Summary
- Volatility is an unavoidable aspect of investment in the markets.
- Diversity is perhaps the main tool used to manage volatility.
- Harnessing the upside is a potential benefit of volatility – but takes skill and strategy and is not always easy to do.
- The long-term nature of pensions offers some relief to some pension schemes, but the long term is getting shorter all the time and pension schemes must carefully manage shorter-term risks.
- Preparation is key – we know volatility will occur at one stage or another, so having a portfolio that has been stress-tested with convincing outcomes is essential.

Choppy waters

Sandra Haurant explores how pension investments are riding volatility

Highs and lows are all part of the game when it comes to the stock market; but there are times when the waters feel far choppier than usual. "At the end of last year, we saw a significant rise in equity volatility and in drawdowns in risk assets, which would have hurt pension schemes' funding levels," says Legal & General senior solutions strategy manager Jonathan Joiner. "Since then we have seen a pick-up in equity markets, and they are not far off their highs."

But while equity markets have picked up, pension schemes may not be feeling that it's time to relax just yet. "Schemes will perhaps not have seen their funding levels improve by as much as might have been expected," says Joiner. "While their assets will have done well, we have witnessed a notable fall in interest rates; 20-year bond yields have fallen by 0.5 per cent, which means liabilities will have increased significantly."

And what has been causing this shift? "In response to recent volatility at the end of the year, many central banks have been easing monetary policy. If we look back to expectations at the beginning of the year, many were predicting that the US federal reserve would implement hikes this year," says Joiner. Instead, he says, people have been pricing in an increased chance of further, significant, cuts to rates.

So how can pension schemes position their investments so that they are best set to ride out the storms of volatility? The first rule is, don't panic. "Anything reactionary should be avoided – pension schemes have to remember they are long-term investors and should look at a long-term horizon," says Joiner. "Therefore our approach has always been to prepare for these periods, not kneejerk-react to them."

Diversify to survive

"We strongly believe in diversification," says Joiner. "Recent volatility has shown how important that is. You might have said, at the start of the year, that emerging market equities were the place to be. After all, they have potential for strong long-term growth and they appeared to have better valuations than some of their equity peers. But, given the surprising escalation in trade war rhetoric, they have performed relatively poorly. This highlights the fact that allocating all of your assets to something you like the look of is not always a good idea; having a diversified portfolio that can weather these volatile times is important."

But, according to Cardano senior client manager Helen Prior, it's not that simple to get the balance right: "Diversification is easy to understand as a concept, but hard to deliver in reality." Past relationships, she says, can too often let you down when you need them most. "Take, for example, the behaviour of equities and bonds. Over the long term, you could conclude that when one goes up the other goes down and they are good diversifiers. However, this relationship isn't always true, and during

times of high inflation, they both tend to disappoint at the same time."

For this reason, she says, trustees should look at how a portfolio would stand up to a number of 'real life' scenarios, rather than relying on 'statistical diversification'. Prior argues: "Only when outcomes would be tolerable in all these scenarios will the investments be truly diversified."

PiRho Investment Consulting director Nicola Ralston agrees that investors should think about 'stress situations', not just volatility, and adds: "It's important not to be fooled into investing in 'false' low volatility by investing in assets that have limited liquidity, and also to be wary about paying too much for diversifying into high alpha products."

She adds: "It is possible to over-diversify; more diversification is not always better. The benefit of adding more asset classes (and more securities within asset classes) is powerful to start with, but tapers off quite quickly. The portfolio can become more complex and costly, potentially even having an adverse impact on expected return. So a priority is to decide how much diversification is enough."

Feeling the benefit

While the notion of managing volatility is usually concerned with avoiding the downside when markets fall, there is also the question of how to harness the upside in markets when they go up. Given pension scheme's commitments, can they benefit from rising markets?

"Most trustees face asymmetry when it comes to volatility – the downside risk is more damaging than the corresponding upside risk is rewarding," suggests Prior. "That means the first priority needs to be getting enough return with levels of downside risk you can live with. Controlling downside risk doesn't mean that trustees can't be alert to the opportunities volatility offers. Volatility is an inherent aspect of markets that can be harnessed in its own right or that can present opportunities to enter or exit investments at an attractive time." And, adds Ralston, it's important to look at the bigger picture when making decisions: "The triggers for upside performance should be thought of in a holistic way on a funding journey."

Is time on your side?

That bigger picture should also take into account timeframes within which a pension scheme is operating. "In a lot of ways, pension schemes have time on their side, particularly if they have strong sponsor governance," says Joiner. The longer-term view perhaps means they can look past short-term volatility, to a degree: "This means they might be able to invest in something such as high-yield credit or bonds, which, while they can be very volatile, have a 'pull to par' nature. As they mature, even if there is volatility, they pull towards their final value."

But just how far do these potentially longer-time horizons shield pension schemes from market volatility? "For most schemes, the honest answer is not very far I'm afraid," cautions Prior. "If your timeframe is infinite or your covenant indestructible, you can arguably afford to think of volatility as 'noise', but how many UK defined benefit schemes can say this? Particularly as schemes mature and start paying out more than they get in, a period of adverse volatility can permanently destroy the ability to meet the benefits as they fall due."

For many trustees, the long term is sliced into a series of segments, or triennial periods, taking them from one valuation to the next, says Prior. And adverse volatility can lead to increased deficits and difficult decisions around contribution levels in the short term, whenever it occurs. "It's a perfect example of integrated risk management at work," says Prior. "Trustees need to be comfortable that their covenant and funding plans support the level of volatility they are taking. If the answer is no, speak to your advisers about what you could do differently." And, adds Ralston: "This 'long term' is getting shorter all the time, especially as schemes turn cashflow negative. Just mathematically, falling behind on a short journey means that the plan might become unrealistic."

For this reason, while diversification may be the most valuable tool they have, pension schemes need a number of others at their disposal. According to Joiner, the three other crucial elements for pensions schemes of all sizes, from £10 million to £20 billion, are liability hedging, careful control of cashflow requirements and good use of currency management.

In general, though, Joiner believes pension schemes have a healthy attitude when it comes to managing volatile periods in the markets. "I think trustee boards are good at not overreacting to periods of market volatility, and we don't often see rash decisions made," he says. "But while they might not make rash decisions, that does not necessarily mean they are adopting the preparations that they could be."

Volatility is an unavoidable part of investment – what goes up will, inevitably, come down, and coping in difficult conditions is part of the deal. Right now, Joiner says, things could be worse: "While we have seen volatility recently, relative to the grand scheme of things, one must remember it has not been all that significant." But given the nature of the markets, perhaps the only thing that can be safely predicted is that there will be more volatility ahead – sooner or later – and preparing for that likelihood is arguably the best course to take when navigating uncertain waters.

Written by Sandra Haurant, a freelance journalist

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