Portfolio Prepared?

Aon, in partnership with *portfolio institutional*, is helping to prepare decision-makers at defined benefit pension schemes to meet the challenges ahead.

Defined benefit (DB) pension schemes are living in interesting times. Many are maturing and may no longer receive contributions from the sponsoring employer, therefore rely on their investments to generate the cash needed to pay members' benefits.

Finding secure income streams at a level of risk that trustees are comfortable with is not easy. On top of this, trustees have to deal with the increasing administration and regulatory burden that they have had slapped on them in the past few years as the government seeks to avoid picking up the tab of another financial crisis.

With these issues in mind, global professional services firm Aon joined forces with *portfolio institutional* to stage 'Portfolio Prepared?' The event was designed to help DB pension schemes to plan and prepare for upcoming market challenges.

At the luxurious Victorian Bath House in the City, trustees heard presentations from speakers with decades of experience of the pensions industry. In between the speeches, attendees separated into groups to share ideas and experiences with their peers on topics such as governance, negotiating adviser fees, the employer covenant's impact on the investment strategy, and buying illiquid investments. Sion Cole, senior partner in Aon's UK investment practice, was on hosting duties.

MAKING INVESTMENT WORK FOR YOU

The first to speak was Susan Anyan, a trustee director at Capital Cranfield. Susan, who works with seven employers whose schemes are worth between £10m and £3bn, explained why pension schemes need to continually assess and evolve their strategy.

This is a hot topic. Decisions on the investment side of a scheme are probably the biggest trustees will make, especially in the current environment.

Investment is more complex than when Susan started working in the pensions industry 30 years ago. "Custody was the bottom drawer of a fireproof filing cabinet" and investment decisions were made by phoning a broker on Monday morning to ask if there was anything that they should buy or sell. Diversification was very simple: gilts, London-listed shares and perhaps some property. Swaps, derivatives and overseas shares didn't feature.

Today, trustees need to think about their scheme's life plan and where it is heading. Is it self-sufficiency or buy-out?

Susan advises trustees to focus on strategy, not management. "Don't get too hung up on the implementation," she said. "Strategic decisions make the biggest difference."

To set the right strategy for a scheme's needs, trustees have to answer a few questions. How confident and competent is your board in making decisions? How much time do you have? What is the governance budget to monitor and manage investments? What is your appetite for complexity? What is your appetite for risk? The answers to these questions will tell the board how much external support they need in order to get to where they want to be. "Choose your partners wisely because they will play an integral part in your success or failure," Susan said. Making sure that your investment consultant or fiduciary manager is closely aligned with what you are trying to achieve will be crucial here.

Do not just accept the standard commercial terms offered when hiring an investment consultant or manager, she advises. Negotiate. Many terms can be improved, including termination rights and liability caps as well as fees.

"It is about your risk appetite and what you are willing to accept," Susan added. "Make sure that you are getting the best out of the relationship."

Susan made it clear that trustees cannot adopt a "set and forget" approach to their investment strategy. "You have to revisit it and recognise that events might blow you off course."

For example, many schemes are in a good place but are now having to re-think their investment strategy because they have reached (or will soon reach) 100% funding; employer's contributions are stopping or reducing, but the scheme is not ready to buy out. "It completely changes your perspective on how to run the strategy for the portfolio," Susan said. "Now it has to throw off enough cash to pay the benefits due, which is very different from the traditional growth and matching concepts that trustees have got used to."

In other cases, affordability and employer covenant are becoming stretched and the consequences for risk and return are very challenging.

TRUSTEE EFFECTIVENESS IN DECISION MAKING

Then, Aon's governance lead Susan Hoare shared her views on how trustees can be more efficient when making decisions.

At the centre of her presentation was research conducted by Aon and behavioural specialist firm Behave London into how trustee decision-making could be improved.

This involved a focus group, facilitated by Behave London and observed by a psychologist followed by an online questionnaire. The results of the project led Aon to develop several planning, meeting and evaluation tools to help overcome biases and time pressures.

