our guest writer.

In this edition Catherine Growney from HSBC Actuaries and Consultants puts forward the case for diversification in pension fund investments. Bob Lancefield talks about the changes proposed by SORP 2007. Last but not least, Kevin Murphy considers whether the Trustees of Pension funds should be vigilant in monitoring the covenants of sponsoring employers bearing in

mind the current economic climate in the UK.

We would welcome comments or suggestions you may have about the content of this briefing.

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SORP 2007



A revised Statement Of Recommended Practice (SORP) for pension scheme financial statements was issued in May 2007. This SORP is applicable to all pension schemes giving a true and fair view in their financial statements and is compulsory for all accounting periods commencing on or after 6 April 2007 and early adoption is recommended. Therefore, a scheme with a 31 March year end is not required to implement the SORP until 31 March 2009 but should seriously consider adopting the SORP for 31 March 2008.

At first glance, the SORP may look very similar to the one we have been using for the last ten years or so, however, there are a number of significant changes which should be considered.

Under contributions, the previous categories of special and additional contributions are now replaced with augmentation, deficit funding and other.

The SORP does not require the inclusion of long term pension liabilities but does require that the note stating that these liabilities are excluded is moved from the accounting policies to a separate statement under the net assets statements.

The SORP, in accordance with recommended United Kingdom Accounting Practice forbids the off-set of assets and liabilities and income and expenditure. As a result, if annuities have been purchased for part of an individual's pension then the income from those annuities should now be shown in investment income and the pension recorded in full.

Perhaps the biggest impact for most schemes will be in the valuation of their investments. Investments are still to be carried at market values, however, for traded investments, market value is now defined as being the bid value rather than the mid-market value previously adopted. It is estimated that the impact of this change would not be material to pension schemes, therefore, the statement does not require a prior year adjustment to be made for this change in the basis of valuation.

If the pension scheme has invested in derivatives or other financial instruments, these are also valued at market value and there are extensive commentaries on how these values are to be both estimated and how the investments are to be disclosed. As the guidance becomes available and there is some use in practice, this will be the subject of future commentary.

As to the future, the statement addresses the financial statements included in a scheme's annual report and it is the responsibility of the Pensions Regulator to suggest revisions to both the format and content of the trustee and investment reports. I suspect we shall see these in the not too distant future.

There is still considerable debate as to whether the long term pension liabilities should be included in the financial statements. The new statement has come firmly against their inclusion although a note is required to the extent of the long term liabilities and hence surplus or deficit within the scheme.

All UK accounting practice is in the process of converging with International Financial Reporting Standards, at present the SORP is under-pinned by United Kingdom Financial Reporting Standards. Therefore we would expect there to be a future revision to bring it in line with international practice. The good news is that this is estimated to be in ten to twelve years time.

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Variety is the Spice of Life - Diversification in Pension Fund Investment

The choice of investment within pension schemes typically has one (or both) of two objectives.

- Firstly, to achieve as high a return or growth as possible.
- Secondly, to reduce volatility or risk, and this should be considered relative to the liabilities.

The second typically lends itself to assets that have sensitivity to long term interest rates or to assets that have low absolute volatility.

Historically, pension schemes have primarily chosen to invest in equities for the growth portion of their assets. However, for a number of reasons HSBC Actuaries and Consultants Limited (HACL), believes that Trustees should create a more diversified portfolio of growth assets. This concept we have called a Diversified Growth Fund (DGF).

Why invest in a diversified portfolio of growth assets?

Changes in legislation and accounting standards mean that equities are no longer a formal reference asset for scheme liabilities. In contrast, the ongoing valuation basis that in most cases drives funding decisions is typically derived from bond yields, with risk premiums where appropriate. In addition to this development, sponsoring employers are increasingly aware of the volatility created by the introduction of balance sheet accounting of pension liabilities from 2005. Finally, there is an increasing recognition that an equity focussed strategy results in a concentration of risk that can be damaging when equity markets fall, such as seen during the 2000 to 2003 bear market.

The natural reaction to these developments is for schemes to invest a greater proportion in bond type assets. Whilst this may be appropriate to protect against the impact that changes in interest rates have on liabilities, bonds are expensive; there is still a need for many schemes to invest in higher return seeking assets, often to try and use the higher returns such assets seek to generate to reduce a deficit that the scheme may be facing.

Investment in global equities, a higher return seeking asset class commonly used by pension schemes, can often lead to funding level volatility as market movements impact on market values of assets. We strongly believe that Trustees should consider the concept of Diversified Growth as a method of achieving equity type returns with the prospect of lower volatility.

Diversified Growth means holding a broad spread of loosely correlated investment classes. In isolation each has a growth expectation but they have exhibited far lower correlation with the quoted equity market. The result is a more stable return pattern.

The HSBC Investment Consultancy Team have been working with the fund management industry over recent years to bring this concept to market in both a pooled and segregated format. It has been well received by the managers, and there have been several funds already launched, with more "going live" with each quarter that passes.

However, while the concept is relatively new to the UK it has been followed for many years by some leading institutions overseas. There

is also evidence to suggest that pension schemes are becoming more interested in investing in alternative asset classes as they seek to benefit from the better risk/return profile such asset classes offer.

Components of Diversified Growth

Below is a sample asset allocation. Although the individual components will differ from fund to fund, and manager to manager, several key drivers are common.

Firstly, any asset class included must be at a reasonable weighting (i.e. 10% or more) in order to have a noticeable impact.

Secondly, we have looked to include asset classes that offer: expected returns at a level similar to the quoted equities that they will typically replace; as low correlation with equities and each other as possible; a broad link to inflation or economic growth; and an established track record.

