Aon Investment Research 2020

Covid, climate and compliance— are you ready for the new investment challenges?

Focus on endgame planning and de-risking

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Foreword

2020 has been a year of significant change for UK pension schemes' investment strategies — even before we take the effects of the COVID-19 pandemic into account. Governance has come under ever-greater scrutiny from The Pensions Regulator, responsible investment is rising rapidly up the trustee agenda, and pension schemes are demanding ever greater cost transparency from their providers.

Emily McGuire
Partner, Aon

Over the summer, we set out to listen and to understand how investment decision-makers were responding to all these changes and accompanying challenges. Through a series of in-depth interviews, we were able to gain real-world insights into key trends, common approaches — and differences — to paint a picture of current thinking in pensions investment.

Inevitably, the pandemic was a common thread running through all the discussions. And, while it's still too early to understand its longer-term effect on schemes and markets, the crisis has already started to reshape investment strategy decisions and the way these are made.

Now, more than ever, investors need support to continue to protect the retirement income for their members and to manage the increased pressure and demands on their investment governance and operational strategies. We have specialist teams and deep expertise to help you to rise to all these challenges — from governance, responsible investment and investing for the endgame to costs and transparency and the DB funding code of practice.

We look forward to continuing the discussion with you.

About the research

In July and August 2020, Maggie Williams, an experienced pension commentator, writer and editor, carried out in-depth interviews with 20 pension scheme decision-makers on behalf of Aon. Interviewees were drawn from a wide range of disciplines — professional, independent and member-nominated trustees, third party evaluators and pensions managers — representing both defined benefit (DB) and defined contribution (DC) schemes. Scheme sizes ranged from a £10m defined benefit scheme, to over £10bn.

The interviews focused on five key areas:

- Investment governance
- Responsible investment
- Investing for the DB endgame
- Costs and transparency
- Investment implications of the DB funding code of practice

Our thanks go to everyone who took the time, during very difficult and challenging circumstances, to participate in this research and to provide valuable insights.

Aon insight
Endgame planning and de-risking

Investors have more endgame options than ever before. Consolidators, capital-backed investment solutions and insurance – all can support trustees and sponsors to get to their endgame more quickly. It is encouraging to see that schemes of all sizes are carefully considering the full range of options now available to them.

No aspect of investment has been left untouched by the COVID-19 pandemic, and endgame investment strategies are no exception, as the research shows. Whether schemes are aiming for self-sufficiency, considering buy-ins, looking at commercial consolidators or are on a longer-term path to buyout, there has been a lot of scrutiny of investment strategies.

The crisis has underscored the need for an asset strategy which is robust and tailored towards the endgame. For example, if trustees are targeting self-sufficiency they must be able to deliver the cashflows the scheme needs in a variety of different ways. Preparing assets to reduce risk versus insurer pricing can be the difference between buy-ins and buyouts being affordable or not.

The need for assets and timeframes to be flexible has also been accentuated by the wider range of settlement options (including consolidators) and attractive insurance pricing opportunities for those schemes that could transact during and following the COVID-19 market uncertainty. Identifying the endgame early, preparing your assets with that endgame in mind and building in flexibility is key.

The crisis has also led to heightened awareness of the impact of any risks schemes are running in their portfolio and underscored the need to de-risk holistically. Reducing longevity risk, managing other liability risks and reducing investment risk — all will enable schemes to get to their endgame more quickly and with less risk along the way. We are increasingly seeing schemes using partial buy-ins as a tool to de-risk and longevity swaps are now available to a much wider range of scheme sizes (£100m+).

The need for an investment approach that, in all market conditions, provides predictable returns with an appropriate level of risk, and enables schemes to meet their cashflows, remains a priority. With our combined risk settlement, investment and delegated expertise, we are well positioned to support you with your endgame asset strategy and to minimise risk and maximise the flexibility of your scheme.

Lucy Barron
Investment Partner, Aon

Endgame and investment strategy

As increasing numbers of DB schemes close to future accrual, trustees have had to make careful decisions about their schemes' long-term strategies and how their investments will help them to achieve their longer-term goals of self-sufficiency, consolidation or buyout.

