REFLECTIONS

In the Minor Key

THE TONE of this year's Reflections is downbeat.

In recent months company pensions have received a lot of airtime. Scarcely a day goes by without a newspaper headline that another final salary ('defined benefit') scheme is closing, and so on.

All the confidence building in company pensions that's gone on since the Maxwell scandal eleven years ago seems to be coming undone.

A number of unrelated factors have combined to cause the present gloom in the UK pensions movement –

- The abolition five years ago of pension scheme tax relief on dividends received from holdings of UK shares. (The loss of income to PSS is currently equivalent to three weeks worth of pension payments a year, every year.)
- Recent statistics suggesting that people, particularly those born since World War two, are likely to live significantly longer on average than had been previously thought, or funded for by pension schemes.
- Dramatic falls since early 2000 in the value of stockmarkets. (See Investment Report, and Financial Statements on the centre pages for the impact on PSS.)
- The potential impact of a statutory Minimum Funding Requirement test introduced in 1997 concerns some employers and the workings of a new accounting requirement (FRS17) on reporting pension scheme costs and surpluses/deficits in company accounts worries many others.

The actual long term cost of a final salary type pension scheme cannot be known for sure in advance. So employers normally undertake to pay the 'balance of cost'. In other words their contribution rate will rise (or fall) according to their pension fund's investment performance and other factors. In the present climate this uncertainty is coming to be seen as too high a risk for the future by many employers. So final salary schemes are being closed – sometimes just to new joiners, sometimes even for existing members. In their place defined contribution plans are being offered, with a fixed employer contribution and no certainty of pension outcome for the member.

HOW IS THE PSS DOING AGAINST THIS BACKDROP?

- The unusual structure of PSS and its implications is outlined in 'Not a penny more, not a penny less'.
- 'Actuarial Valuation 2000' (back page)

l k t th PSS' f di iti t

SCHEME IN THE HANDS OF THE TRUSTEES

NOT A PENNY MORE, NOT A PENNY LESS

Accounts & Investment Report on Pages 2 & 3

WITH OTHER companies closing 'final salary' type schemes, why hasn't Pilkington considered it?

The answer lies in the fact that the PSS's deed defines the contributions to be paid. This means that both the Company's and members' contributions are at fixed rates.

Pensions and other benefits have to be paid out of the funds built up from these fixed contributions. As explained below, this type of fund provides protection for both the members of the Scheme and the Company. This concept of defined contribution was built into the PSS when it was formed by the merger of various pension schemes in 1962.

The costs of final salary schemes cannot be known in advance. Key factors like future inflation and earnings levels and investment returns are not predictable with certainty. In these schemes the employer generally commits to vary his contribution, on actuarial guidance, to meet the 'balance of the cost' of his arrangement.

In 1961 Pilkington (still a private Company) considered that the levels of inflation experienced since the end of the second World War had resulted in its existing money purchase basis of pension failing to provide a benefit which 'maintained a reasonable relationship to salary on retirement'. However the Company was determined not to take on an open-ended commitment in moving to an average final salary scheme. So its contribution rate was written into the new rules, just like the member's.

Provisions were built into the PSS deed to back up the force of the fixed

INCREASES 2002

The general pattern of PSS increases from 1 July 2002 is -

FIRST IN PAYMENT	%
On or before 31 March 2001	1·3
During April 2001	1·1
During May 2001	1·0
During June 2001	0·9
During July 2001	0·8
During August 2001	0·7
During September 2001	0·6
During October 2001	0·5
During November 2001	0·4
During December 2001	0·3
During January 2002	0·2
During February 2002	0·1

GUARANTEED MINIMUM PENSIONS in payment and relating to membership before 6 April 1988 were not increased. These are increased by the DSS with the basic state pension.

MORE, NOT A PENNY LESS

Continued from Page 1

Company contribution rate. Firstly, any actuarial surpluses generated over the years belong to the Scheme. It is not open to the Company to reduce its contribution, or take a full holiday from contributions. On the other hand the Deed says that if an actuarial deficit is identified there will be no requirement on the Company to increase its fixed contribution rate.

The Company reinforces the point in its published Report and Accounts this year.

