Global Pension Risk Survey 2019

UK Survey Findings

Investment strategy considerations

A deeper view

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Introduction

The *Global Pension Risk Survey* is an Aon survey, conducted every two years, of the defined benefit pension scheme universe. 170 respondents replied to the 2019 UK survey, representing schemes of a broad range of sizes from less than 500 members to over 10,000 members. Nearly two-thirds of respondents were trustees, with the remainder primarily being a combination of pensions managers and corporate representatives.

Looking back over the last decade, we can see how the pensions landscape has developed. Ten years ago, schemes were dealing with the fallout from the global financial crisis, and over the following years, increasing numbers of schemes closed to accrual in response to rising costs.

As a result, schemes began to set their sights on long-term, lower-risk destinations, but market conditions and rising longevity seemed to conspire against making progress. The ultimate low risk target forever seemed just out of reach. However, in recent years, schemes' long-term objectives have grown closer than they have ever been (see chart), as schemes mature.

The overall themes in the survey – of maturing pension schemes and reducing time to reach long-term targets – are inevitably reflected in the way schemes have outlined their investment strategies. This survey demonstrates many of the trends we saw two years ago – notably de-risking and diversification. But this year the difference lies in the pace of change and the level of activity; schemes have firmed up their views and acted decisively.

The way schemes have acted has been very much driven by their own circumstances, but typically actions have fallen into two categories: schemes that have reduced equity exposure but increased liability hedging to reduce overall volatility, and those that have diversified from equities into alternative growth assets. We have also seen continuing interest in illiquid asset classes as schemes look to alternative investment ideas.

This year's survey also asked schemes which elements of their investment strategy and implementation they had delegated or planned to delegate in the future. As in previous years, this is an area where attitudes are evolving, with moves to partial delegation the most popular strategy.

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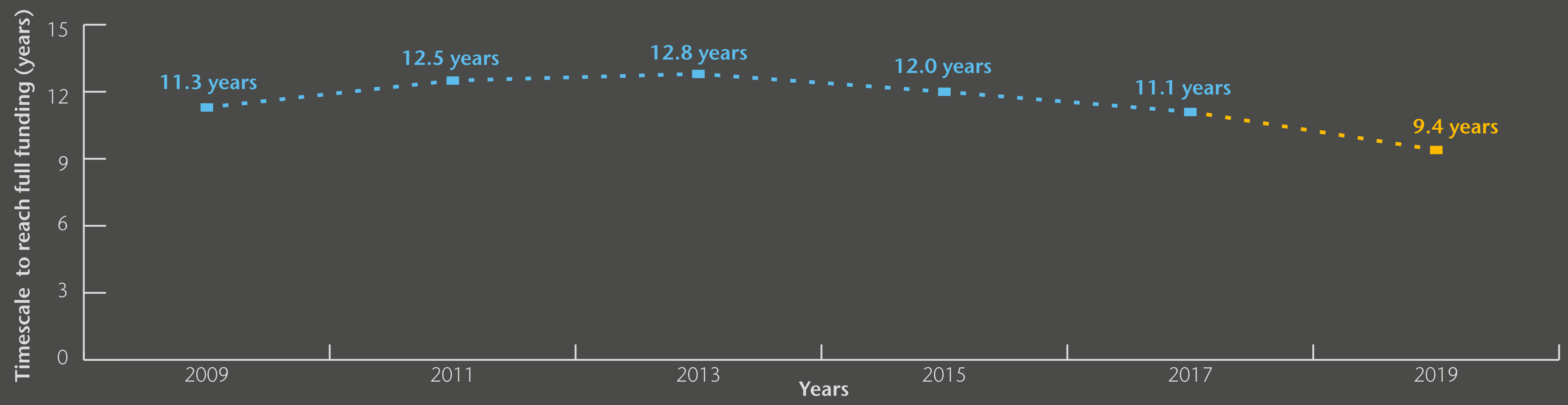
Timescale to reach long-term target as reported in previous Global Pension Risk Surveys