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"More schemes want a predictable, steady return rather than a stellar, unpredictable one," said a professional DB scheme trustee, summarising a general investment trend among the schemes he worked with. This was also the view of a third party evaluator working with DB schemes: "Most of the asset classes that we're looking at now are low-risk. Credit is probably the biggest example, or schemes looking to extend their hedging using Liability Driven Investment (LDI). It's been a while since I was involved in an equity manager selection."

"If you think you've got a fighting chance of going into buyout within say three to five years, you're not going to sign up for something that's illiquid, or something that an insurer won't want, or will say: 'I don't really want it, can you sell it on the secondary market?'"

Professional trustee, DB schemes

One professional trustee added that there are similar shifts in delegated investment mandates as endgame gets closer: "They are becoming more straightforward, because we don't need the bells and the whistles that we once did. We are moving away from illiquids, and from more esoteric asset classes."

For schemes that are aiming for buyout, making sure that their portfolio is going to be attractive to insurers is a priority. However, as one professional trustee pointed out, this can be difficult to gauge. "All sizes of schemes are asking advisers: 'what sort of portfolio should we be holding that is going to be most empathetic to what an insurer wants?' But all insurers are different, so you can't always replicate that exactly."

Respondents felt that schemes planning for buyout in the short to medium term were less likely to hold illiquid assets, in case they limited the opportunity to transact quickly. However, for respondents with schemes aiming for self-sufficiency or with a longer time horizon for buyout, some interviewees argued that less liquid assets could provide attractive regular income streams to meet liabilities. "Secure income assets, such as private debt and infrastructure, might lock you in for a period, but will produce cash," explained one professional trustee and scheme chair.

A professional trustee said that he had begun to see a greater focus on longevity hedging, mirroring wider market trends. In 2019 there were several large market deals, including a £7bn longevity swap carried out by HSBC — the second-largest deal of this kind. "Longevity hedging is notoriously expensive and complex, and not really something that's done for schemes below a certain size, albeit the landscape is changing," said a professional trustee. "Our advisers did some analysis for one of our large schemes and it showed that a longevity swap might be an answer for us, rather than a buy-in. We've also seen other large schemes looking at this recently."

The effect of COVID-19 on endgame planning

COVID-19 has inevitably impacted endgame planning and investment strategy. One participant felt that the wider effect on the economy could mean trustees have to re-interpret their view of 'low risk'. "My macro view is that the recession has barely started, and credit is where the damage is going to happen," said a trustee of three DB schemes. "I'm very much in risk-off mode... the fact the stock markets have bounced back isn't a concern, as it's default rates I'm watching for."

"Risk-management has been key for many clients over the past years. They have taken off a lot of equity risk, they've increased their hedge levels. Although they did feel the impact of COVID-19 and what happened to markets in Q1, I do think it could have been a lot worse. Five years ago, the impact on a lot of schemes could've been much greater."

Third party evaluator, DB schemes

Respondents' views were mixed on whether the pandemic has made moving risk to an insurer more attractive. A third party evaluator perceived some advantages: "Transferring to an insurer has major benefits because they've got natural hedges within their book of business, as well as huge assets. They can afford to take advantage of some more long-term investments that a pension scheme getting close to its endgame cannot do. They've got a different and larger opportunity set than a pension scheme at that stage has. But it comes down to how affordable it is for the scheme."

Schemes that have hedged investment risks generally found their investments well protected in the early weeks of the pandemic when stock markets plummeted. "I think trustees recognise that we are in an uncertain world and risk management becomes more and more important. But behaviourally it has been difficult for some trustees who put hedging off to now do it because suddenly it is more expensive," said a third party evaluator. "The general trend [beyond COVID-19] has been that it has got more expensive to hedge, but it continues to be beneficial to do so."

"We've been suggesting to clients who were part-way through a transition or had agreed a transition [during COVID-19], to go back and ask themselves: What is the reason that is driving this change? Is that reason still valid? And how does the current environment impact that, in terms of liquidity in the market, any increase in trading costs, etc.?"

Third party evaluator, DB schemes

For schemes that had already planned transactions that would remove risk from the investment portfolio when lockdown started, the crisis meant having to question whether that activity was still valid. However, as one third party evaluator pointed out, decisions needed to be seen in context of the scheme's long-term goals, not just as a knee-jerk reaction to current events.

