Summary
• Equity allocations among private-sector DB funds have fallen to an average of 24 per cent – less than half the level in 2008.
• De-risking strategies are a major factor in declining investor appetite, as DB schemes approach their endgame.
• Some larger funds such as USS retain a larger allocation to equities but are reassessing their long-term strategies.
• TPR's new funding code of practice could accelerate the shift away from equities.

Taking stock

With the DB sector heading towards its collective endgame, traditional equity investments are on the decline. Nick Reeve asks: Are equities still a viable investment for DB schemes?

Every year seems to bring more evidence that private-sector defined benefit (DB) schemes are in decline.

The Pension Protection Fund's (PPF) annual data publication, *The Purple Book*, has shown a year-on-year decrease in total DB fund membership every year since 2011, while the proportion of schemes open to new members has fallen from 16-11 per cent in the same period.

As the DB landscape has changed, so have investment strategies. More and more schemes are approaching buyout, with insurers expecting a bumper year for pension risk transfer deals in 2020, and interest in liability-driven investing increasing.

With schemes keener than ever to match their investment portfolios to their liabilities, do traditional equity strategies still have a place in DB scheme allocations?

The evidence suggests that equity allocations are in terminal decline. In 2010, DB schemes allocated 42 per cent of their portfolios on average to equity strategies, according to the PPF. By 2019, average allocations had declined to just 24 per cent – and a growing proportion of this figure is taken up by private equity.

While recent wider investment industry data has indicated that investors are becoming wary of high equity valuations, experts agree the long-term de-risking plans of DB schemes are the primary factor behind falling allocations.

"Many pension schemes have moved on from focusing purely on returns to considering how they will pay pensions both now and in the future – in other words, how they will achieve their endgame," says Insight Investment head of solution design, Jos Vermeulen. "Schemes are de-risking by buying more matching assets such as bonds as they become better funded and are looking for assets to naturally mature to help meet their pension payments as they enter the decumulation phase of strategies."

Those approaching the endgame tend to have less time to address any funding shortfall without resorting to employer contributions, Vermeulen adds, making certainty of an investment decision's outcome a "crucial asset allocation consideration".

Dalriada Trustees trustee, Charles Ward, says that for trustees it is "difficult to justify" taking equity risk in well-funded schemes, "particularly where employers are keen to avoid a deficit reappearing".

Deficit reduction

Schemes with a funding deficit may be tempted to allocate more to equities in an attempt to increase their future expected returns. However, Vermeulen argues that pension schemes are "far less tactical" with asset allocation, instead choosing to focus on longer-term factors based on a planned path to full funding.

"In recent years, funding levels have shown continued volatility as liability values have grown substantially," Vermeulen adds. "This has led many schemes to invest in assets that are sensitive to the same factors that change liability values: interest rates and inflation."

Ward highlights that covenant risk is an important contributing factor to schemes' appetite for equity. Weaker employers are often unable to take the risk posed by a high allocation to equity, he says.

"We still see many schemes in the difficult position of having to continue to invest in equity to make up shortfalls in affordable contributions," Ward continues.

"On a related note, it is rare for de-risking strategies and triggers to work in both directions and this also leads to a gradual erosion of the proportion of scheme assets held in equities, as schemes hit their de-risking triggers but don't have any re-risking triggers in place."

XPS Pensions Group chief investment officer, Simeon Willis, argues that equities still have a role in portfolios for many schemes that are "not where they want to be". However, he expects the asset class' popularity to "decline structurally", particularly among schemes that are close to or have reached their long-term funding targets.

He adds: "The level of risk you would employ would imply either a much smaller holding in equities, or even – as is the case for a lot of schemes now – schemes actually don't need to hold equities at all."

Some schemes – especially those that are not fully closed to new members and future accrual – can take a longer-term view of equities, according to Ward.

"Equities should provide the best return over a number of economic cycles and those schemes with the luxury of time still can, and are, making good use of this expected return," he says.

