

Investment Insights

Setting a long-term objective



Pension schemes are maturing. As members age, the liability structure and cashflow profile of the pension scheme will change. This will have profound effects on the role of the assets in the scheme and whilst time horizons will fall, planning ahead will become more and more important. The Pensions Regulator is alert to this, and is encouraging (for now and soon may compel) all pension schemes to set a long-term funding target. We welcome this. This note provides our views on what schemes should do.

We believe that all pension schemes should consider their long-term objectives and set a realistic long-term goal together with a clear plan for reaching it. We focus mostly here, on the 88% of pension schemes that are closed to new members. The considerations for an open scheme are potentially different and so we leave those for client-specific advice.

There is a lot of jargon in the industry around such approaches – for the purpose of this note, we'll use the term 'journey plan'. This is not just about regulatory compliance; a well-defined journey plan can help ensure that all pensions are paid, in full and on time.

As with planning any journey, there are three key questions to answer:

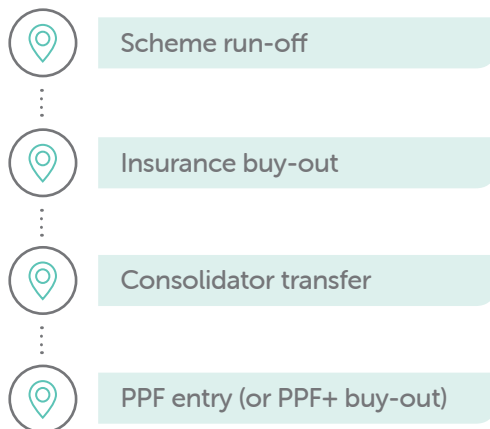
- Where are we going?
- When do we want/need to get there?
- How are we going to get there?

This note sets out what factors should be considered when answering each of these questions and the role of investment strategy on your journey. Like a real journey, these questions can't be considered in isolation – they all need to be considered together to build a coherent plan. Of course, once you have a plan, you should use it to guide the decisions you make along the way, however how can you do this in practice?

Question 1: Where are we going?

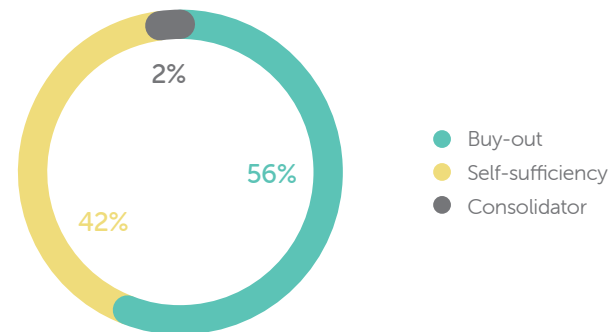
Every journey you take begins with a destination in mind. However, what are the options for a pension scheme?

There are four possible 'destinations' for a pension scheme:



Clearly PPF entry or a PPF+ buy-out¹ is not the planned long-term destination for any scheme and therefore we focus on the options that involve members receiving their full benefits (i.e. the first three). We believe that transfers to consolidators will become a growing trend, but don't expect it to be a suitable objective for the majority of schemes. This was certainly the view from our recent series of client conferences, where our audiences gave their views on their own destinations:

PENSION SCHEMES' CHOSEN DESTINATIONS



Our survey showed a broadly equal split between self-sufficiency and buy-out as destinations, with a very small proportion targeting a consolidator. We do wonder though, whether for some schemes self-sufficiency may be a stepping stone towards the final destination of buy-out. However, there will be a minority of schemes for whom self-sufficiency or a consolidator transfer, are the better solutions.

¹ A PPF+ buy-out can occur when a scheme leaves PPF assessment, having insufficient assets to buy-out liabilities in full, but more than enough to buy-out PPF liabilities. The regulations allow the scheme to buy-out, securing better benefits than would be provided by the PPF, but less than the full entitlement.

We believe there are four key factors that you should consider when deciding between these options.

