

Pensions: Pension insurance

An oil spill in the Gulf of Mexico might seem a long way from UK pension deficits. However, as the BBC pointed out last night, there is a strong link. Most UK pension funds own BP stock.

June 2, 2010

Pension investments

Pension plans are one of the largest investor bases in many developed economies, the UK included. BP would have been seen as a natural choice of stock for pension plans. The company is British, large and has reliably paid a good dividend. Moreover, oil and energy prices would seem to be a good hedge for the inflation risk carried by most pension schemes. Reported figures suggest that something like £1 in every £6 or £7 pounds in dividends paid to UK pension schemes are paid by BP.

Oil shock

The market capitalisation of BP has fallen significantly; more than even the wildest estimates of the cost of the clean up and damages faced by the company for the Gulf of Mexico oil spill. The market cap fell by £13bn in the trading day after the company announced that its top-kill attempt had been unsuccessful. This market action would suggest that traders believe that the damage to BP from the GOM oil spill is far more extensive than just the clean up costs and associated law suits.

Putting the boot in

The Obama Administration has already surprised many, including the American business community, by using the phrase: "... keep our boot on the throat of BP". The President certainly is keen for the company

to take the blame. His latest idea is that BP should cease paying dividends until the leak is stopped. Whilst President Obama's angst to stop the leak is appreciated, this would have a major impact on the everyday population in the UK.

Actions by the US President could have a major impact on UK pensions. This is not a risk scenario that many will have thought about.

UK Pensions

Whether or not BP survives is still to be played out. BRAVE Partners agrees with a recent article in the Times imploring the UK population to support the company. Inquests will apportion blame later, but the company is an important asset for the UK. The most important issue for pension funds right now is not the ultimate value of BP stock, but the potential loss of immediate income through its dividends. Pensions funds need to pay their pensioners. In the current low yield environment, income is scarce. If a large portion of current income

disappears, then this will have a major impact on pension scheme funding. Pension trusts will need to sell assets to meet pension payments.

VaR VaR away

Classic value at risk, and most other, risk modelling techniques would not have highlighted this specific risk. The risks sits between a idiosyncratic and systemic risk. It is an idiosyncratic risk in that it relates to a single stock, BP. It is also a systemic risk in that it relates to selling assets at depressed values. This risk would be hard to pin down.

Pension fund risk management

Most pension funds will not have a good overview of the income sources of their portfolio. VaR and other techniques will look at value risk, but historical volatility measures would make BP's value look quite stable. Over the long term, BP might recover fully. However, the immediate hit is the amount of income that the company provides. Especially, that more rare type of income – dividend income.

A well management pension fund would seek to identify this type of concentration in the production of any of its key risk drivers, income, inflation, etc... It is amazing to BRAVE Partners that the UK pension investments can collectively become so exposed by a single event.

BRAVE Partners' Services

BRAVE Partners can advise pension schemes on their risk exposures at all levels including:

- A broad overview of general exposures
- Specific levels of exposure to key risk drivers through investment and other concentrations.

The firm has also identified a number of income generative, growth assets that can be used to diversify the portfolio.

Interaction

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- The BP crisis could have a major impact on the UK pensions sector.
- BP provides a significant amount of income to UK pensions.
- BRAVE Partners is surprised about how concentrated UK pensions are in BP.
- The firm believes that UK pensions cannot be analyzing their risk effectively if they carry such a concentration.
- BRAVE Partners can advise UK pensions on their risk exposures and concentrations.
- BRAVE Partners can advise pensions on diversifying income generative growth assets that could replace share concentrations such as the BP concentration identified by the crisis.

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