Coming back stronger

Summary

- UK DB schemes registered an aggregate surplus for the first time in nearly two years in March 2021, according to the PPF 7800 Index.
- Despite the initial fall in funding positions at the beginning of the Covid-19 pandemic, many schemes bounced back stronger on the back of good growth asset returns and rising gilt yields.
- Schemes were also generally well hedged, thanks in part to lessons learned after the 2008 global financial crisis.
- The improved funding position is likely to lead to schemes de-risking and moving closer to their endgame.

Following the market crash at the outbreak of the pandemic, DB schemes' funding positions have bounced back to above pre-pandemic levels. Jack Gray explores the reasons behind the improvement and what it means for investment strategies

In the summer of 2020, the aggregate funding position of the UK's defined benefit (DB) pension schemes made for bleak reading. The Pension Protection Fund (PPF) reported a combined deficit of £199.5 billion at the end of July 2020 for the over 5,000 DB schemes in the UK, representing an increase of £164.1 billion from the end of December 2019. Sharp falls in gilt yields and market uncertainty caused by the outbreak of coronavirus had hit DB schemes' funding levels, and there were warnings that the PPF was in for a busy time keeping members' benefits safe.

However, as global markets recovered and government support packages took effect, the deficit began to drop in the autumn of last year. Most schemes took

onboard advice not to panic or make knee-jerk decisions, and to trust in their long-term strategies. This appears to have paid of, with the PPF 7800 Index, which is measured on a section 179 basis, reporting an aggregate surplus for the first time in nearly two years at the end of February 2021. Furthermore, the PwC Pension Funding Index, which is based on schemes' own measures, recorded an aggregate surplus in May for the first time since it was established in 2014.

Coming back stronger

At the time of writing, the most recent figures from the PPF show an aggregate surplus of £94.6 billion, while PwC's statistics show a surplus of £50 billion. "Despite an initial 'slump' in funding at the start of the pandemic, a large number of schemes will now be back at, or above, their pre-pandemic position," notes 20-20 Trustees trustee director, Jim Robson. "In particular, schemes with a high level of hedging, and a reasonable allocation to global equities, will have seen the strongest performance over the period."

Broadstone director of investment consulting, Marc Devereux, describes the primary reasons behind the improvements as two-fold: "Any schemes investing in growth assets have enjoyed some very strong returns from those assets."

"Equity markets have continued on an upward trajectory. Anyone with a decent amount of equity exposure has fared well, but that extends across most growth assets. If we look at fixed-income assets, spreads are very low today compared to historical levels, so they would have benefited across the board in terms of any growth asset exposure.

"On the other side, a key driver is what has been happening in yields. Nominal gilt yields have increased quite significantly. If we look back to the lows at the end of May 2020, the spot rate of a 20-year gilt yield was 0.6 per cent per annum, when today that is more like 1.3 per cent. A 0.7 per cent increase in long-term gilt yields has a pretty dramatic impact on your liability values."

Buck head of retirement consulting, Vishal Makkar, points out that schemes may have gained from "robust negotiation" from trustees on recent valuations and associated recovery plans. "As economic conditions improve, the fortunes of some scheme sponsors may well also improve providing a further boost as any profit-sharing contributions kick in," he adds.

With over 5,000 DB schemes, the journey had not been the same for everyone. PwC global head of retirement and pensions consulting, Raj Mody, explains that there were two primary 'cohorts': "There is a cohort of schemes that did not see that much volatility. They did not crash during the crash last year and nor have they improved drastically. That cohort would have been reasonably well funded to start with and they were pretty well hedged.

"There is another cohort who rode the rollercoaster in what happened to markets last year, they weren't as hedged. They have arguably come out better because of what happened in the recovery. There has been two things going on that brought up the average: schemes that were effective at holding their own and may have improved slightly, and schemes that had a bit more of a rollercoaster but improved significantly."

Mody also notes that there are secondary factors that played their part in improved funding, such as deficit recovery contributions (DRCs) and the fact that longevity has not continued to improve at the rate pension schemes were assuming 18 months ago.

However, it seems that most agree that increased DRCs did not play as big a role in the improved funding positions as growth asset returns and improving gilt yields.

Lessons learnt

Part of the reason that DB schemes fared well during the pandemic could be that they were better prepared following the 2008 global financial crisis. DB schemes were badly hit by the crisis, with Organisation for Economic Co-operation and Development countries' private DB schemes' investments losing an aggregate of 23 per cent of their real value in 2008. Following the crash, many trustees took steps to ensure their schemes could better handle economic shocks.

"The lessons of 2008/09 probably spurred a lot of trustees to do more hedging, so when yields did fall quite materially when the pandemic started taking hold that did provide a good level of protection," explains Devereux. "I think the potential impact was mitigated by any schemes that had hedging in place."

"Schemes are now more mature/

better hedged than they were 13 years ago, and hence were better prepared for a further reduction in gilt yields," agrees Robson.

However, the crisis in 2020/21 was of a different nature compared to the financial crash, which may have also contributed to schemes faring better.

"Although local equities didn't fare well at the start of the pandemic, global equities held up driven predominately by strong performance in companies that benefited from lockdown," says Robson. "This compares to a huge downturn in global equity markets in 2008 when the financial crisis hit."

One of the key differences is that the pandemic is a health crisis that has consequences for the economy, not a purely financial crisis, according to Mody.

Makkar adds: "In general, financial markets had far fewer liquidity issues in 2020 than in 2008, as central banks stepped in to support economies and markets. The markets didn't create the latest crisis, they just reacted to it.

"Pension schemes have matured greatly since then and are now much less reliant on employer contributions to meet the regular outgoings, making them less vulnerable to any potential fall in these contributions. Trustees now also have a greater emphasis on matching cashflows and liquidity."

Taking risk off the table

Covid-19 appears to have had an unexpected consequence on DB schemes in the UK; it has brought many closer to their endgame following the improvement in funding levels.

"I think the improved funding position will change schemes' investment strategies," begins Mody. "Because they are better funded, their risk budget can be reconfigured. If you are better funded you do not need to take the risks you would when eliminating a deficit."

Mody also notes that some schemes may be better funded than they think they are, and urges trustees to review their assumptions.

Robson adds: "Given recent yield movements, schemes are likely to have seen their gap to self-sufficiency/buyout close quite significantly in recent months, and so you might expect schemes start to look to take some risk off the table as they are running higher levels of return than needed to achieve their goals in the desired timeframe."

Devereux agrees, noting that schemes are looking to de-risk due to the general improvement in funding levels. However, he warns that there is some "nervousness" that assets have been on a good run and managers have concerns that valuations are looking a "bit rich at the moment".

"Making sure clients are well diversified is an obvious answer and, where possible, looking to migrate to higher quality assets," he adds.

Makkar expects there to be a greater concentration on cashflow matching and an increased focus on long-term journey planning, as many schemes up their efforts to be ready for endgame.

He concludes: "This could manifest in a number of ways, for instance a move into assets that can more easily be transferred to an insurer.

"It's also likely that there will be a tactical move to de-risk further, capturing the rebound in equity markets and for those well-funded schemes, protecting any surplus."

Written by Jack Gray