**Summary**
- DB schemes have performed well during the pandemic. This means that many are now able to focus on their endgame strategies.
- ESG is an increasing consideration, despite not being mandated by regulation.
- The forthcoming DB Funding Code will expect schemes to outline their long-term strategies and plans, even if some feel that trustees for looking for simplification.

**Pete Carvill explores the investment priorities of DB schemes as they approach their endgame**

# Endgame: Investment areas of focus

The writing for DB schemes, as they approach their endgames, has been on the wall for some time, with an increased focus on this area in recent years.

Writing in *A New World for Defined Benefit Pension Schemes* in October 2020, Insight Investment said: "DB pension schemes face several evolving challenges as they mature and the regulatory environment evolves. These trends are sharpening the focus on how they invest to achieve their goals."

Attention has been external, too. As Abrdn wrote in 2019: "The Pensions Regulator (TPR) has also increased its focus on the endgame. The expectation here is that trustees and employers will set a long-term funding target with a clear strategy for achieving their long-term goals. This involves, recognising how the balance between investment risk, contributions and covenant support may change over time, particularly as schemes mature and their funding position improves."

All this underlines the most-basic obligation of a pension fund, ensuring that it invests wisely enough so that it can meet the needs and obligations of its members. Traditionally, the final stages of pension investment have been about lower risk and consequently lower reward to guarantee safety. Ironically, it is where the potential for failure may be at its highest.

"As you're approaching the endgame,"

says Russell Investments head of strategic client solutions, David Rae, "the risk of making a mistake is potentially catastrophic. That's why there is this large focus on risk management, and why we still use the same techniques around diversification, limiting concentration, and understanding how we invest, along with trying to assess how all that will behave under different future scenarios."

One scenario that few, if any, predicted was the global pandemic that has shut down the world for two years and counting. And, yet, the investments of DB schemes seem to have performed well during this turmoil.

"Many schemes finished 2020 with a healthier funding position than the one they started with," says Insight Investment head of solution design, Jos Vermeulen.

**A move to bonds**

He attributes this to the investment strategies of the big funds. "Schemes going into the global financial crisis had about 70 per cent of their assets in equities," he says. "That's now down to less than 20 per cent on average in the UK. And when it comes to liability hedging, they were doing 20-30 per cent of their liability and trading inflation risk. That's now closer to 80-90 per cent."

The good performance by schemes' investments during Covid, says Rae, has been a boon in one sense. "They have the opportunity now," he says, "to focus more on the endgame."

Strategies vary, but there are common themes across the DB sector. Encouragingly, a recent study from Aon – *The DB Pension Risk Management Journey* – found that a majority (54 per cent) of respondent schemes say that they believed they could meet their long-term targets by adhering to the current funding plans.

Those plans seem to follow a similar route. Aon wrote in *A New World for Defined Benefit Pension Schemes*: "Consistent with our finding that schemes are progressing towards their long-term targets, pension schemes continue to de-risk their investment strategies, with significant monies moving out of equities into less risky asset classes, driven by improving funding levels. This has led to increasing allocations to LDI, credit and increasing hedge ratios. Accessing new opportunities through fiduciary solutions for specific asset classes is also increasing in popularity."

Shifting away from equities is not a surprise, given the nature of the investment, says Aon partner, Emily McGuire.

"Companies can raise money through debt," she says, "such as bonds, with bondholders getting paid back first. That makes it a more-secure investment, even if the earning potential is lower. There's not as much risk. But if you invest in a company through shares, anything can happen."

**ESG**

While a fund's investment aims have been paramount, ESG investing has been increasing in popularity. Those pressures have been both internal – Aon reports that 92 per cent of schemes have considered ESG in relation to its investments, with 20 per cent making

adjustments as a result – and external, with the Task Force on Climate-related Financial Disclosures (TCFD) mandating that schemes with more than £5 billion in assets have to report their investments' climate impacts from 1 October 2021.

The shift towards a more-open conversation around ESG seems set to continue. As Allen & Overy wrote in its recent *ESG for Pension Schemes,* "We also expect additional requirements and guidance in the near future on ESG issues – and in relation to climate change in particular."

But regulation is still largely hands-off when it comes to investments. The TCFD directive only enforces disclosure of the climate impacts of investments, and not the investments themselves. At the time of writing, there is still no push for specific allocations on ESG themes.

If there is an impact on investment strategy, Vermeulen makes the case that it will be an indirect one. "There is clearly an effect," he says, "because there is increased demand to report on these metrics and this raises awareness, which leads to engagement and action. It's a first, positive stage that leads to discussion. That itself may lead onto longer-term actions and positive outcomes."

At least one firm, however, is already reporting increased customer engagement on this front.

Legal & General Investment Management's (LGIM) head of client solutions, Laura Brown, says: "We are seeing an increased appetite from our clients to understand the ESG characteristics of their investment strategies, to consider the impact investments can make, and to upgrade specific mandates to include net-zero alignment. ESG is discussed in every single client meeting we attend and there has been a sea change in trustee understanding of and engagement on this topic."

This engagement may already be shifting the needle. "LGIM's research that the typical DB scheme is currently aligned to a 3°C outcome so there is a lot of work to be done to move closer to the 1.5°C target," Brown says.

**DB funding code**

Much closer on the horizon are TPR's revisions to the *DB Funding Code of Practice,* a move that has been in the works since the UK government's *Protecting Defined Benefit Pension Schemes White Paper* in 2018.

The revisions, in the TPR's own words, are to "[…] clarify the standards we expect trustees and employers to apply to meet legislative requirements".

"Greater clarity," the regulator said in its consultation document from March 2020, "is required to ensure the flexibilities in the DB funding regime are used appropriately, to embed and drive good practice in relation to the management of long-term risks, to ensure DB schemes' efficient run-off phase, and to support more effective and efficient regulation."

According to Secor investment strategist, Devan Nathwani: "The upcoming DB funding code will provide a framework whereby trustees can formally define a long-term objective for the scheme, whilst ensuring the scheme's investment strategy is appropriate for achieving this over an appropriate time-horizon."

"In practice," Nathwani says, "we expect trustees will be looking to deploy more sophisticated strategies, such as equity downside protection, to allow them to continue to allocate to growth assets without excessively exposing the scheme to a worsened funding position during market crises."

Others were more pointed in their expectations. LGIM head of insurance solutions and strategy, Matt Webb, says that trustees were increasingly looking to simplify the complexity of their investment mandates to relieve the governance burden.

He added: "We therefore expect that the *DB Funding Code* will further accelerate a migration of scheme's investment strategy towards endgame investment strategies focused credit and LDI, and ultimately to target buy-in or buyout."

**Written by Pete Carvill, a freelance journalist**