Commentary on...

Pension Scheme Investment for Employers

The investment of assets within a defined benefit (DB) scheme is typically the responsibility of its trustees. However, it is very important for the sponsoring employer to understand pension scheme investment issues so it can influence the strategy to meet its objectives for the scheme. Whether it is the effect of investment strategy on scheme funding, or the importance of maintaining a robust investment governance structure, the company will ultimately have to bear the risks taken within the scheme's investments.

Employers should engage with the scheme trustees on investment matters and must be able to do so confidently and decisively.

This commentary outlines some of the hot topics in pension scheme investment that sponsoring employers should be considering with their schemes' trustees.

A smoother ride - alternatives to equities

The majority of pension schemes are relying on equity level investment returns to help keep the company contributions at an acceptable level. However, for some, the volatility in returns from equities is becoming a greater concern. For schemes looking to achieve a similar level of return to equities, but with lower volatility, one attractive alternative could be 'multi-asset mandates'. The benchmark for an investment manager under this approach might be linked to cash returns (e.g. LIBOR + 5% pa) or inflation (e.g. RPI + 3% pa). The approach is known as 'target return' and involves the manager constructing a diversified portfolio to achieve their target with minimum volatility. Target return strategies can be further divided into two main types:

Absolute return: These funds seek to provide 'capital protection' alongside their return objective. For example, the manager will aim to sell out of equities ahead of an anticipated market fall, or hold derivatives which provide more explicit downside protection. There is a very high degree of manager risk because the strategy relies on the manager correctly timing their decisions. If market peaks are called too early then potential returns are foregone; if market peaks are called too late then the downside protection objective is missed.

Diversified growth: These funds rely on diversification across a broad range of different asset classes and markets, rather than explicit capital protection strategies. The asset allocation is generally set by reference to a model, but judgement is applied to either override or endorse the output of the model to some extent.

Why is this issue becoming more important?

As pension schemes mature and particularly when a DB scheme is closed to future benefit accrual, it is common for the scheme to become "cash negative", i.e. benefit payments out of the scheme exceed the regular contributions being paid in. This requires a strategy for meeting the cash outflows, but also has important consequences for the wider investment strategy due to the impact the pattern of investment returns can now have on overall performance.

Schemes with significant cash outflows, particularly when combined with a long-term strategy of selling equities (as they move out of growth assets into bonds), need to be aware that the returns achieved in the short term can have a significant effect on the long-term future returns required by the scheme. If returns in the short-to-medium term are poor, the growth assets will need to produce much higher returns later to catch up, as the net outflows (sourced from growth assets) will have led to a much lower allocation to growth assets within the portfolio. As a consequence, schemes may need to consider the extent to which they can be classified as a 'long-term' investor in respect of their growth asset holdings.

Property - alternative sectors

Property investment is an established component of many pension scheme portfolios. Its attraction lies in the relatively high expected yield (recently at its highest spread above gilts for 23 years), together with diversification from equity holdings.

Property investment will not necessarily appeal to all schemes as a stand-alone investment, given the illiquidity and relatively high dealing costs. In addition, typical balanced property funds are currently seeing void rates of just over 10%, which will be a significant drag on performance. The void rate for individual properties of course depends heavily on the sector and location.

Typically a Balanced Property Fund, as would be used by most small/medium sized schemes, includes a cross-section of commercial property. However two new sectors are gaining popularity and could be considered as alternatives:

Long Lease: With leases usually over 20 years, this sector is popular as a 'matching' asset for long duration inflation-linked liabilities.

Secondary: With lower quality tenants or locations than the 'prime' property market, higher rates of rent are paid to compensate for the higher associated risks.

More information about property as an investment for pension schemes can be found on our website (*here*).

The price is right - gilt-y questions for UK pension funds

For employers looking to de-risk their scheme by increasing the bond and gilt holdings, the future level of gilt yields (i.e. the yield the scheme will get on future gilt purchases) will be a key determinant as to the cost of the scheme. In addition, pension scheme liabilities are often measured by reference to long dated gilt yields, so short-term changes in the level of gilt yields will have a significant impact on the funding position of a scheme, unless steps have been taken to hedge out this risk.

There is currently a substantial debate within the pensions industry over the future prospects for gilt markets. Barnett Waddingham has produced a note which provides further discussion on this issue and can be found on our website (*here*).

