Marketing material
for professional investors and advisers only

**Perspective**

# Fiduciary Management

## Managing your route to the endgame

**March 2020**

Increasing regulatory pressure and schemes maturing have led to a shift in many trustees' focus towards setting a long-term objective and reaching the 'endgame'.

Typically 'endgame' has been defined as when the trustees fully transition the liabilities to a third-party insurer through a buy-out. However, over recent years the number of options that either directly or indirectly replicate the full transition to an insurer has multiplied.

**Neil Walton**
Head of Investment Solutions

**Sophie Dapin**
Fiduciary Manager


### What are the options for a pension scheme at the endgame?

For our clients, we find that the answer to this question is dependent on each scheme's unique circumstances and individual trustee board's beliefs. At Schroders we can invest for all options depending on what is right for your scheme. Our Fiduciary Management clients benefit from our expertise in investment strategy, fixed income and Liability Driven Investment (LDI) in preparing for the endgame. Specifically, Cashflow Driven Investment (CDI) solutions have the flexibility to act as a base for all eventual endgame outcomes.

**Endgame options**

| | Definition | Pros | Cons |
|---|---|---|---|
| Self-sufficiency | **The position when a pension scheme is sufficiently well funded to be largely independent of the fortunes of its sponsoring employer.** The definition of self-sufficiency is broad. It can be a step on the way to consolidation or buy-out, or an endgame in itself where the assets are invested in a very low risk way and the pension scheme liabilities allowed to run off over time. | – The scheme keeps control of its assets<br>– As there is no burden of insurance company regulation with self-sufficiency, schemes can typically achieve a solution at a lower funding level than they could at buy-out | – Operational and governance considerations to keeping the scheme running over a long time frame<br>– As an investment only approach, self-sufficiency does not allow for longevity risk |
| Consolidation | **Transferring liabilities to a commercial consolidator.** These are fundamentally businesses aiming to make a profit. Different consolidation structures will offer different levels of member security. | – Theoretically, consolidators should be able to offer higher levels of security than self-sufficiency at lower prices than buy-out, given they do not fall under the insurance regulatory framework | – This is a newer option, which is currently untested<br>– There is a potential conflict between profit making objectives and member security |
| Buy-out | **Where a pension scheme pays a premium to an insurer and in return the insurer takes on all responsibility for paying the pensions for the scheme's insured members.** A buy-out may be preceded by a series of buy-ins which involve covering a specific group of members, for example current pensioners. | – Seen as the gold standard for securing member pensions, given insurer regulatory framework<br>– Includes management of longevity risk | – The cost involved reflects the security provided and can be seen as expensive compared to other options |

Schroders

## What does it mean for the way that you invest your assets?

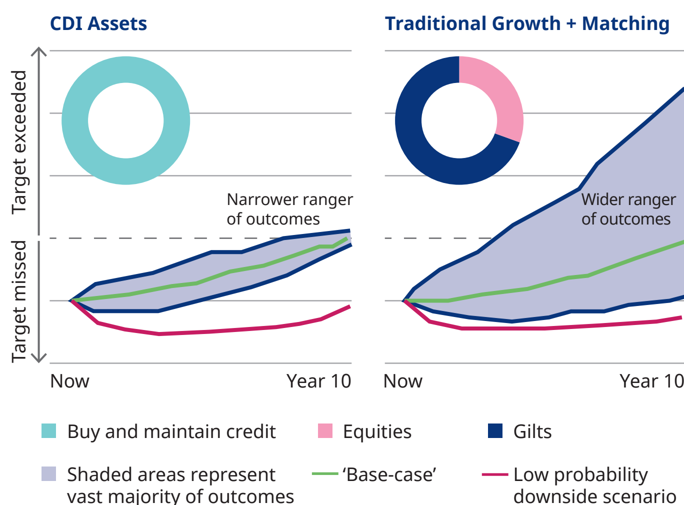
As a pension scheme matures, the investment focus shifts from generating growth to increasing certainty, being cashflow driven and insurance ready.

All of our Fiduciary Management clients have Flight Paths in place. Initially, when higher returns are required, clients are invested in a dynamically managed multi-asset portfolio, alongside a bespoke liability matching strategy. Over time, as the funding level improves, the Flight Path moves the scheme into a CDI strategy, which is tailored according to that scheme's specific endgame.

