Invasion of Ukraine:

Impact on Pension Scheme Assets

First Actuarial Investment Team

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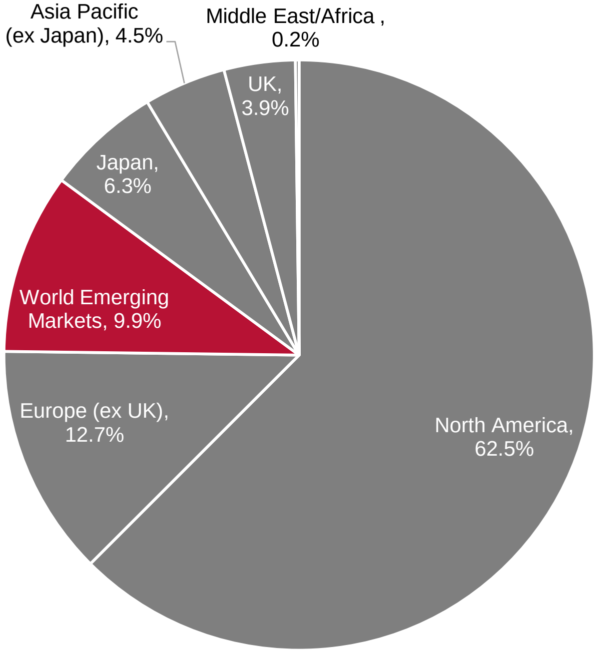
Russia as a % of global investment markets

Country Allocation of LGIM All World Equity Index Fund



Country Allocation of LGIM World Emerging Markets Equity Index Fund

	%
China	35.6
Taiwan	18.4
India	15.3
Brazil	5.2
Saudi Arabia	3.9
South Africa	3.9
Russia	3.5
Mexico	2.4
Thailand	2.3
Other	9.6

Before the outbreak of war, Russia was a tiny proportion of the global equity market.

Based on the data shown alongside (provided by LGIM), emerging market equities represented 9.9% of the All World Index and Russia represented 3.5% of the Emerging Market Index.

This is consistent with Russian equities representing just 0.3% of the global equity market.

Source: LGIM (as at 31 December 2021)

Pension schemes had almost no exposure to Russian or Ukrainian equities

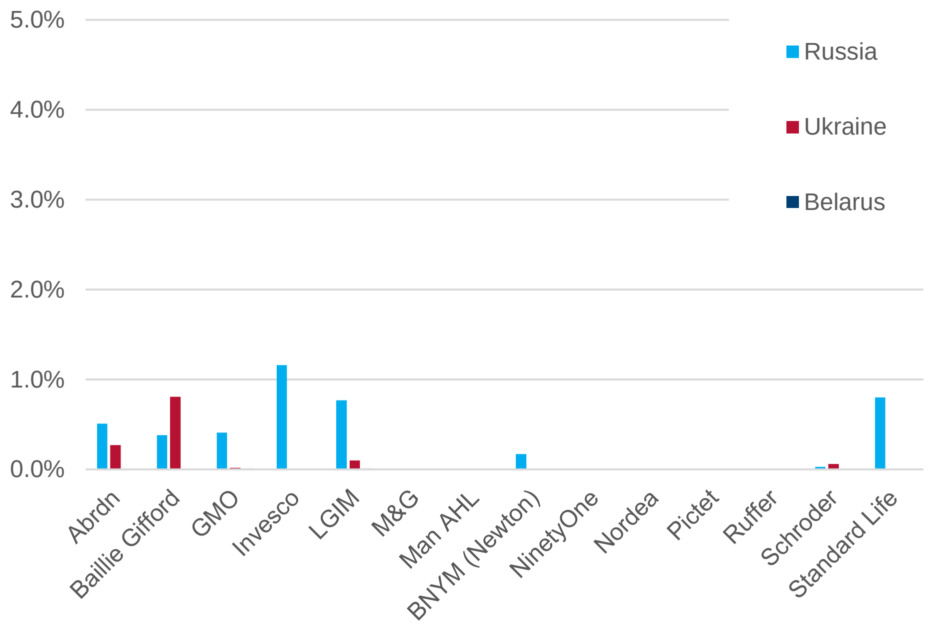
We have asked the investment managers of the funds used by our clients to confirm the exposures they had to Russia, Ukraine and Belarus prior to the outbreak of war. In all cases, exposure was trivial.

The chart alongside shows the responses received from managers of Diversified Growth Funds (DGFs). Where we have received data, all but one fund had less than 1% allocation to Russia, Ukraine and Belarus.

Data received from managers of equity and Diversified Credit Funds has revealed a similar picture. Even funds which had a meaningful allocation to emerging markets had very low exposure to Russia.

The highest exposure we are aware of for any fund used by our clients was an emerging market equity fund which had a 3.4% allocation to Russian equities.

DGF exposures prior to the outbreak of war



Source: Data collated by First Actuarial from DGF managers

What happened to markets until the end of last week?

Russian investments

Russian investments cannot now be traded meaning any such assets that were held prior to the war cannot be sold.

