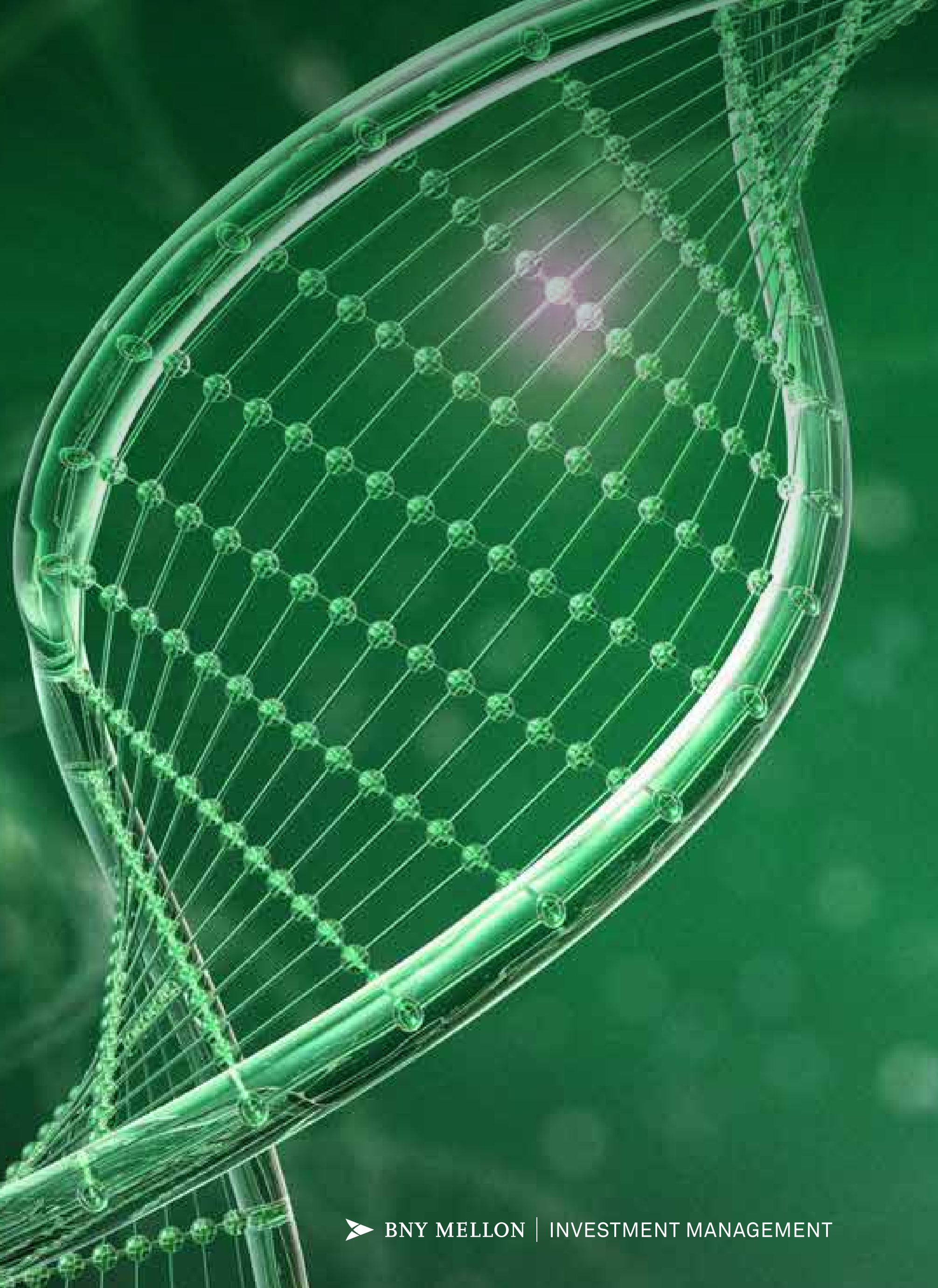
Insight INVESTMENT

THE FINAL PUSH FOR UK DB PENSION SCHEMES

A SURVEY OF MEMBERS OF THE PENSIONS MANAGEMENT INSTITUTE

JANUARY 2020



In association with the PMI

Pensions Management Institute
ACHIEVING PENSIONS EXCELLENCE

BNY MELLON | INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

Against a backdrop of improving funding levels, we conducted a survey of members of the Pensions Management Institute to uncover any observations that could help other investors plan towards their endgame.

