
**Summary**
• The impact of the pandemic on DB investment strategies has varied greatly, but many schemes will be facing increased deficits and sponsor covenant concerns.
• The Pensions Regulator's (TPR) DB funding code has placed further focus on sponsor covenant, as trustees also predict an increased reliance on deficit contributions.
• 2020 represented a lost year for funding progress in an already maturing market, with scheme trustees urged to review funding levels and investment strategies now.

# Making up for lost time

**As industry research prompts concerns as to how DB investment strategies have fared amid the pandemic, Sophie Smith explores the impact of the 'lost year' and what considerations trustees should bear in mind for the year ahead**

Following the pandemic, many will be reconsidering the plans they had for the future, whether it be weddings, travel, or their financial positioning. Pension schemes are not ones to buck the trend, with a recent survey, commissioned by the Pensions Management Institute (PMI) and River and Mercantile, revealing that the vast majority (95.7 per cent) of DB scheme trustees believe they need to consider re-aligning their investment strategy to achieve long-term funding objectives following the market volatility seen amid the Covid-19 crisis, with 91.5 per cent prioritising this for 2021.

"2020 was a challenging period for pension schemes, given the swings in global markets and the impact that had on scheme funding," acknowledges River and Mercantile co-head of solutions, Ajeet Manjrekar, warning that whilst many schemes ended up in a similar or slightly weakened funding position at the end of 2020, they may have found their GBP deficit to have increased, depending on the level of exposure to on-risk assets and the extent of liability hedging.

Arlo International head of global advice, Toby Band, also describes a "stark contrast" in how DB pension scheme investment strategies have fared, explaining that those schemes with high allocations of UK equities and non-inflation-linked gilts, resulting in higher liabilities, will have been worse hit. "In contrast," he says, "investment strategies that leveraged their liability-matching bonds, diversified investments globally and steered away from an inherent bias to the UK all achieved reasonable returns and were less affected by the pandemic."

## A strong foundation

However, it is not only pension scheme investments that have been impacted during the pandemic, as Manjrekar points out that some sectors will have seen a "seismic shift" in covenant strength.

"It is clear that in a post-Covid world, many sponsors will be constrained from a cashflow standpoint and therefore less able to support significant deficit contributions," states Manjrekar, arguing that schemes should evolve their approach to be more self-sufficient to address near-term liquidity needs.

Indeed, Lincoln Pensions managing director, Michael Bushnell, notes that such concerns over covenant strength have already prompted some trustees to review their investment strategies and their approach to journey planning.

"Some schemes have seen minimal impact while others, such as those with sponsors exposed to automotive or hospitality sectors, have seen a rapid deterioration in the covenant and have responded by de-risking their investment portfolio," he explains. "Some schemes have used strong recent market performance to lock in gains and give sponsors more certainty on pension risks while they engineer a recovery."

There are also steps that trustees can take going forward, however, as BlackRock head of UK fiduciary Business, Sion Cole, recommends that the scheme revisit its funding objective, if the pandemic has adversely impacted a scheme's sponsor covenant but is expected to be short term. "For example, they may consider extending their target date to reach their long-term funding objective if the sponsor has to temporarily reduce or suspend contributions," he explains. In contrast, if it is expected to be a longer-term impact, Cole suggests that the scheme reassess whether the level of investment risk it is taking can be supported by the sponsor, and to reduce this if not.

**Looking for alternatives**

However, despite concerns over covenant strength, the recent research from PMI and River and Mercantile also found that nearly three-quarters (71.3 per cent) of trustees expect to become increasingly reliant on deficit recovery contributions to meet pensions cashflow or invest in income-generating assets if they do not sell growth assets, with 68.1 per cent highlighting this as a priority for 2021.

Considering this, Cole predicts pension schemes will invest more in income-generating assets as they become more cashflow negative and seek to reduce reliance on their sponsor. "For example," he explains, "as schemes de-risk and increase their allocation to matching assets, the liability-driven investment (LDI) portfolio will evolve to become a 'cashflow aware' portfolio that invests in government bonds, LDI and high-quality income-generating assets like investment grade corporate bonds and asset-backed securities." In addition to this, he also anticipates that those schemes targeting long term self-sufficiency will make greater use of higher quality illiquid private market assets, such as infrastructure debt, real-estate debt and private direct lending, arguing that these assets offer "significant diversification benefits" versus public markets and generate contractual income over long periods. Adding to this, Manjrekar suggests that trustees work with advisers to forecast their liquidity management needs, emphasising that these should be evaluated in both a normal and stressed environment to ensure adequate cushioning. "We believe that trustees need to evaluate covenant strength and affordability not just today, but to forecast over the next five to 10 years," he adds, emphasising that this should consider both financial metrics and other risk factors, such as environmental, social and governance (ESG).

**Building pressure**

The visibility schemes have on sponsor covenant in the medium term has been bought into sharper focus by TPR's consultation on the DB funding code, according to Cole, who suggests that even schemes with strong sponsors should seek to reduce their reliance on their sponsor beyond three to five years, which may mean taking more investment risk now, when it the sponsor can support it.