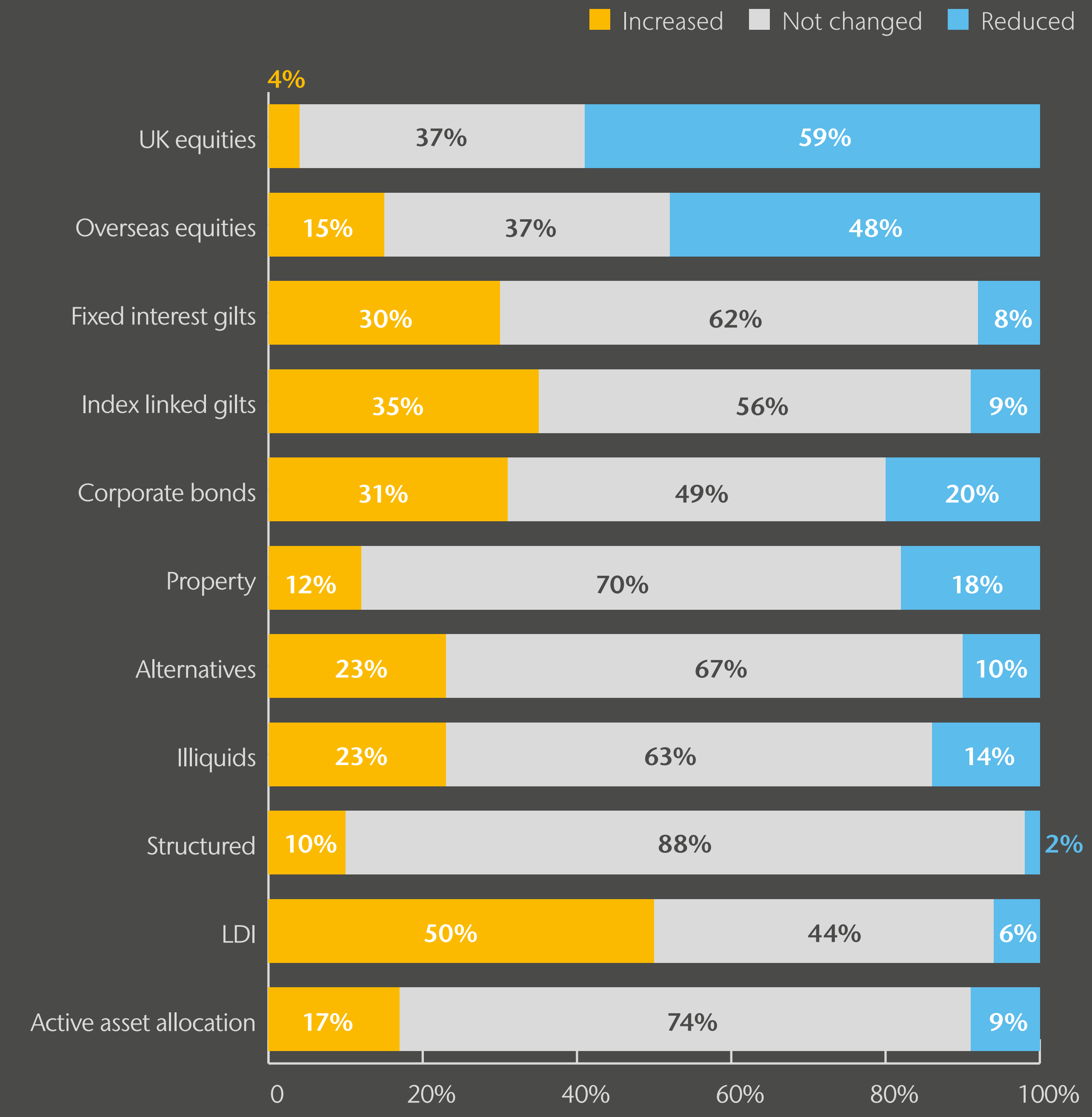
Investment strategy changes

Respondents were asked what investment strategy changes they had made in the last 12 months. The responses demonstrate very clearly a reduction in allocations to riskier asset classes such as equities and increases to risk-reducing assets such as LDI (increased by 50%) and gilts (increased by c. 30%).

There has also been a noticeable increase in asset classes that could be used as part of a cashflow-matching portfolio, such as corporate bonds (31%) and certain illiquid assets (23%).

This trend looks set to continue. Around 40% of respondents anticipate reducing their equity allocations further over the next 12 months. LDI is again expected to be the asset class with the highest increases.

Actual investment changes over last 12 months



Aon insight

The trend observed in previous surveys — of moves away from return-seeking assets and into risk-reducing assets — has continued in our 2019 survey. The destination for these predominantly equity sales very much depends on scheme-specific circumstances but typically fall into one of two categories.