In the past two years several funds in the Local Government Pension Scheme (LGPS) have looked to employ equity protection strategies as a form of insurance against market falls, including the schemes for Merseyside, Worcestershire, Tower Hamlets and South Yorkshire.

LGPS funds typically hold more in equities as they are still open to new members. Data from the scheme's advisory board showed the 87 funds across England and Wales had invested a combined £78.2 billion in direct equities, equal to 28.5 per cent of their combined portfolios. (However, this does not include equities held in pooled funds.)

Equity protection strategies have the effect of limiting the impact of price falls without the need to sell out of the market.

As Willis explains: "Using equity options is a way of participating in the equity markets while having some control over the extent to which it might impact your financial position.

"You tend to find persistently through time buying downside protection is something you'd expect to have to pay a small premium for. There is more demand for downside protection than there is supply, so you tend to see the pricing reflecting that."

Equity breakdown

Year	*UK listed (%)*	*Overseas listed (%)*	*Private equity (%)*
2008	60.4	39.6	0.0
2009	57.6	41.7	0.7
2010	55.3	43.7	1.0
2011	52.7	46.1	1.2
2012	49.9	48.5	1.7
2013	47.5	50.3	2.2
2014	44.9	52.7	2.4
2015	42.2	55.3	2.5
2016	38.8	58.6	2.6
2017	36.3	61.0	2.7
2018	32.1	65.0	3.0
2019	29.6	66.7	3.7

Source: PPF, The Purple Book, 14th edition

Equity allocation of UK private sector pension schemes

Year	*Allocation (%)*
2006	61.1
2007	59.5
2008	53.6
2009	46.4
2010	42.0
2011	41.1
2012	38.5
2013	35.1
2014	35.0
2015	33.0
2016	30.3
2017	29.0
2018	27.0
2019	24.0

Long-term approach

In February this year the £68 billion Universities Superannuation Scheme (USS) announced plans to overhaul its equity strategy. As of 31 March 2019, the scheme had 40.9 per cent invested in listed equities. The scheme is open to accrual and has a funding shortfall – although the exact figure for this is hotly disputed between staff and employers.

While these two parties continue to debate the future of USS, the scheme's executive team responsible for its investment strategy has consistently sought to operate more efficiently.

USS now plans to shift away from a traditional stock-picking approach to focus on "a longer-term thematic approach" that the scheme's investment team believes will better match its liabilities. The new approach – which is expected to involve 13 redundancies within the investment team – will not change USS' asset allocation, but will place a greater emphasis on quantitative strategies and environmental, social and governance factors.

USS Investment Management CEO, Simon Pilcher, said at the time of the announcement: "This change is about focusing our internal investment capabilities on where we can add the most value, given the returns we need to generate for members.

"Longer-term strategic themes, particularly in the responsible investment space, are growing in importance to investors like ourselves and through this we will reshape the portfolio to best adapt to future challenges."

The regulatory regime

The Pensions Regulator (TPR) is currently consulting on a new funding code of practice for DB schemes. While the final code is not expected to be published until later this year, TPR has given several clear indications of what to expect.

One of the main changes is a bigger emphasis on "scheme maturity issues", such as changing cashflow needs. As the regulator has specified that schemes should look to reduce their reliance on sponsoring employers, investment risks and in particular volatility will be of greater interest to TPR in the future.

"For a number of years now the regulator has been gradually moving towards the expectation that schemes have a long-term funding target, and a higher target level of funding than the statutory technical provisions," says Willis.

This has pushed trustee boards towards lower risk strategies and a greater emphasis on scheme returns to fund future accrual, rather than employer contributions.

However, the regulator has also promised a more flexible regulatory regime, especially for larger or more complex schemes. For some, this could mean that they are able to take on more equity risk as a result of better regulatory understanding of their structures and strategies.

Written by Nick Reeve, a freelance journalist