Summary
• Pension funds' investment portfolios are looking increasingly like those of insurers.
• Schemes' individual situations determine why they choose an insurance buyout over a buy-and-hold bond portfolio.
• Patience can be a virtue for even for the longest-term investor.

According to reports, on average, one US insurance company goes bust every year. From small state-level minnows to large multi-sector behemoths, these supposed prudential financial giants frequently fall over.

Fewer topple over in the UK due, mainly, to it being a smaller market. But if the insurance model is not watertight, why are pension funds so keen to mimic its behaviour?

The reason is clear. Compare just one insurer a year in the world's largest market falling to the literally hundreds of company schemes that have entered the Pension Protection Fund's assessment period in the past 10 years.

The majority of companies are fallible – and very few defined benefit pension funds can stand up on their own.

The name's bond

Asset allocation surveys published annually by Mercer show a rampant expansion by pension funds into fixed interest and income securities, just like those held by insurers.

These bond portfolios are increasingly complex, too, using liability-matching tools that have been common for decades in the insurance world.

Aviva Investors investment strategist, solutions team, Niren Patel, explains: "Pension funds are continuing to increase their adoption of cashflow-driven investment (CDI) strategies. The main reason for doing this is to align the asset portfolio with liabilities, as well as managing any cashflow negativity."

CDI portfolios typically contain high-quality debt and debt-like assets, across both private and public markets.

These CDI strategies can help to dampen the effects of volatility in the market, too, according to Patel, which is something investors are keen to do after wayward equity markets have returned.

"With uncertainty dominating the current investment backdrop, real assets are proving popular with pension funds who can benefit from illiquidity premia, without impairing credit quality or pushing up risk," says Patel. They also secure downside protection through real asset backing, alongside regular stable cashflows.

The pain point for investors shifting into bonds and other debt instruments, however, has been the price.

The famously low interest rates over the past decade has meant paying over the odds, in some cases, just to guarantee an income that will match payments going forward.

Private markets often offer a premium over public ones, as long as the investor has the constitution for taking on the illiquidity.

But, according to XPS Pensions Group head of risk transfer, Harry Harper, "everything is very expensive now".

"The low long-term yields and low bank lending rates have driven up the price of all assets, including equities, property, bonds, bulk annuities, the lot," he explains.

Hi-ho silver lining

There is silver lining for pensions, however, and it explains why pension schemes are lining up to imitate insurers: they want to transfer all their risk over to an insurer.

"As pension schemes will hopefully already hold the funds that they need for a buyout in some type of asset, it is really a case of switching from one over-priced asset class to another over-priced asset," says Harper.

Once the switch to bonds has been made, the funding level of the scheme will become a lot more stable (in theory).

"Therefore, if a scheme can afford buyout then it should switch to bonds as soon as it can to try and ensure the buyout possibility does not slip away from the scheme, as it could do overnight if they stay in growth/equity investments," says Harper.

Harper has seen the gradual transition from growth assets to bonds by pension schemes over the past decade, but for those looking to buyout, the process is more rapid.

"Provided assets are in the millions rather than billions, it would only take a couple of weeks to trade out of equities and into bonds/gilts," he says. "Illiquid assets that are held by some schemes to get a better long-term return might take a year or so to exit from at a good price, so if those assets are held it is vital to plan ahead."

For Legal & General Investment Management head of investment advisory, Tim Dougall, pension schemes that have identified buyout as their endgame have little to fear from expensive bond markets – they are already 'in the price' of buyout quotes from insurers.

"Pension funds who wish to buyout will be buying bonds at some point – either themselves or because the insurer will buy them to back the policy and reflect that in the price," says Dougall. "So, in simple terms, pension funds can buy the bonds now, immunising themselves against the future movement in their prices, or buy them later with the risk that they will be even more expensive at that point."

Most pension schemes aiming for buyout are looking for certainty, not risk, he says.

Stick or risk?

But if pension schemes are making all this effort to transform their portfolios into something that looks like an insurer, wouldn't it make sense to save the fee of a buyout and run the scheme into maturity itself?

"There are some schemes who decide to continue to run the scheme rather than buying out even when it is affordable to do so," says Aon head of investment risk settlement, Lucy Barron. "These schemes typically have a number of specific features that makes buyout less attractive, including accounting reasons for continuing to run the scheme, strong scheme sponsors and strong investment (and longevity) risk management."

The process can also be time-consuming, which can put some businesses off. However, with £30 billion in risk transfer transactions completed in 2018, it seems the industry is getting operationally more efficient, leaving this reason for holding on to the risk less relevant.

"The most obvious benefit being to protect against the risk of members living longer than expected," says Barron. "A significant financial risk that most financial instruments (like bonds) are unable to protect against. Furthermore, whilst there may be an upfront time commitment for many stakeholders, the long-term governance requirement is all but eradicated, freeing up stakeholders' time and allowing them to focus their efforts on other areas important to them."

Getting on with running their company, in other words.

Should the worst happen, and markets flip out or crash again, meaning the buyout or risk transfer markets are put on hold or at least run at reduced capacity, looking more like an insurer than a pension fund might have its advantages.

"If clients are in a position to buyout the scheme but the market pricing has deteriorated to a point where it is no longer affordable in the short term (or simply because capacity is low) the reality for most schemes is that time is on their side," says Barron. "While it may be possible for some companies to pay more into a scheme to bridge the gap, this is unlikely to be affordable for most schemes. In fact – all things being equal, the aging of a scheme's membership should make it more affordable as time goes on."

Even if there's no capacity available from a given insurer, given a pension fund is 100 per cent funded on a buyout basis they are in a very strong position, so should focus on managing the existing asset portfolio and monitoring insurance capacity across the market, according to Patel. "What may not be attractive for one insurer may work for others."

For Harper, a reversal out of the insurance model is unlikely to be on the cards.

"Bonds can be sold again, although it's fairly uncommon these days for trustees to decide to 're-risk' by going back into growth assets," he says. "Bonds are the best asset to be in if market levels do change, so the worry about markets changing is really something that should concern trustees who are holding equities, where very large falls at short notice are common."

If insurers increase prices, they should come back again if they wait long enough, says Harper. "It's just a case of waiting – and pension schemes are very good at waiting, if they have to."

Written by Elizbeth Pfeuti, a freelance journalist