Global Pension Risk Survey 2019

UK Survey Findings

Investment strategy considerations

Empower Results®

Introduction

Welcome to the 2019 Global Pension Risk Survey findings concerning investment strategy. These findings form part of our overall 2019 survey of UK defined benefit (DB) pension schemes.

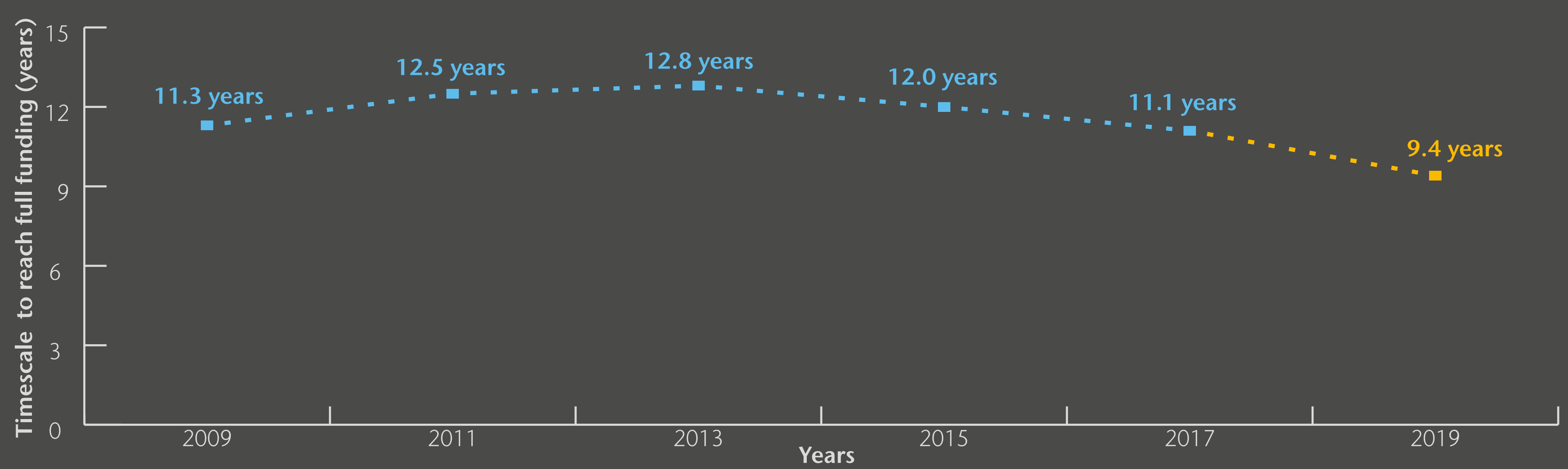
We carry out the Global Pension Risk Survey every two years, and looking back over the last decade, we can see how the pensions landscape has developed. Ten years ago, schemes were dealing with the fallout from the global financial crisis, and over the following years, increasing numbers of schemes closed 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, initially, 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.

Maturity is a key theme of this survey, as it is of many of The Pensions Regulator (TPR)'s recent statements, including the 2019 Annual Funding Statement. As many schemes see significant amounts of liabilities transferring out, they are maturing rapidly, and decisions around long-term targets, management of liabilities, investment strategy and approaches to hedging longevity risk have come more sharply into focus. Even open and less mature schemes will be affected by these changes as well as by the pressure from TPR to have a long-term target. There are also new issues for schemes to confront in 2019, including cyber risk and (finally) dealing with GMP equalisation after 2018's Lloyds Bank court case ruling.

In this set of findings, we look in detail at how schemes have set their investment strategies. The survey findings relating to the other subject areas in the survey are available separately.

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



Unless otherwise indicated, all sources are the Global Pension Risk Survey 2019.

