The asset strategy behind a bulk annuity portfolio

With record levels of DB scheme assets being transferred to bulk annuities, Gareth Collard, chief investment officer at Just, looks at the investment challenges for insurers and some of the assets his team have secured for their annuity asset portfolio

It's often helpful to take a new perspective and look at the world through a different frame of reference. This can improve understanding, even when we're looking at things we believe we know well.

Buy-ins are a case in point. For many schemes they're a means to the ultimate destination of a buyout. But in the meantime, buy-ins are an asset of the scheme. So it's valuable to consider them as an investment, look closely at what they aim to deliver and the assets that underpin them.

The investment challenges for schemes and insurers

The investment challenges facing DB trustees can be very different from those facing insurers. I've seen trustees transition from open funds with equity investment and little by way of cashflow matching (a standard technique for insurers) through to LDI as trustees realised they needed to employ a dynamic hedging approach.

As funding levels have improved and schemes approach maturity, they need to hedge the assets against fluctuations in rates, inflation and credit spread widening. This perhaps explains why there's increased interest in cashflow driven investment as investment strategies for pension funds and insurers begin to converge. But this has always been insurer territory and comes with the additional headache of counterparty and collateral risk management. We're DB consolidators, aggregating the assets of many schemes, and also retail policyholders, across our c£19 billion annuity asset portfolio to guarantee over £1 billion of annuity payments every year. So how we invest is very different from all but the largest schemes.

The recently implemented Solvency II regulatory regime for insurers (January 2016) continues to encourage insurers to follow a disciplined cashflow matching approach and to source assets with long dated and secure cashflows. When coupled with our ability to lock in a proportion of the associated illiquidity premium that compensates us for tying-up capital, we are able to write attractively priced bulk annuity business.

How asset classes can deliver cashflow matching

The basic principle behind asset liability management is to use a portfolio of fixed income assets to meet the expected annuity cashflows at different maturity points.

Our ability to medically underwrite some bulk and retail annuities and our reinsurance of much of the longevity risk we take on when we write bulk and retail annuities means that we're able to predict with some certainty the annuity cashflows we're required to fund. We also hold substantial capital against a variety of risks, including demographic, market and operational risks. This protects us against the risk of members (buy-in) or policyholders (buyout) living longer than expected.

We fund, manufacture and distribute lifetime mortgages (LTMs) – so we have access to a steady stream of these assets and the market is forecast to continue to grow strongly.

The UK public bond market is relatively small and insurers will look to non-sterling issues, hedged to create a synthetic sterling bond. There's increasing competition for other assets such as municipal bonds, commercial mortgages, private placements and infrastructure debt. We have to be particularly careful which long credits we invest in as we require counterparty security extending into decades. I can think of many brands that would have seemed a safe bet 20 years ago but are no longer trading. A critical part of our thinking is to consider issuers whose business model will be valid in 30 years (say) or for which there is the security of an underlying income stream or asset.

And of course utility, infrastructure and social housing have been very attractive and fulfil several important criteria – their durations provide a good match for DB liabilities, some have government guarantees and many have an ethical component – making them highly desirable. But they're in limited supply so there's competition to secure them.

So what assets have my team been sourcing?

As well as sterling public bonds, overseas public bonds and LTMs, we have invested in infrastructure debt, private placements and commercial real estate debt.

During 2017 we secured a significant initial financing, over £150 million, for the Walney Extension Offshore Wind Farm which is located off the coast of

Cumbria. It's up and running now and the 87 turbines are generating power for 600,000 homes in the UK. All construction risk was passed to Orsted, a consortium of six Danish utility companies that own and operate the wind farm and is majority owned and guaranteed by the Danish government.

We liked the investment because it was inflation linked (and therefore a good match for pension liabilities) and achieved attractive spreads with limited credit risk as a proportion of our investment had recourse to the Danish government.

During 2018, we invested over £100 million in financing the construction of the Hornsea Offshore Wind Farm in the southern North Sea off the coast of Yorkshire. This is also operated by Orsted, so it benefits from some of the same protections enjoyed by the Walney financing.

In 2017, we invested around £50 million in a loan to Wheatley Housing Group, the largest registered social landlord in Scotland. The funds enabled them to refinance existing debt and provide capital to build new homes.

My team also look to secure private placements, which typically provide structural protection through covenants, and have invested over £0.5 billion. Separately, in 2018, we bought a Cambridge University 50-year CPI AAA bond and also a US municipal bond issued by Harvard University. We deliver security by selecting counterparties that we believe will be around well into the future. In making long-term investments there are always risks, we seek to manage these by looking at the security and protections in individual investments and seek diversification by not putting too many eggs in one basket.

ESG and ethical investing

With ethical, social and governance and sustainable investment becoming increasingly important for our shareholders and for trustees investing in buy-ins, we have formalised ESG analysis as part of our investment due diligence process. We've created an ESG framework for sustainable investing that we follow when analysing investment opportunities. This aligns with the social purpose that's at the core of our business.

We're also signatories to the UN Principles for Responsible Investment, the first UK insurance asset owner to have signed, which demonstrates our commitment to responsible investment.

Walney and Hornsea with their green credentials meet the criteria of our ESG policy. They exemplify the social purpose that can be derived by harnessing assets ethically and sustainably. Such investments can drive engagement with members when they understand how their pension funds support infrastructure.

Of course ESG also requires us to divest some assets and as an example, we've sold out of all long-dated tobacco exposure.

Security

As you'd expect, I've got strong views on the security we offer to trustees through the UK insurance regime. My view is that insurers offer the ultimate consolidation because the solvency capital buffer that we're required to hold is equivalent to a DB scheme being spectacularly overfunded on a technical provisions basis. Imagine the luxury of such surplus if enjoyed by the trustees of a DB scheme?

Written by Gareth Collard, chief investment officer, Just

In association with
JUST.
RETHINK RETIREMENT