BROADSTONE

Briefing Note – The latest market impact of the Russian invasion of Ukraine and considerations for trustees

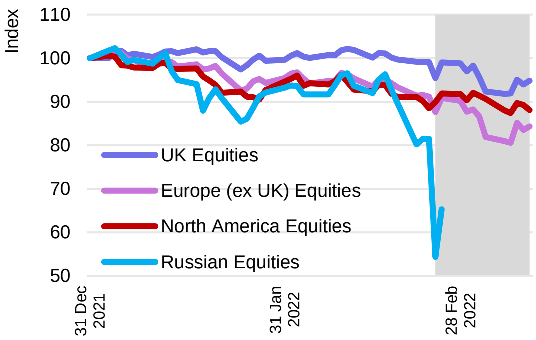
Following on from Briefing Note 220, which described how markets initially reacted to the invasion of Ukraine by Russia two weeks ago, this Briefing Note provides an update on how different asset classes have been affected by the continued escalation of these events.

The biggest impact to schemes from this crisis is likely to be felt via exposure to investment markets, and this note summarises the latest market impact, together with some recommended actions for trustees to consider.

Latest market impact

In the following sections we describe how various asset classes have performed since the beginning of the year to 11 March 2022, and specifically, the effect on investment markets of Russia's invasion of Ukraine.

Equity markets



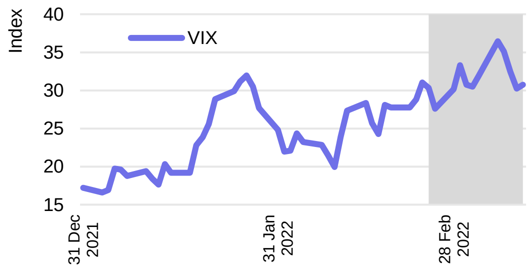
Source: FTSE, MICEX. Scaled to 100 as at 31 Dec 2021. Russian equity markets suspended from 28 February 2022. Shaded area covers Russian invasion of Ukraine.

There has been a general sell off in equity markets since the start of 2022, with global equity markets down around 7% (in local currency terms) for the first two months of 2022.

As you might expect, European equities have been the most affected within developed equity markets, due to their close trading links with Russia and Ukraine.

Russian equities started to quickly sell off following the commencement of the invasion. The Russian stock exchange has been suspended since the end of February, until at least 18 March 2022 (at the time of writing) leading to a freeze on the trading of these securities.

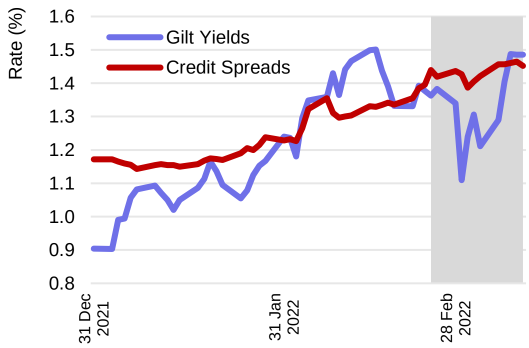
Equity market volatility



Source: VIX. Shaded area covers Russian invasion of Ukraine.

The increase in general equity market volatility (as measured by the VIX index) can be seen above. Volatility in markets has broadly doubled since the start of the year. This can also lead to uncertainty for investors, as well as cause trading spreads to increase, leading to larger transaction costs when moving assets.

Government and corporate bond yields



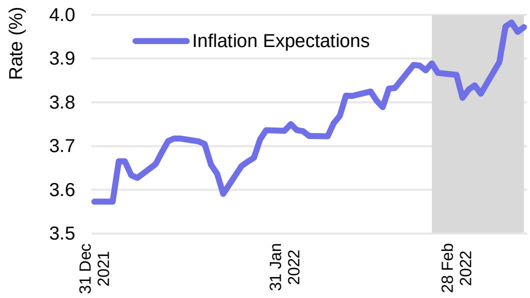
Source: FTSE, iBoxx. Based on 'all maturities' bonds. Shaded area covers Russian invasion of Ukraine.

Interest rates (as measured by gilt yields) rose at the start of the year, as expectations for interest rate rises from several central banks, including the Bank of England and the US Federal Reserve, built.

