Summary
- SME pension scheme funding levels are now at 65.6%, up almost 1% from the start of the year.
- Schemes are increasingly hiring fiduciary managers to save time and benefit from economies of scale.
- Small DB schemes may also implement a simple investment approach incorporating passive management and few fund manager changes.
- The use of LDI strategies by small DB schemes is minimal, partly due to some trustees not expecting their schemes to run beyond a 10 or 15-year timeline, as well as the need for extensive advice in the area.
- Many small DC schemes are a long way from being properly diversified, due to the 0.75% price cap and daily liquidity requirements. Therefore DC funds consisting of 100% equity, moving into gilts and cash five or 10 years from retirement, is still commonplace.
- Smaller DB schemes can use DGFs and a pooled LDI solution to reduce reliance on equities and to manage liability risk.

A tale of two cities

Whereas smaller DB schemes are building up solid investment strategies, their DC trust-based counterparts are still struggling to construct the type of investment funds that their members can comfortably live in

According to one index published this summer, SME's defined benefit schemes have seen a slow improvement in their funding levels since the start of 2015. The Mobius Life Funding Level Index found that SME pension scheme funding levels are now at 65.6 per cent, up almost 1 per cent from where they were at the start of the year.

This healthier collective state has been due to, in part, an improvement in how and where the sub-£100 million schemes in Mobius' index now invest their assets. So smaller schemes are doing something right. But how are they doing it?

Sackers associate director Ralph McCelland says that in general, there are three types of DB strategies at present.

The first, and increasingly fashionable, approach is to hire a fiduciary manager. Outsourcing the task of plotting both an accurate flight path to a possible buyout and a LDI resolution is, he says, attractive for DB trustees who do not have the time or energy to implement strategies with the help of a traditional consultant.

Fiduciary management also lets smaller schemes benefit from economies of scale. So a £20 million scheme can become part of a multi-billion pool of assets and so, for example, be able to allocate to a specialist hedge fund for a much better price.

The second is made up of a camp who have taken the view that simplicity best suits their needs and abilities: "They will tend to have a fairly straightforward strategy, probably relying quite extensively on passive and they don't expect to change those managers much at all - unless there was a major problem."

McCelland says that the third, less prevalent, group consists of ambitious investors who have historically been affiliated with a culture that understands the finer nuances of asset allocation and risk.

Yes we can

These days, joining that third group need not be as tricky as it once was. "It's not a fee issue, they can do it. The barrier is spending the time to look at it," says P-Solve managing director of asset solutions Barbara Saunders.

"A smaller scheme worth £35 million that is now in our fiduciary management solution used to deal with an LDI manager, a specialist bond manager, a global equity manager and a diversified growth fund (DGF). It's quite rare, but it can be done," she explains.

"Smaller DB schemes can use DGFs and a pooled LDI solution to have a serviceable investment strategy," Saunders adds. "It stops them being fully reliant on equity risk and allows them to manage some of their liability risk."

The DGF has certainly come a long way in a few short years. Some of the largest managers now run huge DGFs that give pension schemes tactical asset allocation across a range of assets. And similarly-run products, such as multi-asset credit funds, can also give small schemes access to matching assets, says JLT Employee Benefits director John Finch.

LDI question marks

In comparison to DGFs, the use of LDI strategies by small DB schemes is minimal.

As Finch explains, this is partly due to some trustees not expecting their schemes to run beyond a 10 or 15-year timeline, as well as the need for extensive advice in the area.

"For the smaller scheme, if you don't understand LDI, then you don't do it. It's a degree of sophistication that smaller schemes don't have and it's as much a challenge for us consultants to explain it," he says.

However, for those trustees wanting to implement LDI, it may be worth looking beyond pooled solutions to tailor hedging to their own scheme.

"With changing regulations in LDI there may be advantages of doing it bespoke," explains Saunders.

"Pooled is seen as an easy way of doing LDI. You invest some money into something that has some leverage in it, even if you don't know how much. Most trustees who I meet who have pooled LDI have no idea of the risk reduction that it gives them. They just say that they have invested 10 per cent, or something similar, in LDI."

Ideally, she says, schemes should have an LDI strategy that provides the right amount of risk reduction, with a DGF to earn the returns that are needed: "So if you have a three times leveraged LDI portfolio, then you have to invest 30 per cent of your assets in LDI to get close to a full hedge and 70 per cent in DGFs. A DGF typically targets plus 4 per cent above cash - that translates into a strategy that produces 2.8 per cent above gilts."

Such a return would have been more than enough in the past for most, but nowadays there is a widespread requirement for more returns sourced through sophisticated solutions to also manage risk.

"That's where fiduciary management comes in," says Saunders.

The DC picture

If the smaller end of the DB world has almost climbed to the top of the sophistication ladder when making investment decisions, then DC schemes are still struggling to get off the bottom rungs.

Two external factors have limited DC's capabilities: the price cap and liquidity. The former acts as a restriction on even the largest DC schemes, while the latter has affected the types of products that managers have been able to construct.

"The most serious limitation of DC investing is daily liquidity, which is required of all funds linked to a life insurance platform, caused by the DC members' aggregate need for the ability to trade daily," says Aon Employee Benefits head of DC investments James Monk.

"This issue limits the types of fund that can be linked to providers, and by extension, access to specialist asset class fund managers, which may only offer monthly or quarterly liquidity."

Many smaller schemes are also stuck in a time-warp, says Monk. The traditional provider offering consisting of 100 per cent equity, and only moving into gilts and cash five or 10 years from retirement, is still commonplace.

And even those DC schemes who may have thought that they were doing a little better in terms of giving members more of an asset allocation choice have been left behind by the pace of change in the market.

As J.P. Morgan Asset Management head of UK DC Simon Chinnery points out, before the days of default funds, pension schemes would select either a balanced fund, which usually held an exposure to equities, bonds, cash and possibly real estate; or offer a selection of self-selection funds, which often included a with-profit fund.

"It's likely that many of these smaller schemes will still have these historical offerings although they may have been adapted into an administrator's lifecycle programme," he says.

"It is also likely that a full investment review will have been infrequent or non-existent."

As a result, despite the scrutiny now being placed on DC investment due to growing regulation and auto-enrolment, many small schemes are a long way from being properly diversified, while the lifestyle structures they may have for members are, as Monk said, as far away from being dynamically managed as is humanly possible.

Change on the horizon

Monk believes however, that change is afoot. He says that providers have made great strides in DC and are replicating the DB push for actively-managed DGFs by creating new, diversified multi-asset strategies.

"Most providers have taken the opportunity of new pension freedom regulation, not just to update the investment profile of their default's de-risking toward retirement, but also to revamp the investments used for growth in the early stages of pension investment," he says.

"At Aon, we have seen a high take-up of providers' newer solutions that better reflect the change in the expected retirement decision from buying annuities to maximising flexibility."

Nevertheless, Chinnery warns that there will be no overnight revolution.

"Due to time and cost constraints, the process of review and implementing change in response to new design and better solutions is likely to be very slow at the smaller end of the market."

Written by Marek Handzel, a freelance journalist