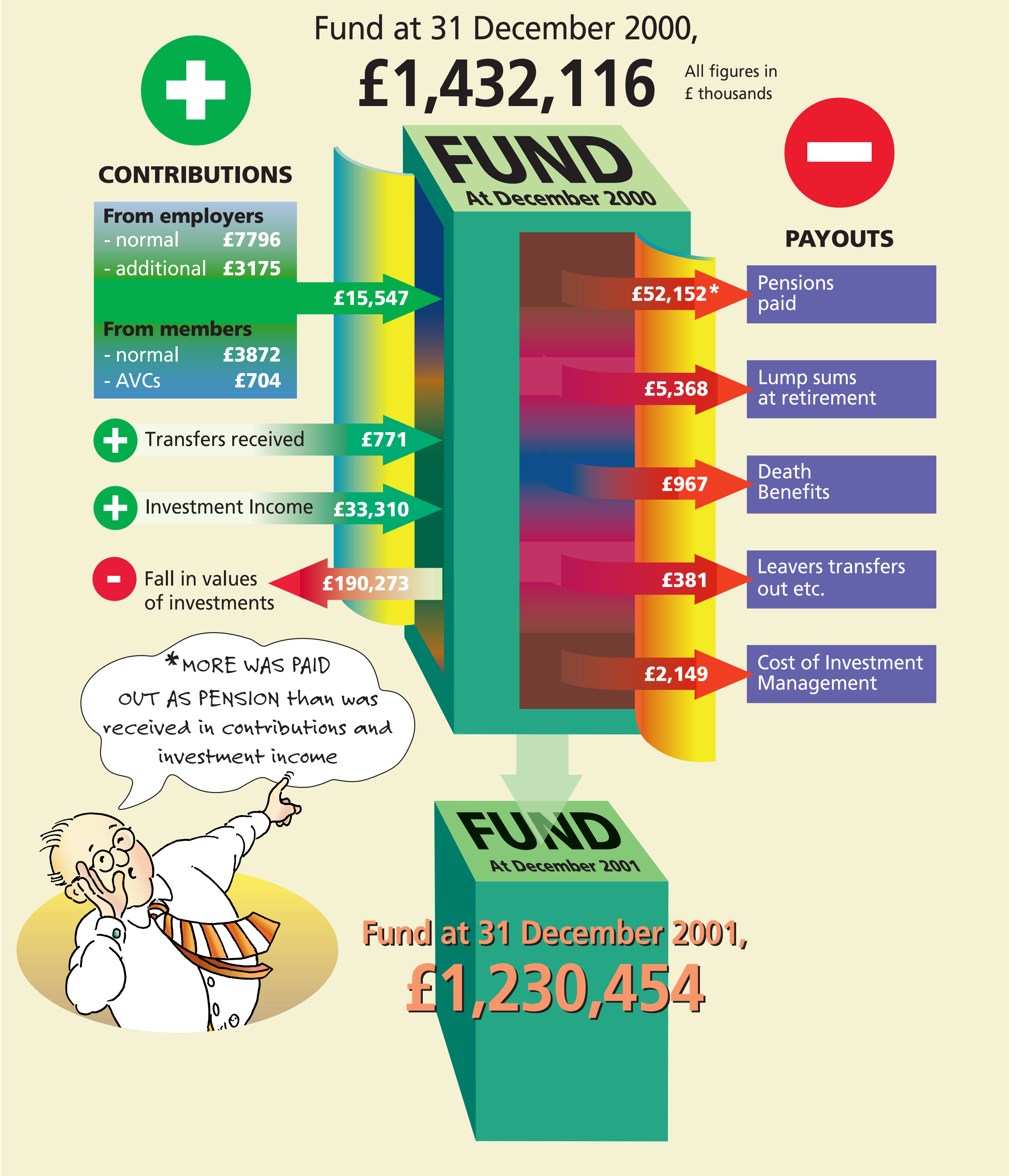
So managing surpluses, and deficits, is in the Trustee's hands. Since it cannot call on the Company for more it has taken a prudent approach to spending surplus. Over the years benefit improvements have been made and annual pension increases paid from the surpluses. Since the mid 1980s those increases have been linked to a published formula. But that formula is conditional on the actuary confirming it can be afforded.

