Research findings:
- Average equity allocations fell by 2.3% between 2011 and 2014.
- Average fixed-interest security allocations fell by 3.7%.
- Allocations to pooled investment vehicles rose by 3.1%.
- Allocations to index-linked securities rose by 2.4%.
- Equities are appearing to be sold in order to increase allocations to DGFs, as pension funds look to diversify their asset holdings.
- LDI strategies are appearing to be implemented through the use of pooled funds, resulting in an increase in pooled fund allocation.
- Institutional investors seem to be becoming increasingly wary of the impact of central government intervention, when quantitative easing programmes are reverted and/or low interest rates begin to rise.
- Investors are turning to alternative asset classes with more visible cashflows such as infrastructure and private debt.
- Traditional fixed-interest securities seem to be replaced with index-linked gilts, as schemes look to address the mismatch in inflation sensitivity between their assets and the benefits that these assets back.

A changing landscape

Adam Cadle analyses latest research detailing the trends in the UK's DB private sector pension scheme investment landscape between 2011 and 2014

The UK's defined benefit (DB) pension landscape is one of change, none more so than in the private sector, as employers and corporate sponsors grapple with increasing liabilities affecting the funding levels of their schemes. Schemes also have to juggle the effects of increasing longevity, changes in regulation and new accounting standards simultaneously to ensure funding levels remain positive and deficit levels do not fall further into the red. DB private sector pension schemes are taking the decision to de-risk in order to fend off the volatility affecting many investment portfolios. This volatility also puts into jeopardy the value and payments of members. Whether the DB pension fund is still well funded or battling rising deficit levels, the right asset allocation strategy has never been so vital.

This unique research explains exactly why specific investment changes are

occurring, both from an economic market perspective and also from a pension fund outlook. Delving deeper into the data from the sample 25 pension funds *[see Methodology below]*, *Pensions Age* has found that whilst equities and fixed-interest securities form the majority of portfolio asset allocations, there has also been increased allocations to pooled investment vehicles and index-linked securities, which could be seen as a de-risking shift to fight volatility.

Methodology
This research uses investment data from a sample 25 out of the top 50 UK DB private sector pension funds (those with publically available data) sorted by assets under management, with statistics taken from financial statements and the Companies House database. For each year from 2011 to 2014 *Pensions Age* has calculated the average percentage asset allocation for all 25 funds. Asset classes include equities, private equity, fixed-interest securities, cash, inflation-linked securities, real estate, derivatives, pooled investment vehicles, index-linked securities, AVC investments, hedge funds and other investments. From this, we have identified key investment trends occurring within the DB private sector space from 2011 to 2014.

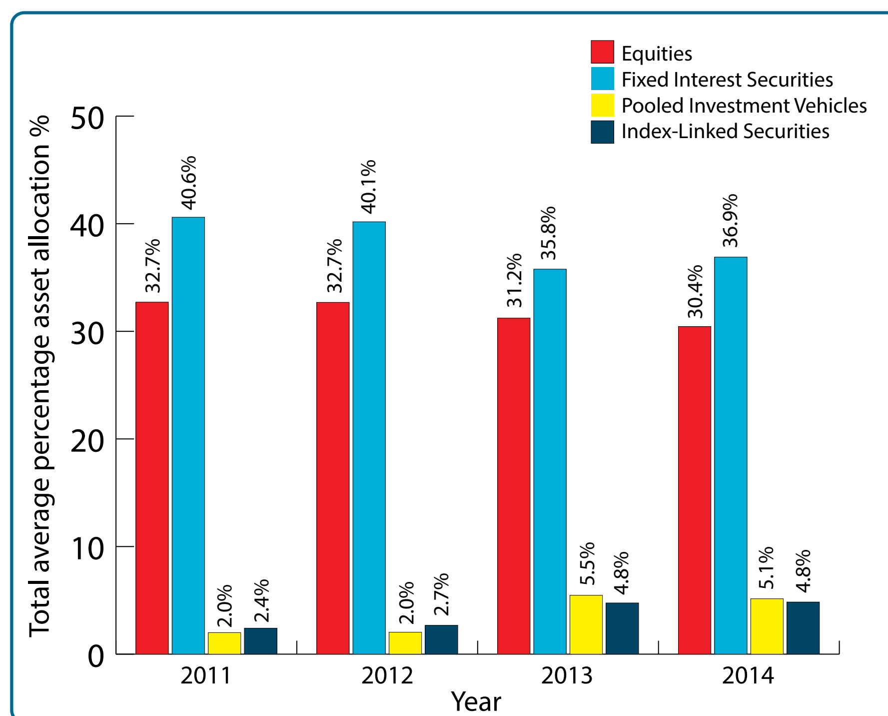

Figure (1)

Figure (1) highlights the changes seen in DB private-sector pension fund asset allocation trends from 2011 to 2014. Average asset allocations to UK and overseas equities in this period fell from 32.7% to 30.4%, marking a 2.3% drop. Combine private equity with UK and overseas equity, and we can see allocations falling from 35.3% to 33.7% in the same period, a drop of 1.6%.

