Summary
- DB schemes face market risk, liquidity risk, interest rate risk and inflation risk, particularly as schemes mature and become cashflow negative.
- The use of longer-dated illiquid credit assets, TPR's integrated risk management guidelines and contingency plans can all help mitigate this risk.
- DB trustee boards have exercised good practice by diversifying their assets.
- Potential political risks should be addressed through stress testing. They also present trustees with opportunities to buy assets at a lower price.
- For DC savers, Pension Freedom Day has introduced them to sequencing risks and longevity risks via drawdown.

Preparing for battle

Fighting investment risks in today's unpredictable age of central bank intervention, unstable markets and legislative reforms is a challenge for both DB and DC schemes, finds Marek Handzel

For trustees of defined benefit (DB) schemes, fighting recurring investment risks is like battling the Hydra, the multi-headed monster from ancient mythology. They chop off one venomous head and turn to strike another one. But before they know it, a new head has grown in the old one's place. And so it goes on.

Sadly, most schemes have not yet found the golden sword of Hercules. And so the Hydra continues to torment them and defy their most valiant efforts.

And at present, says State Street Global Advisors (SSGA) head of LDI EMEA Howard Kearns, the Hydra most certainly has the upper hand.

"If you look at the PPF 7800 index, then at the start of the year the 6,000-odd funds had a funding level of 80 per cent and deficit level of about £300 billion. Roll forward *[to mid-February]* and it's looking more like 75 per cent and £420 billon - the worst it has ever been," he says.

Keeping the cash flowing

In the midst of this volatility, Kearns says that the market and liquidity risk barometers are flashing their red lights. The latter, in particular, he says, has come to schemes' attention.

"If you look at the bond market now, it's a lot less liquid. As schemes mature and begin paying out proportionally more in pensions than their assets, then they become cashflow negative. And liquidity becomes more of an issue as they have to sell assets month after month."

According to Kearns this is a serious issue for schemes that have a leveraged LDI solution in place: "As we move towards a world where we have to clear OTC derivatives, the need for repo is just going to increase. And at the moment, the capacity is decreasing as repo is becoming more expensive for banks to provide."

Schemes are therefore nervously waiting for some alternative solutions to materialise. But as they do so, LCP partner Paul Gibney is advising trustees to protect against negative cashflow by making sure they have exposure to longer-dated illiquid credit assets for example, which can offer attractive capital returns and income streams.

In terms of general market risk, Gibney urges schemes to keep looking at the big picture.

"That means understanding where trustees want to be longer term with funding targets, the way that they're going to get there, and thinking about the risks that could push you off those goals."

He says that using The Pensions Regulator's integrated risk management guidance, and having contingency plans in place, can go some way to addressing market risk.

"Clearly, equities are the most volatile," he says. "So one way to mitigate that is to make sure that you have the equity risk exposure that you think you need to meet your objective, but not any more. And therefore look to diversify away from equities where you can."

Within that equity mix, ensuring that a scheme is holding the right kind of exposure is also vital if trustees want to maximise their returns for the level of volatility they are taking on. The emergence of smart beta strategies has helped in this respect, adds Gibney.

Aon Hewitt head of UK investment consulting Tim Giles says this balancing

act has to be carried out carefully.

"If you try and nail down everything then you don't actually get to a place where you need to be, as you don't end up with any returns," he says.

Giles points out that with most schemes de-risking, growth asset risk has become secondary to interest rate and inflation risk. When it comes to navigating market dangers, trustee boards need to make sure that the risks that remain are the ones "that you want to be taking".

The use of the regulator's integrated risk management guidance also helps when it comes to dealing with business risk and the state of the sponsoring employer, says Quantum Advisory senior investment consultant Amanda Burdge.

She explains that it provides a more holistic approach to funding investment and business risk without being overly prescriptive.

"We feel that the new IRM regime will strengthen the trustees' decision-making process and enable schemes to act quickly whilst avoiding knee-jerk reactions to shorter-term fluctuations," says Burdge.

Methods of dealing with changing circumstances of a covenant vary from accelerating contributions to parent guarantees. But Gibney says that trustees must take the time to think through possible scenarios and how they may deal with them. "That's just good business practice," he says.

Spreading the load

Good practice has been exercised by most DB trustee boards when it comes to concentration risk. Many have allocated more money out of growth assets into bonds or LDI strategies.

For those who still need to diversify further, Burdge advocates the use of smarter financial management tools that use integrated funding and investment modelling to provide clear, effective communication to trustee boards.

Playing politics

Measuring other risks, such as political risk, is a little harder, however.

Events such as the Greek debt crisis have been big drivers of markets in recent times. And this year, the risks remains high with a UK referendum expected in June and the potential for policy mishaps as countries tinker with monetary policy.

