

Serendipity for DC investors

Investors would be forgiven for feeling somewhat sceptical when it comes to new pension legislation. In recent years most developments have not always delivered a clear benefit to workers, employers or pension providers. However, the introduction of Personal Accounts, planned for 2012, may unexpectedly ignite a series of unintended consequences which will ultimately be to the benefit of all involved in defined contributions (DC) schemes. In this issue of Fundamentals, Ian Richards, Legal & General Investment Management's (LGIM) Head of DC Strategy discusses the implications of the "Personal Accounts Delivery Authority's" (PADA) investment consultation paper "Building Personal Accounts: designing an investment approach".

Unintended consequences

History is full of unintended consequences. *Post-it* notes were born when an American scientist accidentally invented a very weak adhesive when trying to develop a strong glue. In fact the father of modern day economics, Adam Smith, explained this concept at length with his analogy of an 'invisible hand' which ultimately guides the public interest as a result of individuals

seeking out their own gain. "It is not from the benevolence of the butcher, or the baker, that we expect our dinner, but from regard to their own self interest."

When it comes to pensions, however, the consequences of changes in legislation have not always resulted in promoting the greater public interest. As a result, there has been considerable debate of late

surrounding the details of the latest DC development, Personal Accounts.

A useful tool?

Considering that there is an election before the scheduled launch of Personal Accounts in 2012, it has been questioned whether they will even happen. And if they are launched, questions remain: Will they do more harm than good by



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A pdf of the “Personal Accounts Delivery Authority’s (PADA) investment consultation paper Building Personal Accounts: designing an investment approach” may be found at: www.padeliveryauthority.org.uk/documents/investment_discussion.pdf

Figure 1

including workers who are unlikely to benefit as a result of means testing? Will they cause employers of reasonable pension schemes to reduce their contribution levels to the statutory minimum?

In LGIM’s view, there is a good chance Personal Accounts will be launched as all the political parties are agreed around the concept, although perhaps the timing and detail might change. For example, a different wrapper may be put around them to make them look like another party’s offering. After all, they are electorally attractive in that they are voluntary for individuals with a compulsory contribution from employers and they have a government endorsement at a time when confidence in private providers is low. With most of the perceived faults able to be solved through some tweaking of the finer details, we firmly believe that they could prove to be a useful tool in any measures taken to tackle the growing cost burden of public sector final salary pensions.

Current DC proposition

In order to evaluate Personal Accounts, let us first look at the current DC proposition. Enormous stress has been placed on financial markets through the recent credit crisis and markets haven’t behaved as they were supposed to. Over longer periods of time, equities are supposed to provide the highest returns from traditional asset classes, while fixed interest securities are expected to provide protection from losses.

However, the recent credit crisis has turned conventional investment wisdom on its head. Instead, the crisis has highlighted a number of significant concerns.

Current concerns

1. Diversification wasn’t effective when it was needed most as markets become more highly correlated in times of extreme stress
2. Target date funds were brought under scrutiny by Securities and Exchange Commission in the USA as the average loss in 2008 of funds with 2010 target date was -25%
3. Absolute return funds were not delivering in line with expectations as only 24 out of 72 funds in the European Absolute return Sector made a positive return in 2008

Finding a solution

While PADA may have similar issues to all DC schemes, albeit with a different membership make up, they have a number of advantages and power over

the provider market which makes their solution particularly interesting.

PADA advantages

No vested interest – Personal Accounts are a start up with PADA tasked to provide the best solution for members unlike those from the provider side of the industry where their views are inevitably biased through self interest.

Index providers have an interest in maintaining the status quo as they command the largest proportion of the existing assets.

Active managers want the assets and will gain most if they challenge the status quo persuading people to move to new solutions.

Consultants need to consult and change requires advice.

Input from across the industry – in addition to contracting with consultants PADA have had input from some of the best brains in the industry both in the UK and overseas.