KEY FINDINGS

CONFIRMATION OF EXISTING OBSERVATIONS

1. Most UK pension schemes have already decided whether buy-out or self-sufficiency will be their endgame target
2. Most UK schemes have an explicit target endgame date

NEW OBSERVATIONS

1. **The majority of schemes are likely to evolve their de-risking and LDI strategies further as their primary de-risking tool on the journey to their target endgame**, rather than pursue a partial buy-in or seek additional sponsor contributions
2. **Most respondents would value further analysis on reaching their endgame target date with the greatest certainty**
3. **The majority of respondents believe their next de-risking step will make it easier to attain their endgame** – or at least, not make it more difficult

GUIDANCE FROM PMI MEMBERS

Think longer term than you currently are, and think that there will be a market crash before you reach your target

PENSIONS INVESTMENT MANAGER, UK UTILITY COMPANY

Keep talking to the sponsor, maintaining an excellent relationship

PMI MEMBER

Prepare for buy-in or buy-out by improving data quality well in advance. Challenge your advisers; they have different house styles and you need to understand how much of the advice is consultant-specific and how much is scheme-specific

INDEPENDENT TRUSTEE

See page 10 for full list of comments

Commentary from Insight Investment

UK defined-benefit schemes are generally in a strong position with average solvency now close to levels prior to the financial crisis of 2008/2009. There is an opportunity now for schemes to secure all of their liabilities sooner than anticipated.

While 2019 has set another record for buy-ins and buy-outs, this has been dominated by a small number of very large transactions. The majority of schemes are looking to evolve their de-risking strategies – such as increasing liability hedges, introducing standalone longevity hedging and/or increasing their allocation to assets that provide 'contractual' returns – to help them get closer to their target positions.

We present a de-risking framework to help schemes attain their chosen endgame with greater certainty. We also suggest that schemes assess the impact of different de-risking options at the total-portfolio level, using objectives measures, such as the required return from the 'free' assets, their ability to hedge liabilities and their flexibility to deal with future uncertainty.

INTRODUCTION

PENSION SCHEMES ARE MATURING. OVER 80% OF DEFINED BENEFIT SCHEMES ARE EFFECTIVELY CLOSED TO NEW MEMBERS, HALF OF WHICH ARE ALSO CLOSED TO FUTURE ACCRUAL.[1] AT THE SAME TIME, FUNDING LEVELS HAVE GREATLY IMPROVED.

Against this backdrop, many trustees and sponsors are considering how to bring their scheme to a point where all its obligations are secured. Therefore, we conducted a survey of members of the Pensions Management Institute to gather their views relating to their journey towards their endgame to see if we could uncover any observations that could help other investors plan towards their goal.

We are grateful to the 43 respondents who answered the following questions:

1. What is the target endgame for your defined benefit scheme?
2. What is the target time horizon for your endgame?
3. What interim de-risking strategy are you most likely to employ on your journey to this endgame?
4. Where would you benefit from further analysis when considering your endgame options?
5. How will your chosen interim de-risking strategy affect the required return from your remaining assets?
6. How will your chosen interim de-risking strategy affect your ability to hedge your liabilities?
7. How will your chosen interim de-risking strategy affect your ability to deal with future uncertainty?
8. What advice would you give to your peers as they think about the next step in their pension de-risking journey?

We are mindful of the small sample size, therefore are careful not to draw spurious conclusions. We present the results of this survey in three main sections:

A – Findings that confirm existing industry observations // 6

B – Three new observations // 6

C – Advice from Pensions Management Institute members // 10

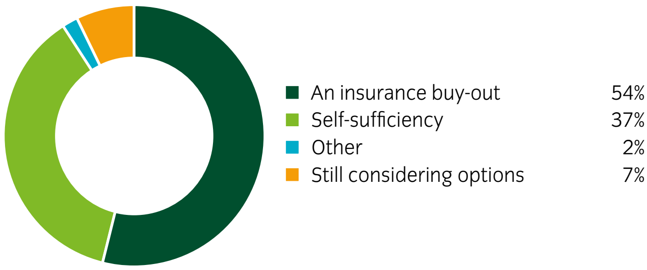
[1] Source: The DB Landscape, published by The Pensions Regulator, November 2019.