The research had three main conclusions. The first was that long-term means different things to different people. Some trustees govern schemes that have decades left to run, yet they struggle to see beyond the next three years. It also confirmed the impact that the chair's behaviour can have on a group.

Finally, a devil's advocate is a key ingredient to help trustees make better decisions. Trustees, the research found, benefit that the board were most likely to take account of a devil's advocate view if at least two people in the room held that view.

According to Aon's *Trustee Meeting Framework*, long-term strategy discussions should be at the top of the agenda. Too many meetings start where the last one finished, and as the day goes on the brain gets tired and when our brains are tired we start to make default decisions. "So it makes no sense to have the important items later on the agenda," Susan Hoare said.

"We have a tendency to focus on the short-term, a present bias," she added. "We focus on things where we are going to see a more immediate outcome. That is why we need to put the long-term strategy at the start of the meeting."

The second item in the Framework is eliminating the hard/easy effect. This is based on the theory that people typically overestimate the time needed to do hard items and underestimate how long it will take to handle the easier items.

"It is the regular items in meetings that are often taking most of the time, the things that you think that you can just rattle off," Susan said. "These are the items that are hijacking meetings and stopping us from getting to the most strategic pieces."

To help avoid this issue, Aon has established a structured process to get through the regular business by putting a time limit on it or moving it outside of the meeting.

Aon has also introduced the idea of flexi-teams, or dynamic sub-committees. Trustees, according to the research, delegate actions even when they know that the individuals chosen will not have to time to make those decisions. Instead, flexi-teams are populated by people with the skill and time to discuss and make decisions.

Aon's *Behavioural Checklist for Chairing Meetings* has been designed to make the chair more effective. The chair has a natural authority and the creators of the checklist want them to use this influence to set a tone where everyone feels free to give their views.

How the chair frames information could impact the trustees. So Aon suggests the chair frames things in a balanced way, neither negative nor positive. If the chair presents an investment proposal saying they are disappointed, it will likely generate a more negative response, and vice versa. To avoid group think, the chair should give the positives and negatives and their opinion last.

Another document Aon created to help manage meetings is *10 Questions to Challenge Your Advisers*. Susan says this was developed in response to the view that trustee boards are not challenging their advisers enough. Her experience as a scheme actuary is mixed in this area, but she believes that questioning key recommendations adds value and helps trustees reach greater comfort with the decisions they are making.

The *10 Questions* also direct boards to ask advisers for an explanation of how they reached their decision, for example, as is there a cheaper alternative that gives similar outcomes? And, also utilising a pre-mortem lens, if in 12 months time everything has gone wrong, what are the causes?

The final area Susan discussed was personality profiling. It can be powerful to understand the contribution that trustees bring individually and collectively to the board. This helps with succession planning and identifying what skills are needed to complement the existing trustees.

All of Aon's documents, frameworks and the behavioural research with Behave London can be downloaded at:
www.aon.com/trustee-effectivenessuk/

CONSIDERATIONS WHEN INVESTING IN ILLIQUID CREDIT

The conference then looked at investing in alternative assets. In the current low yield environment investment-grade bonds may not help trustees generate the returns and income their schemes require.

Aon illiquid assets specialist, Oliver Hamilton, chose to feature illiquid credit when explaining what to consider when investing in assets that are not easily traded.

He chose the asset class because it has proved popular with Aon's UK pension scheme clients, who have collectively invested around £4bn across these markets in the past five years.

Oliver said that the attractive premium over more illiquid credit markets is one reason for this popularity, often while benefiting from stronger covenants. At one end of the spectrum, you have more secure assets backed by real estate and infrastructure, while at the other you can find returns of around 10% a year from non-investment grade distressed lending and junior positions.

Before gaining exposure to the market, there are six important issues to be addressed, such as what return and income do you require, and how much risk are you willing to take?

There are pitfalls. The market is accessed through close-ended funds, which typically tend to exist for five to 12 years. Getting your remaining money out before a fund matures will be very difficult as there is a small secondary market for alternative credit, if at all. So be prepared to be in for the long run.

