The menu of choice

Lynn Strongin Dodds looks at the ways smaller DB schemes are now widening their investment choices to ride the prolonged low interest rate environment

Summary
- Small defined benefit schemes used to have a limited investment menu to choose from. Scarce resources and constrained governance budgets precluded them from venturing into anything too risky or expensive.
- There is now far greater choice thanks to more sophisticated pooled and passive offerings across strategies and the asset class spectrum.
- Since it is fairly commonplace for small schemes to be in deficit, many are retaining allocations to growth assets to help close the gap, as well as allocating to liability-driven investments (LDI) to hedge those risks.
- There has also been an explosion of MAC funds, which typically lump together loans and high-yield bonds alongside emerging market debt and securitised debt, collateralised loan obligations (CLOs) and non-agency issuance.
- A core DGF market of 47 funds from 36 providers in the UK will grow from around £124 billion of assets in 2014 to £218 billion in 2019.

In the not too distant past, small defined benefit schemes had a limited investment menu to choose from. Scarce resources and constrained governance budgets precluded them from venturing into anything too risky or expensive. However, today, there is far greater choice thanks to more sophisticated pooled and passive offerings across strategies and the asset class spectrum.

One reason is that in the prolonged low interest rate, quantitative easing environment the traditional asset classes such as equities and bonds were not delivering the promised goods and trustees were willing to look further afield. However, the first step in assessing different investments should be the same for smaller schemes – which is a relative term as some label them below €1 billion – as for their larger counterparts.

Keeping watch

"The starting point for any scheme is to look at scheme funding levels, the strength of the sponsor, their funding levels, risk appetite and governance structures," M&G Investments global head of institutional distribution Ominder Dhillon says.

"Since it is fairly commonplace for many to be in deficit, we are seeing them retain allocations to growth assets to help close the gap, as well as allocating to liability-driven investments (LDI) to hedge those risks."

This has translated into diversified growth funds (DGFs), multi-asset credit funds and LDI pooled vehicles. The latter are a relatively new phenomenon in the small pension fund community, with research published last year by KPMG showing that LDI mandates grew to 1,287 in 2015, from 1,033 in 2014 and of these, three quarters were pooled.

Meanwhile, there has also been an explosion of MAC funds, which typically lump together loans and high-yield bonds alongside emerging-market debt and securitised debt, collateralised loan obligations (CLOs) and non-agency issuance. They are more popular in the UK because the winding down of the DB market has forced trustees to focus much more on sustainability or buyouts than their continental European peers. This means looking closely at managing interest-rate risk in their portfolios.

"With the yield on traditional fixed-income allocations, such as gilts and investment-grade corporate bonds, having fallen so far, investors have needed to seek alternative sources of return in fixed income," BlueBay Asset Management head of sales – UK & Ireland Anthony Pickering says.

"Furthermore, many finance directors have sought to reduce their exposure to equities in a bid to reduce the impact that material valuation changes to their pension fund can have on their financial statements. These two realities have seen investors increasingly allocate towards higher-coupon fixed income where in the UK, solutions such as multi-asset credit have become increasingly popular."

However, as a 2016 report from bfinance points out, it is important to

understand the biases of the MAC funds and the potential sources of return given the diversity of products currently on offer. The consultancy, which examined 75 fund performance track records from 60 different asset managers, found that within that data set no two products were alike. In fact, some of the strategies weren't even MAC, despite the label on the tin.

In addition, while MAC strategies have generally performed in line with their objectives in the last three to five years in terms of risk and return targets, this has occurred in an environment where spreads have generally fallen. Last year the tide had turned and returns were negative, which was in line with the poor performance of most fixed income sectors.

DGFs

The same words of warning have been applied to DGFs, which continue to be one of the most popular products for the relative minnows. Spence Johnson, the London-based research firm, has estimated that a core DGF market of 47 funds from 36 providers in the UK will grow from around £124 billion of assets in 2014 to £218 billion in 2019.

However, just as with MAC funds, the quality can vary, with some investing only in mainstream asset classes – almost exclusively equities and bonds – with largely static asset allocation, while others can be highly dynamic and employ complex long/short derivative strategies as well as a wider variety of asset classes. They also produced disappointing results last year, trailing 10-20 per cent behind equity markets, which continued to reach ever-dizzying new heights.

Perhaps though investors should not be that surprised. "There is something of an obsession with dampening down volatility but when taken too far you remove some of the upside and it is much more difficult to generate equity-like returns," says Dhillon.

Aon Hewitt senior partner John Belgrove adds: "Investors were disappointed by the performance of the DGFs but I think many have misunderstood the nature of the product. In the long run you would expect them to lag the equity market but the aim is to produce a smoother performance."

Willis Towers Watson UK head of delegated services Pieter Steyn states: "DGFs have done a reasonable job, but can be a slightly blunt tool, because they are also structured to appeal to the DC world where liquidity matters. However, DB funds do not need the same level of liquidity, because they tend to have a different time horizon. DGFs do not necessarily offer the best opportunities for DB funds."

As a result, while DGFs will continue to be a large part of the stable, market participants expect them to be combined with multi-asset funds, which can be a subset of DGFs such as fund of hedge funds as well as MAC and LDI pooled solutions.

"What we are seeing is increasing industry discussions on cashflow driven, and not just liability matching, investment", Stamford Associates head of fiduciary management advisory Carl Hitchman mentions. "A cashflow approach requires pension funds to map specific cashflows to pay out their benefits and this entails a rethink in the way they structure their portfolios and the assets they invest in. One of the challenges for smaller schemes is how to implement such an approach in a cost-effective manner."

Fiduciary management

This changing mindset perhaps explains the move to fiduciary management, which offers integrated solutions by combining investment advice as well as the administration of simple as well as the more complex strategies being incorporated *[see p74]*. The Netherlands has led the way but it is gaining ground across Europe, including the UK.

"Around 10 per cent of the UK pension industry has adopted fiduciary management and has been very popular with smaller schemes in particular," says Steyn. "This is because it gives smaller schemes access to scale that can help lower volatility and improve returns in different market conditions. The KPMG report last year showed that between 80 per cent and 90 per cent of all the mandates were for schemes under £250 million. About half of our mandates are under £250 million."

As with investments though, investors are advised to look beneath the packaging. Last year, the Financial Conduct Authority raised concerns about the conflicts of interest when investment managers provide fiduciary management services, and proposed to introduce greater standardisation of price and performance of the managers due to the opaque nature. "A lack of publicly available, comparable performance information on fiduciary managers also makes it hard for investors to assess value for money," according to the watchdog.

Written by Lynn Strongin Dodds, a freelance journalist

DC and DGFs

Although market participants are looking at different options for the accumulation phase of the defined contribution market, DGFs remain the backbone. However, the industry is still in its nascent stages and in time, market participants expect greater innovation, product development and education to cater to the different members' needs in the early stages.

DGFs are still the most popular investments in the accumulation phase for defined contribution schemes, although given the market rally there has been some concern about the product, Redington head of DC Lydia Fearn. "I think they are more suitable though for the mid-stage of a members journey as they offer some protection but we are encouraging younger people to take more risk at the earlier phase where they need to see investment growth and can afford take a higher level of risk," she adds.