Personal Accounts – Key Facts

- Workplace pension reforms are due to take effect from 2012 with a gradual phasing to facilitate a smooth take on. Larger employers are expected to be first
- All employers must offer a qualifying workplace scheme that all eligible employees must be automatically enrolled into
- A qualifying scheme may be Personal Accounts or an employer’s own scheme that meets the qualifying criteria
- Eligible employees are:
 - aged 22 to state pension age
 - working full or part time
- Minimum employer contribution of 3% on a band of earnings but can be more. The total minimum contribution for eligible workers should be 8% of band earnings, made up of employer and member contributions and 1% tax relief
- Band earnings are currently set at £5035 to £33,450 (to be updated at the time of launch)
- Contributions for both employers and employees will be phased in over a transitional period. For employers likely to be 1% initially, rising to 2% and then 3%. Phasing period to be determined

Figure 2

Article contd.

Timing – they are making decisions with full knowledge of the impact of the credit crunch.

Scale – it is estimated that once the scheme is fully operational, the annual contribution that it is likely to receive could be of the order of £5 billion. This will enable it to consider options that would not be viable for most schemes and for providers to offer solutions that they would not normally be prepared to offer.

Buying power – because of its size, it should be able to negotiate very competitive fees with all its suppliers.

No legacy – they have no existing members and can start with a clean sheet.

Cutting edge administration – they will be putting their investment solution into a purpose built, extremely low cost administration system. With the system built by companies with a track record of delivering large-scale projects of this nature, rather than traditional pension administrators.

Benefits there for the taking

Whether Personal Accounts are launched or not, they have already made an important contribution for DC investors through the investment consultation paper that was published at the end of May (Figure 1). Through the extensive research which has been commissioned, an extensive base of knowledge has now been amassed and is there for the taking.

Since Personal Accounts face the same issues as all DC schemes, the research which has been done offers extremely valuable insight for all DC investors. So while the solution for schemes with a different type of membership might be different, the research that has been done so far to work out that solution is of benefit to all.

Why Personal Accounts will be the benchmark

When the new legislation comes into force, decisions will need to be made on whether eligible employees should go into Personal Accounts or into an employer's own private scheme. In many ways this can be regarded as very similar to the decision on whether employees should be contracted out of the state second pension. This inevitably makes Personal Accounts the benchmark against which employers, employees and trustees will compare any private scheme.

From the employer's perspective

Personal Accounts are likely to offer value for money, a viable stand alone solution with simple administration. They are likely to be perfect for employers who don't want to do anything more than the legislative minimum or wish to use them as a possible foundation to an integrated solution that does far more. To this end, employers will need to convince themselves that they can do better both in general terms and from the investment choice aspect either via a Trust or contract based pension arrangement.

From the employees' perspective

Personal Accounts will receive significant publicity and employees will want to ensure that their scheme is at least as good.

From a Trustees' perspective

Personal Accounts will be the first time where a measure against which a consultant's and providers' advice can be compared. Trustees will want satisfactory justification for anything different. By adopting the same investment strategy being used in Personal Accounts, for example, they also reduce the risk of being criticised. They can then focus on differentiating their scheme in other ways.

Although Personal Accounts are very likely to become an excellent yardstick, it is less likely they will become a working benchmark replicated for day-to-day use by schemes. This is because it is likely that

the scale advantage offered by Personal Accounts provides access to options not readily available to other schemes. So while data will probably become available, it may not necessarily be in sufficient detail or on a timely basis.

The default

Perhaps the most significant contribution to DC investing from PADA's investment consultation paper is the work that has been done to help formulate the decision on the design of the default. Auto-enrolment means that all schemes will need to have a default fund and it is most important that the design of that fund is the best that it can be since inertia is likely to mean that once in, few members will ever leave. In 2007, the annual NAPF survey found 84% of DC schemes had a default fund and 91% of members in these schemes left their money in the default. The numbers for Personal Accounts are likely to be even higher.

