

Successful pension scheme investment



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Pension scheme investment continues to evolve as the provision of pensions in the UK continues to change. Defined benefit (DB) schemes face a shortening of their investment horizon as a result of an ageing membership, which has been accelerated over recent years by the closure of many schemes to new, younger members, and more recently the closure of schemes to future benefit accrual. Defined contribution (DC) schemes are growing in size and importance, and are now facing the challenges of running larger pools of assets, and their own ageing of members, as well as changes in retirement legislation and increased retirement flexibility.

In this article I discuss the areas now taking more prominence in light of this evolution: matching and diversification, dynamic investment strategies, and governance.

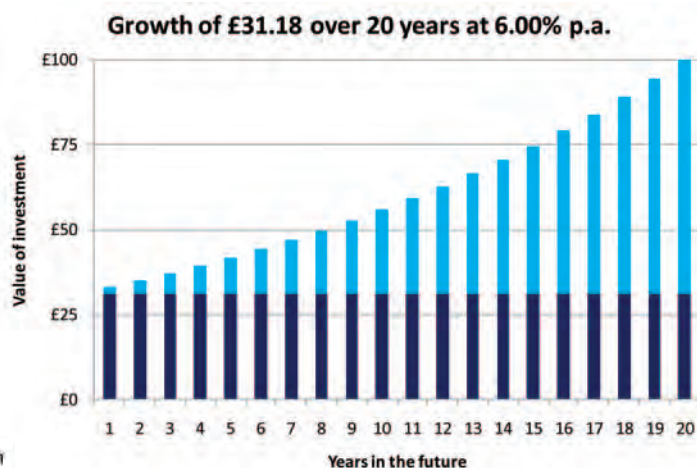
Matching

A DB pension scheme is a vehicle to provide regular pension payments to employees once they retire. In the UK, these pension payments must be funded in advance, i.e. money must be put aside to cover the expected cost of providing these pensions. An actuarial valuation is needed to estimate the amount of money required now to meet benefits that are expected to be paid in the future – the pension liability. The estimate assumes a certain stated level of investment return that can be achieved on any monies put aside.

The higher the assumed level of investment return, the smaller the amount of money that's needed to be put aside today to meet any particular pension payment in the future. The example below left shows how you can accumulate a sum of £100 by investing approximately £31 at a rate of 6% p.a. for 20 years (see graph left).

Increasingly in recent years, UK pension schemes have used the rates of interest available on bonds (bond yields) as the starting point of the investment return assumption for the actuarial valuation. That is because if you buy a bond, and hold it until the final redemption date, then as long as there is no default you know what payments you are going to get, and can work out with certainty what rate of interest you will achieve.

While the pension liability is valued using bond yields as a starting point, the assets of most schemes have historically been invested mainly in equities. As bond yields change with changes in interest rates, the value of the pensions changes: a reduction in bond yields leads to a rise in the actuarial value of the pensions. When this happens, there is no guarantee that the value of assets invested in equities will have also risen. This can lead to shortfalls (funding deficiencies) and more money needing to be paid. However, if a scheme holds bonds, then a fall in bond yields



will lead to a rise in the value of any bonds, thus providing some protection against the rise in the value of the pensions and the amount of money needed to cover the cost of these pensions.

By increasing the allocation to bonds, at the expense of equities, schemes can achieve better protection against movements in interest rates. This process is referred to as matching. There are various degrees of matching, with the highest being achieved by investing in annuity policies that provide the exact pensions that have been promised to members. This is also the most expensive option.

Diversification

Diversification means spreading the investment risk among different asset types to achieve the benefits of not 'putting all your eggs in one basket'. It is an effective method of avoiding significant concentration in any one asset in a fund in order to avoid unnecessarily high concentration of the risk related to that asset. Ultimately a diversified fund is more robust, as it contains a mix of assets that respond to changes in market or economic conditions in different ways.

Pension schemes have historically relied heavily on equity markets to generate their returns. Moving to lower-risk assets such as bonds will reduce the pension liability risk, as described in the previous section, but will also reduce expected investment returns. Diversification seeks to limit the extent to which equity-market falls reduce the value of scheme assets, but without reducing the investment return to that achieved by investing purely in bonds. That has led increasingly to alternative assets being used as a diversification tool. Such assets include private equity, property, hedge funds, high-yield bonds, commodities, emerging market equities and infrastructure. This strategy has been incorporated (for small schemes) into pooled funds often referred to as Diversified Growth Funds. (See graph right).

Dynamic strategies

Reducing risk gradually over time is a common objective for trustees and sponsoring employers of final salary pension schemes. Reducing risk using a 'dynamic' strategy involves putting a framework in place to:

- monitor investment risk on a regular basis
- adjust the investment strategy to reduce risk dependent on market conditions or changes to funding levels

The objective is to reach a well-funded, lower-risk position in the future.