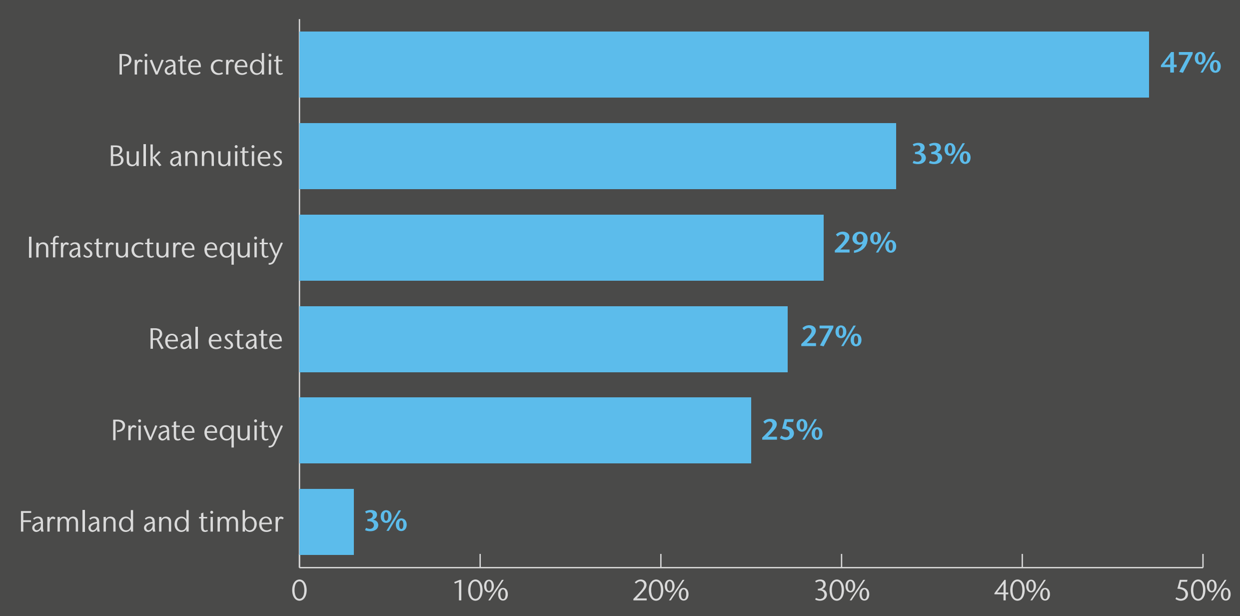
1. A reduction in equity exposure and a simultaneous increase in liability hedging to reduce overall volatility because of, for example, funding level gains.
2. Diversification away from equities into alternative growth assets — reflecting the challenging outlook for equity markets — but with an aim of minimising the impact on the overall level of expected investment returns.

Additionally, we are observing a lot of interest in the optimal structure of our clients' credit portfolios, with discussions focussed on the merits of liquid versus illiquid approaches and their potential role in an 'endgame' investment strategy. This includes consideration of constructing a portfolio with a specific objective to generate cashflows which match liability outflow. This is discussed in further detail in our 'Can you meet your cashflows' paper.

Growing interest in illiquid investments

Almost a quarter (23%) of respondents expect to increase or make allocations to less liquid assets. In terms of anticipated increases across illiquid asset classes, it is interesting to note where respondents are expecting to increase their exposures.

Anticipated investments in illiquids



Pension scheme investors are looking for multiple types of illiquid assets and we are seeing the greatest interest in private credit (47%), which includes direct lending to corporates, real estate debt and infrastructure debt.

Around a third of respondents anticipate purchases in bulk annuities, reflecting the increasing maturity and level funding of pension schemes in general — the overall average timescale to reach long-term targets has fallen from 11.1 years in 2017 to 9.4 years in 2019, a reduction of 1.7 years in the last two years. Aligned to this, there has been a material increase in the adoption of a buyout target since the 2017 survey — from 27% to 35%.

We also see interest across a range of different illiquid asset classes, such as infrastructure with 20 to 25-year time horizons, through to real estate, where we are seeing a shift to global property portfolios, and to more cashflow-generative private credit type investments. Our paper provides further details on global property.

Aon insight

We continue to see increasing levels of interest in illiquid asset classes as pension schemes explore alternative investment ideas which can provide a more diversified source of return from more traditional markets as well as being able to provide predictable levels of income.

Illiquid asset returns are predominantly driven by income with security offered by asset-backed or contractual cashflows; and, or, seniority in the capital structure.