Nevertheless, says Burdge, while these fluctuations are sometimes painful for DB schemes, they also present trustees with opportunities to buy assets at a lower price.

However, as with covenant risk, Gibney argues that any potential fallout from Brexit, and the like, is best addressed through scenario testing.

"It's about looking at how resilient you are," he says. "Given the kind of environment where we are now a bit more fragmented *[politically]*. Testing to see what possible decisions do to your asset mix is a sensible approach to adopt."

Underneath the high profile political negotiations lie the somewhat murky machinations behind currencies. Schemes are split in terms of how they deal with the risk associated with assets that are not held in sterling, with some looking at bespoke hedging and others happy to take the lows with the highs.

"People get unduly worried about risk in currency without seeing it in the context of other risks," says Giles.

"People say they need to hedge out currency risks, but actually many companies, although perhaps denominated in dollar or yen, are wider entities with very different currency risks underlying them. And with the present volatility in equities, currency risk is secondary to that."

However, Record Currency Management chief executive officer James Wood Collins warns that currency risk should not be underestimated.

Although developed market currency risks can wash out over a five- to seven-year period, he says that there are lots of decisions that are made on shorter horizons, such as PPF levy calculations and triannual valuations.

"If you're measuring your scheme when sterling is very strong, then you're going to have a 10 per cent reduction if all things are equal, in non-sterling assets. It can have a material impact on the fund's solvency level at the time you're measuring it, if say, overseas assets make up 90 per cent of equities and 10 per cent of bonds," he says.

Hedging is also plagued by some misunderstanding, says Wood Collins.

Chief among these is that it is costly. He says that a number of savings can be made when implementing a hedge to ease cost.

"There are some very modest transaction costs incurred when you roll over the forward contract positions that are used to manage a hedging programme," he says.

"But that shouldn't cost more than one or two basis points in aggregate a year."

The DC picture

If DB trusteeship is like fighting the Hydra, then in DC it is more like coming face-to-face with the Minotaur. After making your way through the labyrinth of default funds, appropriate contribution levels and communication programmes, providers and trustee boards find themselves battling a Westminster monster with an insatiable appetite for pensions reform.

This has created fresh investment risks for DC savers in the new drawdown environment ushered in by Pension Freedoms Day.

SSGA head of European DC Nigel Aston says that the first of these is sequencing risk.

"If you're relying on a regular income from your investment pot and it suffers from a real downturn in drawdown, then you're eating into that investment, which is a serious problem," he says.

To counteract that, Aston says that volatility management - which has been put to good use in some plans during the saving cycle – needs to be implemented in drawdown to a similar level.

The second key risk in drawdown is longevity.

"We're giving people going into drawdown an incredibly difficult puzzle to solve. Because we're saying here's your £100,000, make it last for the rest of your life," says Aston.

Both here and in the US, providers have been developing new deferred annuities to tackle this challenge. The product, which marries investment with insurance, could well provide the answer for many retirees.

However, allocation risks still exist in the accumulation phase, says AllianceBernstein head of pension strategies David Hutchins.

He says that over the last five years, UK equities have delivered an average return of 5.4 per cent. Global equities meanwhile, have returned 8.2 per cent. Yet many UK default funds still have a huge bias towards domestic equities.

"There is no investment rationale for that," says Hutchins. "You have to get the basics right before you start talking about private debt and infrastructure, and all the fun stuff.

"There are fundamental issues out there in DC that aren't being highlighted."

Written by Marek Handzel, a freelance journalist

Avoiding scams

Investment risk, in the form of scams, continues to cause concern for those fighting fraud.

Last October, the National Fraud Intelligence Bureau revealed a criminal operation that involved offering pensioners an investment in parking spaces. With the new pension freedoms and a growing number of DC retirees looking to maximise their investments in drawdown, scams are expected to grow in number.

Other areas that the public have been warned to look out for are property development, overseas investments and storage pods.

Quantum Advisory senior consultant Robin Dargie says that a code of good practice to combat pension scams, released by the Pension Liberation Industry Group last year, has gone some way to helping possible victims. Ultimately however, says Dargie, there's no real safeguards in place to protect those targeted by cold callers and slick marketing material.

"For DB scheme members, the requirement to take advice for benefits valued at more than £30,000 has undoubtedly helped to reduce scams, but DC savers are still at risk.

"Around 700,000 DC savers are known to have taken their DC benefits under the new freedoms, but we don't know how may have actually how many have moved their money to a pensions liberation vehicle.

"It is difficult for DC providers. DC savers have a legal right to a transfer even when the provider suspects foul play. If a provider follows best practice and keeps to the law, the Ombudsman would not be expected to find the provider guilty of maladministration, despite the individual ultimately losing out."