Summary
- Pension scheme trustees have been accused of being 'recklessly prudent' with their investment approaches.
- Cashflow-driven investing, LDI and increasing investment in a range of credit vehicles have all been recommended to help schemes tackle their deficits.
- A renewed focus on equities and implementing a diversified investment strategy are also suggested.

Preparing to fight

DB shortfalls are threatening to scupper the plans of both schemes that are on the route to de-risking and the few that remain open. Some trustees are prepared to take the fight to their deficits with their investment strategies. But which weapons should they be using?

It was the former chairman of The Pensions Regulator, Michael O'Higgins, who first tagged defined benefit (DB) scheme trustees with the "recklessly prudent" oxymoron.

Using it back in 2012, he cautioned them against being both too conservative with their investment strategies and too demanding in deficit contribution negotiations. O'Higgins suggested at the time that scheme trustees who were blessed with a strong sponsor covenant would be wise to pursue more ambitious investments rather than large employer contributions, in order to avoid jeopardising the scheme, and indeed, their employer, in the long run.

Almost five years later, however, does O'Higgins' admonishment still stand true?

"It is difficult to generalise, but if I was to, I don't think that all DB schemes are being unduly prudent, given their situation," says Aviva Investors head of investment strategies John Dewey.

"We've got to remember that around a half of all UK DB schemes are cashflow-negative with liability payments in excess of the income that they receive from contributions. So they're having to find liquidity from their portfolio. And that situation is only going to perpetuate over time.

"Over the next 10 years, the amount of cash that is going to be paid out by schemes is likely to double."

In those circumstances, Dewey says that it's not sensible to take significant amounts of risk.

Barnett Waddingham partner Matt Tickle concurs. He explains that there are not many DB schemes that could be called recklessly prudent any longer, partly due to the growth in acceptance of liability-driven investment (LDI). In the not-so-distant past he says, trustees used to have to sell equities and buy some gilts or low-risk bonds to cut risk. Now, they can use bonds far more effectively through leverage, which means that schemes are holding onto more risk than they ever intended to only five years ago.

"They can deal with their big risks like inflation through LDI, which is becoming ever more commonplace," says Tickle.

"And in general they're taking more investment risk because deficits have

gone up. Schemes are using risk assets to plug deficits, as well as looking for money from sponsors."

KPMG's head of the pensions strategy team, Simeon Willis, takes the argument a step further. He believes that some schemes are approaching investment from a recklessly simple outlook. This sees trustees settling for strategies that are sub-optimal on the basis that they are straightforward and easy to understand.

"And in doing so, they're missing out on strategies that could be more suited to their needs," he says.

"Cashflow-driven investing is becoming more relevant as DB schemes mature, and not just for the bigger players either"

Not taking the right risk

This can also mean that they are not taking on the right types of risk for their current circumstances, says Dewey. This is perfectly illustrated, he says, by the fact that – according to the Pension Protection Fund – around 37 per cent of assets in a typical DB scheme are still invested in equities.

"While this has been in steady decline, that's still quite a material risk profile to be invested in, given the volatility that we've seen in those assets."

As trustees have a closing window of time over which to correct their deficits, Dewey suggests that there is a better way to address deficits – through different forms of credit.

"We think about alternative income assets, which deliver consistent predictable cash flows over time, but that will give a premium above traditional listed assets," he says.

"So we're talking investment-grade private assets like infrastructure debt, real-estate debt, private credit and certain types of infrastructure equity, which deliver quite a high degree of security. And you can still generate a good premium above some of the lower return, fixed-income instruments."

Aviva like to call this approach cashflow-driven investing. Dewey says that it is becoming more relevant as DB schemes mature, and not just for the bigger players either. Pooled funds can give SME pension funds access to areas such as private credit and infrastructure.

Of the alternative credit avenues that Dewey mentions, Tickle identifies private debt as the one that continues to attract strong interest, whether that is loans at the more secure end, or private lending at the more daring end.

"Schemes are looking at it to generate more return in a more controlled way and accepting the illiquidity that comes with that. But it also helps with cash flow, because they're still paying out decent coupons at four, five, even six per cent potentially."

The most obvious example of the move to private credit was the decision by The Universities Superannuation Scheme (USS) to agree to buy a majority interest in a $3.1 billion portfolio of loans made by Credit Suisse.

Another tactic that trustees would do well to consider is integrating LDI and corporate bonds, says AXA IM head of UK LDI Jonathan Crowther.

He says that in this scenario it is possible for the LDI manager to hold less collateral assets (such as cash and gilts), meaning that freed-up contributions can then be re-invested into the corporate bond portfolio.

"This is possible because the LDI manager has ready access to the corporate bonds," explains Crowther.

"In the event that interest rates rise substantially and additional collateral assets are needed, there are a number of alternatives that the LDI manager can select from to turn the corporate bonds into collateral assets, without necessarily having to sell.

"If schemes access this opportunity,

then the collateral asset allocation can be reduced by 10-20 per cent, thus increasing the expected return by about 1 per cent per annum on any such assets reallocated to the corporate bond portfolio."