Russia's initial invasion of Ukraine led to a general 'flight to safety' in markets, with investors moving towards the historically 'safe-haven' asset class of bonds, amongst others. This caused a brief drop in gilt yields towards the end of February, which subsequently rebounded as investors rebalanced their portfolios.

Credit spreads, the difference between the yield obtained on government bonds and corporate bonds, have been steadily tracking upwards since the start of the year. This demonstrates the general deterioration in market sentiment over recent months.

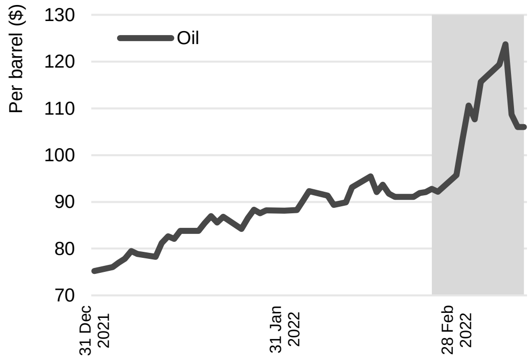
Inflation expectations



Source: FTSE. Based on long-dated inflation expectations. Shaded area covers Russian invasion of Ukraine.

Short-term inflation expectations, already high (relative to recent years) at the start of the year, have continued to move upwards as markets start to price in the impact of rising commodity prices (see below).

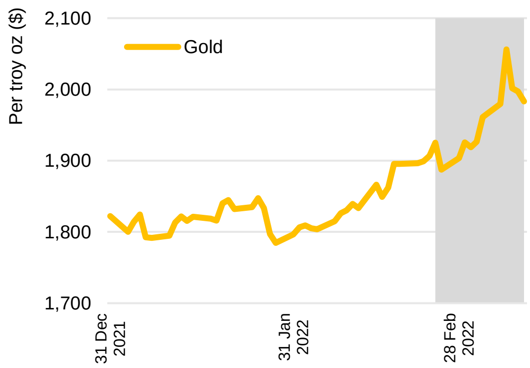
Commodities



Source: WTI. Shaded area covers Russian invasion of Ukraine.

Oil prices have shot up since the start of the invasion, as sanctions imposed by Western countries on Russian oil have raised supply concerns.

OPEC have recently announced an increase in agreed production limits, which they had previously advised would not change. This has eased some of the pressure on supply chains, leading to a slight reduction in oil price increases in the last few days.

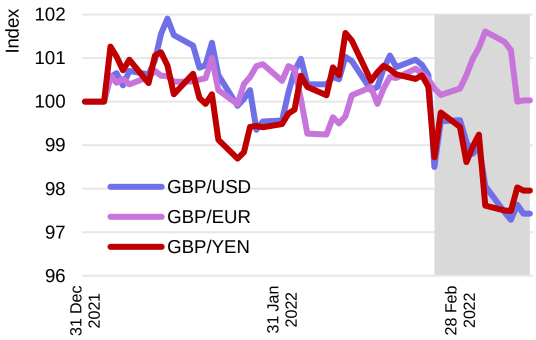


Source: FT. Shaded area covers Russian invasion of Ukraine.

Precious metals, such as gold and nickel, have also seen large price increases in recent weeks.

Gold is still seen by investors as a 'safe-haven' asset class, while nickel, which is used in the production of electric car batteries, has seen its price double twice in the last week, leading to a suspension in the trading of the precious metal.

Currency movements



Source: FT. Scaled to 100 as at 31 Dec 2021. Shaded area covers Russian invasion of Ukraine.

Safe haven currencies such as the US Dollar and Japanese Yen have appreciated over recent weeks.

How are investment managers responding?

Index-tracking managers

Over recent weeks, major index providers including MSCI, FTSE, STOXX and JP Morgan have all confirmed that they have removed, or will be removing, Russian securities from their indices with immediate effect.

The effect of this will be to force index-tracking managers to sell their Russian equity and bond holdings. However, many index-tracking managers have already set the price of these holdings to zero, to ensure they are tracking their respective indices.

Index-tracking managers are likely to continue holding underlying Russian assets within their funds until financial sanctions are eased or removed. It is therefore expected to take some time for Russian assets to be fully disposed of from index-tracking funds.