"The draft UK DB funding code's intention is to "create greater transparency and accountability around the risks taken by UK DB pension schemes", Cole says, continuing: "In order to do this, trustees will need to focus on their long term, strategic issues, while moving towards maturity.

"We believe in some cases, scheme investment strategies will need to reduce risk and reduce reliance on sponsor covenant, as well as ensuring they have suitable journey plans in place. Some schemes will adjust elements of their portfolios to fit with prescriptive fast-track terms."

Adding to this, Manjrekar describes the expectation that DB scheme investment strategies will de-risk progressively over time to have higher levels of risk management and cashflow management as "implicit" in the code. "Whilst this should be welcomed," he clarifies, "we would advocate a measured approach to how quickly schemes de-risk, given this will have longer-term implications to reaching their ultimate end-game."

**An ageing market**

Indeed, amid shrinking time horizons, Manjrekar describes 2020 as a "lost year" in making funding progress for DB pension schemes, highlighting scheme maturity as an increasingly significant issue. He continues: "Ultimately, DB schemes need a regular and predictable source of cashflow to meet their regular pension payments, alongside any elevation in transfer value activity. This needs to be balanced with generating an appropriate level of return today to improve scheme funding and member security."

Cardano client portfolio manager, Nigel Sillis, also emphasises that, as schemes progress towards their endgame, their investment priorities change as growth is de-emphasised, whilst cash matching becomes more important and illiquidity can become a hindrance rather than a source of excess return. "We are already seeing greater interest in the incorporation of cash-matching considerations into schemes' portfolio solutions," he says, clarifying, however, that cash matching should be seen as "a part of the solution" and not the "be all and end all" of the answer to portfolio construction dilemmas.

"Moving too deeply into cash matching too soon can lead to an inflexibility in the overall resultant portfolio," he warns. "Cash matching should be incorporated when appropriate and should be averaged into the overall portfolio construction mix over time. This enables schemes to stay liquid for longer and allows them to retain flexibility."

Band echoes these concerns, emphasising that whilst DB schemes must allocate more of their asset pool to short-term investments as they mature to ensure stability in the short term, this can leave schemes in deficit. "This means they must take greater investment risks, which is a very difficult position to navigate, particularly during an economic downturn and with people's livelihoods in retirement at stake," he warns.

**Re-aligning amid a crisis**

Cole, meanwhile, points to diversification as the main consideration for pension scheme trustees looking to realign their investment strategies. "Covid-19 has accelerated geopolitical shifts that were already starting to bubble up," he explains. "Furthermore, as the timeline of economic restart varies greatly by region, we see direct exposure to multiple regions as integral."

Agreeing, Band says that too many schemes have a bias to the UK, leaving them open to added risk and huge underperformance. "For example, in 2020, the UK was the only developed-world stock market to end in negative territory after the shock of the pandemic," he says. Given this, he recommends DB schemes focus more on growth, stating that liability-matching bonds in a scheme allows liabilities to be matched with a smaller percentage of the asset pool. "The scheme can then invest a greater percentage in growth assets, resulting in a much higher chance of reducing the deficit while ensuring long-term liabilities are met," he emphasises. "More complex strategies like volatility-sensitive equity investing and put options could also be considered."

A post-Covid-19 recovery is not the only consideration, however, as Cole argues that the pandemic has also added fuel to pre-existing structural trends, stating in particular that there has been "much greater interest" in sustainability.

"ESG and climate risk are high on trustee agenda," agrees Manjrekar, stating that whilst trustees near-term focus is to get scheme funding back on track, this area will dominate agendas as they look to evolve their investment arrangement.

**Recognising the risk**

However, just as the impact of the pandemic varied from scheme to scheme, Band emphasises that so too will the impact of the pandemic passing, arguing that whilst there is hope that the pandemic does push schemes to take a more active stance on managing their DB liabilities, it remains to be seen whether the 'pensions black hole' has truly been comprehended. "Some schemes in deficit won't be aware of the need to change strategy and will continue to just pump money into the scheme without any thought about how to ensure scheme sustainability outside of contributions," he says.

Uncertainty more broadly may also prove to be an issue, as Sillis warns that the global macroeconomic conditions that will exist when the pandemic passes will be "unlike anything that has been seen in the past 60-70 years", with the World War II environment cited as the closest comparison.

"Co-ordinated monetary and fiscal policy will continue for some time and, as a consequence, policy settings will err towards a pro-cyclical tendency," he explains, stating that this will have profound implications for the investment landscape and strategies that should most effectively deployed.

In particular, he predicts a generally elevated inflationary environment, that is not countered by the textbook monetary policy response, alongside conditions that threaten to weaken the negative correlation between equities and bonds.

"So, whilst a recovery will emerge, economic outcomes will be less certain and market reactions will be less predictable than at times in the recent past," he warns. "The new paradigm will be fragile. Shocks and discontinuities will abound, and portfolios need to be prepared to weather downside risks as well as be responsive enough to capture upside when opportunities are presented."

**Written by Sophie Smith**