The consultation correctly identifies three key risks for members, apart from the risk of not contributing at a sufficiently high enough level to produce the retirement income desired:-

- Investment and the unpredictability of future returns
- Inflation and the maintenance of the buying power of the accumulating pension. Wage inflation is also an issue as most members will have an expectation that when they reach retirement that they will want to have a lifestyle in keeping with improvements in living standards over their working lifetime
- Longevity and the possibility that as life expectancy increases retirement income will not be sufficient.

These risks have to be balanced against possible returns. A risk free real return could be achieved by an investment in an asset class such as index linked gilts but that is likely to be a very expensive

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means of saving for significant periods during a members' working lifetime. On the other hand if the return objective is too ambitious then that might result in periods of negative returns causing some members to question why they are bothering to save at all. Trustees of different schemes will want to strike the balance between risk and reward according to the profile of its own scheme's membership which may be different from that of Personal Accounts which will contain mostly lower paid individuals, but the principles are the same.

This leads to the question of whether the default's investment objective should be on a best efforts basis, or a benchmark return objective or a target replacement income. There are merits and pitfalls for each, which the consultation paper explores.

Best efforts objective

Investing to achieve the objective will clearly depend upon the objective chosen. That is why much emphasis is being put on determining the correct objective. Traditionally most DC schemes have tended to focus on a best efforts basis but the downturn in markets caused by the credit crunch has caused many to query whether this is really the best approach.

Much depends upon ones views of the equity risk premium. Most members will have long-term investment horizons. Equities can be considered as growth assets that tend to grow in line with both price inflation and earnings, an ideal investment for pension schemes over the longer term. However, studies suggest that over a period as long as 20 years there is a possibility for equities to deliver negative real performance. We are currently experiencing what many describe as 10 years wasted equity investment (FTSE All Share 31.12.98 - 2674 31.12.08 - 2209), which brings into question much of the basis on which many

lifestyle programmes in DC schemes have been based. Over the last 20 years equities have worked (FTSE All Share 31.12.88 - 927) but there is no longer the certainty there once was. Bonds have similarly not performed consistently.

This suggests that most schemes' lifestyle strategies, which are generally used as the default option, ought to be reviewed. The concept of a mixed fund containing a number of different asset classes, including alternatives, may well be an appropriate way forward, which is where most DB schemes stood in the 80's. The only difference today from those mixed funds of yesterday is that there are more asset classes that can be considered. There are of course also more sophisticated tools that can be used to manage the asset mix, but the challenge of market timing remains.

Benchmark return objective

Against this background it is not surprising that the alternative objectives need to be given serious consideration. Abandoning the unconstrained concept of "best endeavours" in favour of a benchmark return objective such as those offered by absolute return funds might seem attractive.

However, while that might be appealing now, what if we go through a long equity market bull run? Will we see a repeat that brought about the demise of with profits?

Originally with profits only ever went up and never fell back below what had already been achieved – a smooth increasing return without volatility. When raging bull markets arrived many investors demanded more of the upside, thereby changing the basis on which returns in the good years were given which of course needed to be compensated for by falls in the bad years. Terminal bonuses and market

value adjustments were the result taking away the greater certainty of return.

Replacement income objective

So perhaps replacement income should be the objective. Of course that is a challenge because legislation requires annuitisation and there is no certainty as to what annuity rates might be at retirement. Many are suggesting a form of deferred annuity but once again history shows why this method, which was once the cornerstone of almost all pension investing, failed. It is simply not possible to predict many years ahead what investment conditions might be like when someone retires. Caution has to be applied to the terms offered. If interest rates are high at that time understandably investors will want a better deal than the terms they contracted to many years ago.

The solution offered was to allow investors to take the cash equivalent and use it on the open market to secure the best terms available. This in turn resulted in the deferred annuity income becoming a guaranteed annuity rate with the investment manager then targeting the best cash equivalent he could. And we all know what guaranteed annuity option policies have done to their providers.

A move in the right direction

Anything that Personal Accounts can suggest which helps us from recreating yesterday's solutions in new wrappers has to be welcomed.

The investment consultation paper should be required reading for all trustees of DC schemes.

