Aon Hewitt
Retirement and Investment

Aon Investment Research and Insights

Endgame Strategies

Cashflow Driven Investment Series

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Empower Results®

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Executive summary

As schemes become more mature, trustees and employers are increasingly looking to agree the ultimate destination of their scheme. In most circumstances this is an objective beyond 100% on a technical provisions discount rate. These goals are typically either 'buy-out' or 'self-sufficiency'.

For each of these, this paper considers:

1. **What does this objective mean?**
2. **Typical endgame portfolio objectives**
3. **Investment strategy considerations**

An overall objective

In order to determine the structure of an endgame portfolio, the overall objective of the scheme should be agreed. There is often considerable debate between trustees and employers in deciding this objective. We believe there are two main objectives trustees can decide on: buy-out or self-sufficiency. In some cases, self-sufficiency will be a step towards buy-out.

Portfolio objectives

The investment objectives will be slightly different when targeting buy-out or self-sufficiency and this will influence the asset mix.

Buy-out considerations

There are three main considerations of a buy-out investment strategy: achieve growth to achieve buy-out premium, match buy-out pricing and minimise transaction costs.

Self-sufficiency considerations

There are four main considerations of a self-sufficiency investment strategy: achieve growth to remain funded and for buffer; maximise chance of paying all pensions when they fall due; minimise funding level volatility; and finally – liquidity for flexibility.

Introduction

This paper discusses the merits of different endgame target portfolios. It is the second in a series of three papers which consider how meeting cashflows can be incorporated into wider considerations about schemes' investment strategies. The other two papers are *Cashflow Management Strategy*, which considers different strategies for cashflow management and *Cashflow Driven Investment Assets*, which considers how a portfolio of assets with relatively predictable cash flows can be constructed to target some or all of a scheme's expected payments.

What is the objective?

In order to determine the structure of an endgame portfolio, the overall objective of the scheme should be agreed. There is often considerable debate between trustees and employers in deciding this objective.

We believe there are two main objectives trustees can decide on: buy-out or self-sufficiency

1. Buy-out

Buy-out enables trustees to transfer both the scheme assets and its liabilities (for the payment of a cash premium) to an insurance company which then becomes responsible for honouring pensioner obligations as they fall due. Buy-out therefore completely removes the scheme as a company liability. This may also appeal to sponsors who feel that running a pension scheme is an unwelcome risk and distraction.

It may appeal as a result of concerns regarding the scheme's ongoing affordability to the employer and the potential for covenant strength to reduce in the future. Trustees and employers may also have concerns regarding ongoing running costs, or governance commitments and exposure to continued legislation change.

It is often the trustees' natural ultimate goal to secure the liabilities under insurance, unless they receive sufficient long-term assurance regarding the covenant. We expect most schemes to target buy-out in time, the exceptions being larger schemes where the scheme size is still manageable for the employer to retain on its balance sheet over the long term.

It is worth noting that we estimate that the direct writers of bulk annuities are able to support around £20bn of new business per annum, with recent years seeing volumes of around £9–£13bn. These volumes could change considerably, up or down, depending on market conditions, asset opportunities and insurers' business decisions. Putting this in context, UK private sector defined benefit pension liabilities are typically estimated at around £2,000bn.

Trustees may define reaching this target as being funded on a basis a little below gilts + 0% for the whole scheme, although we have seen pricing for pensioner liabilities above gilts and annuities are often bought in stages, mainly for tranches of pensioners.

Trustees should be aware that insurers typically price using swaps and spreads on the changeable mix of long-term income-bearing assets (including corporate debt) chosen to back their new annuity business. Your actuary or settlement adviser will be able to advise on prevailing pricing.

2. Self-sufficiency

Although self-sufficiency is not uniquely defined, it is generally recognised to refer to a position where the scheme is low risk, with a high chance of delivering member benefits and has a low to modest chance of calling upon the employer for additional contributions.

Self-sufficiency will appeal more to trustees of schemes with strong sponsors (both now and expected to be in the future) who want to reduce reliance on their covenant over time, but ultimately are happy to run the scheme over the long term (>50 years). Importantly, this aim will not fully remove company reliance until the final payment has been made.

It is worth noting that there are also examples of large schemes which have reached a level of self-sufficiency but have a weak or even insolvent sponsor, yet are allowed by the Pensions Regulator to be run on a self-sufficient basis.

