Setting long-term objectives

Jay Harvey explores what setting long-term objectives means in practice for individual schemes

The recent DWP white paper and subsequent annual funding statement from The Pensions Regulator have both focused on the importance of DB schemes taking a long-term view when setting funding targets.

> **"It is … critical that trustees, in collaboration with the sponsoring employer, should set appropriate long-term objectives for the scheme, and then take those objectives into account when setting the SFO."**
> **Paragraph 87, "Protecting Defined Benefit Pension Schemes", DWP**

Here we explore how trustees might go about this in practice, what it means for their choice of valuation methodology, and why actuarial assumptions are no longer the starting point in valuations.

For a valuation to take account of long-term objectives for the scheme, it is first necessary to know what these objectives are. Typically, this is considered to be a choice between 'self-sufficiency' and buyout – do you aim for sufficient assets to invest in a low-risk manner over the long term, with additional contributions from the sponsor unlikely to be required, or aim to have enough to secure members' benefits with an insurance company? Aon's recent *Global Pension Risk Survey* suggests that the former is the most popular choice, with over half of respondents targeting self-sufficiency.

But a choice between these two objectives is too simplistic for many schemes, and self-sufficiency itself is an ill-defined concept. In particular, for those schemes targeting self-sufficiency, is this the long-term objective in itself or is it just another stepping stone to buyout?

For substantially under-funded schemes, this is perhaps a question for another day, with the short-term focus likely to be bridging the funding gap to technical provisions. However, for better funded schemes, it is a question for consideration now, as it will potentially impact both investment strategy and choice of valuation methodology.

Self-sufficiency as the long-term plan

For schemes where self-sufficiency is the long-term plan, an increasingly common approach is to build a portfolio of income-generating assets designed to meet the scheme's cashflows as they fall due. Where buyout is unlikely to be considered for the foreseeable future, this affords such schemes the opportunity to invest in higher-yielding illiquid assets (such as long-lease property, infrastructure and property debt and direct lending) in order to increase return. However this is not the only approach. Providing that a robust policy for meeting cashflows is in place, supplementing a portfolio of matching assets (which may include gilts, swaps and corporate bonds) with a diversified portfolio of growth assets is a common alternative. Ultimately, the right approach for a particular scheme will depend on issues like preference for equity versus credit risk, any cost/governance constraints and wider investment beliefs.

Self-sufficiency as a stepping stone to buyout

For schemes where self-sufficiency is just a stepping stone to buyout, similar considerations apply. Liquidity becomes more important, however, both to pay benefits and to take advantage of buy-in opportunities as they arise. Depending on return requirements, this may lead more schemes down the 'diversify and hedge' route, with the growth portfolio aiming to bridge the gap to ultimate buyout, and the matching portfolio reducing the risk of that gap growing too large.

Impact on valuation approach

For schemes invested predominantly in income-generating assets, a cashflow driven valuation approach – where the discount rate is derived directly from the yield on the underlying assets with suitable adjustments for re-investment and default risk – is likely to be appropriate.

For others, 'gilts plus' valuation methodologies – where the discount rate is based on the yield on long-term gilts plus a margin – still remain most appropriate. However, the 'plus' should be kept under review at each valuation, particularly where the scheme retains a significant exposure to growth assets.

Summary

Importantly, gone are the days when actuarial assumptions came first and the other advice simply fell into line. Now it is very much long-term objective first, investment strategy to achieve it second, and funding methodology and assumptions then fit in with those.

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Written by Aon scheme actuary and partner Jay Harvey

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