"I had a client that was significantly de-risking and we still went ahead during the pandemic. A trustee challenged saying, 'Are we not locking in those losses?' The response back was, 'You've already got a strategy that is generating far more return than you need. We've identified that it's not well-diversified, you've got a lot of risk, a lot of exposure to equities. All those points are still valid. And we don't know what direction equity markets could take from here. They could get worse; they could get better. But actually, let's go ahead and make that change, increase the hedging, reduce equity exposure'."

"We keep 1–2% of the assets in cash just in case. Back to March when COVID-19 hit the UK I did get worried that we might not even be able to sell gilts, potentially. So, we took the precaution of increasing the cash allocation just to make sure we could meet the monthly pension payroll, but that was very much a one-off."

Trustee, large DB scheme

Investment strategies for cashflow negative schemes

Almost all the respondents work with at least one scheme that is cashflow negative (ie. money coming into the scheme is less than that being paid out as pensions). While in most instances, cashflow negativity is a long-term result of a DB scheme being closed to future accruals, for some schemes it has been caused by a short-term cessation in deficit repair contributions (DRCs) from the employer due to COVID-19. Although a pause in DRCs is a temporary scenario, in some instances COVID-19 will have longer-term impact on the strength of the employer covenant. That, in turn, will affect the scheme's investment strategy.

"All schemes have a much bigger emphasis on cashflow sensitivity. It's a part of everyday behaviour now and very high on the agenda. The focus is around what future cashflows are required and whether these are going to come from cash, from the company or from realised investments."

Professional trustee, DB schemes

For schemes that are long-term cashflow negative because of scheme maturity, consistently performing investments become pivotal. "The last thing you want to do is draw down from an investment which has just lost a lot of money in a volatile time," said a third party evaluator. However, the difficult balancing act for schemes that are both cashflow negative and have a significant funding deficit is that they will require some volatile assets to generate returns. "You are left to balance generating return, generating income or finding cash, and managing risk."

Even before the pandemic, schemes were already battling with a low interest rate environment, making it more difficult to find assets that will help to match cashflows. "[Low interest rates] are encouraging some schemes to look at riskier bonds – which clearly raises the question of how much risk they should take. They are also looking at different types of assets which generate income, such as long lease property" said a third party evaluator.

"For schemes that have been made temporarily cashflow negative (because of stalled DRCs) it's led trustees to ask 'how am I handling liquidity? It's also encouraging schemes to have some rules-of-thumb, such as having some months of expected outgoings in cash, and rebalancing into that. The last thing you ever want is to be a forced seller of assets."

DB third party evaluator

Schemes faced with a short-term shortfall from sponsor DRCs have had to be nimble in their decision-making. "The crudest way is just to disinvest, but you're at the behest of market timing," said another third party evaluator. "For those pension schemes that are also cashflow negative on an ongoing basis it might be sufficient to turn on income streams from share classes that they invest in, for example, to weather the immediate problem."

The benefits of using LDI have also come to the fore for some schemes during the crisis. "fortunately, lots of pension schemes haven't become cashflow negative during this period because they've had LDI funds," said one third party evaluator.

Scenario analysis: what might the future hold?

Scenario analysis – predicting what might happen to a portfolio during different market and other conditions – can help schemes understand and manage the investment risks they might face in the future. Respondents generally felt that using scenario analysis was beneficial. Both professional trustees and third party evaluators felt that its use would increase in future. "Scenario analysis and talking about risk needs to be tangible and understandable," said a third party evaluator. "Just saying 'this is a 5% or 1 in 20 risk over a three-year period' means nothing. What does it *actually* mean? Is it, say a 30% fall in equity values, or an X% rise in inflation, for example?"

"There is no point just labelling ideas as 'scenario one, two, three and five'. Name them, so trustees can think, "This is the geopolitical event or issue that could cause this to happen," so a bad Brexit, for example. Then, put some rough numbers on the impact on equity markets, currency, credit spreads, gilt yields and inflation. It doesn't need to be too complex, but it's giving it an idea of the direction of travel."

Third party evaluator, DB schemes

A professional trustee echoed the need to make scenarios both tangible and actionable but questioned the extent to which scenarios are helping trustees make decisions. "Scenario analysis predictions are often very heavily caveated. Consultants are trying to be helpful – but they are not sticking their neck out enough and saying they want trustees to base their behaviours on those scenarios," said a DB professional trustee. "As a result, I'm not sure it is changing anything."