Russian equities have been marked to zero and removed from indices produced by FTSE and MSCI.

If a pension scheme held a fund which had exposure to Russian assets, those assets will now be worthless. Fortunately, any such exposure before the war will have been trivial.

Other investments

Up until 4 March, the impact of the war on global markets had been relatively modest.

The extensive sanctions package imposed on Russia was designed to avoid disruption elsewhere and, since the Russian economy represents less than 2% of global GDP, markets concluded the impact was unlikely to be too material at a global level.

This week, the position seems to have changed materially and we consider that overleaf.

An interesting development last week was pressure being applied by consumers to encourage companies to cease trading with Russia even where official sanctions did not apply. For example, Ikea, Volkswagen and Asos all ceased their Russian operations with Asos summing up the prevailing sentiment with this observation: “it is neither practical nor right to continue to trade in Russia”.

Meanwhile, BP accepted a significant loss as it decided to offload a $14bn stake in a Russian state oil firm – reducing BP’s share price by about 5%.

However, perhaps the company courting most controversy last week was Shell with a decision to purchase a cargo of Russian crude oil. The significant backlash to this decision providing an indicator that western public opinion was opposed to the purchase of Russian oil.

“Doesn’t Russian oil smell of Ukrainian blood?”

Dmytro Kuleba (Ukraine’s Foreign Minister) in a quote directed at Shell

What is happening to markets now? (an oil crisis?)

Whereas the initial response of markets to the invasion was subdued, sentiment changed materially yesterday (7 March 2022).

Politicians started to openly discuss the possibility of a Russian oil ban and this resulted in the oil price soaring.

Global inflation was already running high and even in last week's calmer market environment it was recognised that the war would add to inflationary pressures through higher commodity prices and supply chain disruption. Other important Russian exports such as nickel and wheat are trading at elevated prices whilst disruption in Ukraine (a major exporter of cereals and sunflower oil) is likely to exacerbate the situation.

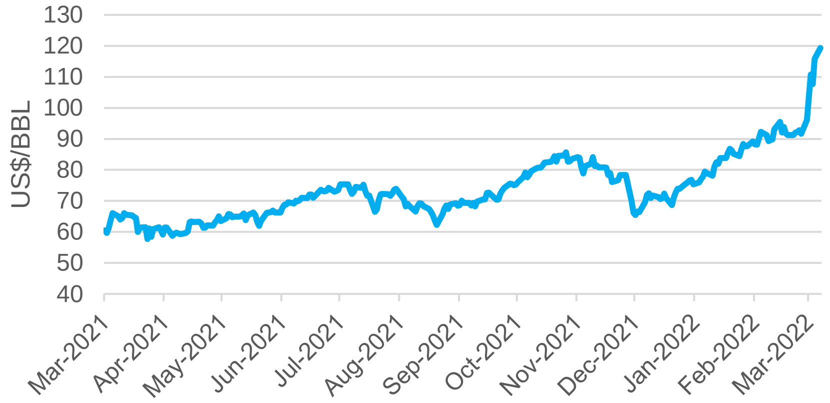
Yesterday, the prospect of a Russian oil ban moved inflationary fears to another level with some commentators speculating that the action might trigger a global recession. This resulted in a sharp sell-off in equity markets.

It should be noted that many other commentators considered that, whilst higher oil prices would be unwelcome, the impact on the global economy was unlikely to be too severe.

UK implied spot inflation (15 year duration)

Source: Bank of England (latest available date 4 March 2022)

Crude Oil WTI Cushing



Source: Thomson Reuters Datastream (1 March 2021 to 7 March 2022)

Impact on pension schemes

Inflation

Inflation expectations had already increased materially in 2022 before war broke out. It now seems likely that inflation may peak at 8% or even higher – a level that would have seemed inconceivable just a few months ago.

For pension schemes, high inflation is unlikely to be a major problem - although liabilities are linked to inflation, benefit structures tend to include caps meaning the impact of rising inflation reduces as increases in inflation become more material.

In contrast, assets held by schemes to hedge inflation (index-linked gilts and real LDI funds) do not operate with caps so these assets will keep increasing in value as inflation rises (even though the liabilities will stop going up). This actually means that well-matched schemes are likely to have observed a funding level improvement recently (all other things being equal) due to the matching assets increasing in value more than the liabilities.

Where trustees have previously introduced a high level of inflation matching, it would be worth considering whether the shape of the inflation hedge remains appropriate. It is likely that increases in inflation have caused such schemes to become over-hedged, meaning that the assets will fall by more than the liabilities if inflation concerns subside.

Interest Rates

If central banks decide they need to increase interest rates to fight inflation, it is likely that gilt yields will increase. This will be beneficial for pension schemes as higher gilt yields result in lower liability values, although this benefit will be dampened to the extent that interest rates are hedged.

An alternative scenario might see central banks hold rates low despite soaring inflation in an attempt to help stave off an economic slowdown. Such action would probably keep gilt yields low but would likely be well received by equity markets.

