Pan European Research

Accounting and valuation research

CAZENOVE

Sponsors controlling longevity - the equity market view

Association of Consulting Actuaries sessional meeting - 26th June 2008

Peter Elwin
Head of accounting and valuation research
+44 (0)20 7155 6404 peter.elwin@cazenove.com

20 Moorgate London EC2R 6DA Telephone +44 (0) 20 7155 5000 www.cazenove.com

Registered Office 20 Moorgate London EC2R 6DA
Registered in England and Wales No 4153386 Authorised and regulated by the Financial Services Authority and a member of the London Stock Exchange

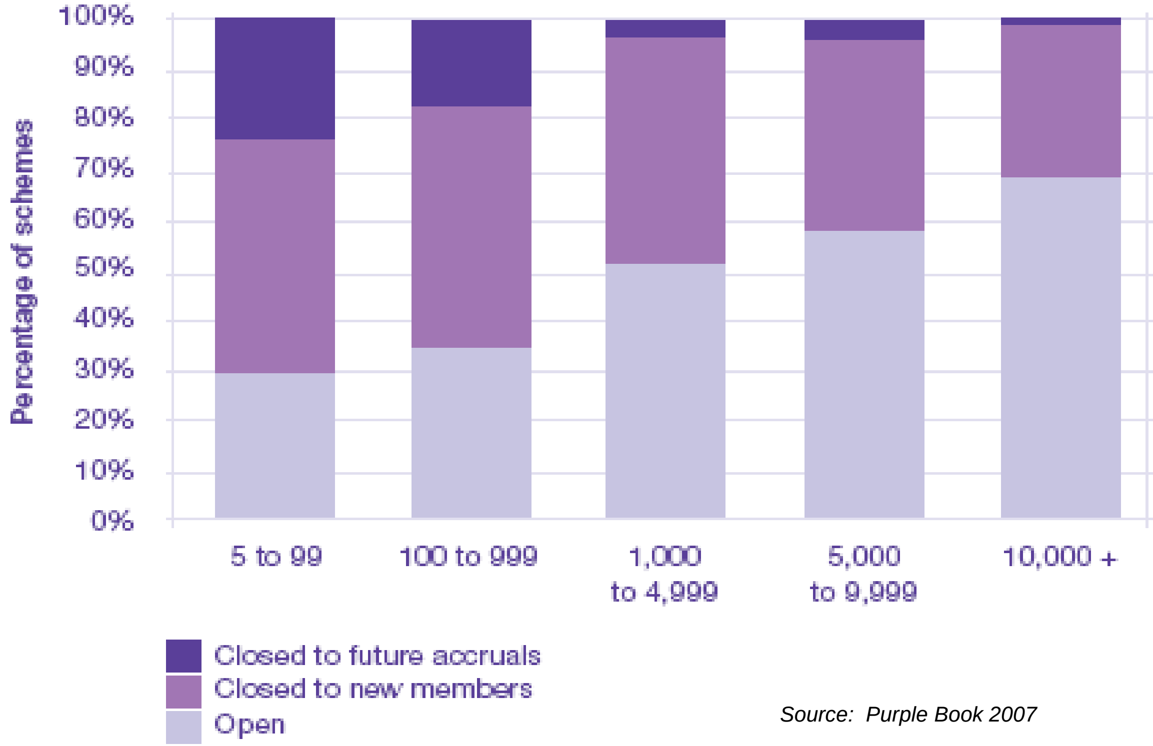
Pensions - no longer an HR issue?

2008 NAPF survey - 31% of schemes are open to new members, 95% are open to new accruals

Pensions Regulator Purple Book 2007 - 63% of total scheme population belong to open schemes