Trustees must also be ready to tackle the documentation, which can be complex. Legal and investment advice are a must as well as, in some cases, seeking tax advice before investing.

When you start looking at illiquid asset managers they can be small and niche firms, so you have to do your homework to make sure you are backing the right manager. Oliver believes that assessing whether or not the manager has the skill to source such debt is a good place to start and you need to be particularly mindful of operational risks if they are newly established.

Governance is a reason why trustees should seek help in running such a strategy. In Oliver's view, for some clients, a fiduciary approach will cover having to approve each decision by the manager and deal with the operational side of capital calls and distributions.

Investing in illiquid assets is attractive thanks to the premium such debt offers, but "they are not a free lunch", Oliver warns, pointing out that there are advisers with the specialist expertise needed for this market.

INTEGRATED RISK MANAGEMENT IN ACTION

Sion Cole then introduced Naomi L'Estrange, a director of 2020 Trustees, to the stage.

She called on her experience as a pensions lawyer and trustee and years spent at the Pension Protection Fund to explain the importance of integrated risk management (IRM).

"It has already been game changing in one aspect, which is how we look at investment and the covenant during the valuation and funding discussion," Naomi said. "In the past, investment tended to be tagged on afterwards."

The focus of her argument was the investment side of trustees' responsibilities. The theory is that if the covenant is weakening, a scheme can support less investment risk. "In practice, however, the position as regards to the right investment strategy is more nuanced," she said.

It is important for trustees to understand not only how weak their covenant is but how that covenant is likely to develop in different scenarios.

Value at Risk is a tool that assesses the level of risk in an investment portfolio. "A *Value at Risk* metric helps sponsors understand that this is not a one-way bet, there is real risk there," Naomi said. "It gives the trustees a sense of a pound risk on their investment risk, to test that against your covenant to see if that is affordable by your sponsor."

However, she warned that the metric has limitations and so it should not be driving everything that a trustee board does. One such issue is that it is difficult for diversification benefits to be brought to life within that metric.

Naomi then used examples of three schemes, each with a different covenant, to illustrate IRM in practice.

The first was a scheme with a moderate to weak but stable covenant. It also has a large deficit.

This is an area where the precise nature of the covenant is crucial because some covenants look worse on paper than they are in reality – so it is important to get advice.

For instance, the sponsor in the first example had large fixed-term contracts with no guarantee that they would be renewed. In practice, there is no-one else providing this type of service, so these contracts are likely to be repeated. Yet when the covenant adviser is reviewing them, they cannot put that value on it.

Or they might be in a challenging environment where you would expect the covenant to weaken over time. "So it is important for trustees to get covenant advice that allows you to judge the direction of travel of the covenant," Naomi said. "Is it likely to stay stable or is it likely to worsen?"

The second example was a scheme with a weak covenant but a moderate deficit. There is a short-term cash-flow crisis, sponsor's future is uncertain and the trustees do not know if the employer is going to be still trading in the next few months.

You don't know if they are going to be around in a month or a year. "You have to step back, take a look and ask if this will go down the tubes shortly," she said. "Or if the book looks good and you could get through the next few weeks it might be better just to sit it out."

Naomi explained that if a scheme gets over a blip like this, but the covenant is weak, then there are strategies for schemes of any size. "I have seen schemes look at synthetic equities, which allow you to increase hedging while not giving up on growth. There are 'cap and collar' strategies that limit your downside in relation to equities. Those can be considered in this type of scenario."

The third and final example is a good news story where the investment strategy saves the scheme. The sponsor was tiny compared to the size of the scheme, which it moved into fiduciary management 12 years ago. That and other good investment decisions have meant the scheme has recently been able to buy-out. "It has saved the scheme and the sponsor, because any contributions over that period might have brought it down."

