

Investment strategies for pension schemes: a focus on returns

Q&A with Aon investment experts



Maximising returns is one of the responsibilities of pension scheme trustees. How can they best achieve this in a risk-controlled way? How can trustees maximise their own effectiveness, and that of their investment portfolio, to deliver the best returns for their scheme?

By **Sonia Gogna**, Principal and **Daniel Peters**, Partner – Global Investment Practice, Aon

Here, two members of Aon's investment team, Daniel Peters and Sonia Gogna, answer questions on all aspects of returns.

1. Funding levels are improving due to a combination of mortality improvements, interest rates and pension risk transfer exercises. How much more return do schemes need to achieve their objectives, and where should they be looking for this return?

DP Daniel Peters:

This is a key question within pension scheme investment at the moment. The actual amount each scheme needs will obviously differ in every case. For all schemes, the most important issue is the need to regularly reassess what their scheme requires. A lot has changed over the

last 12 months in terms of the investment landscape; leaving strategic investment decisions for the three-yearly review is no longer sufficient.

SG Sonia Gogna:

We expect volatility to increase as macro environments change globally and central bank monetary tightening picks up pace. Regardless of whether a scheme's eventual objective is self-sufficiency or buyout, ultimately consistent asset returns above liabilities will be needed to reach its goal.

These returns will be harnessed from asset classes which are genuinely uncorrelated or less correlated to the traditional asset classes like simple equities and LDI bonds. Factor-based equities, customised liquid alternatives, bespoke illiquids, and interesting complements

in fixed income will be key to diversified robust portfolio construction.

2. What should schemes be avoiding in their search for returns?

DP

Firstly, trustees should avoid investing in anything where they do not have a sufficient understanding of the key elements of the investment. Trustees also need to make sure they are clear on their beliefs and avoid taking any investment management approach that is not consistent with them. Many schemes are realising that they cannot realistically make all the increasingly complex decisions required of them, so are turning to delegation in order to get expert day-to-day portfolio management.

SG

Schemes cannot expect that current 'buy and hold' strategies will be sufficient to navigate the increased levels of volatility we are likely to see in the future. Active management can reap significant dividends, as can capacity-constrained bespoke real estate deals. However, schemes should be aware; we find that many managers behave like passive managers while charging active fees. This is where a combination of factor-based equities and active managers can help. This can provide the expertise needed to build portfolios that deliver both returns and cost efficiency.

3. How do trustees deal with more complex investments, such as LDI, being introduced?

DP

Firstly, trustees need to work out how much they need to understand; how much they can delegate with oversight; and how much they can rely on advisers. Schemes need to recognise the potential trade-offs and impacts of the choices they make here. For instance, many schemes fear losing some control when they delegate. In fact, respondents to our fiduciary management surveys who have delegated their investment repeatedly say that the loss of control is not a major issue in practice.

SG

When working with schemes, we treat each trustee group as a unique entity, with its own governance budget and skill composition.

We typically work with clients in two ways. The first priority is to establish that the rationale for adding a complex asset class is justified in the context of the total portfolio and the trustees' long-term investment strategy. When it comes to adding the complex asset class, the approach will depend on each individual trustee committee's aims and preferences; we do not push the scheme into taking any particular implementation route.

We can provide a training programme for the board, and work closely with them to select managers, or we can work with the client to introduce a specialist fiduciary manager. The fiduciary manager will

take over the day-to-day management of a complex asset class, but regularly check with the trustee body to ensure the portfolio is being managed and is delivering in line with the objectives the trustee has stipulated upfront.

The latter approach is more time-efficient from the trustee's perspective, and the portfolio is likely to be better managed under a full-time portfolio manager's monitoring.

4. Some of these new investment solutions tend to be illiquid. Can schemes tolerate this?

DP

Yes, in general. It requires a lot of visibility on scheme cashflow needs, so it is important to map this out and understand how it may change with the scheme or employer's strategic direction.

SG

As long-term investors, pension funds by definition are long illiquidity. So yes, if they are structured in a sensible way, i.e. in relation to the liabilities, illiquid investments can be a very sensible way of introducing diversification, return and income. We work with a number of clients on stress testing and setting our frameworks for liquidity needs, which duly impact when, and how much, a pension fund should allocate to illiquids. Clearly, if a scheme has certain objectives, such as targeting buyout within

five years, this will lower their tolerance for illiquidity.