If the PSS's funding level were to fall because, for instance, of continuing poor investment conditions, the level of increases might fall or their frequency reduce to safeguard the PSS's solvency, because the Trustee cannot insist the Company pays more. The PSS's members and pensioners do bear some risk – just as in defined contribution schemes now being adopted in other companies.

In such a situation, as and when the investment performance improves again, the Superannuation Scheme Trustee's first priority will be to restore the value of pensions.

KEY EATURES O THE PSS FINANCIAL STATEMENTS FOR 2001

The full Financial Statements forming part of the Trustee's Report are available on **www.superpilk.com** or from Pilkington Pension Services Limited



The New Trustee

THALES OPTICS – OPT OUT

31 MARCH 2001 saw an end of Thales Optics Limited's participation in PSS. The 262 PSS members employed by the company, which was previously called Pilkington PE Limited joined a

Thales Optics Limited, St Asaph

transfer their PSS pension benefits to their new scheme PSS paid over a

The u investment report is inc uded in the Trustee s Report

ECONOMIC AND STOCKMARKET BACKGROUND

The horrific terrorist attacks on New York and Washington on 11th September came at a time of increasing doubt about the sustainability of world economic growth. A year earlier the first signs of slowdown in the pace of U.S. growth were emerging, a response to raised interest rates at the 6.5% level together with the burden of high oil prices. In January 2001 a sequence of interest rate cuts had commenced in the U.S. and elsewhere which caused concern in global stockmarkets as the significance of possible recession in both North America and Japan, the 2 largest economies, became apparent.


Popperfoto

During Spring and early Summer sentiment in equity markets swung between optimism that economies would respond quickly to monetary stimulus and pessimism as the effects of slowdown spread to Europe and Japan. By the time of the destruction of the World Trade Centre most major stockmarkets had fallen progressively, investors recognising that an economic upswing in America could well be delayed until 2002.

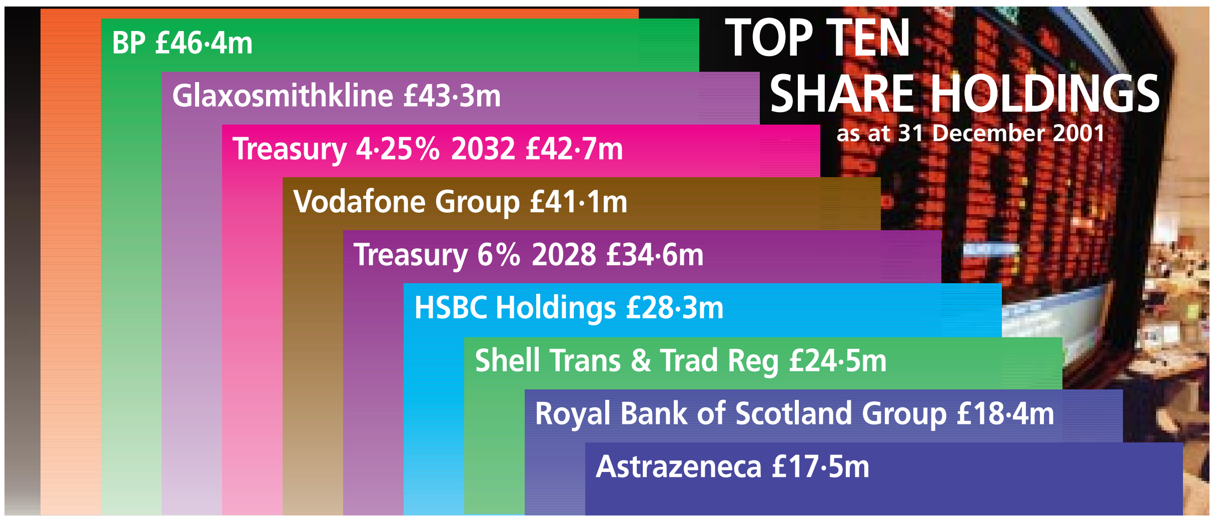
In the immediate aftermath of the attacks stockmarkets plummeted and the enormity of the events caused a change in the perceptions of risk in the developed world. For the first time since the Gulf War the Central Banks around the globe embarked upon substantial interest rate reductions in co-ordinated fashion. There was a flight to quality and to low-risk securities in equity and bond markets alike. Major equity markets had fallen by between a quarter and a third of their value by 21st September.