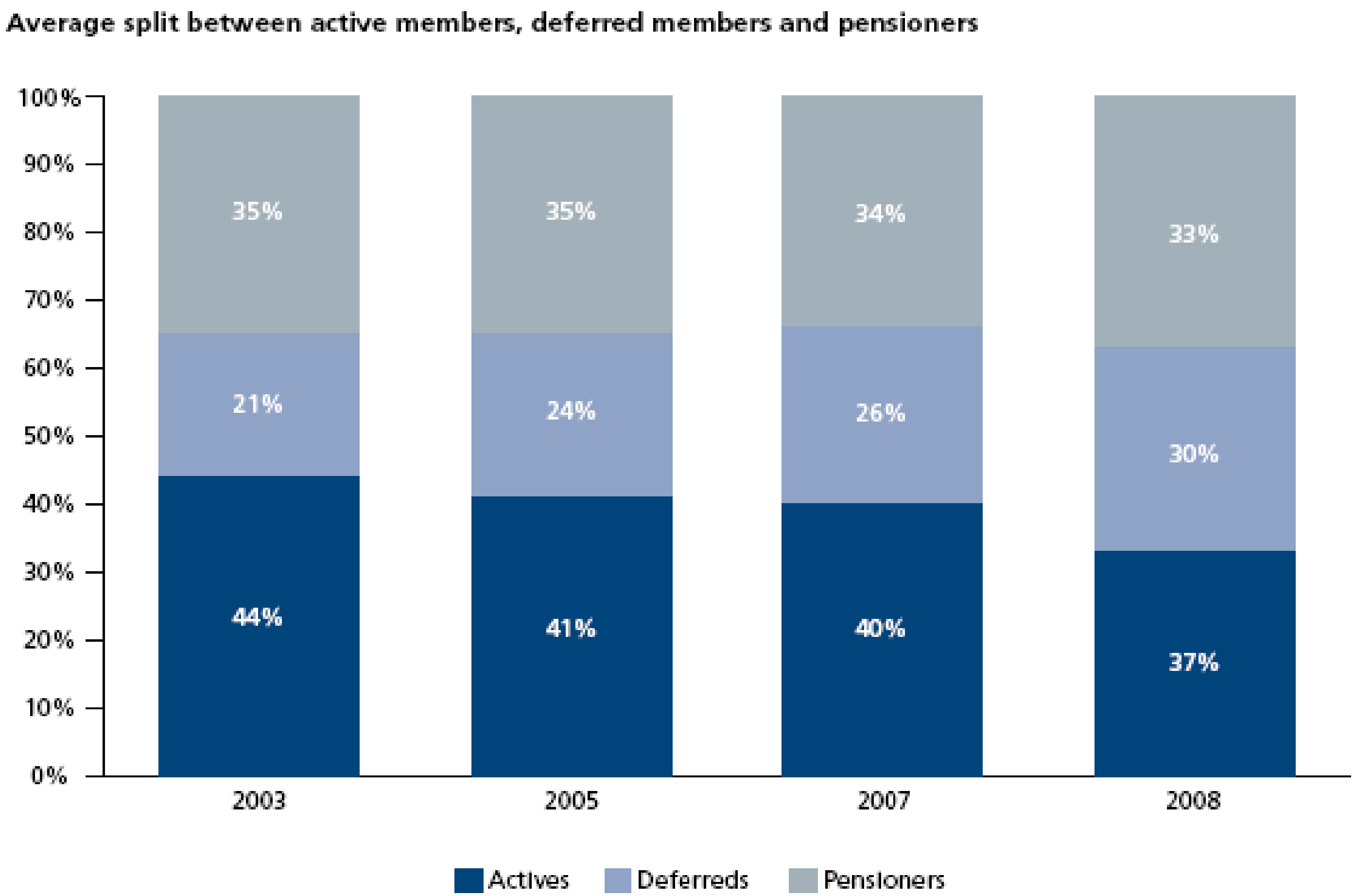
i.e. Larger schemes remain open, smaller schemes have closed

Percentage distribution of scheme status by scheme size (Purple 2007)



Source: Purple Book 2007

The number of Active members is declining (slowly)



Change over 5 years

(03 to 08)