As an example, trustees may define reaching this self-sufficiency as being funded on a basis between gilts + 0% and gilts + 1%, depending on risk tolerance and covenant strength. We expect most trustees to prefer a basis considerably below gilts + 1%. Other discounting methodologies may also be applicable as we will discuss later.

Undecided trustee

It is likely that not all trustee boards know whether self-sufficiency or buy-out is the right objective at this stage and some trustee boards may want to keep their options open. This is a reasonable position while the objective is some way off being met and often de-risking triggers can be agreed that keep both objectives open. However, the sooner the long-term objective can be agreed the more efficient the flight plan will be, enabling a more focussed investment strategy.

We would also challenge schemes targeting self-sufficiency to consider whether the target would change to buy-out once they reached the self-sufficiency target or mature further. Although there can be many similarities between the different possible endgame portfolios, changing direction can lead to transitions and trading costs, particularly when investing in long-term illiquid assets.

Endgame portfolio objectives

The investment objectives will be slightly different when targeting buy-out or self-sufficiency and this will influence the asset mix.

Typical buy-out investment objectives

1. **Achieve growth to achieve buy-out premium**, or typically to get within cheque writing distance (with the residual cost then met by employer funding when accurately known).

2. **Match buy-out pricing**.

3. **Minimise transaction costs** and timescale for transition of assets to annuity, once an annuity purchase becomes attainable.

Typical self-sufficiency investment objectives

1. **Achieve growth to remain funded on discount rate assumed**. Asset growth may also be required to build buffer for longevity, expenses and other uncertainties.

2. **Maximise chance of paying all pensions when fall due**.

3. **Minimise funding level volatility**, reducing need for employer contributions.

4. **Need for liquidity for flexibility**. For example driven by a change in Finance Director, trustee board, or a weakening covenant etc

The balancing of these objectives will drive the investment strategy that trustees target, i.e. their endgame portfolio.

Buy-out investment strategy considerations

There are considerations relating to each of the three investment objectives for a buy-out investment strategy.

1. Achieve growth to achieve buy-out premium

Investment returns are one way to reach buy-out. These should be considered alongside:

a. **Contributions**
   Including discussion with employer regarding what they consider 'cheque writing distance' and ways to avoid a trapped surplus, for example use of escrow accounts.

b. **Liability management exercises**
   Such as Enhanced Transfer Values (ETVs), Pension Increase Exchange (PIE), Flexible Retirement Options (FROs) and Trivial Commutations (TCs).

c. **Cleansing the member database and establishing a fully agreed benefit specification**
   To ensure the target is known as accurately as possible, and avoiding the funding of benefits that have in practice been discharged.

How to achieve asset growth will depend on trustees' beliefs, governance constraints, asset preferences, relative market pricing and risk tolerance. We typically favour a diversified portfolio.

Particular consideration should be given to restricting allocations to illiquid assets, when an annuity purchase becomes a near-term prospect, to ensure assets are realisable when needing to pay for annuities. The size of allocation will depend on the expected timeframe to reach the buy-out funding goal and how flexible trustees may wish to be in acting opportunistically ahead of that timeframe in response to annuity pricing opportunities for parts of the scheme.

Consideration should then be given to matching buy-out pricing and minimising transaction costs on transition of assets to the annuity provider. These aspects are discussed to the right.

2. Match buy-out pricing

There are four ways that trustees can adjust their investment strategy to reduce the risk of variations between the scheme assets and buy-out pricing. The first two are the most significant, while the latter two are second order.

a. **Interest rate and inflation risks**
   The hedging of these risks to an appropriate level is the key part of minimising funding volatility relative to annuity costs. To maximise the protection, these risks should be hedged on the buy-out, not technical provisions, basis.

b. **Growth asset risks**
   Most growth asset classes will act against hedging annuity market pricing. These allocations can be removed as the funding gets closer to the buy-out target. A flight plan with funding level triggers is one way to ensure opportunities to reduce risk are not missed.

c. **Liability hedging instrument risk**
   Insurers typically use swaps as an overlay to their asset portfolio for accurate hedging of interest rate and inflation risks, and measure pricing relative to swap yields. Pension funds typically measure value relative to gilts and are more likely to hold gilts, partly because of their better yield in recent years (around 0.2% p.a. currently for 20 year instruments). The difference in yield (known as the z spread) between similar duration gilts and swaps can be volatile, with a range of around 1% for 20 year instruments over the last 10 years. Trustees should consider the trade-off between better yield and better annuity price matching, together with liquidity (mentioned below). Gilts have other advantages in being the easiest class to transition to an annuity provider, and it is also worth noting that some insurers are able to offer a gilt based price lock, once trustees are very close to transacting (e.g. 4–6 weeks).