For fixed-interest securities, a drop in allocations was also witnessed from 40.6% in 2011 to 36.9% in 2014, a fall of 3.7%. At the same time, *Pension Age*'s research shows that allocations to pooled investment vehicles such as diversified growth funds (DGFs) increased by 3.1% from 2.0% to 5.1% and allocations to index-linked securities rose from 2.4% to 4.8%, an average increase of 2.4%.

Prime examples of these trends can be seen when analysing investment data from the BAE Systems Pension Fund and the Aviva plc Pension Scheme. The former saw its equity allocation fall from 51% in 2011 to 32.7% in 2014. Allocations to fixed-interest securities fell from 40% in 2011 to 31.1% in the same period, allocations to pooled investment vehicles increased from 0% to 13.6% and investment in index-linked securities rose from 0% to 15.6%.

The Aviva plc Pension Scheme's equity allocations fell from 6.6% in 2011 to 0.6% in 2014 and allocations to fixed-interest securities fell from 77.4% to 37.9%. Allocations to pooled investment vehicles for the scheme increased from 0% to 14.6% and allocations to index-linked securities rose to 36.8% from 0%.

Investment shifts

So, whilst equities and bonds still dominate the investment landscape, a definite shift is occurring to other investment strategies and these changes could be influenced by four main factors.

First, looking at the equity drop and pooled investment increase hand-in-hand, in the current economic environment it would seem that equities are being sold in order to increase allocations to DGFs, as pension funds look to diversify their asset holdings.

"DGFs have taken off in popularity because for many funds it is a much more efficient way to access a range of different alternatives such as infrastructure or to access tactical asset allocation skills"
J.P. Morgan Asset Management EMEA head of pension solutions and advisory Sorca Kelly-Scholte

DGFs also give access to active asset allocation in a way that many pension funds do not have the governance

to undertake. Looking at the DB private sector market in general, UBS Global Asset Management managing director, head of UK and Ireland, Ian Barnes believes that liability-driven investment strategies (LDI) are also being implemented through the use of pooled funds. This could explain the increase in pooled fund allocation when looking at our data.

"It's all about de-risking, because the real move here underneath the headlines is that risk assets are being reduced and that is visible in the equity reduction as even the largest schemes in the country look to minimise the volatility of the scheme returns that would affect the need for the corporate sponsor to top up the pension scheme. LDI pooled funds are an example of direct de-risking play because they are meant to match the liability profile to some sort of liability cash flow vehicle"
OMAM head of non U.S. distribution Olivier Lebleu

Pooled investment vehicle usage is set to increase over the next couple of years, due to the culmination of accounting and regulatory frameworks that DB schemes now have to take into account, according to Lebleu.

For JLT Employee Benefits investment consulting director Jignesh Sheth, reductions in equity allocations are also a direct result of institutional investors becoming wary of the impact of central government intervention, when quantitative easing programmes are reverted and/or low interest rates begin to rise. Investors will now be periodically locking in some of the profits experienced on their equity investment.

"There has been an increase to investments with a similar expected return to the sort of return one would expect from equities, but where the source of return is more easily identifiable by having the visibility of cash flows that the investment is expected to generate. Examples of this are infrastructure and private debt such as secured loans and direct lending"
JLT Employee Benefits investment consulting director Jignesh Sheth

Looking for alternatives to equities have guided institutional investors to pooled fund and partnership structures where even larger schemes can benefit from scale and efficiencies. A volatile market environment has seen schemes consider more opportunistic investments, perhaps with a three- to five-year timeframe. Pooled vehicles are more suitable to implement these strategies.

The drop in fixed-interest securities and rise in index-linked securities can also be grouped together in this trend analysis. One micro effect directly causing the trends outlined for these asset classes could be the Office for National Statistics decision in 2013/14 to conduct an in-depth project to review how RPI was to be calculated. Calculations were expected to be chosen that would result in a drop in the RPI, and consequently index-linked gilts cheapened up in anticipation of that drop occurring. Pension funds are now taking advantage of this in order to better match their inflation-linked liabilities. The ONS then decided to keep inflation measurements the same, but pension funds had already grabbed the opportunity.

The cost of inflation protection between 2011 and 2014 has at times been low when compared to historical

averages, so the popular trade has been to replace traditional fixed interest securities with index-linked gilts. This allows schemes to address, at least partially, the mismatch in inflation sensitivity between their assets and the benefits which these assets back. Index-linked gilts can also be used to meet the collateral requirements of the LDI strategies that have already been discussed within this research.