So this is a situation where the strength of the covenant does not matter if you get the investment strategy right…"you can achieve fantastic outcomes, as we have with this scheme". Naomi concluded that regardless of the situation you are in, it is best to maintain decent relations with the sponsor, to have regular dialogue to avoid any surprises. "Look at your journey plan, monitor where you are in relation to it and work together towards a good solution," she said.

Actively seeking returns

Sion Cole, senior partner at Aon and chair of the event, says guests found the group discussions of great value.

KNOWLEDGE IS POWER

Exchanging ideas with your peers can be powerful, especially if you can share experiences about the decisions they have taken that have led to successful investment outcomes.

This was one of the reasons for the success of 'Portfolio Prepared?'; attendees not only benefitted from the presentations but also by being able to share and debate their views on the topics heard. We will be running similar events with new topics in the future and welcome all CIOs, FDs, pension managers and trustees to join us. As delegates, you will be able to exchange stories with other guests and discuss solutions to common challenges. We hope that you will take away new approaches and learnings to apply to your own schemes.

IT PAYS TO BE 'ACTIVE'

In addition to regular peer interaction, we believe investors can further benefit from being 'active'. This is more than just investing in active managers. It is a philosophy that should be embraced across all relevant areas of scheme management. We highlight three of these areas below.

ASSET ALLOCATION

Asset allocation decisions make a key contribution to long-term performance, so it is clearly worth being active here. This is more than managing allocations across return-seeking or matching portfolios. For investors looking to achieve consistent risk-adjusted returns, it requires actively managing allocations within asset classes and sub-strategies, based on investment opportunities and risks in the market.

We can take an example of active asset allocation within a fixed income portfolio. There was a time when corporate bonds offered particularly strong value, and therefore many UK pension schemes had high exposures to them. Fortunately at the time, yields fell significantly and this nicely boosted investor returns. Over the years, falling yields increased market uncertainty, as any subsequent rises would have been detrimental to future returns. Investors had two options – to either take the hit should yields rise, or introduce strategies such as absolute return bonds or bank loans that would help mitigate the impact of rising yields. Being active in asset allocation can allow investors to improve the consistency of returns as well as gaining potentially better outcomes overall than through strategic allocation alone.

GOVERNANCE

Governance practices have a direct effect on the decisions investors make – and being active here encompasses multiple disciplines. Running the scheme like a business with more defined accountability is a way of focusing agendas and improving decision-making. This might include creating a business plan which outlines the scheme's vision, risk/return targets and strategic views on issues such as buyout and use of illiquid assets. Clarifying why a decision has been made is also important. Challenge your providers, asking simple questions like "What are the alternatives to this recommendation and why have they been discounted?" Recognising the important role of the chair to manage the strengths, weaknesses, personalities and dynamics of the trustee board, as Aon's Susan Hoare alluded to in her presentation, can also help you to make better decisions.

RISK MANAGEMENT

Risk management processes are crucial for the safe running of any scheme portfolio. We believe investors should take a three-step active approach: Understand, Measure, Mitigate. Understanding all the areas that could cause your scheme to be in jeopardy is vital. Potential risks include market, political (eg, Brexit), funding level, operational, sponsor covenant, underlying managers and cyber (eg, loss of data). The next step is to measure the risk, and the effect it might have.

For example, how does market risk affect your asset value or funding level? Calculating the probability of those risks occurring and estimating the impact on the scheme helps to give you a sense of the size of the risk. Investors can then determine whether to run the risk or to mitigate it. Mitigating manager risk, for instance, could involve carrying out more operational due diligence – eg, testing whether the manager has the operational structure to deploy their investment capability – or supplementing your portfolio with complementary managers that will perform differently in different market environments.

HOW ACTIVE ARE YOU?

In today's low return environment, it pays to be active on all fronts. Learning from peers can be a valuable tool to help you succeed in your role. Furthermore, being 'active' within the areas of governance, risk and asset allocation can bring many benefits. How active are you in these areas? Where can you be more active and where can you challenge others to be more active on your behalf?

Sion Cole
senior partner in Aon's UK investment practice
sion.cole.2@aon.com
020 7086 9432