d. **Credit spread**
   In the past, insurers invested the majority of their assets in UK investment grade corporate bonds and so pension schemes could track pricing by investing in similar assets. It is now harder to do this because insurers invest in assets that are more diversified, and in some cases unlisted or even uniquely available to that insurer. These include more illiquid and overseas assets, and asset classes such as infrastructure debt, commercial mortgages or equity release mortgages.

Some level of tracking of the credit spread over swap yields reflected in buy-out pricing may be achieved by investing in investment grade credit as a proxy, as the annuity providers expect their other asset classes to show a material degree of correlation with credit markets over time. Trustees should consider the different ways to access credit exposure, for example:

- **Passive corporate bonds**
  Cheap and low governance way of investing in corporate bonds. However, bond indices can be quite different to the kind of assets insurers hold. For example, bond indices will likely have a higher allocation to financial bonds than insurers would have (eg 38% of iBoxx £ Corporate bond index is classified as financials, but insurers maintain a wider diversification by industry).
- **Active or segregated mandates** with clear guidelines may avoid some of the pitfalls of passive mandates.
- **Buy and maintain corporate bonds**
  Could also bring advantage of helping trustees with their cashflow management strategy, although may not necessarily be the most efficient use of assets from a risk/return perspective.
- **Credit Default Swaps (CDS)**
  Can be an efficient way to access credit spread, i.e., requires minimal initial upfront capital. Also typically cheaper to transact than physical bonds. However, brings additional complexity.

3. Minimise transaction costs

Increasingly bulk annuity transactions have largely been implemented by in specie transfers of gilts, including gilts realised from LDI portfolios, and from cash payments from realising other scheme assets.

Some credit assets may be transferred in-specie and retained by the insurer but this depends on the stocks meeting the specific requirements of the individual insurer the trustees have chosen, and (particularly where credit is held in a managed fund) on the support of the scheme asset manager. There is no guarantee an insurer will take credit assets in-specie.

An insurer may welcome transfer of other long-term income-bearing assets that deliver a favourable yield and meet its governance requirements. In practice, insurers' demand for assets is heavily influenced by their capital requirements, preferring assets which are favourably treated for capital, such as a direct holding in high-priority infrastructure debt. As a consequence these assets are often relatively highly priced and so unlikely to be held by pension schemes.

Trustees should be aware of transaction costs and liquidity of their assets and have a plan to run down less liquid asset holdings as the time to buy-out approaches. For example, transaction costs for corporate bonds can be high and variable, e.g. bid-offer spreads of around 0.7% for sterling corporate bonds.

It is also worth noting swaps can be difficult to transfer to an insurer due to their bespoke nature.

Self-sufficiency investment strategy considerations

There are considerations relating to each of the four investment objectives for a self-sufficiency investment strategy.

1. Achieve growth to remain funded and for buffer

The level of growth required will depend on the discount rate at that point, i.e. minimum return required to stay 100% funded, and the buffer required.

Assets chosen will depend on trustees' beliefs, governance constraints, asset preferences, relative market pricing and risk tolerance. Given the long-term investment horizon trustees can consider a broad range of asset classes including more illiquid asset classes which can provide better risk adjusted returns compared with more liquid equivalents.

The trustees are also likely to take account of the employer's views given the level of covenant support being offered. Trustees may also take into consideration the employer's desire to avoid a trapped surplus, for example by using escrow.

When the self-sufficiency funding target is met, it will still need review and adjustments to the asset holdings over time. This is because any set of cashflows are ultimately an estimate of true emerging costs, and depend on assumptions that will need refinement in light of experience.

As such, trustees may move from the traditional growth versus liability matching split of assets to looking at the asset pool as a whole and meeting pension payments as they fall due will become the key priority.

2. Maximise chance of paying all pensions when fall due

Trustees should have a clear cashflow management strategy, as discussed in our paper of the same name.

> The long-term strong covenant and therefore long-term investment time horizon and focus on self-sufficiency, rather than buy-out, could enable trustees to invest more in 'secure income' assets including more illiquid and higher yielding assets.

See *Cashflow Driven Investment Assets* paper for more information.