Not only does it offer a level of insight which is unparalleled in terms of quality and depth, but where private industry research can cost tens of thousands of pounds, PADA's paper is completely complimentary.

Market Overview

Economic data have begun to shift away from doom and gloom to signs the recession is ending. However, while credit conditions remain weak the economic recovery is likely to be subdued throughout 2010, keeping wages suppressed and unemployment high. During the past few months economic data has surprised market participants with its strength. Surveys which measure investor sentiment have continued to improve as global manufacturing production has started to pick up again. In the US, home sales seem to have stabilised and after stalling during 2008, global trade has recovered significantly in the first half of 2009.

Globally, it has been the emerging economies that have been leading the way. Economic improvement from the developed world has been strongest in the UK where policy easing has been delivered swiftly and with force. Given the extent of recent policy initiatives which have been coordinated across the globe, we believe stabilisation of manufacturing output and housing will support the UK and US economies.

Equity Overview

UK

Stronger second half?

UK equities declined -3.6% in June as tracked by the FTSE All Share price index. This follows a string of monthly gains over the past several months (3.7% in May, 9.5% in April and 2.8% in March).

In an effort to boost economic activity by increasing the flow of money in the system, the Bank of England (BOE) extended its quantitative easing programme in May revealing plans to repurchase another £50 billion in assets. This is in addition to the £75 billion announced in March. Last month, further signs emerged that these unprecedented stimulus measures have delivered further improvements in money market conditions. In particular, sentiment towards banks showed marked improvement, as demonstrated by the reduced cost of short-dated funding, though liquidity has yet to return to truly 'normal' levels.

Equity markets are forward-looking, with stocks priced according to what market participants anticipate will eventuate over the coming months. While the market dipped back during the month of June, market strength during recent months has come from expectations of a stronger second half to 2009 for the UK economy as manufacturing activity and world trade

picks up. This should offset renewed concerns that consumer spending will be weaker as real incomes decline (due to lower wage growth and potentially higher taxes and inflation going forward).

US

Economy stabilising

The American equity market declined -2.5% in sterling terms during the month of June (measured by the FTSE All-World North America price index). This follows a dip of -2.3% in May and gains of 7.9% and 6.3% in March and April respectively. Since the start of 2009 US equities are down -9.4% in sterling terms. The significant appreciation in sterling against the US dollar over the first five months of 2009 account for this negative return to UK based investors. In local terms the US equity market has increased 3.3% in the calendar year to date.

US economic data has continued to improve over the past few months. Lending conditions have been better than expected and look likely to strengthen even further if house prices stabilise and corporate profitability improves. If retail sales, industrial production and home sales stabilise, it is possible that we see US

economic data strengthen significantly over the summer.

The innovative efforts taken by the Federal Reserve (Fed) are continuing to support credit markets and are beginning to help households and businesses obtain loans again which should continue to support the US economy.

However, as support from the government fades (following the boost to income from the Obama tax credits) consumer spending may falter. Job losses should ease during the second half of 2009, however job creation is unlikely before the end of 2010.

EUROPE

Weaker than expected

European equities, as measured by the FTSE AW – Developed Europe (ex UK) Price Index declined -4.5% in June. This follows a gain of 1.4% in sterling terms during the month of May. Together with gains experienced in March (8.2%) and April (10.3%), the market is now -10.8% lower than at the start of the 2009 calendar year.

Economic growth across Europe has been weaker than we expected. While car sales have been stronger, official industrial

