Summary
- DB schemes, especially the well-funded ones, are looking to insurance companies as portfolio role models.
- DB schemes are adopting a much more holistic investment approach and looking at a diverse source of returns.
- Equities are out of favour as different liquid and illiquid strategies become more popular.

An open mind

Lynn Strongin Dodds reveals how DB schemes are adopting a much more holistic investment approach to their investment strategies

As the years tick by on the defined benefit clock, schemes have become increasingly thoughtful about the way they structure portfolios for the end game. While the better-funded schemes are adopting more of an insurance mindset, others are looking at different blended approaches to meet their obligations.

Many of their challenges are not new. They have been grappling with low interest rates, quantitative easing, increasing longevity and scheme closures for some time. However, withdrawals are happening at a faster rate than expected as people take advantage of pension freedoms, which were introduced in 2015. They were designed to give over 55s in defined contributions greater choice beyond buying an annuity, but a swathe of DB members have followed suit and have relinquished their gold-plated guaranteed income in exchange for a lump sum.

Numbers crunched by consultancy Mercer show that 300,000 pension transfers, worth a weighty £85 billion, were made between April 2015 and the end of last year due to historic high values. "The mega trend is that schemes are maturing and are closed to new members," says Mercer investment consultant Adam Lane. "However, allied to this is that people are not waiting to reach retirement age to draw their benefits and are taking their benefits earlier than expected in the form of transfer values as a result of pension freedoms. The implications of pension freedoms are that members have greater flexibility but it also means that plans are becoming cash negative with existing asset portfolios not generating sufficient income to meet payments when they fall due."

The 2017 Mercer's annual *European Asset Allocation Report* reveals that 55 per cent of the UK's DB pension schemes are now cashflow negative, up from 42 per cent in 2016, with 85 per cent of the remainder expecting to be cashflow negative by 2027.

J.P. Morgan Asset Management's head of UK institutional Paul Farrell agrees that the speed of people pulling out of plans has become a huge challenge and that now schemes have the additional consideration of estimating the number of transfers. "For the first time, pension plans are becoming cash negative. They will have to think long and hard about what is their end game – is it buyout or self-sufficiency and can they change their mind along the pathway."

Structural changes within the industry are only one albeit important facet driving asset allocation. Market conditions are also changing. "The long-heralded turning of the monetary cycle is actually happening and in 2017 we saw big changes, led by the US, that we have not seen in a decade," says Aviva Investors head of investment strategy, global investment solutions John Dewey. "The expectation is that yields and

potentially credit spreads will rise and there will be further significant volatility in the market."

M&G Investments director of global institutional distribution Annabel Gillard also notes that regulation around derivatives included in MiFID II and the European Market Infrastructure Regulation has also caused a shift in thinking about the best hedging strategies. "Derivatives are a big part of a liability driven-investment approach but collateral requirements may make them more expensive to implement," she adds.

Schemes are at different points on the de-risking journey, with the Mercer survey highlighting that 47 per cent of the UK DB pension looking at self-sufficiency as their long-term funding objective, while 36 per cent were focusing on their technical provisions liabilities and 17 per cent were targeting a buyout. The latter is growing at a clip and expected to break through the £15 billion mark this year but that is still relatively small considering that the UK's estimated aggregate buyout liabilities of over £2 trillion.

"The buyout market is constrained and will only be able to do a certain amount of business," says Royal London Asset Management (RLAM) Head of Institutional John Burke. "Those going for self-sufficiency will also want a lower risk approach to managing cashflow promises as they fall due, but if they are not as well funded they may need to consider a broader range of assets to generate extra yield, such as illiquid credit. A holistic solution would include overlaying an LDI strategy, which also protects schemes from interest and inflation changes."

Heading in the same direction

The overall direction of travel though has been similar, with a move away from equities and into bonds as well as alternative and assets. The Mercer survey reveals that since 2008, UK plans slashed equity allocations from 58 per cent to a new low of 29 per cent last year, while the average allocation to alternatives has been steadily climbing to 22 per cent from 4 per cent in 2008.

"We are seeing schemes act more like insurance companies as they mature and get to the end game," says Gilliard. "They are looking for a series of defined cashflows that is similar to an annuity-style portfolio. It has evolved slowly over time and schemes are moving at different rates. It will depend on their sponsor covenant, current default and funding ratios, cashflow positions and specific parameters."

The better-funded schemes are adopting more of an insurer mindset and are moving more to a cash-driven investment strategy, which places a higher emphasis on liquid and illiquid income generating strategies, according to Legal & General Investment Management head of portfolio solutions Graham Moles. "Broadly speaking this means assets with contractual cashflows and credit sensitivity and so it is not unusual to include corporate and government bonds as well as other fixed income strategies," he adds. "If the goal is to get to a buyout, the benefit is that this strategy is likely to move in the same way as an insurance company's portfolio and additionally it will be easier to transfer the portfolio over."

The difference is that DB pension schemes are not constrained by Solvency II and have a wider breadth of assets to choose from. "We are starting to see clients think about their fixed income portfolios more broadly. This includes coupling traditional fixed income exposures with integrated return seeking and income generating assets," says BlackRock head of UK institutional business, Andrew Stephens. "This fanning out includes asset-backed securities, absolute and total return strategies, buy and maintain credit, private-market debt and longer dated cashflow-generating assets like infrastructure debt and long-lease property. There is a realisation that schemes need to make their fixed income asset work harder and to develop a more integrated and holistic approach."

Other assets making the grade are those higher up the risk spectrum such as emerging-market debt, sub investment-grade credit and catastrophe bonds, which are typically insurance-linked and designed to raise money in case of a catastrophic weather-related events. Each comes with its own set of challenges but the returns can make it worthwhile.

"Catastrophe bonds currently offer a pocket of value – 7-8 per cent yields – even though 2017 was one of the worst hurricane seasons in 20 years with Irma and Harvey," says Schroders strategist Alistair Jones. "However, losses were only 0-5 per cent in many funds and the pick-up in yield may well now be worth the risk in a very diversified portfolio."

While fixed income is a key component, return-seeking assets will also need to be part of the picture for many. "In the past schemes would choose between return seeking or hedging liabilities but today we see a third option emerging, which includes growth assets such as equities and liability-matching assets," says Farrell. "In the middle sits those assets that do not provide a perfect hedge or maximise returns from a Sharpe Ratio perspective but instead offer cashflows with inflation linkage. Together they improve the overall efficiency and cashflow of the portfolio's profile."

Russell Investments head of LDI solutions, EMEA, David Rae also believes the lines are being blurred between growth and liability hedging. "It is no longer a barbell between low-risk government bonds and high-risk equities but there is a middle ground, which is becoming more mainstream, whereby schemes are looking at the different sources of risk in a more integrated way," he adds.

Written by Lynn Strongin Dodds, a freelance journalist