Equities

Equities reacted negatively yesterday as oil prices soared. However, longer term we would expect equities to outperform inflation.

Any investment in equities should have been made with a long-term horizon in mind and the impact of short-term volatility should have been recognised. Unless there has been a material change in a scheme’s specific circumstances (such as a reduction in the sponsor’s covenant) we would recommend leaving equity exposure unchanged and taking a long-term view.

Additional thoughts for DC schemes

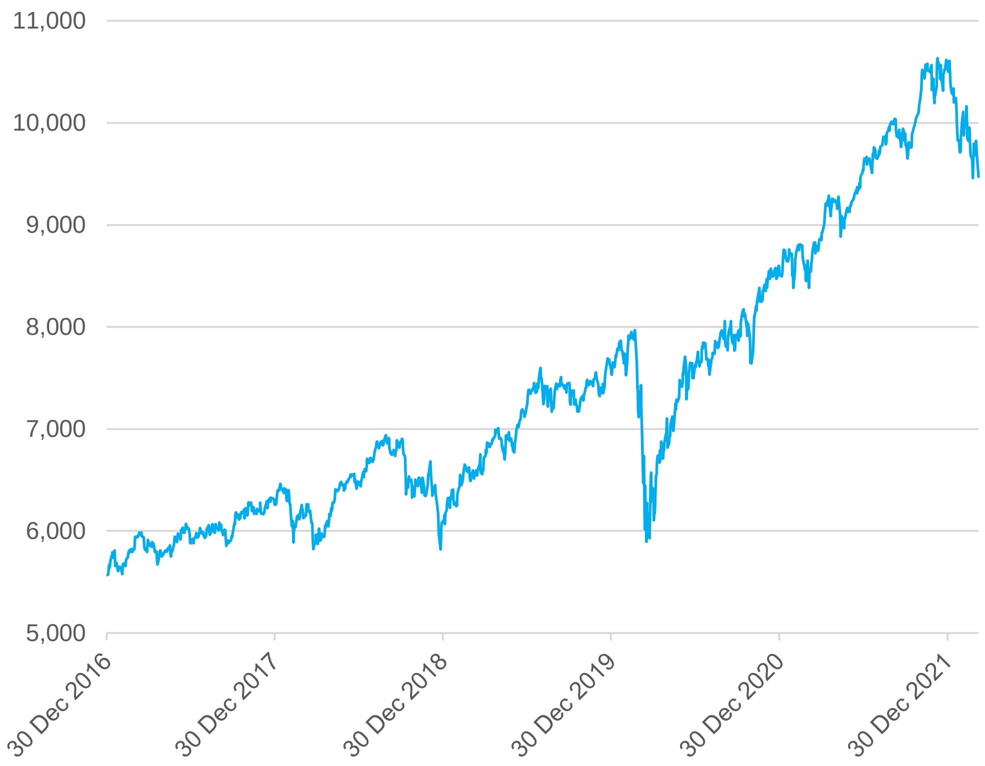
DC investors tend to have a particularly long investment horizon and, if we take a step back to put recent equity market volatility into a longer-term context, the recent movements do not look particularly unusual (see chart to the right).

Where an equity investment is being held by an DC investor in the expectation of long-term growth, this remains appropriate in our view – particularly for younger investors.

For DC investors who are approaching retirement, the short-term volatility that can be associated with equity markets is unwelcome but reducing this volatility lies behind the design of lifestyling strategies that most DC investors will be invested in. Under a lifestyling strategy, exposure to equities will gradually be reduced as the investor approaches retirement and that continues to strike us as being a sensible approach.

Any DC investors who are approaching retirement and who are not in a lifestyling strategy, or any investors who have retired and are participating in a drawdown arrangement, might want to consider seeking independent financial advice to assess whether their investment approach remains appropriate for a higher inflation environment.

MSCI World Total Return Index (US$)
(30 Dec 2016 to 7 Mar 2022)



Source: Thomson Reuters Datastream

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What should pension scheme trustees do?

Covenant

All trustees should consider whether the invasion of Ukraine has any specific impacts on their scheme sponsor that might call into question previous assessments of covenant strength. If the covenant has changed, it would be appropriate to review the scheme's investment strategy.

Investment strategy

Markets seem to be reacting primarily to the shock realisation that inflation might be higher than expected but high inflation might not be too bad an outcome from the point of view of a pension scheme. Where covenant strength is unchanged, our view is that it is probably reasonable to adopt a 'wait and see' position with respect to a pension scheme's investment strategy.

However, any trustees who had previously implemented a high level of inflation hedging should consider whether the hedge design needs refining to reflect the impact of material increases in inflation expectations.

Transitions in progress

The funds used by our clients continue to operate as normal and we see no reason to delay transitions that have already been agreed. Our transitions team continue to monitor market conditions and, if we conclude that it is no longer appropriate to transact, we will notify trustees accordingly.

The only exception to this is where a transition is due because it has previously been identified that a scheme's funding position has improved. For such cases, it would be sensible to ensure that the funding level has not fallen back over recent days before proceeding with the transition.

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