As it became clear that a knee-jerk military response was not possible, that all main powers were in sympathy with the U.S. and that the new President could not declare war against any one nation, markets absorbed the scale of the response. Equity markets snapped back, retrieving the September slump by early November. Improving news from Afghanistan, tax handouts in the U.S., falling oil prices and interest rates at 1960's levels - 11 cuts in the U.S. to 1.75% - helped investor sentiment improve during the last quarter of the year.

Within individual markets the year presented specific events and conditions with local influences, some favourable, others less so. In the U.K. it was general election time with public sector spending acting as support to the overall background of robust consumption, even though manufacturing suffered badly in contrast to many areas of the service side of our economy. Low unemployment, very low real interest rates and declining energy prices helped the consumer not least in the demand for housing, which drove up prices and stimulated related spending.

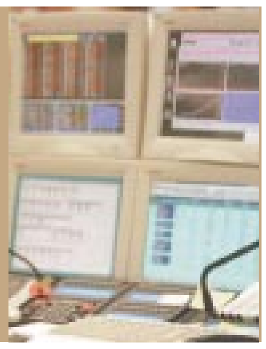
European economies operated at a variety of speeds during the year and the European Central Bank found difficulty in adjusting interest rates lower to assist Germany in particular and world growth in general, given that Eurozone inflation stayed stubbornly high. Japan continued with the painful adjustment towards structural reform both within the overall economy and the banking industry, still hampered by lingering problems of bad loans. Deflation, rising unemployment and recession was an unenviable combination for Japanese companies to endure.

In the U.S. and elsewhere there was a crop of failures amongst the very large companies, some as a result of excessive borrowing during the telecoms and media euphoria a couple of years earlier, others unable to escape the exposure of financial manipulation in accounting such as the Enron



INVESTMENT POLICY

	£000's
U.K. Bonds increased by	15,752
Overseas Bonds decreased by	(5,833)
Index-Linked increased by	59,281
U.K. Equities decreased by	(76,183)
Venture Capital decreased by	(81)
Overseas Equities increased by	32,843
Property decreased by	(33,154)
	(7,375)



The policy outlined, together with movements in market prices during the year, resulted in the following changes in the distribution of the investment portfolio:

	31/12/2001	31/12/2000
	%	%
Deposits, Cash	**4·3**	3·6
U.K. Bonds	**12·6**	10·2
Overseas Bonds	**2·9**	3·3
Index Linked	**7·4**	1·8
U·K· Equities	**44·2**	51·7
Venture Capital	**0·5**	0·5
Overseas Equities	**27·2**	25·7
Property	**0·9**	3·2
	100·0	100·0

RETURN ON INVESTMENT

The return (i.e. capital depreciation plus income) on the investments held by the Scheme was – 11.3%. The Retail Prices Index increased by 0.7%.

Over the last 10 years, the annualised return on the Scheme's investments was 10.0%, retail price inflation was 2.5% and there was a real return of 7.3% per annum.

The 20 year annualised return was 12.6%, inflation 4.1% and real return 8.2% per annum.

RELATIVE PERFORMANCE

	1999	2000	2001	3 years	5 years
	%	%	%	%pa	%pa
Scheme Annual Returns	23·8	-3·5	-11·3	2·0	6·9
Benchmark Returns	21·2	-1·8	-10·8	2·0	6·9

Note *the Trustee Directors set performance targets from 1st January 1997 at +0.5% above the benchmark (WM All Funds median return) on a rolling 3 year basis. The benchmark was changed from 1st January 2001 to a series of specific indices for each asset class, and a higher Bond content was simultaneously adopted. As a consequence of the transition to new benchmarks and weightings the Directors withdrew targets for the year 2001.*

BENCHMARKS

Following the events of September 11th and the collapse in equity markets the Scheme's portfolio briefly breached its 70:30 equity:bond limit set by the Trustee Directors. In what were highly uncertain times the Trustee Directors sanctioned temporary suspension of the 70:30 limit until their meeting in November 2001 and pending a planned revision of benchmarks

Notice of Change in 'Added Service' AVC formula

On advice from the Actuary 'added service' voluntary contributions paid from 1 January 2003 on will be pensioned on a different formula from those paid up to 31 December 2002.