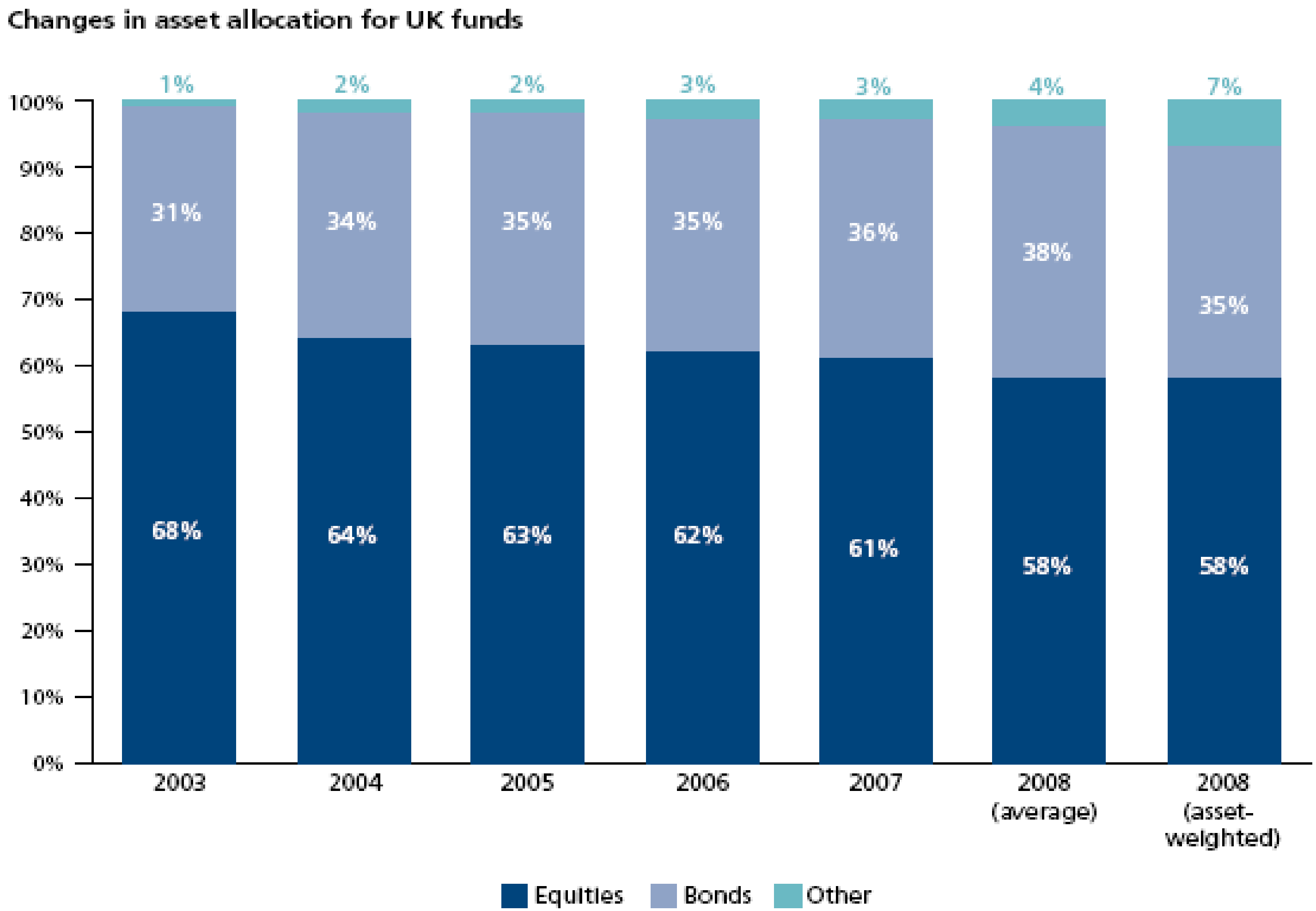
-2%

+9%

-7%

Source: Mercer Asset Allocation Survey 2008

Asset allocation - shifting away from equities (slowly)



