Briefing

A disrupted year in pensions investing

How did your scheme weather in 2020?

RISK | **PENSIONS** | INVESTMENT | INSURANCE

Investment markets have been dominated by significant uncertainty and disruption during 2020 and there was a wide range of outcomes for different pension schemes. This creates a perfect opportunity for trustees and sponsors of pension schemes to take stock of the impact of their investment strategy and decision making framework on funding level outcomes over the past year.

Looking forward, we consider potential investment opportunities and risks, as wells as enhancements that could be made to governance frameworks to improve resilience for whatever 2021 and beyond has installed for the global economy and markets.

Coronavirus crisis

Global equity markets started the year strongly, rising 4% to their peak in mid-February. However by the end of the first quarter the COVID-19 pandemic began to spread throughout the developed world as local governments brought in lockdowns to control the virus.

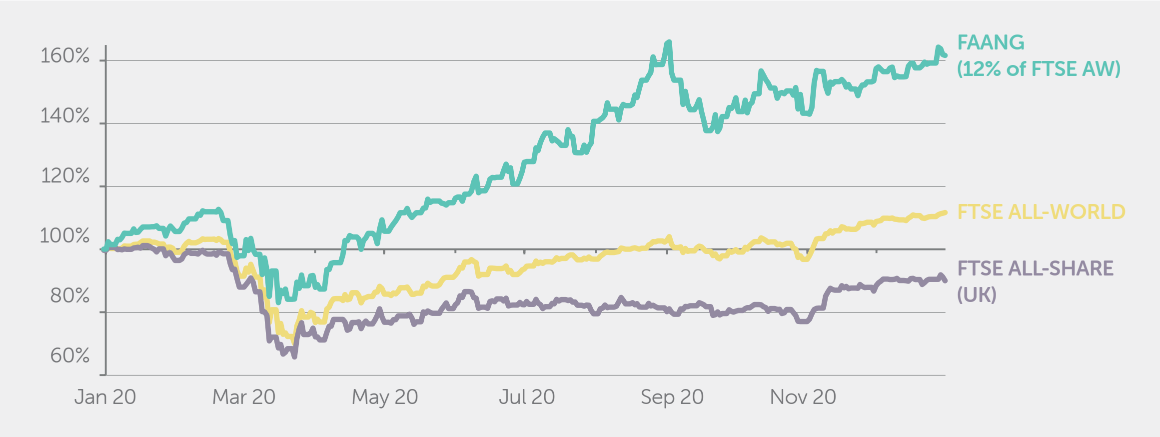
> Markets quickly reacted and by mid-March equity markets had fallen 33% from the peak to trough.

The market disruption caused by the lockdowns was not confined to the equity markets and other assets saw similar declines. Meanwhile unemployment increased enormously in March rising by 10 million people in the US in the last two weeks of March alone, shattering economic growth globally. Once it became clear that the pandemic would result in large-scale outbreaks in the developed world, central banks responded quickly by cutting interest rates. By mid-March the US Fed and the Bank of England had both cut rates to just above zero. Against this backdrop, bond yields have been extremely volatile over 2020 which, combined with volatile equity markets, has put substantial pressure on the funding level of defined benefit schemes. This has resulted in a strain on these schemes' sponsors at a particularly unfavourable time when many are still feeling the effects of the pandemic.

The road to recovery

Following the volatile period of March, markets rallied and recovered, boosted by support from central banks. However this recovery is far from universal, with a huge divergence between the best and worst performing regions and a similar split is evident when you look across equity market sectors.

For example, large tech related stocks such as the FAANGs (Facebook, Apple, Amazon, Netflix, Google) have hugely outperformed sectors like finance or energy which dominate the UK market. The high level of economic uncertainty has held back most stocks, but technology companies, whose business models are less affected, have been able to take advantage of the policy support.



A tale of two schemes

The effect of the pandemic on UK defined benefit scheme funding levels has been far from uniform. Schemes running a higher level of investment risk, with little interest rate hedging in place will have experienced a far more difficult year than those who started the year fully hedged with a well-diversified portfolio of growth assets. As shown above, the recovery of equity markets has been far from universal and schemes with a UK bias within their equity portfolios will have also struggled more than those with a well-balanced exposure of regions.

The events of 2020 have thus provided a point of reflection and an opportunity for trustees and companies to consider how their investment strategies and decisions have fared over this time of uncertainty. Many trustee boards are now considering what they can improve to avoid exposure to similar events in the future.

Improving Investment Governance

Amidst the backdrop of volatile equity markets and falling bond yields over the year, trustees and sponsors have turned their attention to enhancing their investment governance. Good governance can improve trustee decision making and ultimately improves outcomes for both schemes and their sponsors.

> When considering whether any changes in your scheme's governance approach are appropriate, it is usually sensible to reflect on whether there is anything that can be materially improved.

In the context of trustee investment governance, we think this can be categorised by whether decisions relating to the investment of assets are being made effectively and efficiently.

For sponsors and trustee boards who do consider there to be areas for improvement, there are a range of solutions to consider. The optimal solution will depend upon the nature of the issue it aims to address – correctly identifying the issue at heart is therefore key to deciding on the right solution.

A range of potential solutions for enhancing pension fund investment governance is summarised below.