Survey demographics at a glance

170 UK respondents to the 2019 survey

15% of respondent schemes had fewer than **500 members**

28% of respondent schemes had over **10,000 members**

Wide range of asset sizes covered.
From sub-£100m to over £1bn of assets

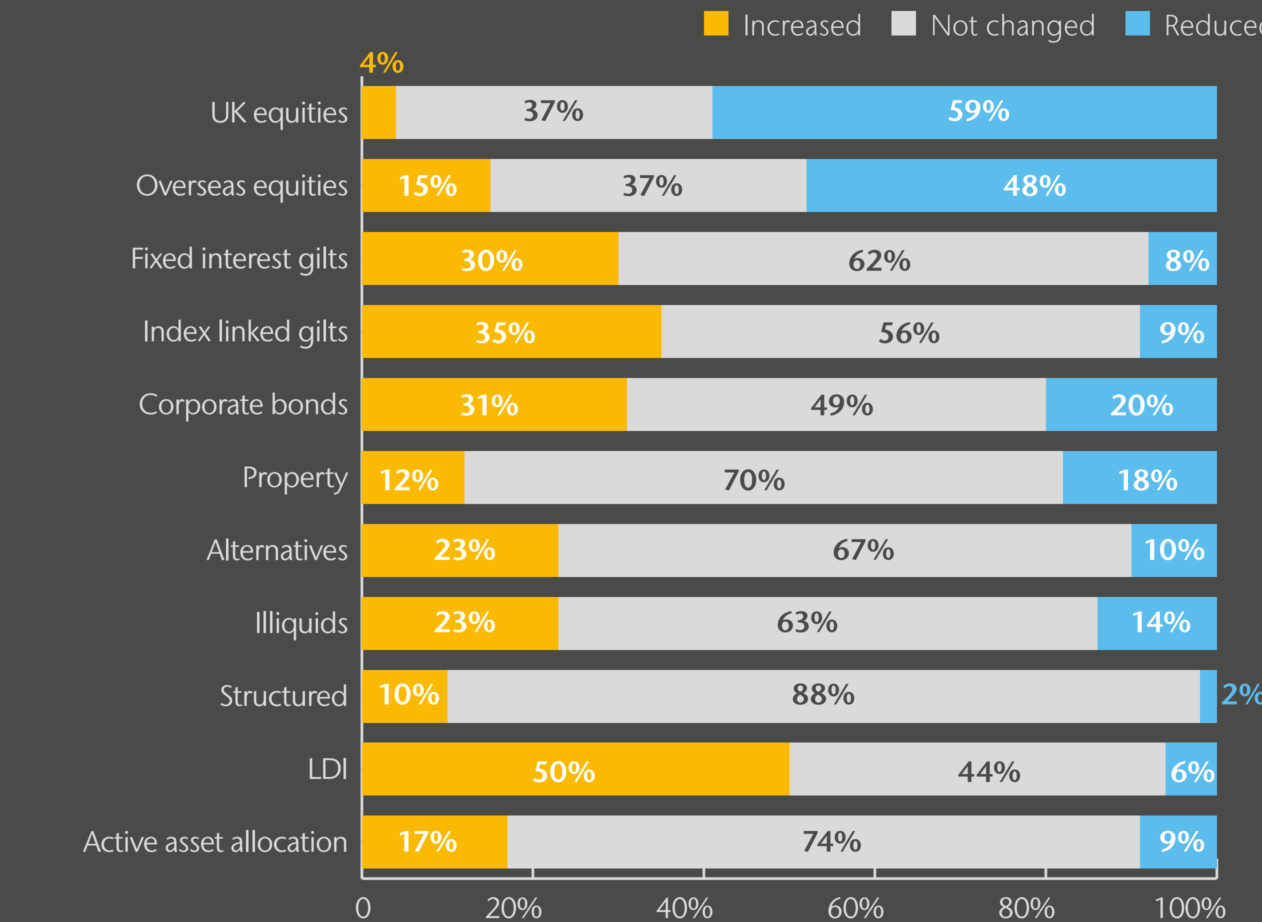
Nearly 2/3 of responses came from trustees

Investment strategy considerations

The themes of maturing pension schemes and reducing time to reach long-term targets are also reflected in the investment strategy responses.

The primary trend is the continuation in de-risking initiatives on the back of improved funding positions. This has been partly driven by the strong equity market performance, with schemes looking to reduce equity market risk and increase hedging levels. Additionally, it is noticeable that a number of schemes are looking for a better understanding of their future cashflow needs and to identify asset classes — including less liquid structures — that could help meet those requirements.

Actual investment changes over last 12 months



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 a third).

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%).

