

Press release

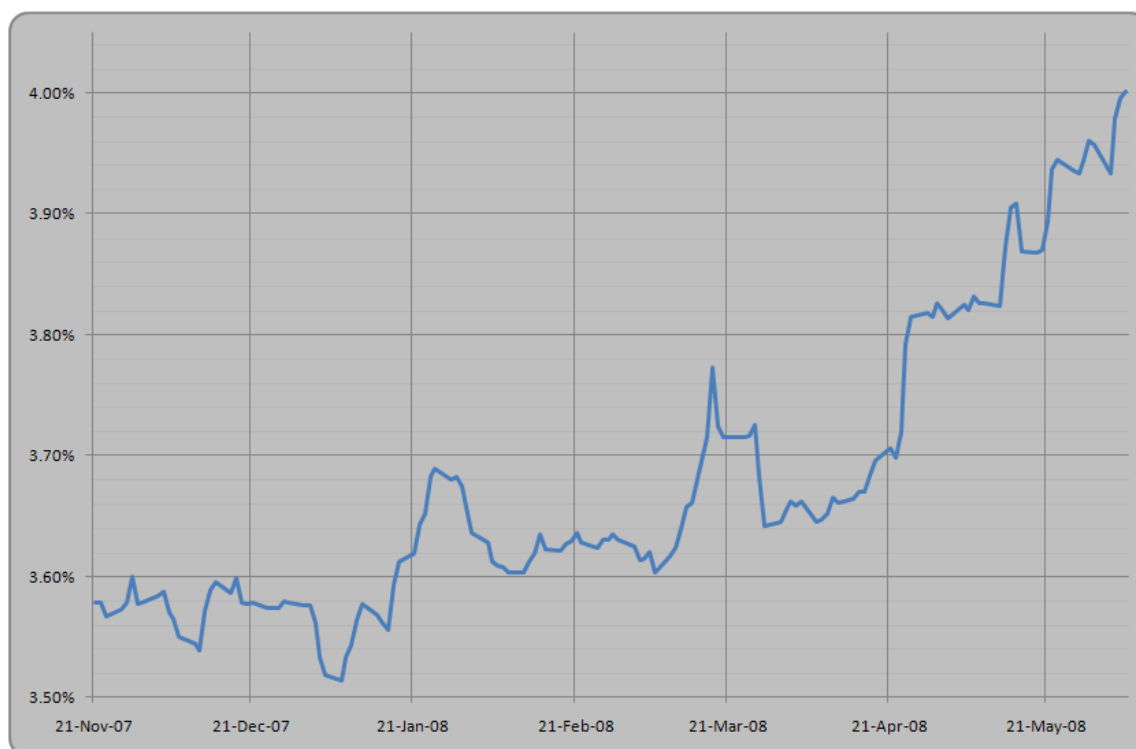
RISING INFLATION THREATENS DEFINED BENEFIT PENSION SCHEMES

Estimated £56 billion added to value of liabilities of aggregated schemes of FTSE100

London, 11 June 2008: Redington Partners, the independent consultancy firm that advises pension schemes and insurance companies on investment strategies, said that the recent rise above 4% in long term inflation expectations will have serious repercussions for defined benefit pension schemes.

In the past year, long term inflation expectations have increased by around 0.70%. Redington estimates that this increase has added approximately £56 billion to the value of the liabilities of the aggregated pension schemes of the FTSE100.

Figure 1: Breakeven Inflation on 2047 Index-Linked Gilt



Source: Bloomberg

Long term interest rates are not rising by anywhere near enough to offset the sustained rise in inflation expectations. This has put pressure on the real yield, the difference between nominal interest rates (which are typically above inflation) and inflation expectations (which are typically below interest rates). The result has been that the long term real yields have fallen to historically low levels, below

those seen in January 2006 - their previous historic lows. The yield on the 2055 index linked gilt has now fallen to just 0.29% in recent days. Only those pension schemes that already hold a sufficient quantity of very long dated index linked gilts (few do) or have hedged the risk using inflation derivatives are protected. For the rest, their liabilities are soaring and their assets are not keeping pace.

In the last few weeks the problem has been exacerbated as the capital markets have become more constrained and volatile. Even the short end of the Euro swap market – which is usually highly liquid – has experienced much greater volatility than usual and the inflation market has suffered from the same effects of constraint and uncertainty. In addition, August sees the removal of the 2 ½% 2013 index linked gilt from one of the major benchmark (Over 5yr ILG) indices tracked by pension schemes. This will increase the duration of the benchmark and will lead to even greater demand for long end gilts in order to match the new adjusted benchmark.

Dawid Konotey-Ahulu, Partner and Co-Principal at Redington Partners, said: “Pension schemes that fail to address the insidious slow burn of rising inflation are rolling a loaded die. These inflation expectation levels may be a temporary aberration but fundamentals as well as technical signals look ominous. Systemic demand for inflation linked assets continues to outstrip supply, and assumptions that these high levels can’t or won’t last may turn out to be heroic. Shortly, we are likely to see negative real yields at the long end and that is going to have profound implications for pension schemes as they try to match their burgeoning liabilities.

Robert Gardner, Partner and Co-Principal at Redington Partners, added: “Although current corporate accounting methodology provides some minimal protection, FTSE 100 pension schemes in aggregate are seeing serious real deteriorations in their levels of funding. Each 0.01% increase adds around £820 million to FTSE 100 liabilities.”

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Notes to editors:

About Redington Partners LLP

Founded in 2006, Redington Partners was established by two investment bankers, Dawid Konotey-Ahulu and Robert Gardner, to offer pension schemes and corporate sponsors clear and independent advice on investment strategy. The firm's aim is straightforward – to help clients implement an investment strategy with the greatest return on the scheme's assets in return for taking the lowest risk. Their approach is to blend investment banking technology with actuarial consulting to help trustees understand the risks they are running with respect to interest rates, inflation, equity, credit, property and longevity (among others). The ultimate aim is to achieve solvency on an economic basis within a significantly reduced timeframe.

Konotey-Ahulu and Gardner spent several years advising on risk management strategies for their clients and, in 2003, devised and implemented the first full LDI risk management transaction by a pension fund, Friends Provident Pension Scheme. Their experience allows them to harness effectively the technology of investment banks and asset managers to provide clients with a wide range of solutions.

First, Redington carries out a state-of-the-art analysis of the risks being run within the pension scheme. Then the firm advises on how best to control and reduce those risks cost-effectively.

Some of Redington's clients approach them having already embarked on the risk management process and re-allocation of assets, but requiring an independent assessment of their current position and the alternatives available to them. Others are just starting the process and require full strategic and analytical advice.

Redington has over £80 billion in assets under consulting.

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