The key ingredients to a successful strategy include:

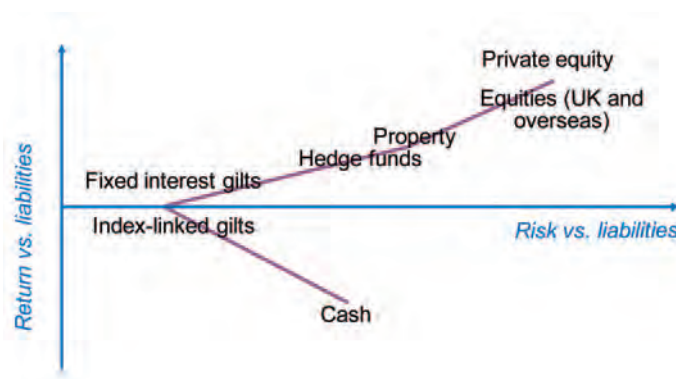
- understanding the current investment risks
- identifying which risk-reduction techniques could be used and understanding the associated costs
- setting targets for risk reduction over a specified period
- agreeing on 'triggers' for implementing changes that will reduce risk
- delegating monitoring and decision making to a sub-committee or adviser that can act quickly
- monitoring progress regularly and reviewing the objectives and the policy from time to time

There are four main categories of investment risks:

1. Equity risk – the risk of a fall in equities leading to a fall in the value of assets
2. Credit risk – a risk specific to any holding of corporate bonds where the risk of the failure of companies who have issued the bonds can increase. This in turn leads to a fall in the value of these bonds
3. Interest rate risk – the risk of a fall in long-term interest rates, increasing the cost of providing pensions and hence the liabilities of the scheme
4. Inflation risk – many benefits are linked to inflation; increases in inflation lead to an increase in the pensions to be paid and hence the liabilities of the scheme

Equity risk can be lowered by reducing equity exposure. Credit risk can be controlled by reducing corporate bond exposure in favour of government bonds (gilts). Interest rate risk can be reduced by increasing the allocation to bonds ▶

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or extending the duration of the bond portfolio with longer-dated bonds or interest rate swaps. Inflation risk can be reduced by increasing the allocation to index-linked bonds (or other asset classes with a high correlation to inflation) or holding inflation swaps.

Once trustees have decided upon the risks they would like to monitor and reduce over time, trigger points can be agreed to aid decisions on the implementation (timing and scale) of changes.

It is important when using a dynamic strategy that decision-making structures and arrangements for monitoring will allow changes to funding levels or market conditions to be captured and reacted to efficiently. Evidence suggests that active application of a dynamic strategy can result in significant improvements to investment returns and reduced levels of investment risk over time.

DC

DC investment was somewhat left behind when compared to the developments that have taken place in the DB investment arena over the last decade. Many DC default funds – the fund that member contributions go to if they don't specify any other option – rely solely on equities for real asset growth and do not hedge their currency risk, while DB schemes tend to have diversified into one or more alternative asset classes and use sophisticated hedging mechanisms. At the same time, annuity rates have worsened, leaving DC members even worse off. The Pensions Regulator has run several initiatives to focus attention on DC schemes. The impending arrival of NEST in 2012 is also sharpening this focus, as well as the launch of the National Association of Pension Fund's new Quality Pensions Mark in October 2009.

With default funds used by up to 90% of members, it is important to review the ongoing appropriateness of default options on a regular basis. There is a case to be answered for diversifying DC default funds away from over-reliance on equities, at least in the latter half of a member's working life. Most default funds incorporate a 'lifestyle' strategy to gradually de-risk the fund in the last five to ten years approaching expected retirement. This helps to avoid large capital losses just prior to annuitisation, with an associated loss of retirement income. The design of these lifestyle strategies has barely altered since their introduction over 15 years ago, despite significant advances in investment thinking and asset-liability modelling for DB schemes over that period.

We are starting to see more innovative and flexible products within the DC arena, which we believe will give trustees much greater latitude in designing default options that are appropriate for their memberships. One such development is the use of target date funds, which adopt the same de-risking principle as life-style strategies, but are offered as a range of funds which members select based on their expected retirement date. Target date funds are already very popular in the US and have recently been gaining an increasing amount of attention in the UK.

Trustees need to take into account a wide range of factors when reviewing their DC investment arrangements. Many of the advances which have been developed for DB schemes are now being considered and applied to DC schemes. The question marks surrounding the best ways to de-risk and plan for annuitisation and income-drawdown are being addressed, and more flexible strategies are being devised.

Governance

A good governance framework is important to protect both members and trustees alike. DB governance processes are well established. The regulator recommends that DB schemes adhere to the 'Myners Principles', which are as follows:

- effective decision-making
- clear objectives
- risk and liabilities
- performance assessment
- responsible ownership
- transparency and reporting

DC governance has historically not been a big focus for trustees. To reflect the growing importance of DC provision the regulator consulted key stakeholders, including employers, trustees, providers, advisers and member representatives in 2010. As a result the following principles have been devised for trustees to apply:

- clear roles and responsibilities
- effective decision-making
- appropriate investment options
- appropriate default strategy
- effective performance assessment
- clear and relevant communication

All of the issues discussed here are challenging trustees of both DB and DC pension schemes to focus more on governance as the investment world becomes more active. ■