Where a fund holds general exposure to emerging markets, there is also expected to be some rebalancing of assets away from Russia and Ukraine, and towards other emerging market countries such as China, Thailand and Mexico, to reflect changes in the composition of the emerging market indices.

Active managers

Active managers have more discretion over what they hold in their funds. As such, they will not become forced sellers of any Russian or Ukrainian assets and can choose when to change the underlying holdings in their funds. However, like index-tracking managers, most active managers are unlikely to be able to sell any Russian or Ukrainian assets in the short term, even if the manager wishes to do so.

The majority of investment managers used by UK pension schemes are expected to have very limited direct exposure to either Russia or Ukraine in their funds.

Indirect exposure

Even if a fund does not have significant direct exposure to Russia or Ukraine, indirect exposures may be present, and can often be difficult to determine accurately.

The list of companies withdrawing from Russia continues to grow daily, either as a result of the sanctions imposed by Western nations, the company's own internal decision-making, or because of pressure from consumers or social media. A reduction in revenues may lead to lower global corporate earnings, and in turn, equity prices falling. The effect of this may not be fully realised within markets for some time.

Some managers are also reporting that some multi-national companies, such as Russian gas provider Gazprom, are now scoring lower on their internal Environmental, Social and Governance (ESG) scoring systems and becoming 'sells'.

Impact on scheme funding levels

The large rise in gilt yields seen above will have reduced the value of Defined Benefit pension scheme liabilities considerably, all other things being equal.

However, this has been countered by a similarly significant increase in inflation expectations.

The overall effect of these movements on the value of a scheme's liabilities will depend on its specific interest rate and inflation exposure.

During times like these, with large movements in interest rates and inflation expectations, it is more important than ever that trustees ensure that there are appropriate levels of hedging in place for their specific scheme.

Falls in growth asset values should also be factored into any assessment of funding level.

Trustee actions

We set out some practical considerations for trustees below. Trustees may wish to convene a special meeting to discuss their investments and the following items and recommendations with their advisers.

Employer covenant – trustees should understand the impact of the conflict on the sponsor. This impact could come from a number of different aspects, such as exposure to the geographical region through operations, suppliers or customers. This impact may be more acutely felt for schemes with an overseas sponsor.

Recommended actions:

- Review the latest employer covenant report or recent reports from the sponsor for any reference to potential exposure.
- Discuss the conflict with the relevant representatives from the scheme sponsor.
- Consider contacting the covenant adviser for an update on the impact on the scheme sponsor.

Scheme funding – changes in the employer covenant, coupled with volatility in asset and liability values, could all impact the scheme's funding position.

Recommended actions:

- Contact the Scheme Actuary for their assessment on the current funding position and any contingent plans that need to be instigated.
- Ask the Scheme Actuary to comment on the transfer value basis to ensure fair value is provided to members.

Impact on members – individual members could be impacted across a number of different areas:

- Members of Defined Contribution schemes may need some support to consider their self-selected funds and ensure that these remain appropriate. This may be more important for those members currently going through a lifestyling transition, or who are close to retirement.
- Members of Defined Contribution schemes may also want to understand and/or reduce their exposure to Russia, to reflect their personal views.

- Similarly, members of Defined Benefit schemes may also have views on the investments held by trustees, and may seek assurances from them as to the scheme's exposure to Russia.
- Members may have bank accounts in Ukraine or Russia (or accounts with Russian banks elsewhere) which may be impacted by sanctions levied on the Russian economy. For example, pensions may not be able to be paid to such banks.

There may be an increase in scams which ride on the coat tails of fear stoked by the current events.

Recommended actions:

- Consider whether a member communication should be issued which provides support for members who may be considering their investment options, and which details the trustees' actions in respect of their investment holdings to date.
- Contact members who have been identified as having bank accounts that are in the region or could be impacted by the sanctions.
- Remind members to be wary of the increased risk of scams.

Operational – there may be an increased risk of schemes being unable to operate efficiently, either through an increased risk of cyberattacks, or due to advisers outsourcing their work to Russia or Ukraine.

Recommended actions:

- Ask advisers to confirm whether they have any exposure to the region relating to services for the trustees or sponsor. We can confirm that Broadstone has no exposure in this regard.
- Ask advisers to confirm what they are doing to ensure they can cope with the heightened risk.

