Summary
- The dominance of equities within DB portfolios has declined.
- Private debt and infrastructure investment fit well with the cashflow-matching requirements of DB schemes.
- The difference in available assets according to scheme size is starting to shrink.
- Scheme maturity and their end goals also determine portfolio structure.

Creating the right blend

Laura Blows explores asset allocation trends within DB scheme portfolios

A DB scheme portfolio, by blending together different asset allocations, paints a picture of its future goals. But just like any work of art, it may need tweaks and retouches as the years go by to ensure the image does not get faded away by environmental changes.

Equities

The long-term trend towards de-risking has resulted in one of its staple 'colours', public equities, no longer dominating the canvas as it once did.

According to LGIM head of solutions, Will Riley, changes in UK DB schemes' asset allocations are most clearly viewed through the lens of their inexorable journey towards buyout or self-sufficiency.

Traditional fundamental equity mandates are seeing less demand, with DB schemes preferring to access via a market or factor-based index approach, or specialist high conviction mandate, he says.

Allocations to alternative asset classes have also increased at the expense of equities for those schemes able to manage the additional complexity, Riley adds.

While public equities do continue to be the primary asset used to generate returns for schemes, Hymans Robertson co-head of trustee DB investment, Elaine Torry, says, what has been changing over the past couple of years is the mix of equity strategies that schemes hold.

"There has been a growing interest in equity allocations that have an ESG tilt. This ESG focus for equities has typically been driven by regulatory requirements for schemes to demonstrate that this has been considered, and a belief by trustees that it is the right thing to do for the long-term success of their scheme and its members," she explains.

On the private equity side, the illiquid nature and long build-up and run-off periods mean that, for many schemes, new investment in private equity is becoming less appropriate, Torry adds.

Lower yields and increasing investor sophistication have led to greater interest in private markets, but "private equity holdings are likely to be somewhat transitory for maturing schemes", Riley agrees.

"Overall, equity allocations have been decreasing for many years", he adds, "as schemes look to reduce risk by investing more in liability-matching government and corporate bonds."

Credit

Indeed, credit assets are increasingly becoming a key feature within the portfolio picture.

"The focus is increasingly on identifying assets that generate secure income streams and cashflows," Russell Investments head of strategic client solutions, David Rae, says. "This is true in both the liquid and illiquid space – high quality investment grade credit and private debt."

"As the range of credit assets has continued to grow, particularly since the financial crisis in 2008, this has better provided trustees with opportunities to seek returns in the credit space, even if not at a stage where they are requiring cashflow/not particularly mature," Torry says.

According to Torry, a particularly popular credit asset is private debt, where many schemes are starting to see their first forays into private debt funds mature. "The consideration now is whether to reallocate to the private debt asset class or invest the proceeds somewhere else," she states.

Riley says that private debt and infrastructure investment fit well with the cashflow-matching requirements of DB schemes, and that while demand for traditional growth-focused fixed-income assets has declined, schemes are instead investing heavily in buy and maintain credit mandates as a key part of their liability-matching portfolios.

Asset-backed securities are a continuing to be a staple of many schemes' asset allocation, "due to the floating rate nature of the coupons, which is attractive in a rising rate environment, and the secured nature of the coupons", Torry notes.

Speculative grade credit has also been an area that many schemes have included in their asset allocations, which "in part is due to the relative returns that they provide over their investment grade counterparts", she adds.

ESG

ESG integration and sustainable investment considerations are now a key focus for trustees, leading to a rise in thematic investing across all asset classes, LGIM head of solutions, Will Riley, notes.

The focus on responsible investment is likely to be the single biggest factor that will continue to drive the adaption of asset allocations for DB schemes, Hymans Robertson co-head of trustee DB investment, Elaine Torry, agrees.

In liquid markets this focus will lead to different styles of implementation, with the introduction of factor-based strategies, different benchmarks and different objectives, such as aiming to reach net zero, Aviva Investors head of UK and multinational DB pensions, Matthew Graham, says. "We may also see new asset classes/strategies evolve in areas such a carbon credits."

However, Torry notes the extent to which new mandates and asset classes are introduced is less obvious. "The most notable trend will likely be 'cleansing' portfolios of existing assets, eg by overlaying existing assets with a carbon filter, rather than selling and investing the proceeds in alternative funds," she predicts.

Scheme size and maturity

DB scheme size traditionally determined the nature of the portfolio 'masterpiece' created; smaller schemes were limited to the primary colours of equities and fixed income, with larger schemes able to access a wider range of investment hues.

However, "in terms of size, the difference in asset allocation between large and small schemes is reducing as more pooled fund products become available in non-traditional asset classes that have lower minimum investment criteria", Torry says.

The maturing nature of DB schemes over the past few years and their increased cashflow requirements to pay pensioners has also led to a shift in asset allocation from capital-seeking to income-driven investments," Aviva Investors head of UK and multinational DB pensions, Matthew Graham, agrees.

"This shift has been further supported by a large number of schemes being better funded and looking to de-risk. Income return driven investments such as credit, property, infrastructure and private debt can provide stable return with strong cash yields," he adds.

"Larger schemes are further along [*de-risking]* journeys than smaller schemes on average, and have higher allocations to both liability-matching bonds and alternative asset classes," Riley adds.

For those schemes looking at self-sufficiency/low dependency, there are a wider range of potential asset classes, Graham acknowledges.

"Much like the annuity book of an insurer, but with the added flexibility of a pension scheme, they can consider a wide range of public credit and private market assets," he says.

"At the other end of the spectrum, a scheme looking to buyout in the next couple of years would not look to introduce private market allocations and would instead implement through public credit, gilts and liquidity investments."

Inflation

Threatening to tear a hole in schemes' portfolio pictures is inflation. However, LDI strategies can be a useful tool to brush over any cracks.

Rising inflation is a concern for pension funds given their inflation-linked liabilities, Riley acknowledges, "but heavy investment in index-linked bonds and inflation swaps by UK schemes as part of LDI portfolios over many years means that many are already well-protected".

Schemes that haven't fully hedged can take some comfort from the fact that caps on pension increases mean the full effect of high inflation isn't passed through to scheme liabilities, he adds. "Nevertheless, recent price rises are serving as a call to action for those that have been slower to implement LDI mandates, with some schemes increasing their index-linked bond holdings as a result."

Future trends

Along with inflation, regulatory change – including the DB Funding Code and the UK's approach to insurance solvency regulation post-Brexit – will have implications for schemes' asset allocation, Rae notes.

According to Torry, a typical DB scheme in three to five years will likely be a blend of 20 per cent growth assets, such as public listed equities and property, 40 per cent income assets (eg investment grade corporate bonds, speculative grade corporate bonds, private debt and asset-backed securities) and 40 per cent LDI/protection assets such as government bonds and swaps, and buy-in policies.

"At a more granular level, the allocation to growth and protection assets is likely to be relatively consistent across schemes," she says. "However, where this will likely differ between schemes is the income asset allocation and how hard the income assets are having to work. The higher the return and the greater the need for cashflow, the more likely the income assets will be weighted towards private debt, asset-backed securities and other forms of secured lending."

So the individual portfolio pictures may vary by scheme, but they all broadly hang within the same de-risking gallery.

"Over the next few years, we expect schemes to increasingly focus on how well-prepared their portfolio is for insurer buyout, as this will be the ultimate goal for many," Riley says. "Government and corporate bonds will be used for protection against an increase in buyout prices, but it will also be important for trustees to consider whether the assets they hold can be transferred to an insurer or are sufficiently liquid to be sold if not."

Written by Laura Blows