1. DELEGATING DECISIONS TO AN ASSET MANAGER

All pension fund trustees delegate investment decision making to some extent, for example delegating stock selection. However, in recent years there has been a trend towards the delegation of higher-level allocation decisions For example the delegation of selecting asset classes through investing in 'diversified growth funds'. Some trustee boards will even go as far as delegating all but the most strategic of investment decisions to a single provider, known as a fiduciary management approach. Whatever the approach taken, trustee boards and sponsors must consider trustee accountability, control and cost.

2. DELEGATING ADMINISTRATION TO AN INVESTMENT PLATFORM

For trustee boards who do not wish to delegate all decisions, but are frustrated with the process and timescales for making changes to the portfolio, a more proportionate approach could be to invest via an investment platform. Here, trustees are delegating administrative investment matters to the platform provider, who can be instructed to make changes to the portfolio without the need for significant additional paperwork.

3. REVIEWING YOUR INVESTMENT CONSULTANTS ADVISORY OBJECTIVES

It may be possible to solve certain investment governance issues by modifying the remit of your investment consultant. Being clear with your consultant about how they should advise you and reflecting this in their statutory advisory objectives could impact the speed at which investment decisions are made.

4. REVIEWING TRUSTEE BOARD STRUCTURE AND PROCESS

The structure of trustee boards and their decision making processes vary greatly between pension funds. For some boards, the availability of time to dedicate to trustee meetings is often considered to be the greatest constraint for trustees. In this case, possible solutions include forming an investment sub-committee, adopting specified in-meeting decision-making processes, and adopting protocols for decision-making between meetings.

5. PAYING INVESTMENT ADVISORY COSTS THROUGH THE PENSION FUND

Historically investment management expenses have almost always been paid directly by pension funds, whereas investment advisory costs have quite often been met by the pension fund sponsor. Paying investment advisory costs through the pension fund can have a clear governance benefit for the trustee board by relaxing a constraint around taking advice It also helps the sponsor by enabling the cost of expenses to be spread over time, through regular funding contributions.

Risks and opportunities

Whilst 2020 has brought a great amount of volatility to global equity markets and put substantial pressure on the defined benefit pension schemes, it has also brought a number of opportunities for pension fund trustees, as well as a number of further risks to consider. Below we cover one such risk (fallen angels) and one such opportunity (illquids).

Fallen Angels

As the effect of the pandemic continues to be felt by companies around the world, we expect to see credit rating downgrades. When investment grade bonds (BBB rated) are downgraded, funds that have strict restrictions on non-investment grade holdings become forced sellers. These downgrades present an investment opportunity for investors allocating to these "fallen angels". This is because after a downgrade, often the company fundamentals may remain solid and the company can be expected to recover – in some cases this will be with significant external input/restructuring (distressed debt) but, in other cases, the company will recover on its own (stressed debt).

Fallen angels typically refer to bonds that were initially rated as investment grade but have since been downgraded to high yield due to a deterioration in the issuer's credit rating.

Historically fallen angels perform poorly as they approach an official downgrade and then rebound in the following months after a downgrade, if the risk of default before maturity reduces. We think there are lots of opportunities to find solid companies with debt trading below face value, meaning investors can benefit from higher returns without a commensurate increase in the default risk.

However, at the same time, pension funds invested in passive investment grade bond funds could find themselves in the undesirable position of being forced sellers of these bonds at an unfavourable time to sell. BBB rated bonds are particularly exposed to this downgrade risk as they are on the cusp of investment grade status.

> Trustee boards and their sponsors are encouraged to review their exposure to investment grade bond funds, in order to understand if they are at danger of being a forced seller.

The risk is greater for those clients invested in passive investment grade bond funds, which are often forced to sell downgraded bonds due to rules within their funds.

Illiquids

As a result of the market turmoil over the year (and the expectation this may continue next year), many investors are now in need of greater liquidity and will be forced to – or may wish to – sell their illiquid holdings. They can only do this on the secondary market. This may lead to an excess of supply and a potentially significantly discounted price, thus presenting an opportunity to those that are able to take on the illiquidity.

Investing in **secondaries** involves the purchase of pre-existing investor commitments to private funds (typically equity or debt but can also include other alternative asset classes i.e. infrastructure and real estate) in the secondary market (i.e. not directly from the issuer).

As well as strong returns where discounts are offered to net asset value, the time horizon of the investment opportunity will be much shorter when investing in secondaries versus a direct investment in a private asset.

We expect the opportunity in secondaries to last for as long as investors require liquidity, which will be highly dependent on the extent to which we see volatility and falls across financial markets. The driver of this opportunity is the need for liquidity. If markets recover quickly, there will be less of a need for liquidity and investors will not need to sell their holdings, not least for a discount.

The year 2020 certainly has been a challenging year for many. There remains a considerable amount of uncertainty around how the disruption caused by coronavirus, prevention measures and resulting fiscal and monetary policy will evolve over the coming months and years.

> It is clear from the past 12 months that having a robust strategy and effective governance framework in place does play a huge part in how well pension schemes can navigate these choppy waters.

Therefore, now is a great time to be considering if any enhancements can be made to the investment strategy or decision making process to ensure better resilience in 2021 and beyond.

Barnett Waddingham are a leading, independent UK professional services consultancy at the forefront of risk, pensions, investment and insurance. We are free from any external stakeholders, meaning that we take the long-term view on working in true partnership with our clients, rather than focussing on our own short-term profits. We are therefore well placed to independently assist you with your pension scheme's investment strategy and decision making framework, as we have the freedom to think differently about each scheme's challenges and to bring fresh ideas to the table.

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

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