This will be the first change in the formula since 1994.

The present formula converts each 16.94% contribution into one 'added year'. The 2003 formula will change the cost of an 'added year' to 19.46%.

The change reflects assumptions concerning investment returns and increased longevity made in the latest actuarial valuation.

A New Benchmark

One of the questions emerging from the actuarial valuation (back page) was – is the investment strategy right?

Like most UK pension funds the PSS has invested the great majority of its assets in *equities* – shares traded in UK and other stock markets. Over the years equities have produced higher returns than *fixed interest* securities and enabled the Trustee to make benefit improvements.

However any investment holding out the prospect of a greater return than another normally has a catch. It will be more risky. Its performance may be more volatile – more like being on a roller coaster ride from year to year – than the 'safer' lower risk alternatives.

Actuar al Valuat on 2000

THE RESULTS OF an actuarial valuation of the Scheme were reported to the Trustee in November 2001.

An actuarial valuation presents a snapshot of the financial strength of a pension scheme on a particular day, in this case 31 December 2000.

The actuary's task is to compare the assets held by the fund with the capital value of the pensions and other benefits due to pensioners and members for completed membership to the valuation day.

In evaluating the cost of those benefits the actuary has to make assumptions about life expectancy, future salary growth (contributors' pensions will be based not on salary levels at the valuation but on levels near the time their contributions end i.e. on leaving/retiring), and price inflation (to cost the effect of possible pension increases).

In many pension schemes an actuarial valuation is also used to assess the future contribution rate ("the balance of the cost") needed from the employer to ensure that a funding level target is maintained or achieved. However, this is not a consideration in PSS as the employer's contribution is fixed in the Rules.

The 31 December 2000 valuation was the first at which the actuary simply took the fund's assets at their actual market values. Previously he had valued the assets on the basis of the income they might generate into the distant future. However changes in taxation by Gordon Brown presented practical problems in continuing with that approach.

Actuaries argue that any valuation must treat the assets and liabilities (pensions, death benefits etc.) consistently. As the assets were taken at actual market values this time, so too were the liabilities.

The starting point for costing the liabilities was the choice of an interest rate to use in putting a value today on pensions payable some years in the future. The interest rate used was that available on Government stock ('gilts') purchased in the market on the valuation date. An adjustment was made to allow for the higher returns actually expected on the assets held by the Scheme.

On the assumptions used the Scheme's liabilities (allowing for contributors' future salary increases and pension increases for current and future pensioners) totalled £1.153 bn. As the assets, after minor adjustments, amounted to £1.414 bn, a surplus of £0.261 bn was disclosed by the valuation. Put another way the fund (as at 31 December 2000) appeared to have £1.23 set aside for every £1 of liabilities it might ever have to pay.

It seemed a strong position to be in. There is a problem. Market values can vary sharply over short periods.

2001 saw most world equity markets falling, with the slide only stopping soon after the 11 September catastrophe. The Scheme's assets, worth £1.414 bn at the valuation date, had fallen by £266m to £1.148 bn at end September.

So by the time the Trustee received the valuation findings in November any thought of benefit improvements seemed unwise. Much of the surplus (and strong funding cover) had disappeared with the fall in the value of the Scheme's assets.

The actuary explained to the Trustee that, although values of assets had fallen steeply over 2001, rises in the interest rates at which gilts could be purchased had also reduced the value of liabilities still leaving the Scheme with above one hundred percent funding cover.

The chart shows the actuary's later estimates of funding cover, through to 31 March 2002.

In the light of the valuation findings, the Trustee has decided to change the mix of the Scheme's assets, with the aim of ensuring more stability of funding level (see New Benchmark, page 3).