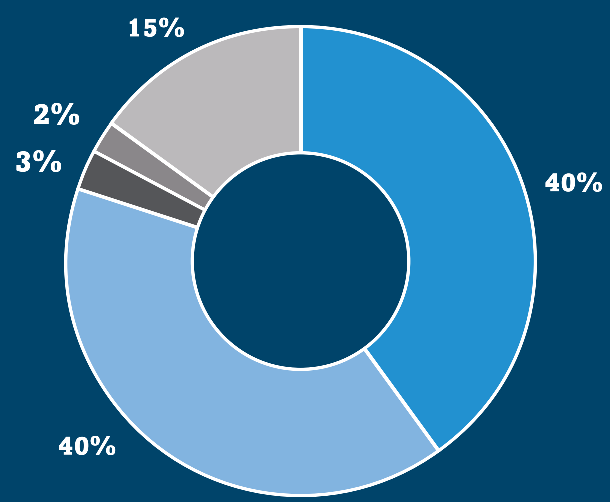
One could easily believe that gilt yields will rise over the next few years. However, to the extent that the market believes this, the impact (lower gilt prices in future) will already be priced into the gilt market at appropriate durations. Employers need to be aware of this point and understand the implications for their scheme from a funding and investment perspective if gilt yields do not rise in future. Equally, if the anticipated rises in yields do materialise, employers should make sure that opportunities to de-risk at an acceptable price are considered and, where appropriate, taken without delay.

The extent to which current gilt yields are impacting on scheme funding will depend on the maturity of the scheme in question. For example, in a scheme with an average term to payment (duration) of 20 years, each 1% drop in the reference gilt yield will, all other things being equal, increase the value placed on the liabilities by 20%. Employers may therefore wish to consider ways of funding their scheme which are less bound by the conditions in the gilt market. The Pensions Regulator's (TPR) Annual Funding Statement issued earlier this year emphasised different approaches to funding, which provided encouragement in this area.

In addition, we have also seen employers managing increased funding deficits by extending recovery plans, which is in line with TPRs new objective to minimise any adverse impact on the sustainable growth of an employer. Employers may also want to look at alternatives to financing these deficits up front, such as asset backed funding, to provide security for scheme trustees but without risking trapped surpluses if gilt yields revert to their previously higher levels.

Asset allocation in practice

The investment strategy is a crucial component of the risks associated with a pension scheme.



EQUITIES BONDS PROPERTY CASH OTHER

There are around 80 companies in the FTSE350 which disclose details of their asset allocation beyond the most basic classes shown above. Bulk annuity policies are the most popular example, but schemes are also allocating more assets to Diversified Growth Funds and Liability Driven Investments.

The allocation to equities has been steadily decreasing over the past decade - a typical asset allocation was once 60% equities and 40% bonds, but this has essentially now switched the other way around as schemes mature and employers seek to reduce the volatility of scheme deficits reflected in their balance sheets.

What to do with your gilts?

Although gilt holdings provide some hedging of pension liabilities, a much better match is provided by a bulk annuity policy. These of course match the longevity risk, in addition to the investment and potentially inflation matching offered through gilt holdings. The downside is that the price paid will include an allowance for insurance company margins for possible adverse experience, expenses and their profits.

Traditionally, bulk annuities were used only to 'buy-out' pension liabilities upon winding up a scheme, but it is now more common to 'buy-in' liabilities whereby the bulk annuity policy is simply an asset of the scheme that matches a portion of the liabilities (e.g. just the pensions already in payment).

Insurers' pricing of bulk annuities reflects, among other things, the yields available on the assets that will be held to back them, which is generally a combination of gilts, corporate bonds, and swaps. As a result, schemes that are invested in gilts may find that a portion of these could be used towards a buy-in policy for pensioner members with minimal negative impact on the scheme's funding level. This option was particularly attractive in 2012 when there was a large gap between gilt yields and corporate bond yields. Although the opportunity is not as good currently, employers may still find this a palatable way to remove risk for a relatively small cost. This approach is most appropriate where the portfolio of protection assets would retain sufficient coverage after the bulk annuity purchase for those liabilities not covered by it.

Investment governance - an alternative structure

"The trustees of a scheme may choose to appoint a 'Fiduciary Manager' who then takes responsibility for implementing the overall strategy (including the selection and appointment of fund managers), monitoring the strategy and reporting to the trustees."

An increasing number of UK pension schemes are opting for fiduciary management. Typically the trustees (together with their actuary and any independent investment consultant appointed) will first agree the level of investment return that is required from the scheme's assets in order to ensure that funding and investment principles are consistent, and in line with risk appetite. The fiduciary manager will then devise an investment strategy that fits these specifications and agree it with the trustees.

This is often a tempting prospect for trustees of DB schemes who may otherwise find it difficult to constantly monitor market conditions in order to make informed investment decisions quickly. The market for this service is currently weighted towards smaller schemes - in 2012, around two-thirds of full delegation fiduciary management mandates were for schemes with less than £100m in assets.

Overall, fiduciary management greatly simplifies the investment decisions that trustees and the employer are required to make and brings on board the expertise of the fiduciary manager.