A significant benefit of CDI strategies is that, used as a base, they are flexible enough to be able to achieve a number of different outcomes. The term CDI can be misleading, however. A CDI strategy is not just about meeting immediate cashflow needs, but is about securing future returns for the remainder of the scheme's life. It does this by investing in credit assets that can deliver the excess return above gilts that the scheme needs, and by removing re-investment risk by holding these credit assets to maturity. Rather than being used as an alternative to LDI, LDI is an essential component of CDI solutions. In fact, the detailed cashflow matching obtained within efficient CDI solutions is carried out using LDI.

It is a common misconception that CDI solutions are only for self-sufficiency. It is true that they provide an efficient self-sufficiency solution, but actually they also work well on the route to consolidation (although this is not yet fully tested in the market) or buy-out.

The main attraction of a CDI approach is that by holding a large proportion, or all of the assets, in fixed income assets managed to maturity, it offers significantly more certainty of achieving the target returns required to meet each liability payment than a more traditional growth + matching strategy. As shown below, the distribution of returns on CDI assets held to maturity is a different shape compared with conventional growth assets, with the end outcome concentrated around the yield to maturity. The strategy on the left shows outcomes generally more clustered around the central outcome with the exception of extremely low probability default events.




This means that CDI can also be used to achieve buy-outs with greater certainty than traditional growth strategies. For well-funded schemes that are already close to buy-out, this can involve simply investing in buy and maintain investment grade credit until the scheme can afford buy-out. Alternatively, for less well funded schemes, 'front loading' the delivery of credit spreads by investing into higher-spread, shorter-duration assets can be used to lift the buy-out funding level over the required horizon. Aside from the increased certainty of outcome, such solutions also benefit from their natural evolution into a 'buy-out ready' portfolio which is more attractive to insurers.

## How can you prepare your assets for buy-out?

At Schroders, our client base includes leading life-insurers that require assets to be managed under Matching Adjustment rules. Our heritage in insurance asset management means that we can structure endgame solutions in an insurance friendly manner, which is an advantageous if buy-out is an ambition.

Our CDI strategies are designed and implemented by the same teams that invest on behalf of our insurance clients, investing in assets that are attractive to insurers. This means that as the schemes mature and buy-out pricing becomes favourable, insurance pricing moves towards our clients.

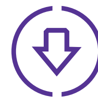
There are additional considerations to make when preparing your assets for buy-out:

### A plan for illiquid exposures

Having the long-term perspective to not be overly exposed to illiquid assets, and taking a phased approach to reducing illiquid exposure over time

### Matching assets

Investing in assets that are attractive to insurers, such as buy and maintain credit



### Ability to reduce transaction costs

Ensuring that assets can be transferred to insurers in a way that minimises cost and operational risk for our clients

## Start with the end in mind

We believe it is never too early to start planning for the endgame. Having a journey plan in place that you can measure success against is essential. The beauty of having a framework where you migrate gradually from a traditional growth plus matching portfolio into a CDI solution is that it is akin moving the flight plan onto 'auto pilot' to land the strategy, **whatever your endgame.**


**Important Information**

The views and opinions contained herein are those of the authors as at the date of publication and are subject to change due to market and other conditions. Such views and opinions may not necessarily represent those expressed or reflected in other Schroders communications, strategies or funds.

This document is intended to be for information purposes only. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or security or to adopt any investment strategy. The information provided is not intended to constitute investment advice, an investment recommendation or investment research and does not take into account specific circumstances of any recipient. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice. Information herein is believed to be reliable but Schroders does not represent or warrant its completeness or accuracy. No responsibility or liability is accepted by Schroders, its officers, employees or agents for errors of fact or opinion or for any loss arising from use of all or any part of the information in this document. No reliance should be placed on the views and information in the document when taking individual investment and/or strategic decisions. Schroders has no obligation to notify any recipient should any information contained herein changes or subsequently becomes inaccurate. Unless otherwise authorised by Schroders, any reproduction of all or part of the information in this document is prohibited.

Any data contained in this document has been obtained from sources we consider to be reliable. Schroders has not independently verified or validated such data and it should be independently verified before further publication or use. Schroders does not represent or warrant the accuracy or completeness of any such data.

All investing involves risk including the possible loss of principal.

Third party data are owned or licensed by the data provider and may not be reproduced or extracted and used for any other purpose without the data provider's consent. Third party data are provided without any warranties of any kind. The data provider and issuer of the document shall have no liability in connection with the third party data. www.schroders.com contains additional disclaimers which apply to the third party data.

Issued in March 2020 by Schroder Investment Management Limited, 1 London Wall Place, London EC2Y 5AU. Registered in England, No. 1893220. Authorised and regulated by the Financial Conduct Authority. UK000462