HYMANS ROBERTSON

investment perspectives

on the outcome of the EU Referendum

24 June 2016

It is hard to underestimate how momentous this decision is. The UK's decision to leave the European Union leads to a huge amount of political and economic uncertainty. The ramifications are already being felt, but not just in the UK. The consequences are much wider, affecting Europe and indeed the rest of the world.

What's happened to markets?

In the run up to the vote, markets had already seen a build-up in volatility, reflecting the swings in newsflow from polls. On balance, either outcome was going to lead to further market volatility, but the decision to leave was considered the less likely of the two, and as a result financial markets have responded even more dramatically to the result than expected.

Table of market indicators

	FTSE 100	S&P 500	£/€	£/US$	10-year gilt yields
31 Dec	6,242	2,044	1.36	1.47	2.0%
11 Feb	5,537	1,829	1.28	1.45	1.3%
31 Mar	6,175	2,060	1.26	1.44	1.4%
23 Jun	6,338	2,113	1.30	1.48	1.4%
24 Jun (10:45)	6,019	2,027	1.25	1.38	1.1%

The FTSE 100 opened 8.7% down and subsequently rallied to back over 6,000 over the following couple of hours, but the implications of this decision are not limited to UK markets. There have been more widespread falls, especially on European markets. Similarly, sterling has fallen sharply against all currencies, hitting a 30 year low against the US$, before regaining some of the initial losses.

Unsurprisingly, a combination of a flight to safety in times of extreme uncertainty and volatility coupled with a mark down in growth expectations has led to the yield on Government bonds falling by around 0.25%. Index-linked yields have fallen almost as far.

It is important to put this volatility in the context of market movements over time. The UK equity market is still operating in the trading range of the last 9 months, and sterling is still above its low point earlier this year.

What is more challenging is the further fall in gilt yields, on top of what has been a fairly persistent downward journey. Lower yields will place further burden on the scale of UK pension fund deficits. The outlook for inflation expectations, and the associated implication for funding, is more uncertain.

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How has this affected Defined Benefit scheme funding?

Clearly there has been an immediate impact on markets and hence on the funding positions of Defined Benefit (DB) pension schemes; but the full, longer-term impact remains to be seen.

Overall the immediate impact on the UK DB funding position is a deterioration of around £100bn to its highest level of £900bn.

What should those running DB schemes do?

In the run up to the EU Referendum, pension funds have been limited in their ability to protect themselves fully from the uncertainty of a binary outcome. Having made the decision to Leave, today is the first day in what will be a long process, with much uncertainty along the way.

Volatility will no doubt continue, and there will be periods of further pain for pension funds but also opportunities. Volatility and uncertainty is not something new, and pension funds have worked through many such periods before. We always caution against knee jerk reactions to short term market volatility. Those running DB schemes need to remember that pensions are a long-term game.

While we'd advise schemes to avoid over-reaction to short term market volatility, as the dust settles, it will be necessary to consider how well the investment strategy stacks up to the new environment. Depending upon the economic outlook, we may enter another period of lower absolute returns for all assets, with consequences for the relative attractiveness of growth dependent assets versus assets that deliver more of the return through income. Trustees and sponsors should have the right balance between growth assets, income based assets and downside protection to meet their needs.

There will also be some more immediate considerations for pension funds, in order to ensure the efficient ongoing day to day management of portfolios. In particular:

- Schemes with negative cashflow will wish to avoid being sellers of assets that have fallen in value – an issue we have identified to be of increasing relevance for clients in the last couple of years;
- Monitoring and reviewing actions around rebalancing programmes in a time when market movements will have altered the balance between growth and hedging assets;
- The fall in yields will have increased collateral pools in LDI programmes. In the case of pooled LDI funds, there may be cash paid back to schemes that could provide a buffer against other liquidity needs, reinvested or held as dry powder for buying opportunities;
- Conversely, currency hedging programmes are likely to be underwater, and may need cash for settlement.

What about members in Defined Contribution schemes?

Many members in defined contribution schemes will hold significant assets in equity markets, and will see the value of their investments fall; this will be an area of concern. However, as noted earlier, this needs to be considered in the context of markets over time and not just on a single day.

For those in the accumulation phase, contributions are now buying assets at lower prices and members have the benefit of "pound averaging" to smooth returns over time.

For those closer to crystallisation, most DC schemes have lifestyle arrangements that ensure members have a material proportion of their assets held in more defensive cash and Government bonds. The cost of annuity purchase will rise, but their pots will have been protected against the short-term downside.

Those drawing income from their DC pot need to ensure that they are not forced sellers of assets, in the same way as DB schemes, and are drawing income from the assets but not selling them down at an inopportune time.

Conclusion: The need for more resilience

The events of recent weeks highlight the need for schemes to become more resilient to risk. Specifically, schemes need to look through to the long game. This will involve a reappraisal of the likely long-term future returns in the "new world" of less political enthusiasm for maintaining global free markets. Meantime, schemes should try to avoid being caught up in making unnecessary short-term reactive decisions. For many the immediate focus will be on how to generate the cash required to meet immediate benefit payments without being forced to sell assets. With a clear plan, schemes can and will still manage their assets and their funding through these difficult times.