Asset transfers – trustees should consider delaying any transfers that are not time critical, in order to avoid potentially increased transaction costs or crystallising recent market losses. Otherwise, it may make sense to stagger transitions to avoid moving assets at an inopportune time. Trustees and their advisers should ensure that any out of market exposure is as low as possible, due to the raised levels of market volatility.

Asset rebalancing – trustees should consider whether any asset rebalancing needs to be undertaken as a result in the volatility seen in markets since the start of the year. The appropriateness of any rebalancing will depend on the scheme's specific holdings and taking into account our comments on asset transfers.

De-risking triggers – due to the increased volatility in markets at present and the recent rise in gilt yields, de-risking triggers may be hit sooner or more frequently than previously predicted. Trustees should be ready to act quickly once these triggers have been hit but should also consider whether the de-risking action remains appropriate.

Cashflow needs – trustees should ensure that they have enough liquidity in their portfolios to ensure that benefit payments can still be made. Trustees should avoid becoming forced sellers of growth assets and be aware of any of their holdings that may currently contain 'frozen assets'.

Hedging levels – trustees should ensure that the scheme's hedging levels against interest rate risk and inflation risk remain appropriate. In addition, if inflation expectations rise further, the inflation sensitivity of a scheme's liabilities could fall as any caps on pension increases start to have more of an influence. Trustees may therefore wish to review the level of inflation hedging in place.

Collateral pools – trustees should ensure that the collateral pool used for any LDI holdings remains sufficiently large and liquid enough in the event of larger and more frequent LDI collateral calls. Otherwise they risk becoming a forced seller of growth assets.

ESG – the Russian invasion of Ukraine has brought into sharp focus the reliance of European nations on Russian oil and gas supplies, and accelerated the conversation on the need of Europe to de-carbonise its energy markets. Such de-carbonisation is likely to require significant amounts of investment, and pension schemes may wish to consider being part of this change.

Broadstone view

The risk exposure of schemes to this crisis may not be immediately obvious, and this note has set out some of the most pertinent points for trustees to consider.

However, having gone through the coronavirus pandemic, we believe it is likely that trustees' processes to cope with unexpected shocks, and their ability to react in a timely way, are now stronger and more resilient than they were previously.

Opposite we set out a five-point checklist of the issues that we believe are the most important for trustees to focus on in the current climate.

Please do not hesitate to contact Broadstone to assist you in any of the recommendations set out in this Briefing Note.

If you have any additional questions on the behaviour of markets, or specific issues relating to your scheme, then please contact your investment consultant or scheme consultant in the first instance.

Once again, our thoughts and wishes are with all those impacted by the ongoing situation in Ukraine.

Top 5 Checklist

We appreciate that this briefing note provides a vast array of things for trustees to be thinking about at this moment in time, on top of their normal trustee duties.

We have therefore set out a five-point checklist below of the most important issues which we believe all trustees need to be considering in respect of their pension schemes:

1. **Asset exposure** – trustees should understand the scheme's asset exposure to the regions and asset classes affected by the events in Ukraine. Trustees should also understand how further sanctions may impact the scheme's assets, and whether any assets are at risk of being frozen and becoming illiquid.
2. **Funding and risk exposure** – trustees should assess how the scheme's funding position and risk exposures have changed in light of the moves seen in global markets as a result of the crisis.
3. **Liquidity** – trustees should ensure that their asset portfolio has enough liquidity to continue to pay pensions and other benefit outgo, and that the scheme has limited assets that are at risk of becoming 'frozen'. In addition, trustees may wish to review the level of assets being held on their bank account for meeting pensions payments.
4. **Cyber security** – there is some evidence of increased cyberattacks since the war started, as well as an increase in the amount of misleading information on social media. This can lead to issues for trustees, companies and pensioners in accessing bank accounts, and may lead to an increased risk of pension scams. Trustees should refrain from transferring large amounts of money to unfamiliar third parties, and warn members to be wary of any unsolicited approaches to transfer their pension benefits.
5. **Member communications** – members may benefit from reassurance that trustees are managing the situation as best they can, and a communication to members could help with this. We have learnt from the COVID pandemic that members like to be informed and updated in uncertain times. We recommend that trustees consider whether their members would benefit from such reassurance at this time.

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