Key findings

Clear allocation reduction in riskier asset classes

Allocation increase in risk-reducing assets

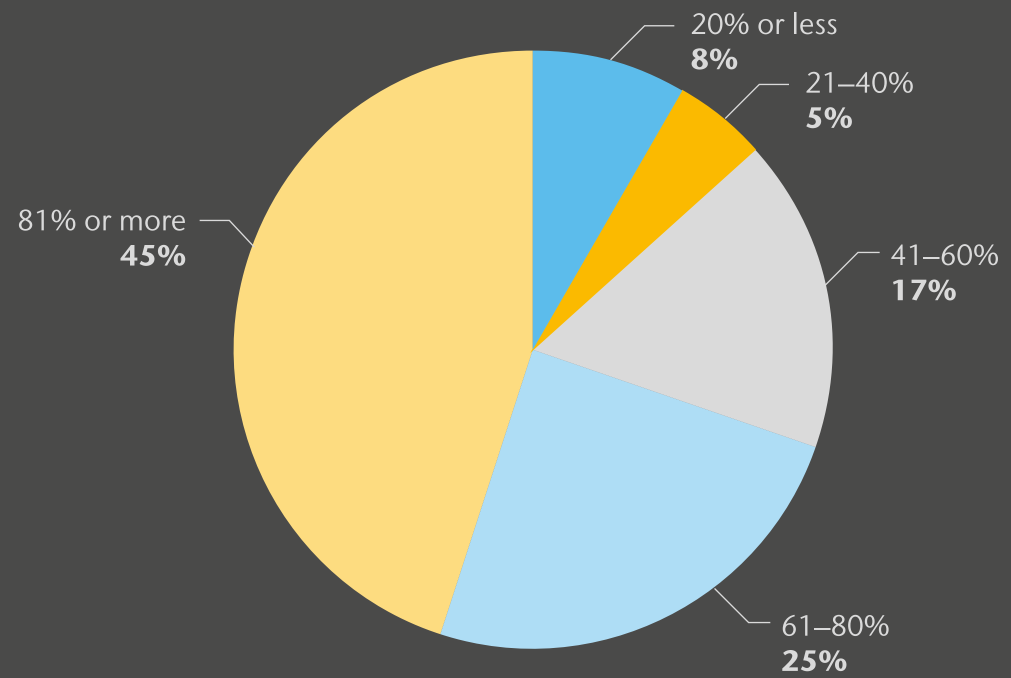
45% of respondents are hedging **over 80% of interest rate risk**

A rise from less than 30% in 2017

Almost **2/3** delegate manager monitoring to their advisers

Around **1/4** delegate full fiduciary mandates

Interest rate hedging ratios



Aon insight

We have long been advocates of pension schemes looking to hedge liability risks, where affordable, and it is encouraging to observe that more respondents have reduced their liability risks. We view exposure to interest rate risk as a significant and often unrewarded risk, and a scheme's risk budget is often better 'spent' elsewhere within a diversified portfolio of growth assets to help generate returns.

Where clients have taken this advice, they 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 of these clients are now in a position where their endgame is now within reach.

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.

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 very similar.

Success story

A pension scheme was looking to de-risk its return-seeking portfolio by reducing its allocation to equities following funding level improvements.

Aon worked with the scheme to design a portfolio of cashflow-generative assets to replace their equity portfolio. A new portfolio of mainly illiquid assets, with allocations to direct lending, property debt and infrastructure was put in place and was designed to:

1. De-risk the scheme's assets while maintaining sufficient expected return to meet the trustee's long-term objectives
2. Increase cashflow income, which could be used to meet benefit payments and expenses
3. Take advantage of illiquid investment opportunities which were attractive from a risk/return perspective