The range of strategies available provides flexibility, in that they can form part of a scheme's growth portfolio or part of its de-risking strategy. The income-orientated nature means they are likely to be more defensive, while the lack of reliance on capital appreciation is also attractive in a range of market environments and scenarios.

Client case study: Increasing exposure to illiquid assets

Background

A £3.2bn pension scheme was looking to de-risk its return-seeking portfolio by reducing its allocation to equities following improvements in the scheme's funding level and stellar returns from equity markets.

Solution

Aon worked with the trustees to design an alternative to the scheme's equity portfolio. A new portfolio of mainly illiquid assets, with allocations to direct lending, property debt and infrastructure was put in place, designed to:

- De-risk the scheme's assets while maintaining sufficient expected return to meet the trustee's long-term objectives
- Increase income to meet benefit payments and expenses
- Take advantage of illiquid investment opportunities, particularly in the credit sector, which were attractive from a risk/return perspective

We ensured that the expected income from the return-seeking portfolio would be sufficient, with company contributions, to meet a majority of the scheme's expected cashflow needs.

Outcome

The new return-seeking portfolio is projected to be more efficient than the previous portfolio and a greater proportion of the scheme's cashflows are expected to be met through the asset income.

Barriers to illiquids investing

We also asked respondents to explain, where applicable, what is preventing them from considering illiquid asset classes.

The most cited reason (40%) is that schemes are exploring buy-in or buyout in the near term.

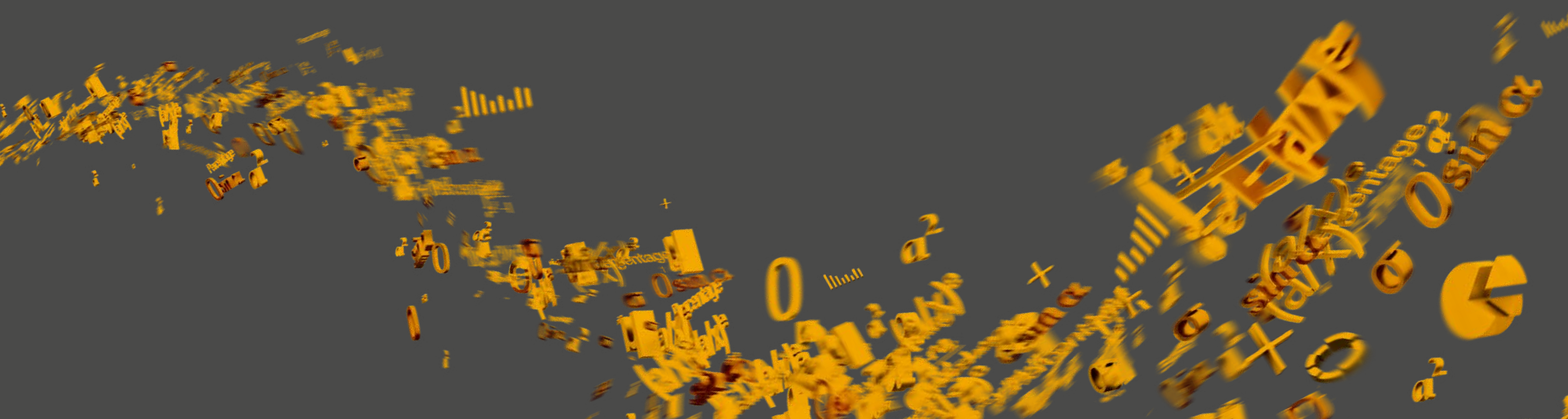
Just over a third of respondents (33%) do not believe illiquid assets offer attractive risk-adjusted returns compared to liquid markets.

Just under a quarter (22%) gave as their reason for not investing in illiquids a lack of resources or expertise to have a meaningful allocation to illiquid assets.

Aon insight

For those schemes closest to buyout, allocations to illiquids may not represent the best option for their portfolio — locking down risks and liquidity are significant factors to ensuring assets that are easily transactable. But, for schemes aiming to achieve self-sufficiency, and depending where on their journey they are, illiquid assets can offer attractive risk-adjusted returns relative to liquid markets and generate cash to pay benefits when they fall due.

Historically, meaningful allocations to illiquid assets have been the preserve of larger schemes, such as the client in our case study. However, they are increasingly becoming more accessible to a broader range of schemes, for example through partial delegation strategies, such as those offered by Aon in the areas of private credit and global core real estate.



