Time for change?

Jon Exley, head of solution innovation at Schroders Solutions, considers whether it is time for defined benefit (DB) pension schemes to invest like an insurer

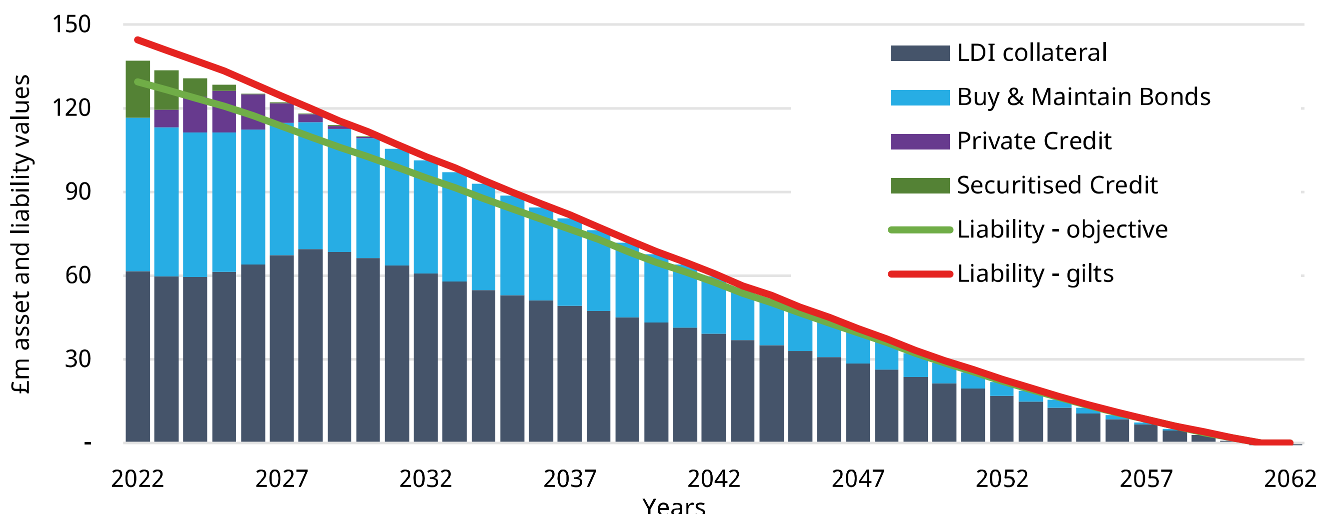
Most DB pension schemes benefitted materially in funding terms over the last year. Sharp increases in gilt yields have meant that many schemes are now close to fully funded on a more prudent 'low dependency' funding basis. A low dependency basis is consistent with investing in low-risk assets, reducing reliance on the covenant, and increasing security for members.

What does this mean for trustees setting future investment strategy?
It is a shift in mindset for trustees. The emphasis moves away from 'well-risk managed growth' portfolios to the mindset of our insurer clients where their core aim is to achieve 'stability and certainty of return'.

How do insurers invest their assets?
Solvency II regulation and sound risk management principles encourage insurers to invest conservatively to ensure they can meet their obligations, even in very stressed market scenarios. This means a strategy with less reliance on equity markets or manager skill. Instead, they invest in more secure and contractual assets, such as high-quality corporate bonds and infrastructure debt, intending to hold those assets to maturity. The contractual nature of these assets means 'locking in' yield at the outset (assuming they set aside adequate reserves for any potential impairment or default), giving more certainty on meeting those obligations in the future. Through derivatives and other means, an insurer will also remove unwanted risks, such as interest rate and inflation risk, with low leverage. This is the same philosophy of cashflow-driven investment (CDI) strategies used by, and becoming popular with, pension schemes.

The below chart illustrates a CDI strategy. It shows the forecasted values of a CDI portfolio against a DB pension scheme's projected liability values. We can invest a CDI portfolio across the risk and illiquidity spectrum, considering scheme circumstances. For example, this illustrative solution includes the building up and running down of a private credit portfolio in the early years.

Illustrative CDI portfolio relative to scheme liabilities



Source: Schroders Solutions, for illustrative purposes only

By investing like an insurer, a scheme can achieve several things:

- Improve the certainty of outcome by reducing the reliance on market returns (beta) or the need for manager skill (alpha)
- Increase the certainty in delivering member benefits
- Invest in line with end-game objectives

Consistent with endgame objectives

For schemes targeting buyout, investing in similar assets to an insurer's investment portfolio can provide a match for annuity pricing when the time comes. For trustees looking to run their schemes on in a low dependency manner, a CDI strategy is also attractive. CDI portfolios of schemes targeting low dependency may differ from that of a client targeting buyout. For example, these portfolios may hold a wider range of private credit and infrastructure equity, and longer-dated assets. This can be attractive assets for clients with a longer time horizon and offer attractive risk-adjusted returns at present.

Have a 'Plan B'

As a final thought, the recent rise in gilt yields has meant that there has been a surge in demand in the bulk annuity market. This has risen to a point where it is not clear how many schemes the market can absorb, and whether some schemes cannot transact for a period of time. For schemes targeting buyout in the short to medium term, having a 'Plan B' is going to be important. Instead, seeking to invest like an insurer may be the best way to ensure certainty of the outcome, and ultimately greater security for members.

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What are the risks?
Interest rate risk for fixed-rate instruments: interest rate volatility may reduce the performance of fixed-rate instruments. A rise in interest rates generally causes prices of fixed-rate instruments to fall.
Deterioration of the credit quality of the bond: caused by a change in the market environment (for commercial activities) or a change in law / regulation (for all infrastructure activities).
Risk of issuer default: a decline in the financial health of an issuer can cause the value of its bonds to fall or become worthless.
Prepayment risk: the capital may be repaid by the borrower before reaching maturity.
Exchange rate risk: where assets are denominated in a currency different to that of the investor, changes in exchange rates may affect the value of the investments.
Illiquid and long term investment risk: an investor may not be able to realise the invested capital before the end of the contractual arrangement.
Capital loss: the capital is not guaranteed.