A – CONFIRMATION OF EXISTING OBSERVATIONS[2]

1 Most UK pension schemes have already decided whether buy-out or self-sufficiency will be their endgame target

Over 90% of pension schemes responding to the survey have agreed their endgame target and are broadly equally divided between pursuing a buy-out or self-sufficiency (see Figure 1).

Figure 1: What is the target endgame for your defined benefit scheme? (Pick one answer)



2 Most UK schemes have an explicit target endgame date

Only 11% of respondents do not have a finite endgame time horizon (see Table 1).

Table 1: What is the target time horizon for your endgame? (Pick one)

Target endgame	0-5 years	6-10 years	11-15 years	15+ years	Still deciding	Total
Insurance buy-out	14%	17%	14%	7%	2%	54%
Self-sufficiency	2%	19%	9%	5%	2%	37%
Other	0%	0%	2%	0%	0%	2%
Still considering options	0%	0%	0%	0%	7%	7%
Total	**16%**	**36%**	**25%**	**12%**	**11%**	**100%**

52%

77%

B – NEW OBSERVATIONS

Guidance from PMI members

"Think about bringing the date of self-sufficiency forward and don't consider pushing it out further."
– PMI member

"Don't delay" – PMI member

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Commentary from Insight Investment

UK defined-benefit schemes are generally in a strong position, with average solvency now close to levels prior to the financial crisis of 2008/2009. Combined with agreed additional future contributions, there is an opportunity now for schemes to secure all of their liabilities sooner than anticipated. However, as attention turns towards attaining specific outcome targets over ever-shortening timeframes, there is likely to be a greater need for outcome certainty. This may require a different investment approach.

[2] Examples include: Global Pension Risk Survey 2019, Aon, and European Asset Allocation Survey 2019, Mercer.

1

A preference for de-risking evolution rather than buy-in or additional sponsor contributions

Most respondents have identified a clear route to reaching their goal, with the majority of respondents seeking to evolve their de-risking or Liability Driven Investment (LDI) strategies further as their primary tool on the journey to their target endgame. This option was more than twice as popular as any other option, such as partial buy-ins or seeking additional sponsor contributions (see Table 2). However, we acknowledge that respondents will utilize multiple de-risking strategies.

Table 2: What interim de-risking strategy are you most likely to employ on your journey to your target endgame? (Pick one)

Target endgame	Additional sponsor contributions to secure the target funding level	Conduct partial-member buy-in	Evolve your de-risking/LDI strategy further, e.g. employ longevity hedging	Other	Still deciding	Total
Insurance buy-out	10%	17%	23%	2%	2%	54%
Self-sufficiency	2%	2%	26%	7%	0%	37%
Other	0%	2%	0%	0%	0%	2%
Still considering options	0%	0%	3%	2%	2%	7%
Total	**12%**	**21%**	**52%**	**11%**	**4%**	**100%**

Guidance from PMI members

"Focus on volatility. This becomes an increasingly material factor as schemes mature (i.e. less time to recover). Investment strategy needs to be aligned to funding strategy so that investments in assets of a contractual nature are increased as the funding position improves."
– Trustee Services Manager, UK Master Trust

"Liability hedging is key to reduce volatility"
– Tax Director, European Company

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Commentary from Insight Investment

While 2019 has set another record for buy-ins and buy-outs, this has been dominated by a small number of very large transactions. The majority of schemes are looking to evolve their de-risking strategies – such as increasing liability hedges, introducing standalone longevity hedging and/or increasing their allocation to assets that provide 'contractual' returns – to help them get closer to their target positions.

2 Schemes are focusing on outcome certainty

Most respondents to the survey said they would value further analysis on reaching their endgame target date with the greatest certainty.