Liability hedging

Linked to the general de-risking trend, it is interesting to note that levels of liability hedging have increased materially compared to our previous survey — the number of schemes hedged less than 60% has halved in in two years.

45% of respondents to this year's survey are hedging over 80% of their interest rate risk with just 30% of schemes hedging less than 60%.

This is compared to our 2017 survey where less than 30% hedged more than 80% of interest rate risk and almost 60% of respondents hedged less than 60%.

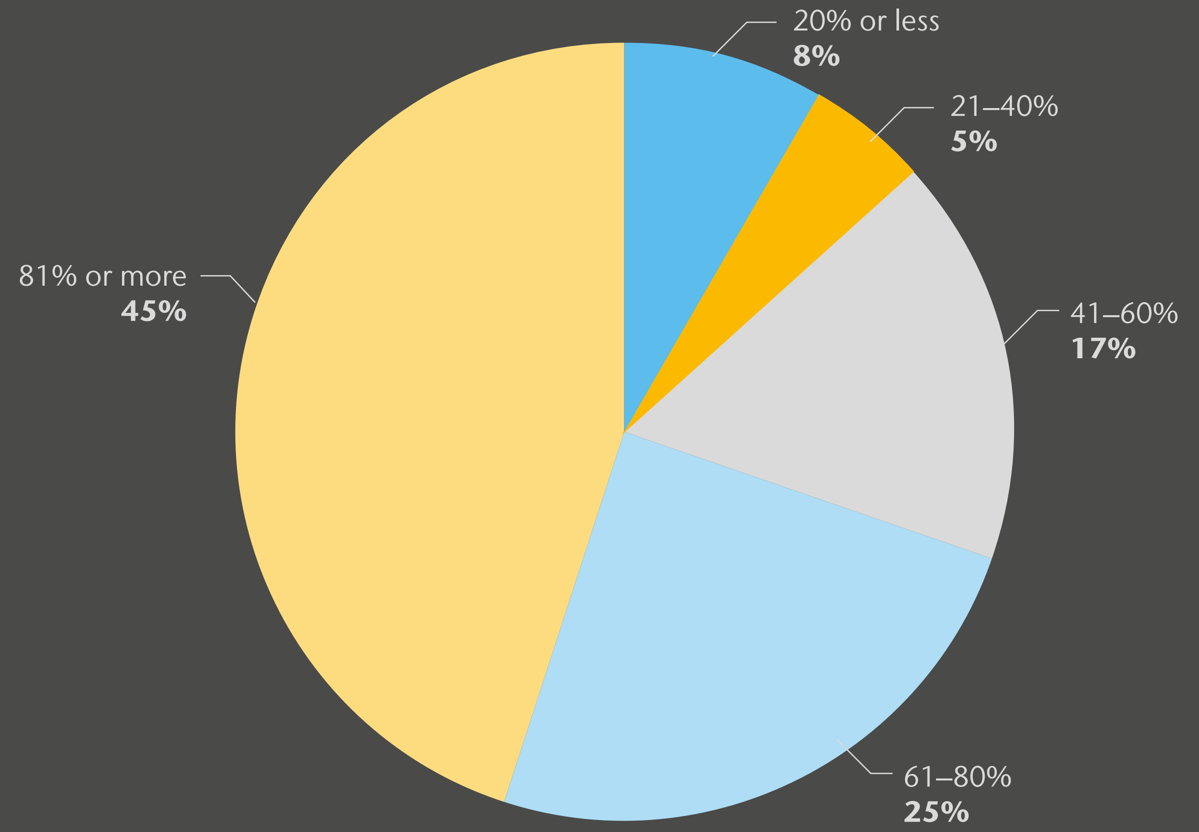
The results for inflation hedging levels are also very similar.

Aon insight

We have long been advocates of pensions schemes looking to hedge liability risks, where affordable, and it is encouraging to see that more (or 'an increasing number of' respondents have reduced their liability risks. We view exposure to interest rate risk as a significant and often un-rewarded risk. Additionally, a scheme's risk budget is often better allocated elsewhere, within a diversified growth portfolio, to help generate returns.

Schemes that are fully hedged have been insulated from the material fall in gilt yields experienced in recent years and the adverse impact this would have otherwise had on funding levels. As a result, some are now in a position where their endgame is now within reach — in line with the overall trend identified by this report.