1. Factor to consider: Appetite for risk

Throughout this note we will be quite deliberate in how we use the terms “buy-in” and “buy-out”. When talking about a “buy-out” we are referring to a full discharge of scheme liabilities to an insurance company and the wind up of the scheme. A buy-in refers to the purchase of annuities for a proportion of a scheme’s liabilities and the annuity becomes an asset of the scheme.

Run-off: In most cases, trustees wanting to run a scheme on indefinitely would want to aim for a low risk, ‘self-sufficient’, level of funding. This means getting the scheme to a strong enough funding position so it can pursue a low risk strategy and the chance of ever needing significant additional contributions from the sponsor is sufficiently small.

However, ‘low risk’ doesn’t mean ‘no risk’. No matter what level of funding you target, if the scheme is going to be run-on indefinitely, then there’s always a chance you don’t have enough money. The key to setting a self-sufficiency target is understanding how much risk remains.

Buy-out: On the other hand, buying-out with an insurer is, in general, the gold standard. It’s usually the lowest risk way of securing members’ benefits, and you can then wind-up the scheme. However, improving the funding position to this level may require more risk-taking in the short-term, in pursuit of returns.

Consolidators: The regulatory regime for consolidation hasn’t been set yet, but it’s looking likely that it’s going to be a bit less secure than buy-out.

2. Factor to consider: Covenant strength

The regulatory framework is still evolving, but we expect that a transfer to a consolidator is only likely to be an option for schemes with a relatively weak covenant, so schemes with a strong covenant should consider alternative targets.

Schemes with an extremely strong covenant may take the view that achieving a buy-out level of funding, would not add a material degree of security over and above self-sufficiency, and in extreme cases (e.g. a government-guaranteed covenant) there is an argument that actually executing a buy-out could in fact result in a lower level of security. Such schemes may therefore look more towards self-sufficiency.

3. Factor to consider: Cost

One common argument against buy-out is that it is too expensive. Insurers do exist to make profits for their shareholders, and so when they take on a scheme, they will be pricing in a profit margin. This doesn’t necessarily mean bad value though. We would encourage trustees and sponsors to weigh-up the cost against the benefits a buy-out would bring. Generally speaking, smaller schemes are likely to see greater benefits here than larger schemes. This is due to the insurance companies’ ability to achieve economies of scale on ongoing costs (e.g. due to pooling of investments) and, perhaps more importantly, diversification of mortality and investment risks across schemes.

4. Factor to consider: Scheme size

Very large schemes (i.e. multi-billion) may take the view that a buy-out wouldn’t be practical, as they may take the view that capacity in buy-out markets will make this an unrealistic target. However, over recent years capacity has been increasing and these large schemes have found that executing these deals is possible. In our view, it is only the very largest schemes (£10 billion+) where this is now a genuine concern.

Smaller schemes may find that the ongoing costs (i.e. admin costs, advisory fees, audit costs etc.) make running-on forever too expensive, and so self-sufficiency probably isn’t the answer for these schemes. For small schemes, the operational efficiencies available through consolidation may be attractive.

Medium-sized schemes, say between £200 million and £1 billion will have the most choice. All options will likely be open.

Question 2: When do we want or need to get there?

In a real-world journey, once you know where you're going then the next question is "when do you want or need to get there?"