Figure 2: Where would you benefit from further analysis when considering your endgame options? (Pick multiple)

Managing the unexpected cost to the sponsor	17%
Managing funding level volatility	22%
Reaching your endgame target date with the greatest certainty	41%
Generating sufficient liquidity to meet cashflow needs	20%

Guidance from PMI members

"Assess the quantum of funding-level risks and determine possible responses now to be employed, if necessary, at a later date" – Chairman, UK Pension Scheme, and Director, Corporate Strategy

"Plan well ahead and think about what can cause you to miss your target" – Pensions Manager

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Commentary from Insight Investment

Ultimately, the key goal of any de-risking strategy is to narrow the range of potential future outcomes – meaning a scheme can be more certain of achieving its endgame target within its desired timeframe.

Insight's framework for helping schemes to evolve their strategy is based on three steps:

- **Lock down target outcomes** by hedging liability risks including interest rates, inflation and longevity
- **Manage the uncertainty problem** by investing in 'contractual' assets, such as bonds, to generate the cashflows and returns needed to meet obligations
- **Manage liquidity** to ensure the scheme can cover its outflows and avoid being a forced seller in difficult markets

By adopting such an approach, we believe schemes can greatly increase the certainty of ultimately fulfilling their pension promise – and perhaps do so even sooner than they previously expected.

No solution can be 100% certain, so schemes should create buffers calibrated by stress testing any residual risks such as reinvestment risk or the risk of default in their bond portfolios. They should also construct portfolios that help to preserve flexibility to deal with setbacks.

3 The majority of respondents believe their next de-risking step will make it easier to attain their endgame – or at least, not make it more difficult

We gauge views on whether the next de-risking step will make it easier or harder for schemes to attain their endgame based on the impact of their strategy on the following three factors:

- required return on assets
- ability to hedge liabilities
- flexibility to deal with future uncertainty

For each factor, half of respondents believe that their chosen approach will have no impact on their ability to attain their chosen endgame (see Tables 3-5). Of the remaining answers, respondents were much more likely to believe their approach would make it easier than harder to achieve this goal.

Table 3: How will your chosen interim de-risking strategy affect the required return from your remaining assets?

Interim de-risking strategy	Increase	No change	Decrease	Still deciding
Additional sponsor contributions to secure the target funding level	0%	9%	2%	0%
Conduct partial-member buy-in	5%	9%	2%	5%
Evolve your de-risking/LDI strategy further, e.g. employ longevity hedging	9%	21%	12%	9%
Other	0%	7%	5%	0%
Still deciding	0%	3%	2%	0%
Total	**14%**	**49%**	**23%**	**14%**

Table 4: How will your chosen interim de-risking strategy affect your ability to hedge your liabilities?

Interim de-risking strategy	Make it harder	Leave it unchanged	Make it easier	Still deciding
Additional sponsor contributions to secure the target funding level	0%	7%	5%	0%
Conduct partial-member buy-in	2%	12%	5%	2%
Evolve your de-risking/LDI strategy further, e.g. employ longevity hedging	0%	25%	11%	14%
Other	0%	7%	5%	0%
Still deciding	0%	5%	0%	0%
Total	**2%**	**56%**	**26%**	**16%**

Table 5: How will your chosen interim de-risking strategy affect your ability to deal with future uncertainty?

Interim de-risking strategy	Flexibility will be reduced	No change	Flexibility will be increased	Still deciding
Additional sponsor contributions to secure the target funding level	0%	2%	10%	0%
Conduct partial-member buy-in	7%	7%	7%	0%
Evolve your de-risking/LDI strategy further, e.g. employ longevity hedging	2%	28%	10%	12%
Other	0%	9%	2%	0%
Still deciding	0%	2%	2%	0%
Total	**9%**	**48%**	**31%**	**12%**

Guidance from PMI members

"Self-managed buy-in strategies may leave the trustee with greater investment flexibility than the purchase of expensive annuities which reduce flexibility in the remaining asset pool" – Director of Staff Pensions, global insurance company

"Set a target and be flexible. Don't buy-in too soon as you need the assets to generate returns" – Chair of Trustees at a UK pension scheme