Interest rate hedging ratios



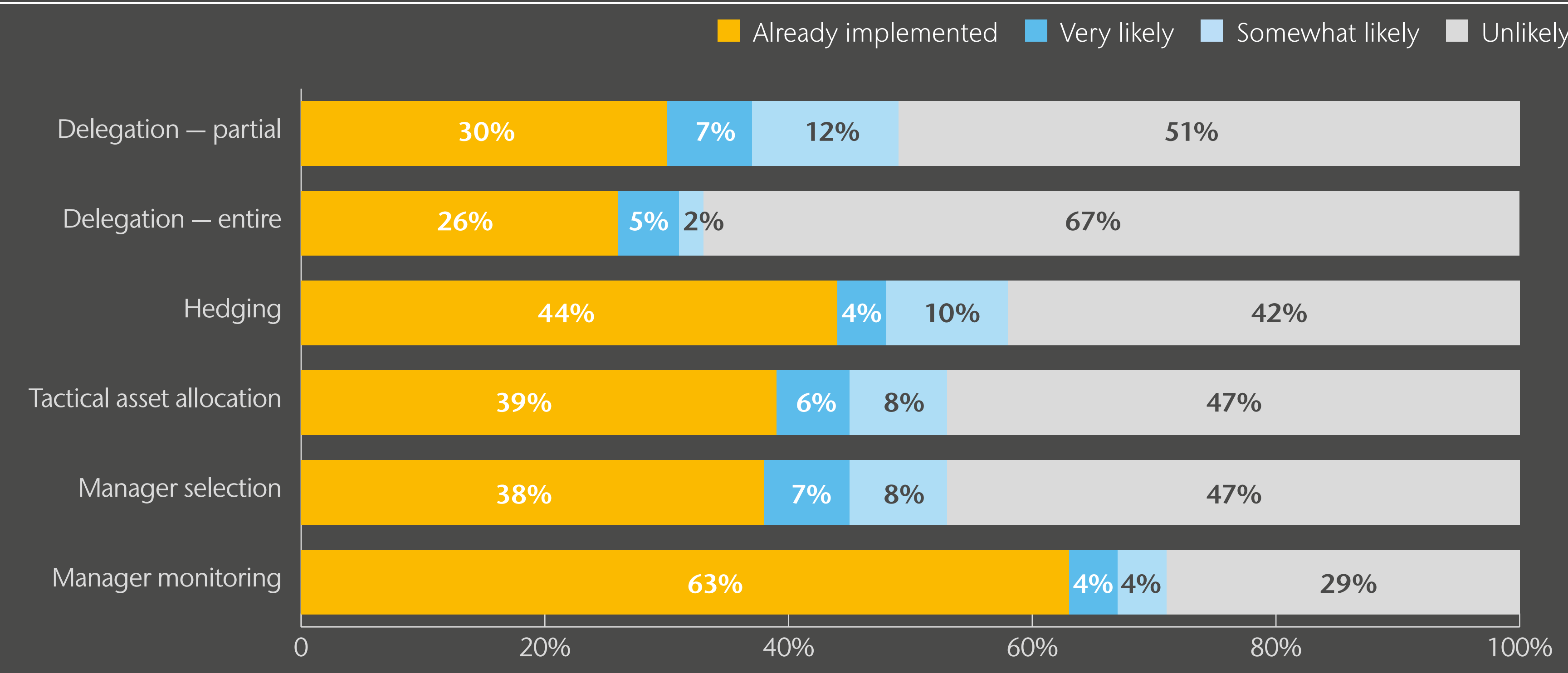
Attitudes to delegated investment

The survey also asked about attitudes to delegation and which elements of their investment strategy and implementation schemes had already delegated or planned to in the future.

We continued to see schemes looking to delegate certain functions to their advisors. These tasks range from manager monitoring (63%) right through to fully-delegated mandates — 33% have either already delegated their entire portfolio or are likely to do so.

However, partial fiduciary management was the most popular response, with 30% of schemes already using it and an additional 20% considering it over the next 12 months.

Attitudes toward delegation



Attitudes towards delegation continue to evolve, with more respondents open to delegating manager selection and monitoring to their adviser. We are also seeing a growing trend towards partial delegation, which we expect to continue to rise.

Following the market investigation into the investment consultancy and fiduciary management sector, the Competition and Markets Authority has called on schemes to consider the right approach for them. As a result, we expect to see many schemes continue to assess the relative merits of delegated investment to meet their governance requirements and as a way of implementing their investment strategies in future. Aligned to this, we expect the role of third-party evaluators and professional trustees, to assist in the decision-making process, to become more important.

