Pensions feel the risks of “de-risking”

By Editor Test   *Wed, Sep 7, 2011*

In July, the combined funding deficits of the 100 largest U.S. DB plans rose by $68 billion, to $254 billion, said Reuters, citing the Milliman Pension Fund Index.

Falling equities prices and tumbling bond yields continue to hurt the viability of pension funds in major industrialized economies, with potentially dire impact on the ability of members of the world’s Baby Boom generation to retire on time and with adequate incomes, Reuters reported.

As pension plans in the U.S., the euro zone, Japan and the UK “de-risk,” they implicitly reduce their long-term rate of returns and raise their need for fresh funds—funds that might otherwise be invested in business expansion. Overall, the shift from equities to bonds by pension fund managers has driven down stock prices and fixed income yields.

The global pension industry controls about $35 trillion, or about one-third of global financial assets. But funding deficits have been growing.

“We had a credit crisis and government bond crisis, and [now we have] the pension crisis. Everything is going wrong and there’s no obvious way out,” said Kevin Wesbroom, UK head of global risk services at consultancy Aon Hewitt. “Liabilities are going up because, in the flight to quality, everyone gets out of equities and runs for cover in safe assets like government bonds. And yields are falling.”

In the United States, funding deficits of the 100 largest DB plans rose by $68 billion to $254 billion in July, according to the Milliman Pension Fund Index.

Even if DB sponsors in developed countries were to achieve an 8% return and keep the current benchmark yield of 5.12%, their funding status would improve only to 93% by end-2013, from the current 83%.

Aon Hewitt estimates deficits of DB pension plans for FTSE 350 companies rose £20 billion in the month of August to a 2011 high of £58 billion. Their funding ratio stands at 89.8%, down from 94.1% three years ago.

In Europe, the benchmark double-A rated corporate bond yield fell to 3.55% from more than 6% in the past three years, according to Barclays Capital. A 50-basis point drop in the discount rate roughly results in a 10% increase in pension liabilities.

“Trustees do want to de-risk but financial directors have an irrational desire to have equities. They are too wedded to equity markets,” said Pat Race, senior partner at investment consultancy Mercer. “You still have massive uncertainties with a potential for another dip into recession. I don’t see any reversion to days when equities are a dominant part of DB plans.”

Pension funds and insurance companies in the U.S., the euro zone, Japan and UK bought $173 billion of bonds in the first quarter, boosting their bond buying for the third quarter in a row, according to JP Morgan. At the same time, they cut equity buying for a fifth quarter in a row, selling $22 billion of stocks in Q1.

In Europe, pension funds reduced equity allocations to an average of 31% in 2011 from 43.8% in 2006, while fixed income holdings rose to 54% from 47.8% in the same period, according to Mercer.