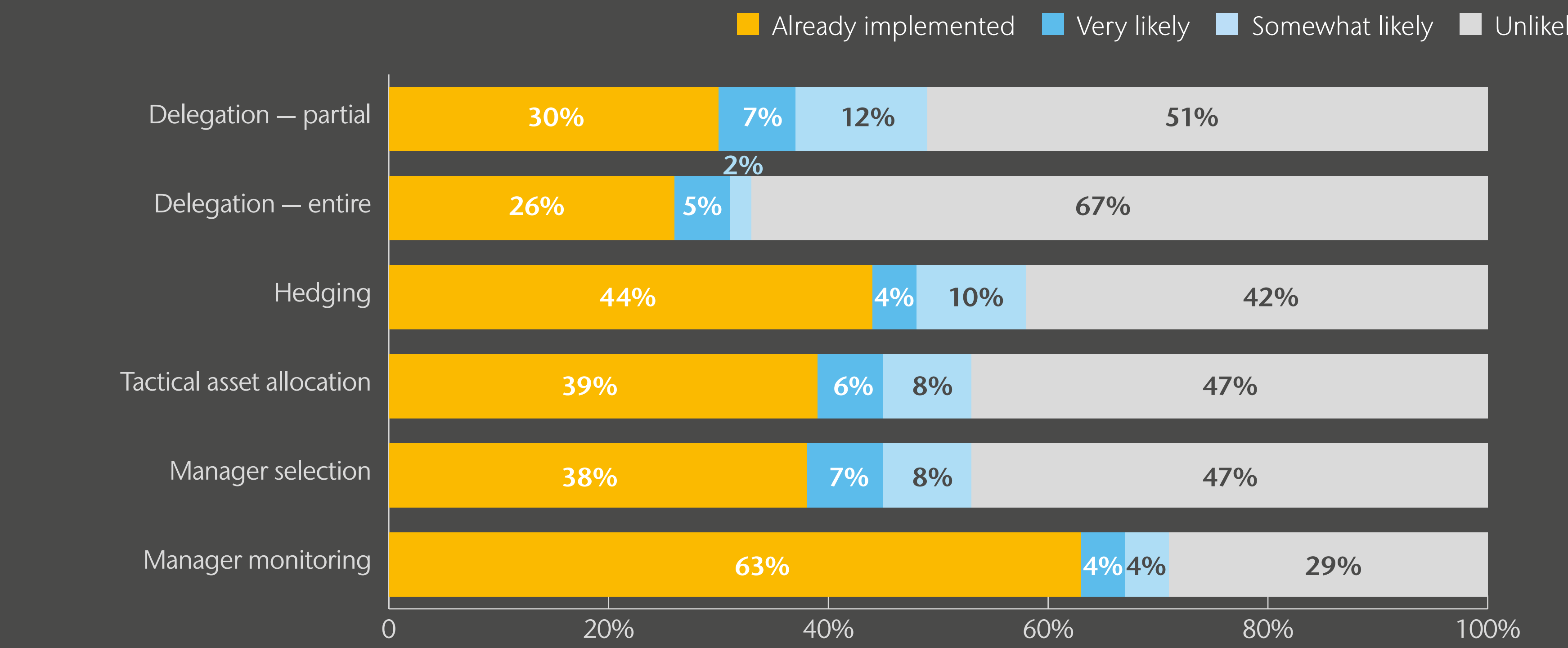
We ensured that the expected income from the new return-seeking portfolio would be sufficient to meet a majority of the scheme's expected cashflow needs. The new portfolio is projected to be more efficient and a greater proportion of the scheme's cashflows are expected to be met through the asset income.

The survey also asked schemes which elements of their investment strategy and implementation they had delegated or planned to in future.

We continue to see many schemes looking to delegate certain functions to their advisers. These tasks range from manager monitoring (with almost two-thirds of respondents delegating this responsibility) right through to full fiduciary mandates (around one quarter of respondents).

The number of schemes looking to implement a partial fiduciary mandate over the next 12 months is significantly higher than those looking to implement a full mandate.

Attitudes toward delegation



Aon insight

The demands on pension scheme trustees and sponsoring employers continue to grow due to the ever-increasing level of regulatory requirements, the range and complexity of options and time required to agree solutions.

Attitudes towards delegation continue to evolve, with more respondents open to delegating manager selection and monitoring responsibilities to their adviser. This is a trend that we have seen with our clients and one we expect to continue.

We are not surprised that the results indicate a reduction in the level of activity taking place earlier in the year. We observed this trend at the time and it appears to be linked to the Competitions and Markets Authority (CMA) review of the industry which took place over the past couple of years.