Click here for more information on Aon's Delegated Consulting Services.

Client case study: A role for delegated investment for achieving long-term targets

Background

A £240m pension scheme had a desire to move forward towards the ultimate aim of being able to buy out all of the benefits with an insurer. However, to reach buyout, the scheme required further growth with minimal funding level volatility, while also being able to reduce risk nimbly when opportunities arose. They also needed a more diversified portfolio across several asset classes.

Solution

In 2014, the scheme put in place a full delegated solution to help further diversify their growth portfolio into various asset classes and strategies. The delegated arrangement allowed the scheme to have a dynamic growth portfolio which invested across equities, hedge funds, a broad range of credit and emerging market wealth. The scheme was invested in 50 different mandates. Fiduciary management also allowed the trustees to set a flight plan targeting buyout that was monitored daily. This allowed locking-in of any funding gains with automatic de-risking funding level triggers..

Outcome

Two years later, the scheme began hitting its de-risking triggers as its funding level improved further. With the end-goal in mind, the trustees wanted to lock in recent gains and reduce risk further, while ensuring the target of buyout was attained in a reasonable time period. The scheme then reduced allocation to growth assets and disinvested from risker assets.

In mid-2018, the scheme entered a buyout agreement to transfer its liabilities to an insurer, allowing benefits to be secured for members. Since then, the trustees have wound up the scheme and returned a surplus of several million pounds to the sponsoring employer.

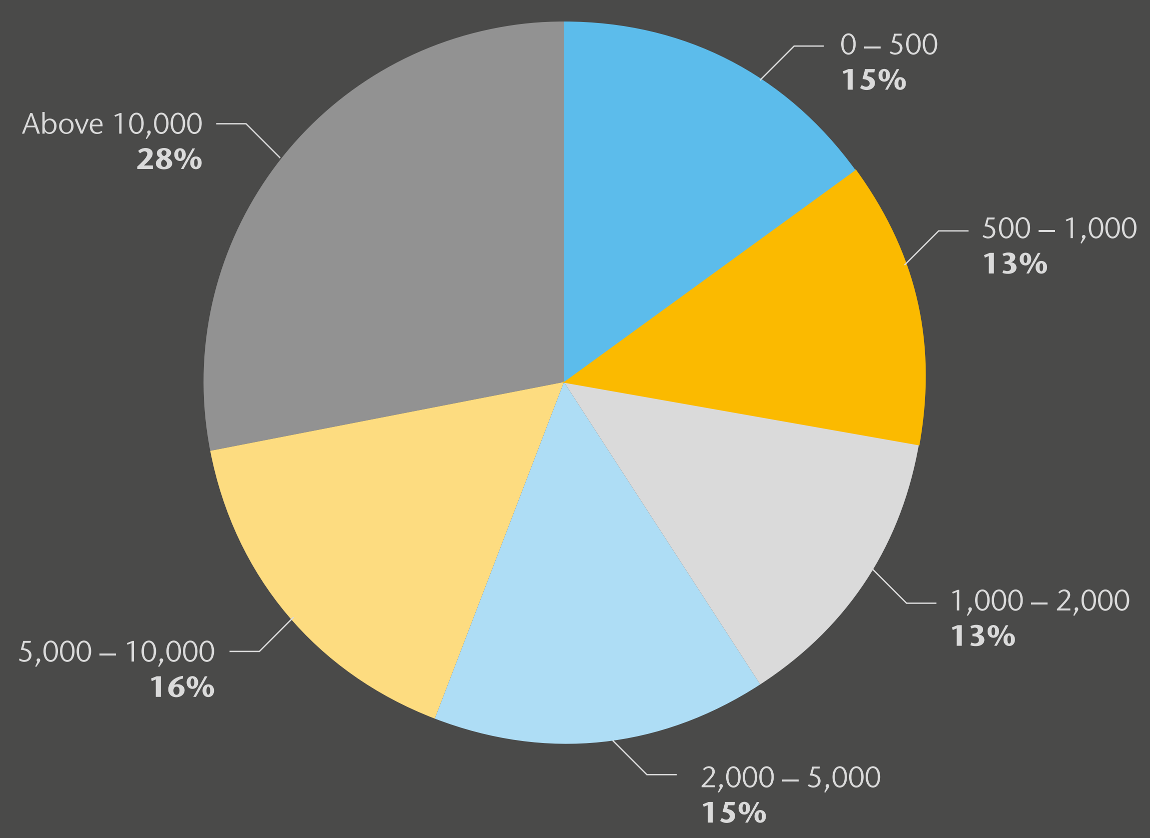
About the survey

We had a total of 170 UK responses to the 2019 Global Pension Risk Survey, covering schemes of all different sizes, from the small with only a handful of members (15% of respondents' schemes had fewer than 500 members) to the very large with hundreds of thousands of members (28% of respondents' schemes had over 10,000 members).

