Feature

Tackling residual investment risks

By Jos Vermeulen
Head of Solution Design, Insight Investment

Most UK defined benefit pension schemes, we believe, have established liability-driven investment (LDI) strategies, hedging interest rate and inflation risks to reduce their impact on funding levels and increase the probability that long-term objectives can be achieved. We are finding that pension schemes' focus is now shifting to the residual risks they will face in the years ahead.

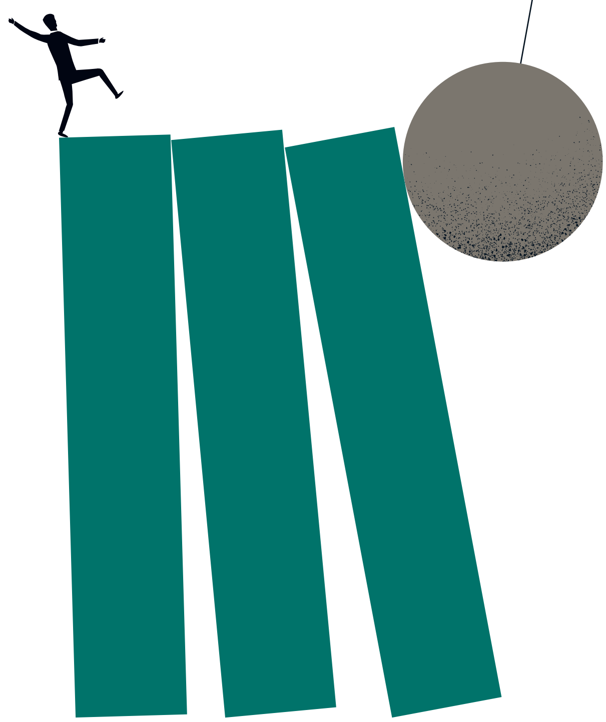
Tackling these residual risks could decide whether a scheme can achieve its target endgame on time. We offer an overview of some of the key remaining risks and how to mitigate them.

Longevity risk: hedging longevity risk effectively can keep a pension scheme on track for its endgame

As exposures to interest rate and inflation risk have been mostly hedged, and pension schemes have migrated out of equities, longevity risk has become the largest unhedged risk that many schemes now face. We believe there are three approaches to mitigating longevity risk:

1. Build a reserve: A scheme could target a funded status higher than 100% to build a buffer for future changes in longevity, but it is difficult to know what size of buffer may be needed.

2. An insurance buy-in: A scheme pays a premium to an insurer who takes on the liability and investment risks for a portion of the scheme's liabilities. The buy-in is held as an illiquid asset alongside other investments, and does not reduce reliance on the sponsor. However, unless a scheme is very well funded on a prudent basis, a buy-in could hinder its journey to its target endgame, due to the risks associated with the liabilities not covered by the buy-in, and the implications for the remaining scheme assets.



3. Hedging via a longevity swap: A scheme agrees to pay a regular premium to hedge longevity risk associated with the liabilities covered. In the past, longevity swaps were only available to very large pension schemes, but today schemes with liabilities in excess of £500m can implement longevity swaps.

Collateral risk: a dynamic approach aims to efficiently manage the collateral pool

Most schemes use derivatives as part of their LDI strategies, and so need to hold a pool of eligible assets (typically gilts and cash) to fund collateral calls. If this is too small, schemes could be forced to sell other assets to meet collateral calls. However, given that collateral pools typically consist of low-returning liquid assets, if this is too large a scheme's long-term investment returns could be impaired.

Both of these risks – that of forced selling or performance drag – can be mitigated by an LDI manager implementing a dynamic collateral risk management framework. For example, as interest rates fall and the collateral pool increases, the manager can deploy the excess collateral into liquid, high quality assets that are expected to generate a return above cash. However, if interest rates then rise and the collateral pool reduces, the manager can easily sell these liquid, high quality assets to top up collateral. By managing this dynamically the manager can help ensure a scheme doesn't have too much, or too little, collateral.

Credit risk: default risk and 'shape risk' require different approaches

As pension schemes have de-risked, they have reduced their exposure to growth assets (e.g. equities) and increased their exposure to corporate bonds. This means there are different risks to be managed.

- **Default risk – the risk that the money you have lent to a company is not repaid.** This can be mitigated through extensive credit analysis, where a manager seeks to only invest in companies that are financially sound. Additionally, limits can be specified to restrict how much is invested in any single corporate issuer. A scheme may also build a buffer to absorb defaults based on historical experience, to help cope with adverse scenarios.
- **Shape risk – the risk that the 'shape' of the future cashflows generated by your corporate bond portfolio does not match the liability payments.** This can result in reinvestment risk and forced-selling risk.
- **Reinvestment risk:** If the cashflows from your corporate bond portfolio are too heavily weighted to the early years, then those cashflows will need to be reinvested before you achieve your endgame. There is a risk that market pricing will have changed when you need to reinvest, and that you cannot achieve the returns you previously expected.
- **Forced-selling risk:** If the cashflows coming from your corporate bond portfolio are not sufficient to meet your liability payments as they fall due, the cash may need to be raised by selling corporate bonds. You may be forced to sell your bonds at an inopportune time.

To manage these risks, we believe it is essential to design credit portfolios to take into account both the liquidity needs and endgame objectives of your pension scheme.

Currency risk: an integrated approach reduces forced-selling risk

As UK pension schemes have increased their exposure to corporate bonds, many have turned to the much larger euro and US dollar corporate bond markets as they seek to build an efficient and well diversified portfolio. This introduces currency risk for pension schemes with sterling liabilities, which many schemes then hedge.

However, if currency hedging is undertaken within a corporate bond mandate, there is a risk that the corporate bond manager will be forced to sell bonds at distressed levels to cover currency hedging losses during periods of crisis – as seen during the early stages of the pandemic. If corporate bond spreads then tighten as the crisis dissipates, there is no opportunity for the scheme to benefit from this recovery.

In our view, a better approach is to integrate currency risk management with the LDI mandate, allowing liquidity for currency hedges to be sourced from the same collateral pool as the liability hedge. This allows for the efficient implementation of a currency-hedging strategy without introducing forced-selling risk.

An integrated approach to risk management could hold the key

Some pension schemes are tackling these risks using a more integrated approach as they approach their target endgame. By refocusing on their specific endgame objectives, and the cashflows required to achieve them, it is possible to manage these risks more effectively and efficiently, according to how they specifically impact the journey to a scheme's ultimate goal.

IMPORTANT INFORMATION: Risk Disclosures
Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.