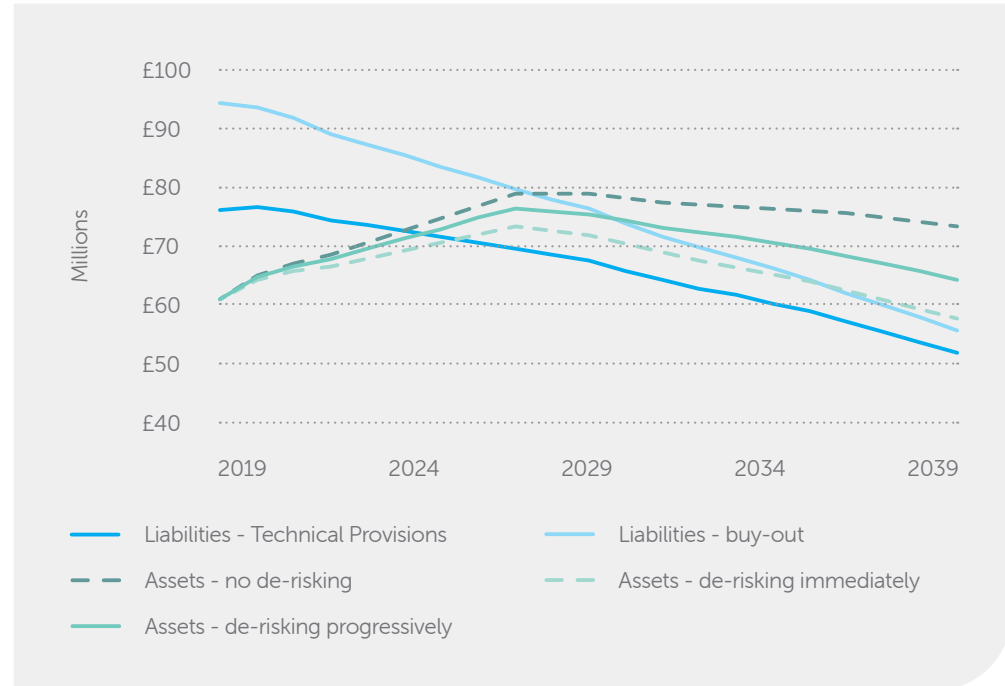
1. Factor to consider: The art of the possible

As with any journey, when setting out you give yourself a reasonable amount of time. You wouldn't try to get from London to Edinburgh in 15 minutes, and you shouldn't expect to bring a pension scheme from 50% buy-out funded, to 100% in a year. However, what is reasonable?

Key questions that need answering include: How quickly could you get there? When would you get there in a safe and steady manner? What level of company contribution support might be available? What level of risk would be needed? And how does this risk level compare to the trustees appetite, taking account of the covenant?

A good way to approach this is to use a 'required return' framework. In essence, this is looking at the different investment returns that are needed to meet different long-term goals, given different contribution scenarios and time horizons. These required returns can be compared to the expected returns from the current investment strategy and possible alternatives. This enables you to quickly and easily see what is and isn't reasonable.

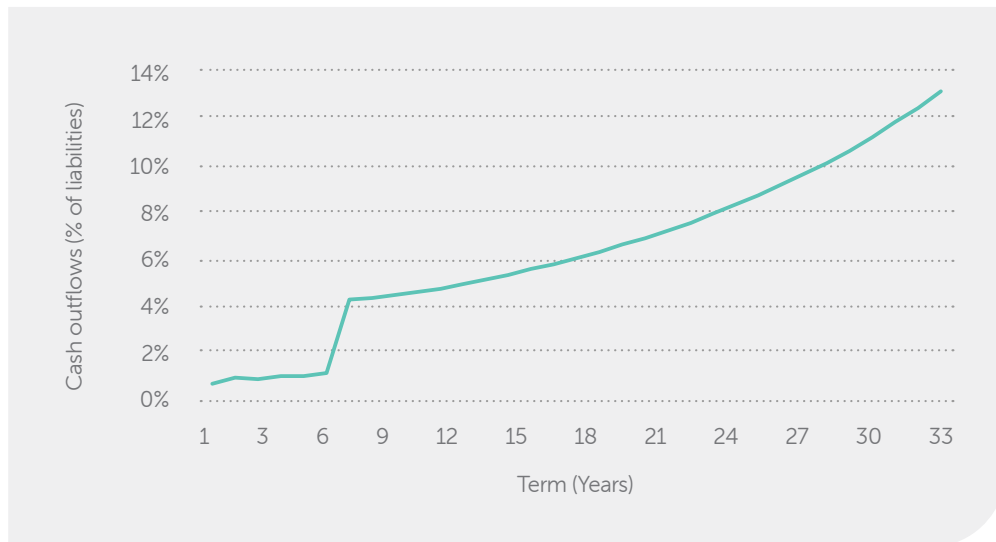
In this example, we show three strategies (in green): maintaining the current asset allocation with no de-risking, gradually de-risking over time, and immediately de-risking. This analysis shows that based on these 'book end' strategies, full buy-out funding (in blue) might be achievable between 2027 and 2036 for this scheme.