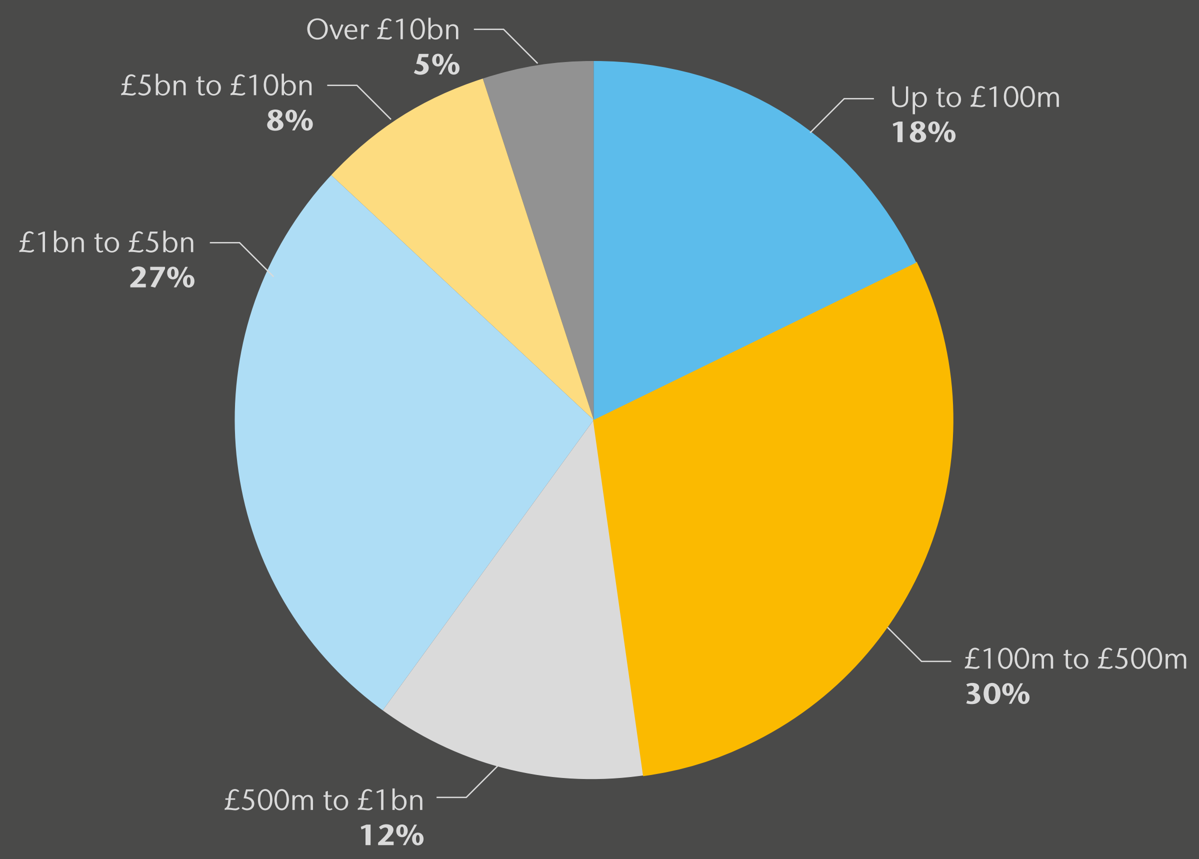
Nearly two-thirds of the survey responses came from trustees, including professional trustees. The majority of the remaining responses came from pensions managers and scheme sponsors.

The survey responses also covered a wide variety of schemes by asset size. Nearly 20% of the responses were for sub-£100m schemes, which we have defined in these results as 'small' schemes, while 40% of responses related to schemes with over £1bn of assets, which we have defined as 'large' schemes, with the remainder 'medium' sized. At various places in the survey report we have split the results by scheme size to see how industry trends are affecting schemes of different sizes.

Respondents based on number of scheme members



Respondents based on scheme asset size



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About Aon

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 xanalytics to deliver insights that reduce volatility and improve performance.

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