"When you are going through a quiet period of 5 or 10 years of everything generally going in a positive direction, there can be a tendency to forget about risk events coming around and hitting you out of the blue. But that is the very nature of risk and uncertainty. I think now that such an event has happened it will probably make more trustees realise that actually we need to get risk off the table."

Third party evaluator, DB schemes

Both forward-looking and historical analysis can provide benefits, argued one third party evaluator. "We'll put a portfolio into our model and say, 'how would it have performed in the last 20 years, and what would the effect of each year be on the funding level?' It's a crude measure but you can see how one portfolio versus another might have fared in the global financial crisis, and why. You can then roll that into your forward-looking modelling."

"Sometimes cashflow planning only looks at normal market conditions. But trustees need to look at what happens in a stressed scenario, how does that impact the liquidity of the scheme? Because if you don't, you're almost saying, 'We know we're going to have a problem in a stressed market environment.'"

Third party evaluator, DB schemes

Are consolidators a new endgame destination?

Transferring to a commercial consolidator is another option now available to trustees planning their scheme endgame. The Pensions Regulator announced an interim regulatory regime for consolidators in June 2020, setting out expected governance standards and requirements for financial sustainability. This could give trustees more confidence in considering a consolidator in the future. "I definitely think there's a space for consolidators," said one professional trustee. "Provided [consolidators are] conducted and regulated well, there's no reason why they can't be a success."

Given that consolidation is still a relatively new proposition, few schemes have seriously considered it yet. "I feel like consolidation has been discussed a lot, but I haven't seen many of my clients actually take that forward just yet," said a third party evaluator.

Overview of consolidation options

	Pooling			Transfer of asset / liability risk	
	Assets	Liabilities	Governance	To a third party	Off balance sheet
Sole trusteeship	✗	✗	✓	✗	✗
Pooled investment funds / fiduciary management	✓	✗	✗	✗	✗
Buy-in	✓	✓	✗	✓	✗
Master trust	✓	✗	✓	✗	✗
Commercial consolidators	Varies	Varies	✓	✓	✓
Buy-out	✓	✓	✓	✓	✓

Source: Aon's UK Risk Settlement Market Review 2020

For schemes that are already on a clear path towards insurance de-risking, respondents felt that the new option to consolidate would be unlikely to encourage them to change course, either in terms of their endgame or their investment strategy. "I doubt whether consolidators are for us, just because of the position we're in," said a DB scheme trustee. "We've got a very good funding level, almost fully funded on a buyout basis. It would be hard to say, 'we'll go down the consolidator route rather than the traditional insured route'."

Some participants also felt that the consolidator options in the market at present might not fit the needs of all schemes.

"I think one of the current consolidator propositions should be quite attractive to small schemes, but I suspect their business model doesn't work for them," said a trustee. "I think that's where help is most badly needed, however. Anyone with a scheme size under £100m is, I suspect, struggling both at the trustee board level and at cost level."

"I think it is extremely unlikely that we would consolidate with anybody else. We haven't had enough discussion to even think about it. Our company covenant is a very important issue, and until COVID-19 was absolutely rock-solid."

Trustee, DB scheme

In the short term at least, respondents didn't feel that the option of consolidation would make any difference to their investment strategies: "I don't think you're going to alter your investment strategy or amount of risk just because the consolidator option exists. You'd only do that if you'd actively engage in a consolidator conversation with your employer," said a professional trustee. "It's a bit like a conversation with an insurer. You only invest in a way that's empathetic to an insurer when you're close to that outcome."

One respondent who is personally involved with a DB consolidator, said that for consolidators themselves, the biggest challenge is to "make sure we can combine both the economies of scale that consolidation offers, and the bespoke approach to match the pension funds life cycle."

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Further reading and resources

Risk Settlement – it's not just about benefits and data – assets matter!

Reaching the end: minimising risk and maximising flexibility for scheme endgames

Winning the pensions endgame

To buy-in or not to buy-in?

Aon Investment Research 2020

This report forms part of a body of research into current thinking in pension investment.

Access all the reports in the series to discover key trends and common approaches among pension scheme decision-makers as they rise to the challenges presented by covid, climate and compliance.

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Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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