More Choice

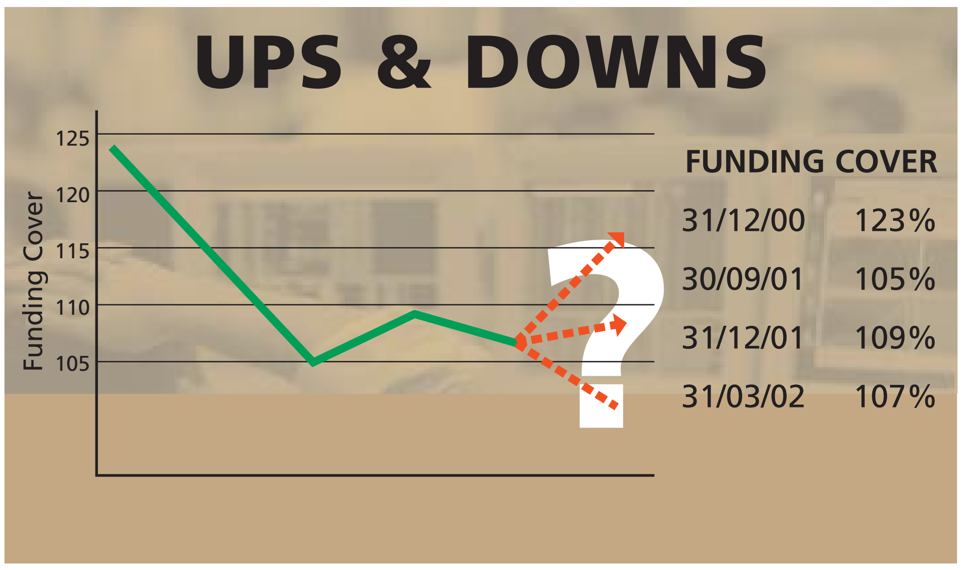
THE PSS RULES allow contributors and pensioners to make written declarations setting down their wish as to whom any lump sum payable on death should go. These declarations are not binding on the Trustee, but will guide its decision on the disposal of a lump sum death benefit.

Until mid January the Rules placed a practical restriction on the declaration of wish. If you had any relatives or dependants then the choice of names to go on your declaration had to be from them.

This restriction was removed by a change of Rule taking effect on 16 January 2002. Now you can name anyone or anything (club or charity) on your declaration of wish form.

IT'S NEVER TOO LATE

IT'S POSSIBLE to make tax efficient contributions to your favourite charities using the GIVE AS YOU EARN arrangements operated by the



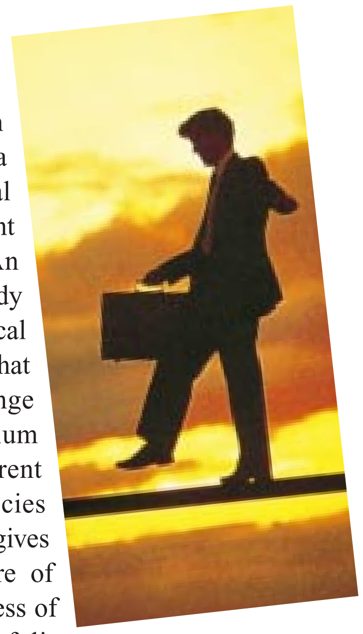
A New Benchmark

Continued from Page 3

'Safer' investment classes like *fixed interest* become increasingly important when pension schemes are faced with the need to meet sizable pension payments month by month – PSS now pays out £4 millions plus a month.

As last year's Reflections explained, at the back end of year 2000 the Trustee decided that the PSS fund should move over the following twelve months towards a new target composition involving a higher percentage of fixed interest stocks than in the past.

The decision was seen as the first of a possible series of such moves, depending on the information revealed by the actuarial valuation and an asset-liability study linked to it.



As explained (see Actuarial Valuation) an actuarial valuation gives a picture of a scheme's financial health at one point in time. An asset-liability study provides a statistical picture of how that health may change over the medium term if different investment policies are adopted. It gives trustees a measure of the relative riskiness of different portfolio mixes and the chance of their scheme becoming underfunded as well as generating surplus.

The conclusion the PSS Trustee drew from the study was that the *fixed interest* holdings should be increased (and so equities reduced) in two stages –

- To 35% of the fund in January 2002
- And, subject to review, to 40% in January 2003.

35% is actually the centre of the range (30/40%) within which the investment managers have freedom to position themselves.

Fixed interest has been taken by the Trustee to include gilts and index linked stock issued by the Government and high quality corporate bonds.

The investment managers continue to be tasked with outperforming the theoretical return calculated for the new porfolio mix by 0.5% a year on a rolling three year basis.

Full details of the new structure are published in the Statement of Investment Principles available from Pilkington