5. How do trustees decide which way of accessing returns is best for them?

DP

This goes back to the scheme's beliefs. What skill set does the trustee board bring, and what do they want to buy in from outside? The best scheme decisions make use of everyone's expertise and experience alongside the combined diverse opinions of the board members, which creates valid challenge and debate.

SG

There is no single answer here. The governance budget is a large determinant, as is a desire to focus time on key strategic decisions, rather than tasks like manager selection. If schemes want to use complex investments like hedge funds or illiquids, these are prime areas where outsourcing portfolio construction and manager selection to advisors or fiduciary managers can pay dividends.

6. How much risk should a fund manager be allowed to take to access returns?

DP

I believe the risk should be commensurate with the asset class and its role in the scheme portfolio. This question also

links to beliefs again, and so the answer will be different for each scheme. Every trustee board should be clear on the amount of risk it is comfortable with.

SG

This very much depends on the scheme's objectives and direction. It is worth remembering that risk can be manifested in a number of ways; it is not just about financial return. Schemes might also want to consider the operational risk in managing an illiquid portfolio, or the risk posed by sub optimal due diligence, when they take on responsibility for ongoing manager monitoring.

7. How much should portfolios be able to adapt to allow for global market changes?

DP

A good process to follow here is: review, check, evolve. While portfolios do not need regular radical change, they do need to evolve in line with market dynamics. Implementation needs to be sensible, with decisions underpinned by an awareness of markets.

SG

Having a nimble and dynamic portfolio that can react immediately to global events or market disruption is crucial. Many periods of good returns can be eroded by one big, dramatic, unexpected

drawdown, and it can take many years to recover the loss back to the initial position. The liabilities, in tandem, may continue increasing.

Schemes need a governance framework which enables investment decisions and implementation to occur in good time. Fiduciary management and flight planning with triggers are two different ways of setting up an intelligent decision making framework; the investment consultant or personal portfolio manager can make quick decisions, while staying in line with the trustees' long term strategy, return hurdle or risk limit.

8. What can schemes do to capitalise on funding level improvement?

DP

Schemes should regularly reassess their position so they know when funding levels have improved enough to make change desirable. Once they have sufficient funding, there is a range of options available: they could consider de-risking, via any of the pension risk transfer options available, or may want to sell out of expensive markets.

SG

Schemes should look at their long term journey plans and, if progress is ahead of schedule, reassess their asset allocation. This may involve a risk settlement exercise or simply cashing in and de-risking the scheme to move into 'maintenance mode'. What is key, is to be able to act quickly before any gains are reversed.

9. How can trustees react quickly enough to changes affecting their portfolio?

DP

This comes back to the need for trustees to understand their skill set and gaps, and the need to engage external expertise where they identify shortfalls. Schemes need to recognise what they can realistically do themselves, and where outside experts can help to make portfolios more agile. The governance of any approach chosen should be in line with the scheme's objectives and beliefs.

SG

As for the earlier question about market changes, a dynamic and agile portfolio is essential here, and drawing on external expertise can definitely help. Schemes need

to ensure they are structured to manage the governance and work involved in whatever approach they choose. We work with clients which operate along the full spectrum, from full delegation to a highly dynamic partnership model.

10. How can trustees and their advisers tell if they are doing a good job on returns?

DP

Schemes need to have a clear plan, and be regularly reviewed to make sure it is being followed. Both trustees and advisers should sense-check actions against the plan on a regular basis. Sometimes larger strategic decisions can be a casualty of busy meeting agendas. Make sure your meetings are structured to ensure strategic direction is addressed alongside tactical action points.

SG

Measuring managers is easier than monitoring a trustee board or an advisor because for boards and advisers, the opportunity cost of an alternative route is not easily quantified.

Schemes also need to remember that the returns angle is only one lens; effective risk management is also key.

We work with clients in a number of ways to measure all the relevant metrics, and have noticed that more and more are keen to assess their governance practices. Many trustee chairs and boards are looking for ways to create better governance processes.

11. How can trustees work together effectively?

DP

Again, having an understanding of what everyone brings to the trustee board is crucial. Respecting others and having sufficient diversity on the board for well-rounded decisions is essential.

SG

By understanding each other, and recognising the behavioural tendencies that may hinder good working practices or decisions. Running meetings effectively, and making sure they are chaired well, so that everyone has a share of voice; all of these things can help trustee boards make the most of their diversity and come to informed conclusions.