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How does the recession affect pension funds?

Background

If you, or your employees, are invested in a pension fund, like many of our clients and their employees, you may be feeling nervous and uncertain due to the volatility of both stock and currency markets. I hope that this overview will provide you with some clarity and comfort.

Nobody really knows what is going to happen and every event like this over the last 100 years has had its own distinct shape, specific problems and a variation in the time taken to achieve economic recovery. The current "credit crunch" is certainly no different.

A 50 percent drop in the value of the FTSE 100 since July 2008 is scary whichever way you look at it, and if you look at it head on, then it is positively terrifying. Despite this, the net result of where we are today is that there are four times as many people buying shares rather than selling them right now.

What is likely to happen now?

Now that it is clear we are in a recession, we can begin to join the dots and speculate as to what type, and how bad, it is really going to be this time. As we have already said, each episode of this type has its own distinct features, however, you normally see some common factors such as a stock market crash, a lack of cash, downward pressure on currencies, house prices falling and increased unemployment. In the past, specifically in 1929 - 1933 and 1987 - 1991, these key indicators all took place over a long and drawn out four year cycle.

The main difference this time is that four out of the five key features have already happened: the stock market crash, the credit crunch, house prices falling and a currency devaluation. With many employers talking about making significant redundancies in the coming months, and others drawing up contingencies for redundancies in Q1 2009, we will effectively see all five key indicators collide inside four months, as opposed to over four years as happened after 1929 and 1987 events.

The perfect financial storm

In effect, this could be the perfect financial storm, which has never been experienced before.

Whilst there are a number of possible outcomes from this "Big Bang", these two seem the most likely:

1. It will take three/four years for the world's economies to recover.

or:

2. The effect of this massive conflagration happening in such a short period of time is a bit like bombing a raging forest fire. Starved of oxygen by the blast, the fire is extinguished and by the next full year, often green shoots are seen coming through.

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The fact that interest rates are lower and people have more savings (albeit we have borrowed more as well), combined with the underpinning of various major financial institutions by assorted governments, will all help to soften the blow of this recession. However, it would be foolhardy and wrong for us to say that this is not going to be a tough time. It will be extremely tough, with much personal financial hardship, house repossessions, business failures and wholesale redundancies hitting most businesses and people in the UK.

That said, the more we look at the second possible outcome, the more it has resonance for us.

The road to recovery - what does the past tell us?

As we have said, whilst no two stock market crashes are the same, there is evidence to suggest that whilst members of the public are suffering personal hardship in a recession, the stock markets are still able to recover lost ground fairly rapidly.

If we look at the 1929 event, the full effect of the Great Depression did not bite until 1932 when the Dow hit rock bottom and the index actually grew 30 percent between 1932 and 1933, despite people suffering dreadful financial hardship.

The worst short term crash of recent years, saw the market fall nearly 800 points from October to November 1987. Then, of course, the market was only at the 2400 level, so the effect was far more dramatic. However, by 1989 the market had recovered 50 percent of its losses and by 1990 all of them. In fact the worst period of all for stock market losses was from April 2001 to July 2003 when the market fell by nearly 3500 points - half its value - from nearly the 7000 level to the 3500 mark - a massive and consistent drop yet, how many people remember or know that?

Let's now explore how the drop in 1987 affected the main pension providers and their flagship "managed" funds.

The following analysis was carried out by Thomsons Online Benefits on six of the main pension providers in the UK: AEGON Scottish Equitable, AXA, Friends Provident, Legal and General, Norwich Union and Standard Life.

Of these six providers, all of them averaged a drop in fund value of 21.5 percent in October 1987, however, by October 1989, all of them had regained their losses and advanced by an average additional 10 percent. It is clear from our analysis, that even in the worst drop in living memory, only those who wanted to retire within two years of October 1987, were adversely affected by variances in their pension funds at that time.

So what happens next?

Let me try and finish on a positive note. Pensions are a long term saving plan, in an ideal world we would all pay our pension contributions into our pension funds each month at the lowest possible price and then see the markets soar just before we cashed in and retired.

It is quite possible that a severe and savage correction like this will be looked back on in a few years time as a "rebasing" of investment and currency values. This "rebasing" ensures that the next investment cycle has a solid foundation which will allow all of us a chance to invest in pension funds when they are at a significant discount to the prices achieved over the last few years.

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Finally a few words from Warren Buffett from a piece in last weekend's broadsheets:

"I do not like to opine on the stock market, and again I emphasise that I have no idea what the market will do in the short term. Nevertheless, I will follow lead of a restaurant that recently opened in an empty bank building and advertised: "Put your mouth where your money was". Today my money and my mouth both say equities".

So if you have more than two or three years to go to retirement, it might well be time to consider "filling your boots" and re-entering the stock market in equity pension funds, but if you are in any doubt, you must always check first with your own personal independent financial adviser or contact us directly.

Michael Whitfield
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