SEE PAGE 10 FOR FULL LIST OF COMMENTS

Commentary from Insight Investment

Schemes should consider how their next de-risking step will impact their ability to reach their endgame target in the desired timeframe. One way that they can objectively measure this is by looking at the impact across the whole portfolio on the following factors:

- **Required return on assets**: Does the chosen de-risking step leave fewer assets to make up any funding level deficit? If so, this would increase the target return needed, everything else being equal. The pursuit of higher target returns increases the chance of defaults and negative returns.
- **Ability to hedge liabilities**: Does the chosen de-risking step divert assets away from hedging purposes? If so, schemes would either have to re-allocate funds for hedging purposes, potentially pushing up the required target return on non-collateral assets, or decide to accept a lower hedge ratio – either way, increasing risk.
- **Flexibility**: Up to the point of attaining the endgame target, there will always be risks affecting the assets or the liabilities that cannot be predicted or hedged. Examples could be poor short-term returns, transfer values forcing payments earlier than expected, or changes in legislation causing changes to benefits. Does the chosen de-risking step tie up a significant portion of assets which cannot be reversed? If so, this leaves the scheme with less flexibility to deal with any setbacks.

C – GUIDANCE FROM PMI MEMBERS

What advice would you give to your peers as they think about the next step in their pension de-risking journey?

1. Set a target and be flexible. Don't buy-in too soon as you need the assets to generate returns.
2. Think longer term than you currently are, and think that there will be a market crash before you reach your target.
3. It's worthwhile taking your time to plan properly since once embarked on, your ability to recover from surprises may be reduced. Make sure you get advice from all your advisers (actuarial, investment, legal and administration).
4. Focus on volatility. This becomes an increasingly material factor as schemes mature (i.e. less time to recover). Investment strategy needs to be aligned to funding strategy so that investments in assets of a contractual nature are increased as the funding position improves.
5. Don't delay.
6. Get a good quality independent investment adviser and avoid high cost fiduciary active management. Don't let your investment strategy get over-complicated. Keep it as simple as possible so that the Trustees can understand the ongoing position and the impact that changes in the scheme's investment strategy can have on their long-term goals.
7. Ensure that a clear definition of self-sufficiency and timing to get there is agreed with the sponsor.
8. Think about bringing the date of self-sufficiency forward and don't consider pushing it out further.
9. Plan well ahead and think about what can cause you to miss your target.
10. Working with your trusted advisers, identify and agree the aim (endgame) with the sponsor, look at all the realistic options for achieving it, agree the most appropriate path with the sponsor, take advantage of every opportunity to reduce risk and reduce liabilities within the constraints of the agreed path, including perfecting the member data.
11. The markets are extremely volatile: research for good solid data and proven track record is imperative.
12. Establish an effective monitoring framework and engage with investment adviser and scheme actuary.
13. Ensure you all look at the endgame and put in place a flight path with datelines that could be extended, if required, but try and maintain flight path timescales if possible; leave flexibility in your plan for good or indifferent times which may mean you have to tweak the plan.
14. Assess the quantum of funding-level risks and determine possible responses now to be employed, if necessary, at a later date.
15. Beware of the herd mentality. Schemes and sponsors are diverse.
16. Make sure you have accurate and timely information available.
17. Ensure that all member data is up to date and your investments are liquid enough to be able to take opportunities as they arise.
18. Get on with it.
19. Liability hedging is key to reduce volatility.
20. Be clear that the scheme sponsor and the Trustees share the same vision.
21. Self-managed buy-in strategies may leave the trustee with greater investment flexibility than the purchase of expensive annuities which reduce flexibility in the remaining asset pool.
22. Have a clear goal and a practical time frame to achieve it.
23. Keep talking to the sponsor, maintaining an excellent relationship.
24. Prepare for buy-in or buy-out by improving data quality well in advance. Challenge your advisers; they have different house styles and you need to understand how much of the advice is consultant-specific and how much is scheme-specific.
25. It is a journey and there will be surprises forwards and backwards.
26. Don't lose sight of the fundamentals such as ensuring your data and benefits match your governing documents.

IMPORTANT INFORMATION

RISK DISCLOSURES

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

FIND OUT MORE

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