2. Factor to consider: Scheme maturity

When I'm setting off on a real world journey, there's usually a time that I need to be there. When I'm commuting into the office, I'm considering my contractual start time, and any early meetings I have that day. For pension schemes, there are similar considerations. Scheme maturity is key. As a closed scheme matures, the cash outgo will increase as more members retire and then start to decline as members die. Some people therefore focus on 'peak cashflow' – this is simple and intuitive. However, a better way is to express the cashflow as a percentage of the asset or liability value. This gives a better idea of when the cash outgo is actually going to be problematic. In the example below, net cash outflow is expected to be close to zero for the first six years, but when the existing recovery plan ends, it will spike up to around 4% p.a. of liabilities and then progressively rise.

CASH OUTFLOWS AS A PERCENTAGE OF FUTURE LIABILITIES



Becoming a net-disinvestor is not a problem – it's a natural consequence of being a closed defined benefit pension scheme. It becomes a problem if you are, at that stage, poorly funded and therefore forced to take high levels of investment risk. A bad situation can then become unmanageable fairly quickly. As a rule of thumb, net annual cash outflow of more than about 5% of assets is likely to be problematic, if poorly funded

or not conservatively invested. This is because cash outflow above this level, is very difficult to meet from investment income alone and so a substantial portion of the assets will therefore need to be sold each year to meet outgo. Therefore, planning to get well-funded and cautiously invested before this point is a good idea.

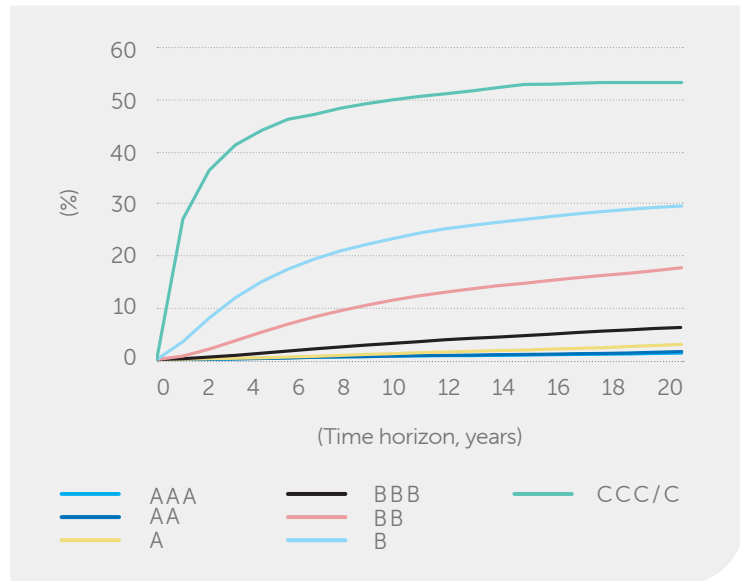
Bulk annuities for deferred members are usually a lot more expensive than for pensioners. However, over time deferred members inevitably get older and retire, becoming pensioners. Therefore, over time, as your scheme matures, you might reasonably expect your buy-out cost to come down. Understanding this is a key step towards designing a strategy to target buy-out. Aiming to generate high levels of returns to target buy-out before most of your members are pensioners, is likely to mean that you are taking unnecessary risks to get there. Instead, you could wait a little longer for the buy-out price to 'come to you'. We call this the 'scheme maturing effect'.

3. Factor to consider: Covenant visibility

Understanding the covenant is critical. If a pension scheme is taking investment risk, then it is implicitly requiring the scheme's sponsor to underwrite that risk. So a strong covenant can support more risk-taking than a weak one.

However, there is also a more subtle point. The covenant visibility refers to the length of time the trustees can be confident in the covenant. Clearly, this is related to covenant strength, as the chart on page 6 illustrates – all else being equal, you can rely on a strong covenant for longer than a weak one. For example, according to S&P Global Ratings, the chance of an A-rated company going bust in the next 20 years is in the low single digit percentages, whereas the equivalent chance for a B-rated company is almost a third, based on historical data from 1981 to 2018.