Interestingly, we have seen a noticeable uptick in activity over the months since the CMA findings were published and we expect to see many schemes continue to assess the relative merits of fiduciary management as a way of implementing their strategies in the future.

Also linked to the CMA review, we expect the role of third-party evaluators and professional trustees in assisting in the decision-making process to become more important.

Investment strategy considerations

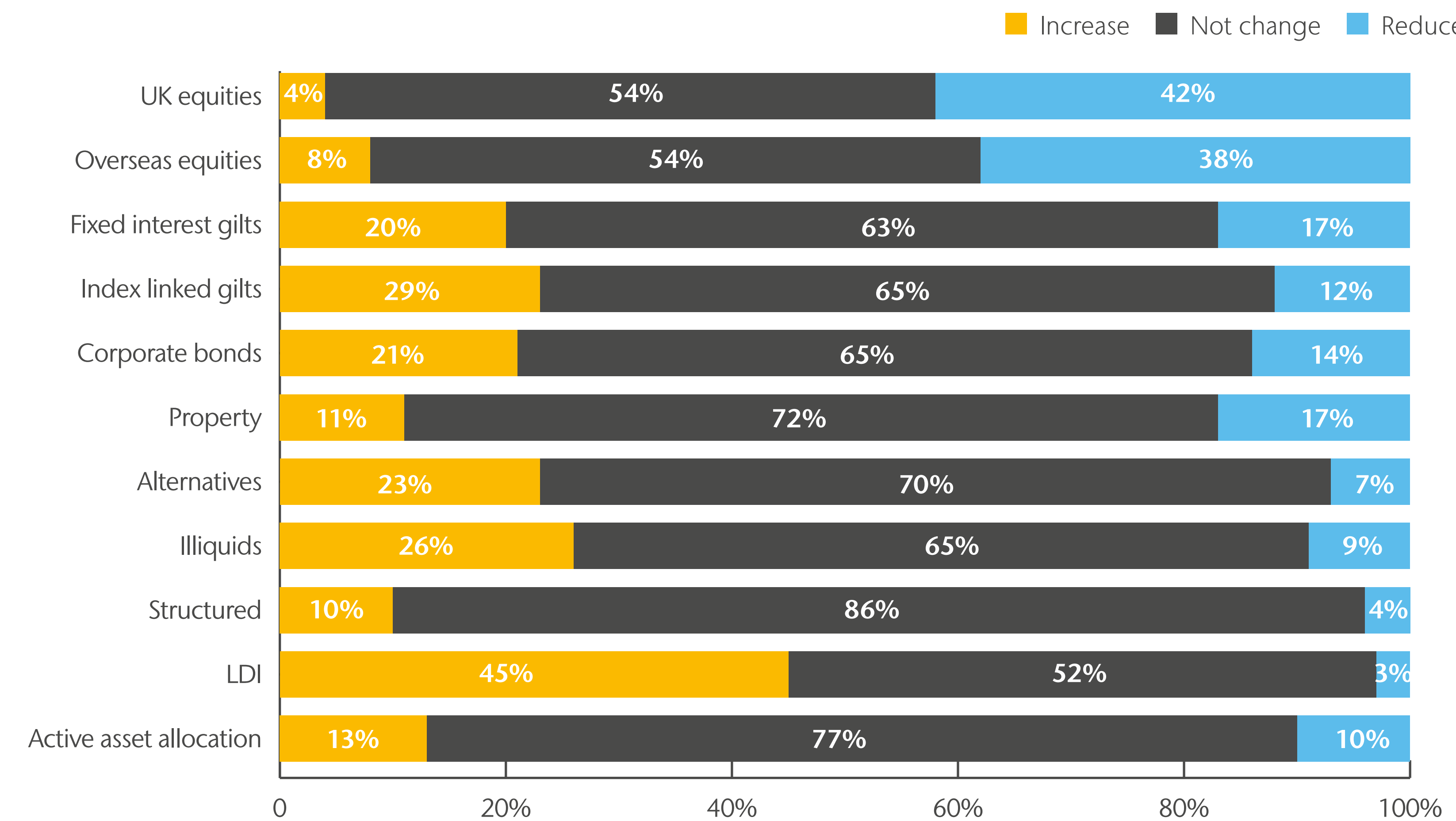
In more depth

In more depth

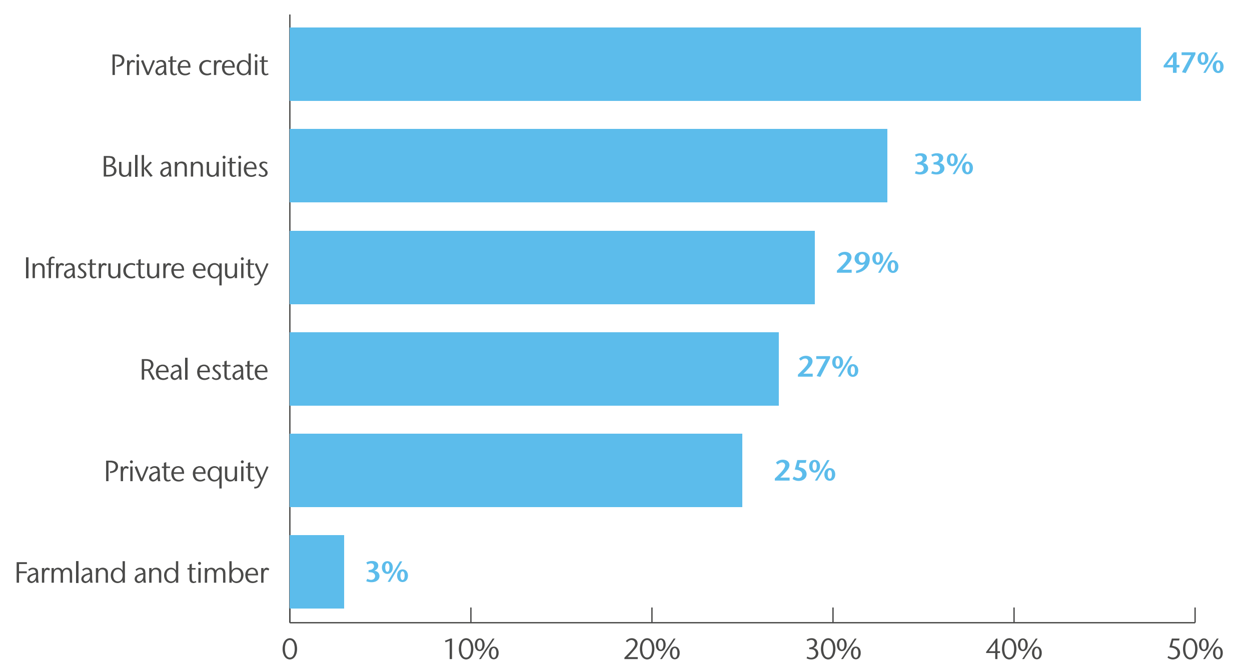
We have discussed the actions taken by respondents over the past 12 months in terms of asset allocation, and the de-risking trend looks set to continue.

Around 40% of respondents anticipate reducing their equity allocations further over the next 12 months, with LDI again expected to be the asset class with the highest increases. With a large amount of activity planned over the next year, cost of change is going to be important and having full transparency will be key.

Expected investment changes over next 12 months



Anticipated investments in illiquids



In terms of anticipated increases across illiquid asset classes, it is interesting to note where respondents are expecting to increase exposures.

Around one-third of respondents anticipate purchases in bulk annuities, again reflecting the increasing maturity and funding level of pension schemes in general (and a trend that we discuss in the next section of this survey).

We also see interest across a range of different illiquid asset classes, ranging from asset classes such as infrastructure with 20- to 25-year time horizons through to more cashflow-generative private debt type approaches.

Aon insight

We continue to see great interest in less liquid asset classes, as pension schemes look to investment ideas which can provide diversification from more traditional markets, but are also able to provide predictable levels of income — a feature increasingly important as schemes reach full funding on their Technical Provisions.

In particular, approaches such as real estate debt, direct lending and bank capital relief have been implemented by our clients.

The key advantage of investing in these asset classes is the income generation offered. Returns are predominantly driven by income with security offered by asset backed/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.

It is worth noting that there has been a huge interest in these areas over recent years and this 'overcrowding' means that a robust approach to manager and fund selection is vital.

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