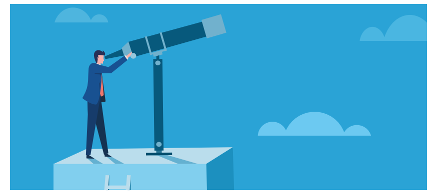
# A long-term look

## Rupert Kotowski considers how long-term goals are shaping DB schemes' investment strategies



As they increasingly target buyout, the long-term goals of defined benefit (DB) pension schemes are affecting their appetite for investment risk.

The Aon *Global Pension Risk Survey 2021/22* surveyed 137 UK DB pension schemes of widely different memberships and assets under management. For the first time since we launched this survey a decade ago, we found that more schemes are now targeting buyout (47 per cent) than self-sufficiency (34 per cent).

Timescales to achieve that target are also falling. The average anticipated time fell from 9.4 years in 2019 to 8.8 years in the 2021/22 survey.

However, as 63 per cent of respondents will depend on asset performance to reach their long-term goal, finding the right balance between risk and return remains as crucial as ever.

Improved funding levels have allowed schemes to reduce risk in their portfolio. At the same time, greater awareness of the impact of environmental, social and governance (ESG) factors on investment is also reshaping schemes' investment approach.

The funding level of three-quarters (75 per cent) of schemes monitored by Aon is now higher than before the Covid-19 pandemic, and that has helped respondents reduce risk in their investment portfolios. More than half (51 per cent) said that they expect to lower their equity exposure over the next year, while 34 per cent expect to increase their use of credit, and 37 per cent expect to allocate more to liability-driven investment strategies.

Hedging ratios have also improved as schemes look to retain the gains of recent years. Almost three-quarters (74 per cent) of respondents now have interest rate hedge ratios of over 80 per cent (of assets), compared to just 45 per cent in our 2019 survey.

As funding levels improve, schemes are turning their attention to other sources of risk in their portfolio. In particular, ESG-related risk has risen up trustees' priority lists, driven both by regulatory change and increasing awareness of the economic and social impact of climate change. A total of 92 per cent of respondents now say that they have considered their ESG policy, although they are at different stages of development and implementation.

It is positive to see that a fifth (20 per cent) of schemes have already made changes to their investments based on their ESG policy. For example, in equity portfolios, those changes include tracking ESG-specific indices rather than more traditional market cap indices, screening out persistent polluters, and investing in renewable forms of energy.

This focus on ESG looks set to grow further, with 84 per cent of respondents saying that they have already reviewed or are likely to review climate-related risks within the next two years. This includes exploring opportunities that arise from the transition towards a lower carbon environment, as well as investing for social or environmental impact (57 per cent).

We found that respondents are becoming more committed to measuring the climate-related impact of their portfolio. Nearly two-thirds (64 per cent) of respondents said that they will consider carbon metrics and targets within the next two years. As measurement evolves, ESG is likely to become an integral part of future investment decision-making and will further sharpen schemes' appetite to reduce their carbon exposure. Understanding the current carbon footprint of a portfolio will be an important starting point for setting realistic targets and timescales.

For schemes that are not targeting buyout in the immediate future, illiquid assets remain an important part of their portfolios. The increased focus on ESG is also reflected in respondents' desire for illiquid asset allocations, which include funding energy transition projects and clean energy generation.

Inflation protection, diversification and good return opportunities are some of the other key benefits of illiquids. Opportunities that provide capital growth alongside a consistent income stream to help meet liabilities, such as infrastructure (34 per cent) and real estate (32 per cent), are particularly popular.

For schemes that are looking to buyout, trustees will need to make sure their investment approaches are easily matched to annuity pricing and meet insurers' needs. That will help position schemes at the front of the queue with buyout providers when there is an opportunity to transact.

Regardless of a scheme's long-term objective, as the drive towards their target gathers pace, keeping investment risk under regular review will become more important than ever. Further improving funding positions, reducing risk across portfolios, addressing ESG issues and monitoring use of illiquids will all continue to be at the forefront of trustees' minds.

**Written by Aon associate partner, Rupert Kotowski**