GLOBAL CORPORATE AVERAGE CUMULATIVE DEFAULT RATES BY RATING (1981-2018)



Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.

However, as is so often the case, it's not that simple. For example, imagine a company that manufactures naval instruments for the Royal Navy. The company has a ten-year contract to make these instruments, guaranteed by the government. This is 95% of the company's business. The covenant might be assessed as strong, because the business is highly profitable, and the contract is highly secure. However, there is considerable uncertainty beyond the end of the contract. Will it be renewed? If so, on what terms? Can the company find other customers? A trustee of this scheme should be thinking about how they can reach their long-term target within the next ten years, whilst they have covenant visibility.

Question 3: How are we going to get there?

When I set out on a journey I decide whether I'm going to walk, cycle, drive, fly or go on the train. These are my modes of transport. Often I combine modes of transport together – I might walk to my local train station, take the train and get a taxi at the other end. When you're thinking about your scheme's journey plan, you also need to consider your modes of transport to your long-term target. You have three:

1. **Investment returns**
2. **Employer support – for example, cash contributions**
3. **Liability management – for example, transfer value communication programmes, or pension increase exchanges.**

Ultimately, you need to come up with a strategy that balances these three options in an appropriate way for your scheme. Trustees will generally have a preference for contributions over investment returns and risk, but the employer may have the opposite preference. So this comes down to a negotiation.

Key questions will be:

- What is the appetite or ability of the sponsor to pay contributions?
- What level of investment risk are the trustees prepared to take – a 'risk budget'?
- What returns are needed, and can these be achieved within the risk budget?
- How do you plan to evolve the asset strategy over time? (e.g. do you plan to de-risk progressively or not?)
- What liability management options do you wish to consider and how much impact will these have?
- What are the actions you expect to take if progress is faster, or slower, than expected? (e.g. if progress is faster than expected, do you expect to reduce contributions or reduce investment returns first?)

All of these points can be discussed at the beginning of the journey plan. You don't need to pre-commit to actions, but discussing these issues upfront will help decision-making along the way.

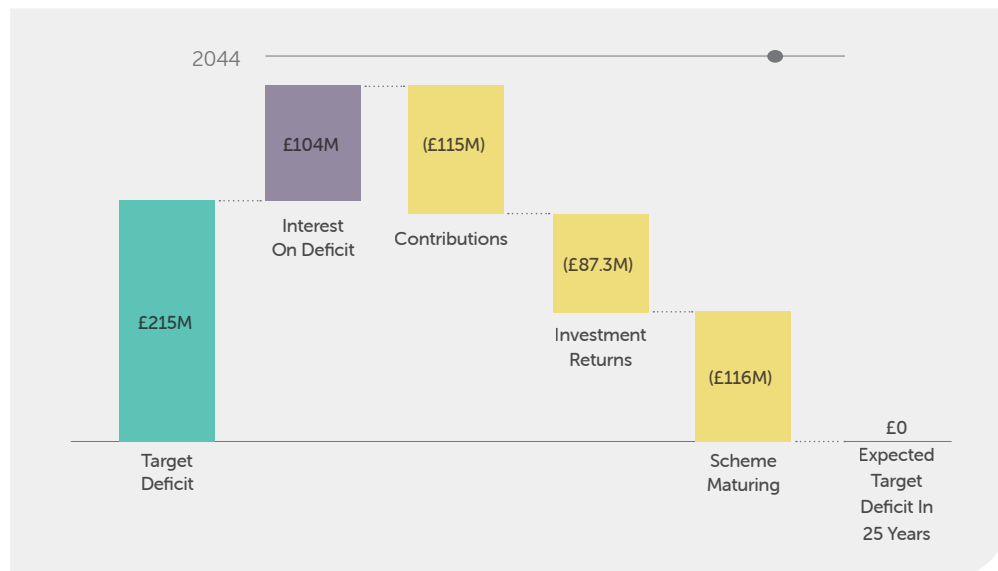
What does a good journey plan look like?