Change over 5 years

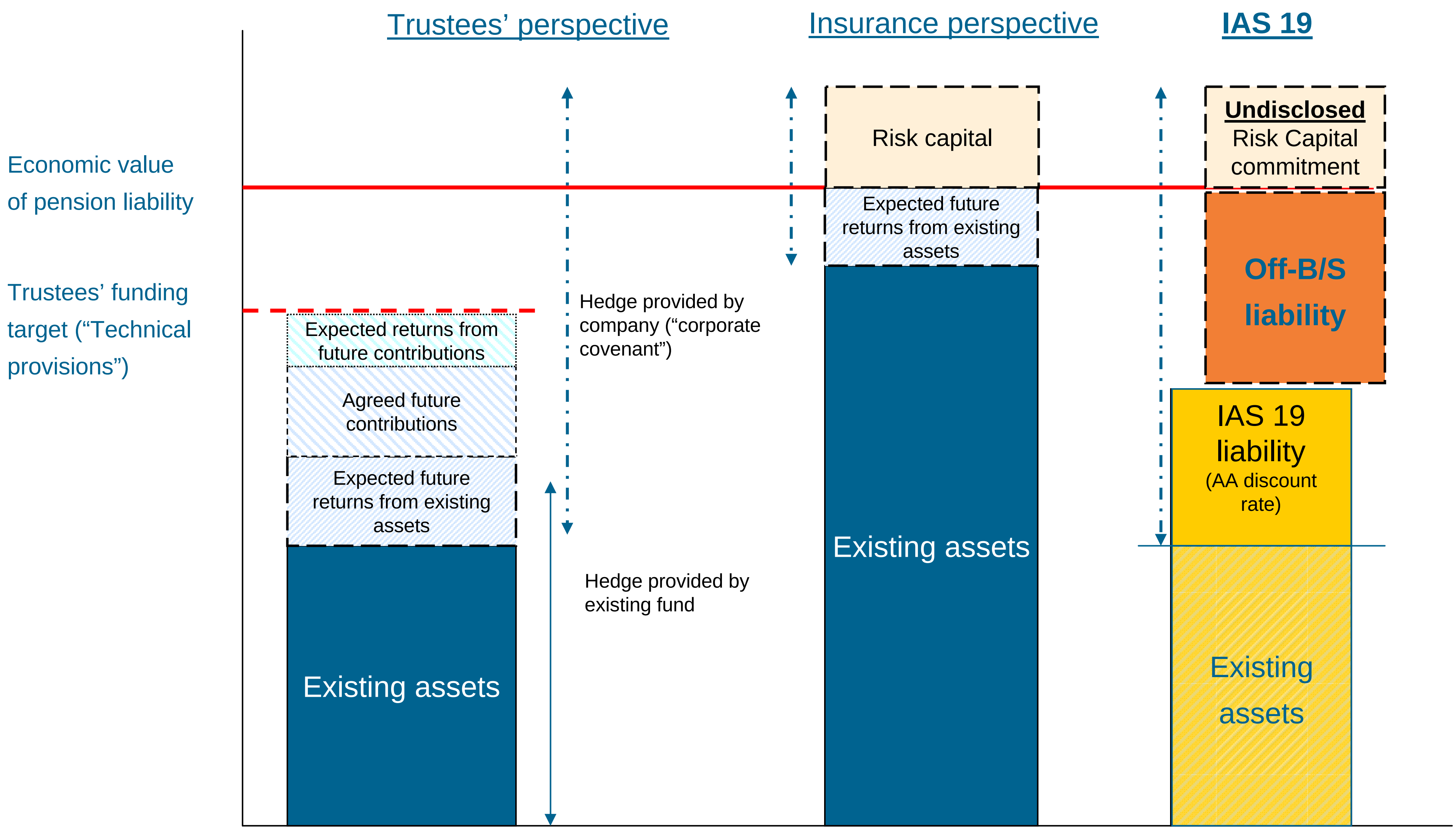
(03 to 08)

+7%

-10%

Source: Mercer Asset Allocation Survey 2008

IAS 19 doesn't show the risks



Mortality is (still) not fully priced in

UK longevity is increasing by c. 2.5 months per annum (= annual liability growth rate of around 0.75%)

Pension Regulator’s summary of pension scheme recovery plans - 44% still do not use a “medium cohort" adjustment to reflect improving mortality

The equity market is only just beginning to get to grips with this - accounting disclosures are gradually improving

Rule of thumb: adding one year adds 3% to the liability

High bond yields have provided an opportunity to “hide” the impact of increased longevity

Example: WS Atkins - added 3 years to longevity (adopted PA00, medium cohort with 1% underpin)

Adding 3 years increased the IAS 19 liability by 9% (£100m)