3. Minimise funding level volatility

The level of risk within the endgame portfolio should reflect the level of risk trustees deem acceptable given the long-term covenant of the sponsor.

Trustees should continue to monitor these risks as part of their integrated risk management framework.

As part of this we would expect the investment strategy to influence the discount rate used by the Scheme Actuary to discount the liabilities, for example for the triennial technical provisions. As such, it is useful for trustees to have an understanding of the likely approaches taken by actuaries based on different investment strategies. There are differences in approach between actuaries, so it is important to engage with the actuary on the approach. The below table sets out three example investment objectives and portfolios together with what could be a suitable discount rate.

Regardless of funding discount rate, we encourage trustees to build understanding of their investment strategy by considering it through multiple lenses including beliefs, economic scenarios and risk breakdown. For example, cashflow driven investment (CDI) portfolios typically have a high allocation to credit risk. However asset risk, for example as measured by Value at Risk, may appear low when viewed relative to a CDI discount rate compared to a gilts discount rate.

4. Liquidity and flexibility

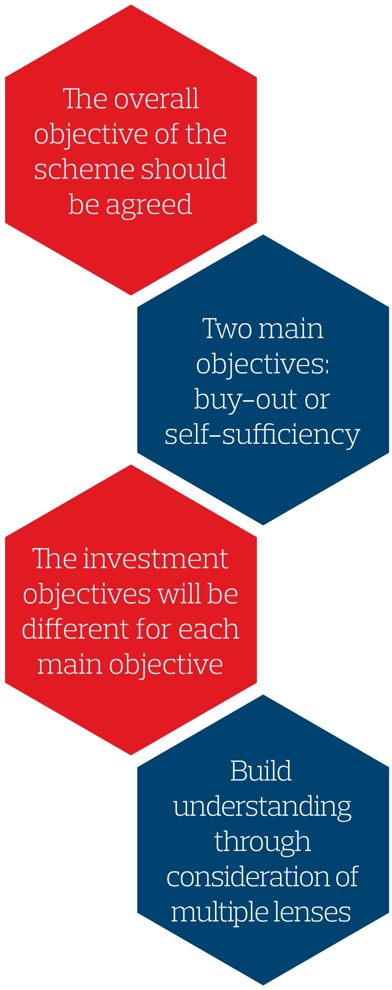
Trustees should be aware of the liquidity and opportunity cost when deciding how much to allocate to illiquid assets or assets which are expensive to trade. For example, even if targeting self-sufficiency how much do trustees wish to take advantage of partial buy-ins when pricing is attractive?

Investment objective	Example investment portfolio	Discount rate
Gilts (or swaps) plus a fixed margin. For example, strategy targeting gilts plus 0.5% and unlikely to be above gilts plus 1%.	Majority of assets gilt (or swaps) based LDI, with a diversified portfolio of growth assets to achieve the additional return. LDI hedging close to 100% of exposure to interest rates and inflation.	Gilt (or swaps) plus a fixed amount, which is less than the target return. For example gilts plus 0.25%. Expected return minus a margin may also be acceptable.
Meet cash flows as they fall due.	Large amount of credit assets, including long illiquid credit, which are intended to be held to maturity. See CDI assets paper for more information. Remainder in LDI to ensure full hedging (particularly to cover very long liabilities and inflation linkage).	Yield on portfolio less an appropriate prudence margin for default and reinvestment risk. Note the prudence margin may need to be increased if credit spreads increase dramatically, to ensure it is adequate to cover the heightened default risk.
Mixed approach that aims to meet cash flows and also to achieve some target return (which may not be a fixed amount over gilts).	Some CDI assets plus a small diversified portfolio of growth assets with the remainder in LDI.	Either gilts plus or yield minus may be appropriate, although in either case the plus or the minus may need to be varied at future valuations to take account of conditions at that time. A stochastic valuation that gives a high probability of being able to pay benefits may also be an appropriate check.

Conclusion

As schemes mature it becomes more important for trustees to decide a long-term objective and to understand the different possible endgame portfolios that may be suitable for them.

Deciding which endgame portfolio is appropriate will depend on the priority given to different investment objectives. For example, for trustees aiming for buy-out and close to transacting, the balance between matching buy-out pricing and minimising transaction costs will be important. For self-sufficiency, trustees may wish to consider a strategy with a high allocation to CDI – see the third paper in this series for more information.



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