As figure (2) shows, DB private sector pension schemes are also diversifying their portfolios with cash holdings, which have increased by 0.4% between 2011 and 2014. Derivative allocations increased by 0.4% and hedge funds increased by 0.3%.

"The reality is that if you are still holding a lot of equities and are a long-term asset owner then you should feel a significant amount of pressure from society and the government to make sure one is investing responsibly. This means you are an active asset owner, voting on issues, pushing corporate governance in the company you hold and this will be extended into the impact on society. In 10 years time, schemes should be asking what is the impact of owning these companies, and how should they deal with this and manage that over time"

UBS Global Asset Management, managing director, head of UK and Ireland Ian Barnes

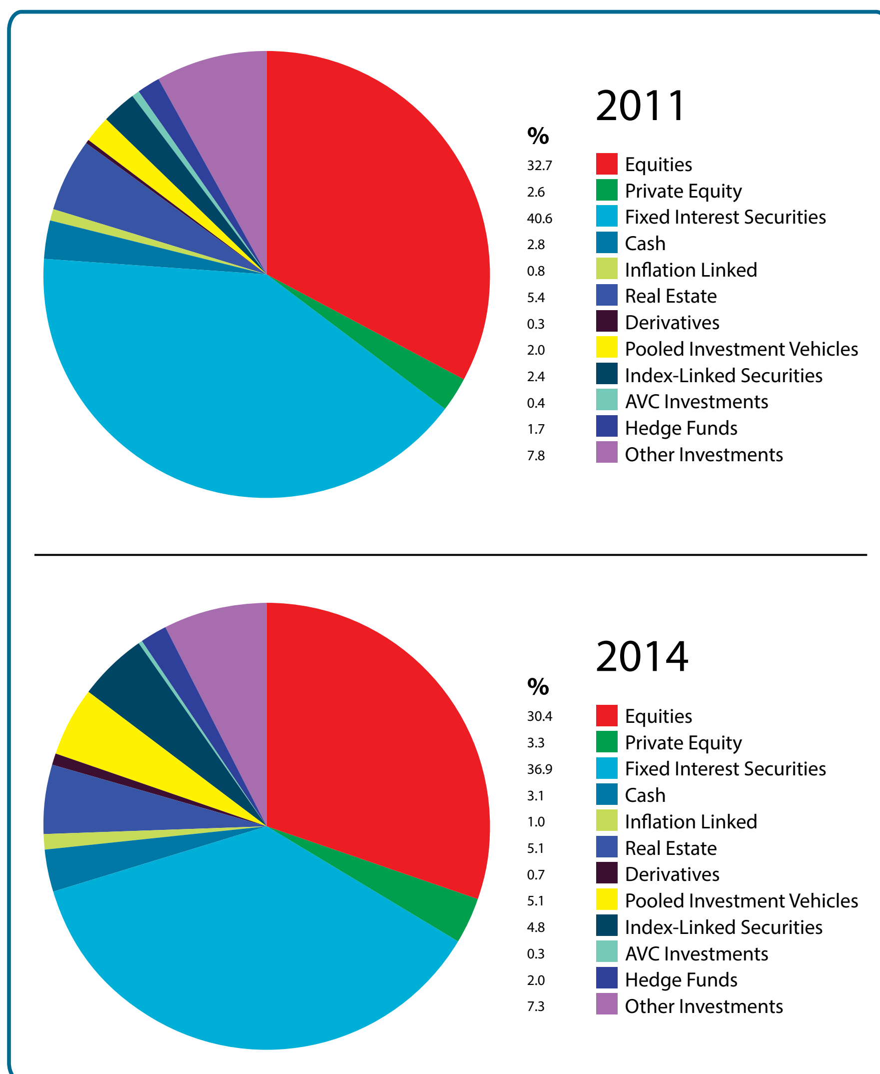

Figure (2)

Conclusion

Pension Age's latest investment research reveals the significant shifts occurring in the DB private sector pension fund universe. By drilling down into asset allocation data in this area between 2011 through to 2014, we have drawn up evidence highlighting that there is now a 'de-risking' movement firmly in place among maturing schemes closed to new members and future accrual. Schemes are moving away from the traditional growth asset classes such as equities.

Figures analysed by *Pensions Age* show average allocations to equities between 2011 and 2014 fell by 2.3%. Bonds fell by 3.7% with pooled investment allocations increasing by 3.1% and index-linked securities by 2.4%. Pension schemes are now looking for other investment methods to add to their portfolios in order to reap the highest possible financial rewards whilst fighting market volatility. Through the increased usage of DGFs and LDI schemes are now accessing alternatives such as infrastructure in order to smooth out their risk/return balance. The relative cheapness of inflation protection over this period has resulted in fixed-interest securities being replaced with index-linked gilts, allowing schemes to address the mismatch in inflation sensitivity between assets and the benefits that these assets back.

Written by Adam Cadle