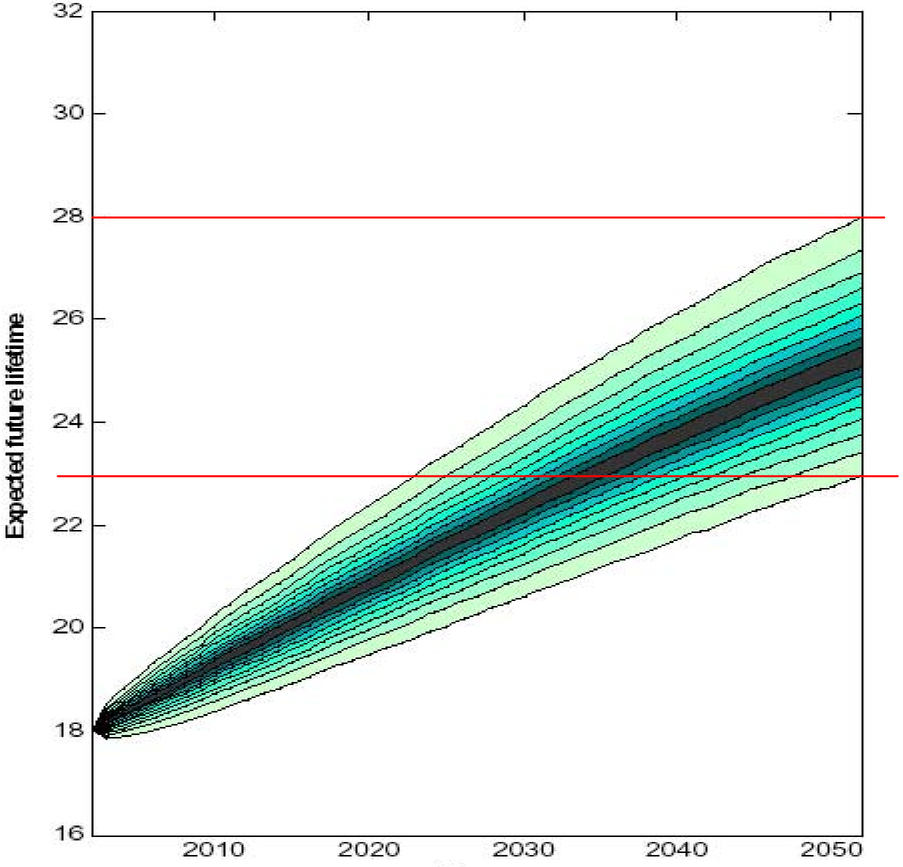
But the AA discount rate increased by 115 basis points (5.35% to 6.50%) shrinking the IAS 19 liability by 23% (£242m)

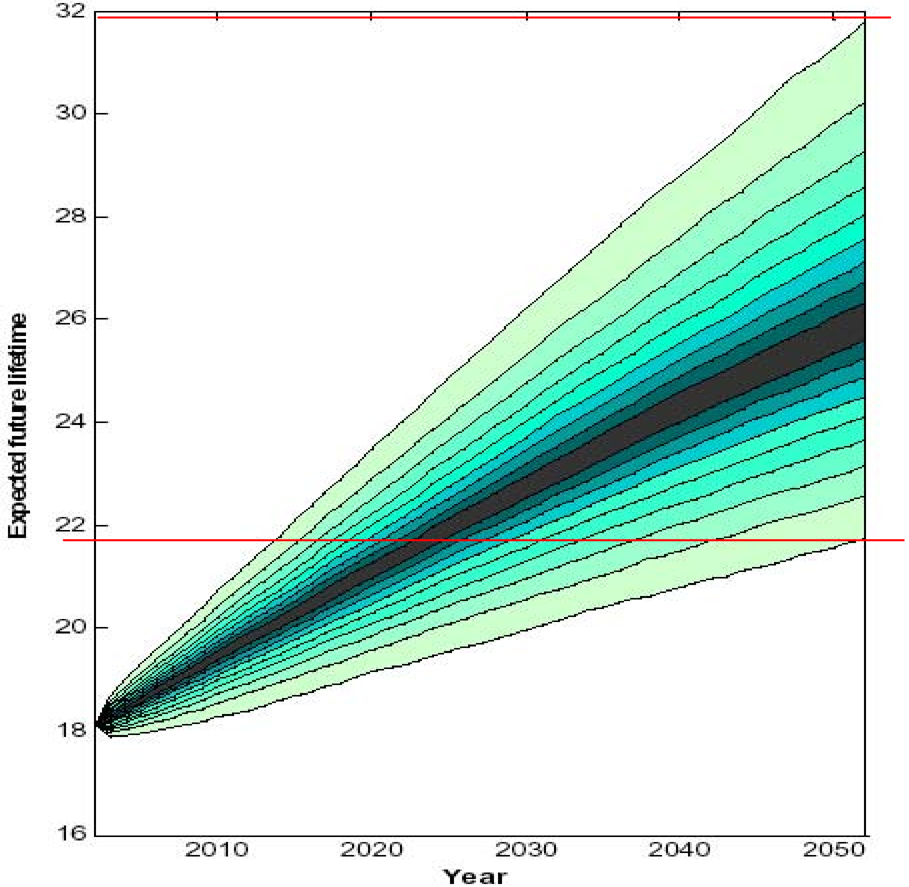
Share price fell 1.5% on the day (vs FTSE 250 up 1.4%) - equity market probably more concerned by the impact of the increased interest rate on forecast earnings

If actuaries don't know - how can CFOs?!