Major Equity Markets – Total Returns £ 2008/2009

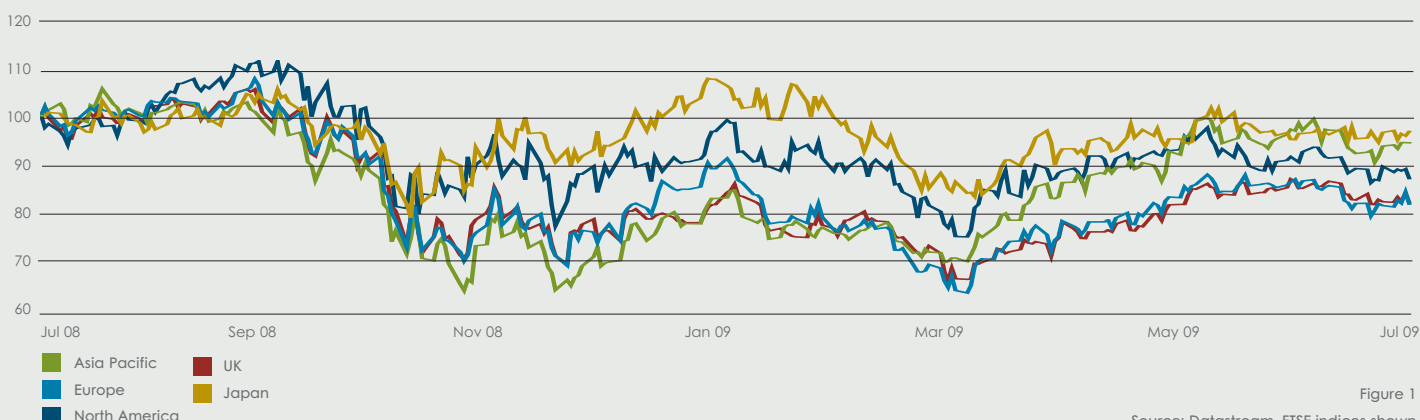


Figure 1

Source: Datastream, FTSE indices shown

Equity Overview Contd.

▶ EUROPE (CONT'D)

Weaker than expected

production remains weak in Europe and over the past month we have become more pessimistic on the outlook for economic growth across the major European economies, believing the economic recovery will lag the UK, US and Japan.

The European Central Bank (ECB) cut official rates during the month of May to 1% and has recently started to buy covered bonds. While economic conditions remain difficult, fears of deep recession have been replaced by opportunistic investing, as tentative signs of economic activity and growth have emerged.

Global trade ground to a halt last year as the credit crisis spread. More recently, global trade has begun to stir again. Shipping volumes are recovering slowly and demand (particularly from China) has begun to pick up. This has been positively received by many major European firms whose businesses rely heavily on exports.

▶ JAPAN

Rebound ahead?

The Japanese equity market dipped -0.2% during June (as measured by the FTSE AW – Japan total return index in sterling). After declining significantly in February, the market rose in March, April and May in sterling terms and remains -11.2% below where it began 2009.

The rebound in equity markets across the developed world and tentative signs of strength from the global economy have supported Japanese equities during the past couple of months.

As world trade increases and the benefits of significant government stimulus packages begin to take effect, we believe the Japanese economy will rebound faster than most market participants are currently anticipating.

▶ ASIA / EMERGING MARKETS

Leading the economic recovery

Emerging equity markets have been a mixed bag during the past few months. As a whole the Asian equity market dipped -1.9% in sterling terms (as measured by the Asia Pacific Ex Japan price index) in June, with a wide dispersion of returns experienced across regional equity markets. For example, the Korean equity market fell slightly over the month while Chinese equities rallied. After huge gains during the month of May, the Russian equity market and Brazilian equities declined in June.

Emerging equity markets have strengthened considerably over the past few months as tentative signs of improvement in the global economic backdrop have emerged and global trade begins to stir. While growth from some Eastern European countries continues to lag, the Russian and Polish economies appear to be stabilising. There have also been some signs of improving domestic demand such as record car sales from many emerging economies, which suggests that financial markets and credit mechanisms have begun functioning more effectively.

Fixed Income

As signs of economic recovery emerged, government yields increased. A more encouraging macroeconomic outlook caused investors to rediscover their appetite for riskier assets, leading to a large amount of switching from government bonds to corporate bond markets. During the past few months, optimism has grown that the sheer scale of global economic support packages (particularly in the US and UK) should bolster the medium-term corporate trading outlook. In Europe, however, some concerns remain over banks' potential exposure to bad debts.