However, the trustees will typically spend at least as much time as before on investment matters – reviewing the actions taken by the fiduciary manager and checking they are comfortable with the developing approach. The trustees and employer also lose their ability to reflect their own investment views in the day-to-day investments made and will be placing great reliance on the expertise of one firm. Switching away from the fiduciary manager in future can also be a complicated and expensive process. Fiduciary management should therefore be considered with caution.

De-risking - what is the most effective approach?

"Most pension schemes will have a long-term funding strategy in place which assumes that assets are gradually switched from growth-seeking (e.g. equities) to protective (e.g. bonds)."

It is common for a scheme's investment strategy, and hence their funding strategy, to assume that growth assets are held in respect of non-pensioner members and protection assets are held in respect of pensioner liabilities. This would require that when a member reaches their retirement age, all of the assets held in respect of that member would be switched from growth assets into bonds. Of course, this does not happen in practice, but the strategy still suggests there will be a gradual switch towards bonds.

Where the overarching strategy is the gradual transfer of assets into bonds or even bulk annuity policies there are various approaches that can be taken. This switching will be most pronounced for closed schemes that are effectively looking to run off existing liabilities. The trigger for switching may simply be mechanistically time-based (e.g. quarterly or annual switches), or based on asset performance or scheme funding levels. The main advantages and disadvantages of each approach are considered below:

Fixed mechanistic triggers

- ✔ Most economical for schemes with a small governance budget
- ✔ Provides a 'smoothed' transition to reach a long-term target
- ✘ May miss out on opportunities to de-risk at an advantageous time in between the scheduled switches
- ✘ Modelling suggests this is sub-optimal where a scheme holds volatile assets such as equities

Investment performance-based triggers

- ✔ Profits are "banked" when growth assets outperform either their assumed return or the return on protection assets
- ✘ Higher governance costs compared to fixed annual switches
- ✘ Does not allow for the impact on liabilities of changes in investment markets
- ✘ If trigger levels of outperformance never occur then the intended switching strategy is not implemented

Funding-based triggers

- ✔ Growth assets are sold as outperformance emerges, with consideration of the development of the liabilities as well as the assets
- ✘ Higher costs of monitoring, including updating demographic assumptions from time to time
- ✘ Mechanisms are required to ensure that decisions can be made quickly when triggers are reached
- ✘ If trigger levels never occur then the intended switching strategy is not implemented

In relation to funding-based triggers, we have modelled the relative outcomes for different frequencies of monitoring and lag times for implementation.

Our study suggested that quarterly monitoring with a lag of no more than two weeks could provide a good balance between the costs and benefits of this approach. However, the spread of outcomes demonstrated that no single approach will be correct for everyone. If you would like more information about trigger-based de-risking then please feel free to contact us.

Pensions investment coaching for Finance Directors

Finance Directors will not require formal advice in relation to every pensions investment decision or issue under consideration. However, given the complexities surrounding DB scheme investment issues it can be very helpful to talk matters through over the phone and receive expert feedback on the spot. In some cases, it may also be helpful for this to be independent from both the regular trustee and employer investment advisers.

Barnett Waddingham can provide this service on the basis of a simple appointment letter enclosing our terms of business. This includes our agreement to keep discussions and materials confidential and also emphasises that the service is to provide information and opinions, rather than advice. This service is not intended to replace formal investment advisers, but to help ensure that you maximise the benefit gained from the formal advice you already receive.

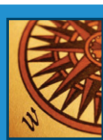
Regulatory update – TPR's Code of Practice on scheme funding

TPR published a consultation in early December 2013 on a suite of new scheme funding documents, covering TPR's strategy and policies for regulating scheme funding as well as a revised Code of Practice. The focus is to achieve an integrated approach taking account of the employer covenant, funding strategy and investment strategy, whilst minimising any adverse impact on an employer's sustainable growth. As a key part of this, the revised code provides much more detail on TPR's expectations for investment governance. In particular, TPR suggests that:

- although legislation doesn't require trustees to consult with the employer whilst developing an investment strategy, trustees should keep employers well informed as the strategy is developed and implemented.
- trustees should consider the impact of investment volatility on the employer's business and growth prospects. That is, although the employer may be able to afford increased contributions if the investment strategy results in a worsening of the funding level, what adverse effect would this have on the business?
- the investment strategy should be set with consideration of:
    1. funding objectives
    2. risk appetite and the employer covenant
    3. liquidity requirements
    4. the employer's needs

The final scheme funding documents are expected to be published in May 2014 and the revised code will apply to valuations undertaken from July 2014. They key concepts set out within the consultation are unlikely to change, though, so TPR urges trustees and employers to operate in line with these from as early as possible.

Online Pensions Guide for Finance Directors



Visit our online pensions guide for Finance Directors *www.fdpensions.co.uk* for a single source of clearly written, up to date information on defined benefit pension schemes.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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