Willis says that this re-evaluation of credit is eminently sensible for most DB schemes. Instead of sitting on a very large holding of index-linked gilts that are generating next to no return, DB schemes could be much better off securing a large proportion of assets invested in high quality, relatively low yielding assets that deliver a premium above gilts. Derivatives can then be used to provide some matching that the gilts are currently providing.

"Rather than having a portfolio that's made up of black and white, you're probably better served having more grey," says Willis.

Equities

Some of that grey, says Thomas Miller Investment managing director Matthew Phillips should be made up of a renewed focus on equities.

One of the problems with cautious investment, as he sees it, is that trustees are driven by the triennial cycle of liability calculation, and not the very long-term nature of the liability itself. He believes that schemes should be concentrating on the long term and the shape of their liability curve, not short-term liability modelling.

"To be clear, I am not talking about open season for risk, with pensions schemes backing Bermuda property developments and interesting crowd funding ideas with 80 per cent of their assets," he says.

"What I am arguing for is to think about the long-term ability of equities to produce real returns over and above most other assets classes."

In order to take more risk and produce real growth, Phillips says that he would suggest nothing more than a plain vanilla, diversified investment strategy, using a mixture of passive and active funds.

"I would certainly consider matching investments and LDI for a proportion, but this should be driven by the nature of the liability and not be undertaken at the expense of the long-term growth of risk assets."

Intech Investment Management president David Schofield says that equity investment need not immediately be labelled with a huge risk sign when the idea is floated at trustee meetings.

Intech has seen a heightened interest in the past year or so of pension funds looking to increase their allocations into higher return seeking assets such as equities, but in a reduced-risk way, with lower absolute volatility.

Low volatility strategies can insulate schemes from the worst equity market drawdowns by 20 to 30 per cent, thereby considerably shortening a recovery period.

More sophisticated strategies can also give a scheme protection from overcrowding, which is always a danger when institutional investors simply build up their portfolios with the least volatile stocks that are out there.

"You need a diversified way of doing it," says Schofield. "We have a very different approach ourselves, a mathematical one that we have been using for almost 30 years now. We call it smart alpha. It has a source of return that doesn't require the stocks in the portfolio to outperform for the portfolio to outperform."

Essentially, it is a process based on rebalancing the portfolio. The manager builds a portfolio filled with hundreds of stocks and has a target weight for each stock. The manager then consistently rebalances back to the chosen weight and this act of rebalancing, over the long run, generates a premium. Schofield says that it is an alpha source that is underutilised.

"You can apply that even in a low-volatility portfolio," he says. "You use it as your source of return and still reduce the overall volatility by using the correlations between stocks. So you need to consider how the stocks in your portfolio move relative to each other."

This means that even in a low-volatility portfolio, a scheme can afford to include some stocks that are more volatile, since they contribute well to the rebalancing premium.

"We're seeing pension funds making specific allocations to this rebalancing premium as a defined source of return alongside more traditional risk premia."

It all almost sounds rather, well, prudently reckless.

Written by Marek Handzel, a freelance journalist

Are DC default funds ambitious enough?

DB schemes can garner sympathy for their caution, but can the same be said of DC plans?

There is an impression that the caps on investment fees and auto-enrolment project have dampened enthusiasm for ambitious default funds, with the latter not wanting to scare off savers and the former pushing schemes to basic passive management.

DC savers who have Royal London as a provider end up in its balanced fund as the automatic default. At the initial stages, 75 per cent of contributions are exposed to equities, 17 per cent to property and 6 per cent to commodities. The rest are split between long duration bonds and gilts. When members get to five years outside retirement, equity exposure drops to 38 per cent, property to 12.5 per cent, while commodities stay the same. Meanwhile, there is a bigger allocation to bonds, cash and absolute return.

"*[The balanced fund]* is quite diversified as well, compared to some that are 100 per cent equities at first," says the provider's investment strategy manager, Lorna Blyth.

With that in mind, Columbia Threadneedle director of DC Andrew Brown says that, on aggregate, it is difficult to argue that DC members require higher allocations to riskier assets.

"We believe that many members are already too heavily exposed to stock market volatility due to the increased use of passive investment designs for the bulk of their accumulation phase," he says.

"This is only partially mitigated through lifestyle strategies that reduce volatility as a member nears their retirement date. We would argue that DC schemes are too heavily concerned with cost and that active asset allocation and an increased focus on risk-adjusted returns is key to ensure good member outcomes."

State Street Global Advisors senior DC strategist Alistair Byrne also argues that some default funds focus too much on equities.

"Asset class diversification can improve the efficiency of the portfolio," he says.

"We're seeing interest in strategic diversification across asset classes to improve portfolio efficiency, and in dynamic asset allocation and volatility management techniques that can allow schemes to hold equities and other growth assets in favourable markets and provide protection in more volatile conditions. Smart beta is also a growing focus, based on evidence that factor-based portfolios can have the same level of return as market capitalisation weighted portfolios, but with lower levels of volatility."

When it comes down to it, however, says Blyth, no matter what the exact investment split is in a default fund, the biggest factor in a successful default fund will always be contributions. And they remain far too low.