Finally, we needed asset classes that are available to institutional investors on a pooled basis from a range of investment managers, so that they are investable.

The precise asset allocation and weightings that are used are ultimately at the discretion of the individual fund manager(s), and we would expect some investment managers to adopt a Tactical Asset Allocation approach, i.e. changing the mix to reflect their views on the different markets at any given time.

Discussions with Scheme Actuaries

The input of Scheme Actuaries is vital, as they are required to



comment on investment strategy, and will take investment strategy into account when setting assumptions. The consensus opinion that is prevalent from our discussions with our own actuaries and the Scheme Actuaries working with our clients is that the DGF structure can be viewed in a similar way to equities in terms of expected return. The asset classes should each attract a risk premium over time and the various market cycles should ensure that risk is reduced.

From an Actuarial Valuation perspective therefore, any switch into a DGF product is unlikely to have an adverse effect on the discount rate that a Scheme Actuary will apply to the product, relative to that assigned to traditional equity holdings, however it is important to confirm this position before investing to avoid any unintended consequences.

The Market - Accessing Diversified Growth

There are four options as to how to access Diversified Growth, with increasing need for Trustee involvement, close management and scheme size;

- Pooled products with a single investment manager determining asset allocation, wrapped into one fund.
- Pooled products individually selected by the Trustees with the allocation between them managed by the Trustees.
- A segregated fund under one investment manager that is responsible for managing the asset allocation.

- Segregated funds individually mandated by the Trustees with the allocation between them managed by the Trustees.

For many pension schemes we believe that a single pooled provider is preferable to a multi-manager strategy (i.e. the first approach).

Many of the managers we have held discussions with have, or are planning to, launch a pooled fund offering for their DGF product - meaning clients with only a limited amount of assets can still access such funds.

To offer a DGF product an investment manager needs to have experience of managing a breadth of alternative asset classes or have access to third party guest funds. However, we would normally only expect a manager to access one, or possibly two, guest asset classes. Given the practicalities involved in managing a DGF product the managers involved in the development of the product have tended to be the larger investment houses. Additionally, if the manager is intending to provide Tactical Asset Allocation, it is important that they are also skilled in this area. This is particularly important as asset allocation can have a significant impact on returns.

The HSBC Investment Consultancy Team is committed to working with the industry to drive through the development of a number of other funds/products, and in addition to the number of pooled diversified growth funds currently in the market, certain investment houses would have a suitable range of funds that could be combined to achieve a Diversified Growth approach, albeit

without the convenience of a single pooled fund umbrella. Furthermore, a bespoke arrangement using various different managers remains an option.

Conclusion

There is both a theoretical and empirical case for the Diversified Growth approach. Any examination of the more forward thinking pension and endowment funds in North America and on Continental Europe shows that they are also moving in this direction for many of the reasons advocated in this paper.

The lower volatility of such an approach has galvanised support from Scheme Actuaries within HSBC especially in the new regime of Scheme Specific Funding.

The shift from equities to bonds is welcomed for the purposes of achieving a similar sensitivity to yields within the assets as exists for the liabilities, but not for long term growth. A move from equities to other growth assets for many schemes should therefore be contemplated because they can deliver the equity type growth required by the scheme (and assumed by the actuary) but without the damaging peaks and troughs along the way.

Diversified Growth is a genuine alternative to Global Equities and we believe it should be embraced in a disciplined framework and form part of a scheme's overall investment strategy.

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Ongoing Covenant Monitoring



Given the uncertain outlook for UK business, combined with the ongoing effect of the credit crunch, Trustees of Pension funds should be vigilant in monitoring the covenants of sponsoring employers in order to get early warning of any signs of distress.

Where Trustees are already familiar with the strength of the covenant, and with the various risks facing the employer, it may well be appropriate for Trustees to request an update via a presentation from senior management. Whilst the content of the presentation will vary depending upon the individual circumstances of the employer, it will generally cover matters such as:

- Recent trading performance (and comparisons to previous forecasts)
- Ongoing forecast profits and cashflows
- Balance sheet strength
- Sector analysis

- SWOT analysis (strengths, weaknesses, opportunities, threats)
- Changes in credit rating / D&B score
- Banking covenants / availability of debt funding

Where the presentation raises concerns, or where Trustees are not yet sufficiently familiar with the covenant, Trustees should consider commissioning independent expert assistance to advise on the covenant and on the options open to protect the Scheme.

Clearly, once an employer becomes financially distressed, the options are usually more limited. By this stage, cash will usually be tight, and major assets (such as freehold property) may have been already pledged as security to lenders. Therefore the earlier Trustees identify a potential problem, the better the prospects of finding a solution which protects the Scheme.

Ongoing monitoring will also assist trustees in considering possible Type A events. Under the new guidance from The Pensions Regulator, Trustees are required to assess whether detrimental events are 'materially detrimental' to the covenant of the employer. Where there are signs that the employer's covenant has weakened, the proportion of events which are materially detrimental is likely to rise.

We have advised a number of schemes on setting up systems for ongoing covenant monitoring, and in addition provide a 'helpline' facility to deal with day-to-day queries regarding the covenant. For further information please do not hesitate to contact:

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This newsletter has been written for the general interest of our clients and contacts. It is essential to take advice on specific issues. We believe that the facts are correct as at June 2008 but there may be certain errors or omissions for which we cannot be held responsible.

The opinions expressed in guest articles are those of the respective contributors and their firms. We believe that these should be of interest to our clients and contacts but the articles do not necessarily represent the views of Chantrey Vellacott DFK LLP.

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