Major Bond Markets – Total Returns £ 2008/2009

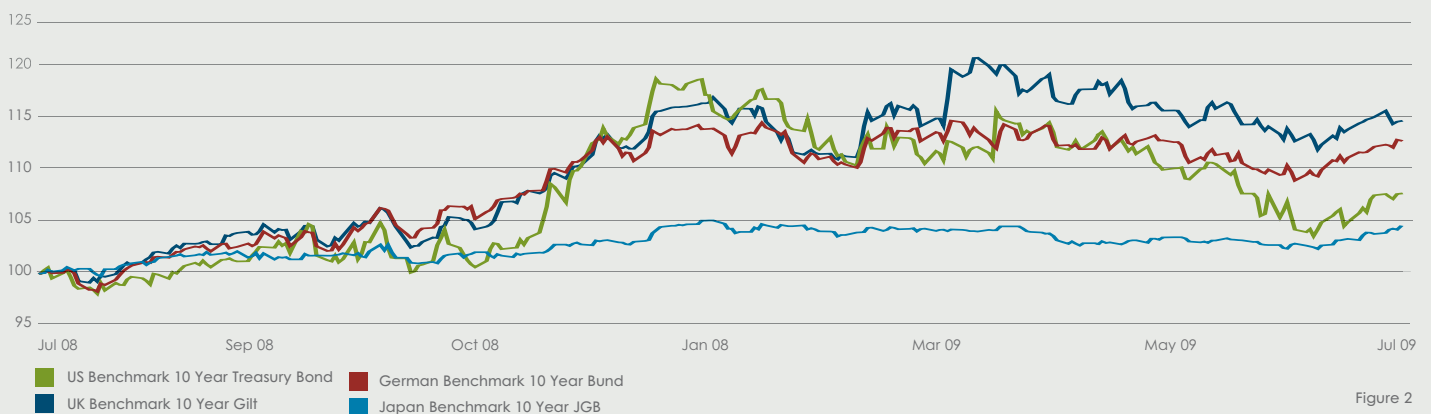


Figure 2

Source: Datastream

Snapshot

Rate expectations

Economic data have improved in recent months and financial markets are now speculating about when the Bank of England will raise interest rates from record-low levels. We think the Bank of England will prove more patient than markets expect. This is because it is more worried about deflation than high inflation. Premature rate hikes could endanger the economic recovery by squeezing consumers' spending power.

Figure 1 shows how market expectations of 3-month bank borrowing costs have changed in recent months. Money markets continue to expect borrowing costs to remain just over 1% at the end of 2009. But they see borrowing costs above 4% by the end of 2011. This is almost 100bp higher than what was expected in March.

UK interest-rate expectations have increased in recent months



Figure 1
Source: Reuters Ecowin

We think the economy will prove extremely sensitive to any changes in short-term interest rates. This is because we believe around 75% of the mortgage stock is on variable rate mortgages. Around half of this reflects people whose fixed rate deal has expired. They have either been unable to refinance due to negative equity or have chosen not to because of higher fees charged by banks.

If base rates rise to around 4% by end 2011 in line with market expectations we believe the interest-servicing burden could rebound to levels not seen since the peak of the boom in 2007 (Figure 2). Our lead indicator suggests this would reduce GDP growth by around 0.75 % points per year.

