Reaching the end

Lucy Barron looks at minimising risk and maximising flexibility for scheme endgames

No aspect of investment has been left untouched by the Covid-19 pandemic, and pension scheme endgame strategies are no exception. Whether schemes are aiming for self-sufficiency, considering buy-ins, looking at commercial consolidators or are on a longer-term path to buyout, the past few months will have required close scrutiny of investment strategies.

Overall, the Covid-19 crisis has made trustees only too aware of the impact of any risks they are running in their portfolio. It has also heightened the need to be able to see and act on opportunities as pricing changes quickly.

In March, we saw credit spreads widen significantly, alongside dramatic falls in equity markets. As UK bulk annuity pricing is largely dependent on the cost of buying corporate bonds, that presented a golden pricing opportunity for transacting buy-ins and buyouts. Schemes with flexible investment strategies that were ready to act therefore had an opportunity to secure insurance at very attractive levels. Schemes that were further away from buyout were able to buy credit more cheaply to reduce pricing volatility for future insurance transactions.

As markets continue to be volatile, minimising risk and maximising flexibility will give trustees the best opportunities as they work towards their scheme endgame.

Minimise risk

There is always great debate about whether schemes should invest like insurers if they are aiming for buyout. While it is an interesting debate, it is almost impossible to put into practice. While schemes need to generate high levels of investment returns to close the gap to insurer (or consolidator) pricing, it is typically most appropriate to have a diversified investment strategy that generates the required return with the lowest level of investment risk. Schemes also have to contend with the fact that all insurers will have different strategies using a wide range of fixed income and illiquid assets. In addition, the assets that are attractive to insurers at any one time will depend on factors such as the transaction size, capital requirements and asset pricing.

That said, trustees can prepare by minimising investment risk versus insurer pricing. Having a high level of interest rate and inflation hedging will mean a scheme is well-positioned versus insurer pricing and, where gilts are held, to provide liquidity and transferability alongside cash. Holding credit is also likely to provide some protection against insurer pricing moves and is often an attractive asset for any insurer. On the other hand, holding assets that will not move in line with insurer pricing, such as equities, needs careful consideration. Schemes have to be sure that they still need to hold them and that the growth they provide will get trustees closer to buyout and not increase risk as they move closer to a transaction.

There may also be other assets that insurers will take in certain circumstances, including for larger transactions some illiquid credit assets. One approach that can lower the risk of volatility close to transaction, is to agree a price lock in advance with the trustees' chosen insurer that will move in line with the scheme's actual gilt and corporate bond assets and will be used to pay the premium.

Maximise flexibility

One of the biggest investment strategy lessons from the crisis is the need for trustees to ensure that the asset strategy is robust, flexible and tailored towards their 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. If sponsor contributions stop – as they have done for some schemes in recent months – the trustees still need to be able to cover the scheme's outflows.

Schemes that are aiming for buyout also require a clear picture of what success looks like, and the time frame in which the trustees might want to transact. The investment strategy must be sufficiently flexible to achieve that while also being able to take advantage of opportunities to act earlier if they arise. For example, investing in illiquid assets with a five-year lock-in period will become a roadblock if trustees suddenly find they might have been able to transact a buyout after three.

The Pensions Regulator's recent guidance on scheme consolidators has also given trustees another low-risk destination for their scheme. While it is early days, a lot of the same principles apply to preparing assets for a consolidator as they do for buyout. Minimising risk and maximising flexibility are again crucial here.

In terms of the settlement market, the expectation is that there will be fewer buy-in and buyout transactions completed in 2020 than the c£44 billion of transactions completed in 2019. That might mean in the second half of 2020 and early 2021 there is better pricing on offer from insurers as they look to achieve volume targets. But this will be for the schemes that are prepared from an investment, as well as a wider data, benefits and governance, perspective.

Written by Aon partner, Lucy Barron

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