Securing an income post-Covid-19

With income investing increasingly proposed as an investment strategy for pension schemes, Sophie Smith looks at how it could support defined benefit (DB) schemes in a post-Covid world

When thinking of a pension, many simply think of the income they will have in retirement. This is an expectation that pension scheme trustees, especially those of DB schemes, must work to meet and protect in a sustainable way. As Willis Towers Watson managing director, Alasdair MacDonald, highlights however, many DB schemes are getting very mature, and in turn are paying out a substantial portion of their assets every year in benefits, which must be done at an acceptable level of risk, requiring close cashflow matching.

Lane Clark and Peacock (LCP) partner, Dan Milkulskis, notes that as DB schemes mature, they have tended to seek returns more from contractual sources like bonds, rather than being overly dependent on equity markets and shares. Income investing is one such approach, which is viable primarily for medium to large, well-funded, mature schemes that expect to continue to pay benefits, rather than transfer to an annuity provider, Dalriada Trustees professional trustee, David Fogarty, highlights.

A maturing landscape

However, LCP investment partner, Mary Spencer, points out that many DB schemes are going through challenging times as a result of the pandemic, with a recent survey by LCP revealing that 57 per cent of responding pension schemes had seen either their funding level (23 per cent), covenant (28 per cent), or both (6 per cent) deteriorate as a result of the pandemic.

She emphasises that, against this backdrop, trustees looking after a DB scheme may need to make some "difficult decisions", with the same survey revealing that changes to investment risk was the most common change in response to the ongoing pandemic.

"Typically, this would start with understanding the impact on covenant," she explains, "as any risk being taken within the scheme's investments is effectively underwritten by that covenant strength." Spencer notes that once this is understood, and whilst ensuring excessive risk is not being taken, trustees can focus on the challenge of closing the funding deficit over time, which would typically involve allocating to a range of different assets, some more reliant on income than others.

Indeed, PGIM Real Estate head of business development EMEA, Faris Mansour, emphasises that amid an "uncertain and low yield environment", pension fund investors have increasingly focused on lower volatility income-focused strategies with downside protection.

Opportunity in crisis

"Real estate debt is now widely appreciated for offering a compelling alternative to traditional investment-grade and high-yield public fixed income," he states, adding that demand for real estate lending has continued to grow as investors increasingly see the benefits of the collateral and transparency real estate debt offers, while providing premium returns for equivalent risk.

A number of factors have further underscored the investment opportunity for real estate amid the pandemic, according to Mansour, such as bank retrenchment, exacerbated by regulatory pressure, and sponsors needing continued or new sources of capital.

Considering these uncertain market conditions, Mansour emphasises that real estate lending strategies post-Covid-19 should remain focused on core asset classes, with a disciplined focus on largest and most liquid markets, and cyclical opportunities from market re-pricing in low vacancy office locations.

He adds that rental income growth and value creation through active asset management by specialist sponsors, as well as a focus on structural trends, particularly in logistics and living sectors, should also be areas of focus in real estate lending strategies post-Covid.

"In that context," Mansour explains, "we expect that borrowers and investors alike will continue to focus on partnering with institutions that provide long-term, proven fund management and execution track records with demonstrably strong performance and relationships across market cycles."

A shift in pace

Redington investment consulting director, Nick Lewis, argues however, that the pandemic has not impacted strategic rationale, but rather has altered the affordability, as well as further emphasising the importance of prioritising diversification and flexibility.

"An 'endgame' portfolio that focuses on high quality assets with contractual cashflows remains the target for a significant number of DB pension schemes," he explains, arguing that those with a weakened covenant as a result of the pandemic will be considering

Creating a sustainable income?

During the lockdown period, there has been an increased focus on environmental and social issues, and pension investments are no exception, with the emergence of consumer campaigns such as Make My Money Matter. MacDonald agrees that environmental, social and governance (ESG) factors have been thrust into the wider consciousness, noting in particular that a greater understanding around the social aspect has emerged throughout the pandemic. He adds that whilst DB schemes may not see the member drive for this investment type that defined contribution (DC) schemes would, this has not stopped it from being integrated into portfolios.

"Corporate bond managers who have been managing these cashflow portfolios for a very long time just naturally think about ESG issues," he argues, explaining that longer-term downside risks are a natural consideration in long-term lending.

Indeed, Milkulskis notes that bond investments can frequently exert significant influence on companies, even though they don't carry the same voting rights as equity and arguing that fixed-income investing is "highly aligned with ESG integration".

MacDonald meanwhile, highlights that property assets that generate income are also generally "very good impact investments" and can create a positive impact to society, as well as in terms of return. Agreeing, Mansour emphasises that ESG is an "integral part" of property investments and is comprehensively incorporated across the acquisition process, management, and maintenance of all assets.

"Additionally, on an ongoing basis, data collection and benchmarking are prioritised so that we can accurately assess the environmental performance of the property and pursue data driven strategies to continually improve our consumption metrics," he continues, also noting resilience to climate change as a "critical" consideration.

The environment is not the only concern however, as Mansour emphasises that the impact on the local community is also considered, highlighting the importance of ensuring active management to ensure the property is well-positioned to foster stronger community relations.

bringing in their planned time horizon to reach this portfolio in order to reduce their reliance on the sponsor "sooner rather than later".

Lewis notes that a "slightly unusual quirk" of the pandemic market-sell off in Q1 2020 saw some schemes actually get closer to this objective. He highlights the example of pension schemes who are heavily invested in liquid alternative assets that sold off less sharply than, for example, investment-grade corporate bonds, explaining that as a result, the affordability of endgame portfolios had improved, despite a fall in funding levels, with some schemes able to de-risk into these portfolios in early Q2.

MacDonald, meanwhile, remains unconvinced that the pandemic has made much of a difference in aggregate, although he agrees that there have been individual changes of pace. He explains that whilst some clients find they can no longer afford to de-risk into cashflow matching strategy, other clients whose sponsor has weakened are left with no alternative.

Adding to this, Fogarty agrees that the Covid experience is likely to have slowed the pace, clarifying however that income investing more broadly has been proposed more frequently over the years, with many schemes looking to judge the effectiveness of such approaches in a post-Covid world. He adds that even within those schemes who are already pursuing income investing, there has also been a surge in the range of bond type investments being considered, although "time will tell how resilient these different types have proved".

It seems then that whilst the pandemic may have bought shifts in affordability and pace, it has also bought opportunities for those schemes looking in the right place.

Written by Sophie Smith