A good journey plan has:

- a clear objective: e.g. to reach a buy-out level of funding
- a target time-line: e.g. to do so by 2035
- a coherent and achievable plan for getting there: e.g. the employer will pay £x a year, and the gap will be bridged by returns and the scheme maturing effect
- a pre-discussed framework for making decisions on corrective actions in the event that progress is materially different from initially expected.

Overall, a good journey plan will have the above mapped out, with a clear, central, 'expectation' of how the objective will be achieved.

DEFICIT PROGRESSION BREAKDOWN



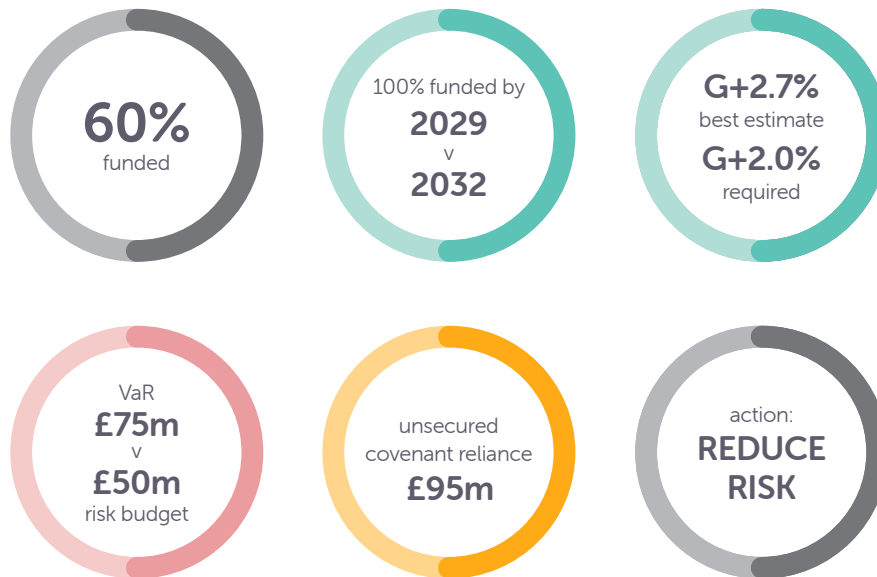
Bringing it together and using the journey plan

Agreeing a journey plan is a project that will require input from all parties: trustees, company, actuary, investment consultant and covenant adviser. It will require collaborative working and a variety of different analyses to come to a mutually acceptable solution. It's a big piece of work, but it will really help you to develop a clear and consistent funding and investment strategy.

If you haven't already, we'd encourage all schemes to think about their long-term goals and design a journey plan to achieve them. When designing your journey plan, consider all options. There is no 'one size fits all' approach. The right strategy for you will depend on where you're going and where you're starting from. What's important is to consider the unique features of your scheme and your covenant to develop the right solution.

Once you have a journey plan, you need to use it. There would be no point developing a plan for you to then continue to manage your pension scheme in exactly the same way as before.

The key will be to focus your monitoring framework around your long-term goal. You need regular reporting against your journey plan so that you can take corrective action if necessary. We'd suggest using a simple dashboard to do this.



By looking at a dashboard like this at every trustee meeting, you can quickly see if you're on target, if you're taking too much risk, or if your covenant support is no longer sufficient for your journey plan. This will help you prioritise decisions. We would suggest discussing in advance what actions you're likely to take if you're materially ahead of your journey plan (e.g. accelerating de-risking, reducing contributions or bringing forward the target date) and what decisions you're likely to take if you're materially behind your journey plan (e.g. postponing de-risking, increasing contributions or pushing back the target date). This will mean that you can prompt action and capture any fleeting opportunities to take action.

Finally, remember that your journey plan shouldn't be set in stone. You should review it periodically to make sure it's still right for you and your scheme. We'd suggest reconsidering it at each triennial valuation, or after any major change in your situation for example, a change of sponsor.

Please do get in touch with your usual Barnett Waddingham contacts if you'd like to discuss how we can help you develop a journey plan for your scheme.

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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