Parameters assumed to be certain - max life expectancy in 2050 = 93 (min = 88)

Parameters acknowledged to be uncertain - max life expectancy = 97 (min = 87)





LONGEVITY FAN CHART FOR 65-YEAR OLD MALES: 2002 ONWARDS
(parameters certain and uncertain)

Why should a company run a pension liability?

Old model: work for a company until retirement - company pays for the five years from then until death

Best efforts promise - accounting disguises the cost

New model: work for a series of employers - company picks up a liability which crystallises decades after the worker leaves, and lasts for decades after that

Scheme trustees control the assets and the investment policy - if it goes wrong they can draw down on company resources

Negative feedback loop - failing companies will be required to pay more into schemes as trustees raise the funding target

Unhedged longevity risk

Significant regulatory risk

Strategic constraint

Accounting starting to reveal the true cost (but only very slowly)

So what do CFOs want?

1. To spend a lot less time on pensions!
2. Cheap solutions - because their shareholders haven't priced in the risks yet

Full buyout can look good if you've already got a surplus (zero value in analysts' SOTP)

Partial buyouts are a cheap way to look as though you're on the case

Hedging inflation and interest rate risks makes sense but the equity markets will not give you any credit for it

Hedging longevity might be regarded more positively - but that doesn't protect shareholders against the risk that the IAS 19 liability under-prices mortality

Closing schemes to new entrants has been done - closing to future accruals hasn't (hidden labour costs?) - brings the day of reckoning closer

Adventure holidays for pension scheme members?

The future

Pension buyouts will increase - LCP and Aon both estimate £10bn in 2008 (PSTS and PwC are more sceptical)

A growing number will be pensioner-only “buy-ins” not full buyouts

Buyout prices will start to rise again if bond spreads narrow (not in 08?) and insurers aim to increase margins

Larger schemes may decide to run off using alternative solutions (e.g. PensionsFirst platform)

Longer-term:

Equity allocation will continue to reduce (towards 40%?)

Lack of bonds will force investors to look for alternatives

Public DB vs Private DC and Private DB (minority) vs Private DC (majority) creates significant HR issues

Australian-style superannuation fund?

Companies buying deferred annuities when employees leave?

Disclaimer

This report has been prepared for information purposes only and is not a solicitation, or an offer, to buy or sell any security or to participate in any trading strategy. It does not purport to be a complete description of the securities, markets or developments referred to in the material. The information on which the report is based has been obtained from sources which we believe to be reliable, but we have not independently verified such information and we do not warrant that it is accurate or complete. All expressions of opinion are subject to change without notice. Third party data providers make no warranty relating to the accuracy, completeness or timeliness of their data and shall have no liability whatsoever for losses that may arise from reliance upon such data. Cazenove shall have no liability whatsoever for losses that may arise from reliance upon this report (including, without limitation, such third party data). This report is confidential and for your internal business purposes only. This report is solely for institutional investors to whom it is addressed and must not be disclosed to or relied upon by any other institutional or non-institutional investor for any purpose whatsoever. This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial objectives and circumstances of the recipients. You should consider this report as only a single factor in making an investment decision. JPMorgan Cazenove Limited and its connected companies, and their respective directors, officers and employees may from time to time have a long or short position, or other interest, in the securities mentioned and may sell or buy such securities and may trade them in ways different from those discussed or recommended in this report.

Additional information with respect to any securities referred to herein will be available upon request.

THIS RESEARCH HAS BEEN PRODUCED BY JPMORGAN CAZENOVE LIMITED IN LONDON. IT HAS NOT BEEN PRODUCED IN THE UNITED STATES OR BY CAZENOVE INC.
Proposed transactions by U.S. persons in the securities described in this report should be discussed with Cazenove Inc. and not JPMorgan Cazenove Limited.

The registered address of JPMorgan Cazenove Limited is 20 Moorgate, London EC2R 6DA
Telephone +44 (0)20 7155 5000 Facsimile +44 (0)20 7155 9800
Research e-mail: caznet@cazenove.com Research web site: www.caznet.com