4% base rates in 2011 could push the debt servicing burden up to 2007 levels

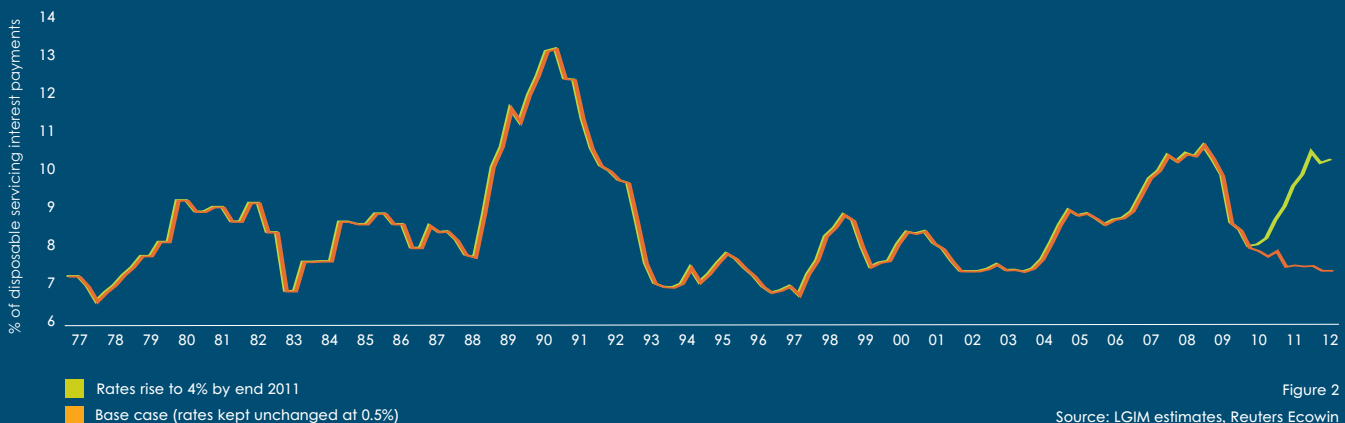


Figure 2
Source: LGIM estimates, Reuters Ecowin

The only reason the Bank of England would want to do this is if the economy were booming. In the absence of strong growth, unemployment would remain high and wage inflation subdued. In other words, we would still be at risk of deflation. The Bank of England has hinted that it is more worried about deflation than inflation because once deflation starts, it is difficult to get out of. So we believe the Bank of England will be reluctant to squeeze consumers' spending power by raising rates prematurely. Instead, the debt servicing burden is likely to remain low – as it was between 1993 and 1997 following the last recession.

UK Forecast

Consensus is catching up

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2009	2010	2009	2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%				
	High	2.10	2.50	-2.80	1.80	4.60	4.50	0.50	n/a	1.85	1.90	0.95	0.97
	Low	1.00	1.00	-4.30	-0.10	3.25	3.60	0.50	n/a	1.20	1.48	0.81	0.72
	Median	1.75	1.50	-3.55	0.90	3.70	4.05	0.50	n/a	1.62	1.67	0.86	0.81
	Last month median	1.65	1.50	-4.10	0.35	3.67	3.92	0.50	0.50	1.55	1.66	0.86	0.80
Legal & General Investment Management		1.90	1.70	-3.80	1.80	3.50	4.00	0.50	0.50	n/a	n/a	n/a	n/a

Source: Bloomberg and LGIM estimates

Amidst the current volatile environment, the table has been altered to extend the range of forecasts to capture a greater sample size. This now reflects more up-to-date adjustments. The forecasts above are taken from Bloomberg and represent the views of between 20-40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

While we have revised our UK GDP forecasts lower, and consensus has revised theirs higher, we remain more optimistic on economic growth than the market. As manufacturing confidence continues to improve, global trade resumes and house prices appear to have stopped falling, the worst of the recession appears to be over.

We believe we are approaching the second stage of a relatively weak economic recovery, where the first stage was marked by a sharp downturn followed by strong growth as depleted inventory levels were restocked. The second stage, however, should be a more anaemic period of growth as credit conditions remain a drag on growth and unemployment remains high (putting downward pressure on wages). As a result we anticipate a decline of -3.8% for 2009 (down from -3.3% last month) and a recovery in the magnitude of 1.8% for 2010 (down from 1.9% last month).

The median forecast from a Bloomberg survey of market participants shows the UK economy contracting -3.55% (it stood at -4.10% last month) this calendar year, and climbing back into positive territory in 2010 by 0.90% (up from 0.35% last month).

We continue to anticipate higher inflation than the median forecaster, however we have reduced our 2010 inflation forecast from 2.2% to 1.7% this month reflecting revised expectations of further cuts in utility bills.

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