Adding value through investment solutions

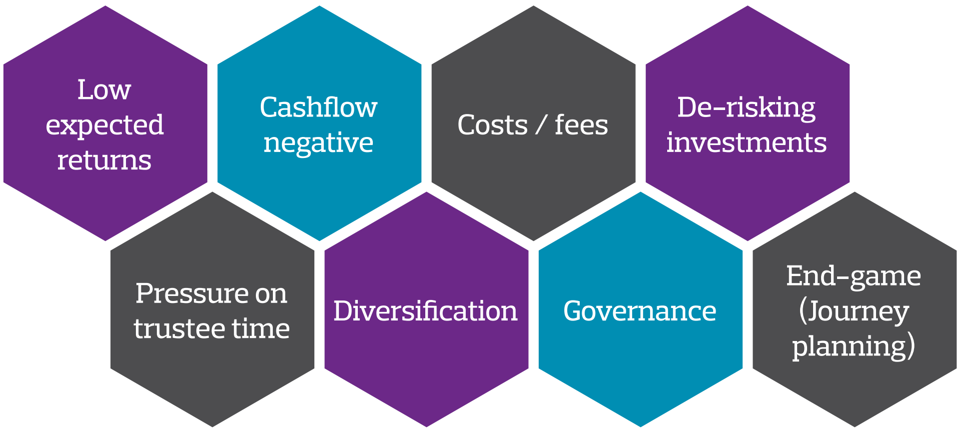
Empower Results®

Table of contents

Introduction

It seems we say this every year but the combination of challenges and pressures facing pension schemes today really has never been so great. From lower expected returns impacting funding levels, to getting the right level of diversification to help smooth returns. How best to de-risk the scheme and make progress towards the desired end-game is another on-going challenge trustees face. Not to mention the increasing pressure on trustees to make timely investment decisions in the volatile environment.

Some of the challenges facing DB schemes



How can pension schemes tackle some of these issues? We will look at three different combinations of challenges and provide insight into how schemes can address these through a range of investment solutions.

1. Diversification and low governance

Many trustees have been searching for more consistent returns through portfolio diversification, but do not have the governance structure in place to achieve this in a more ‘active’ way by investing across multiple managers. They want to achieve this with low governance. Traditionally, schemes have overcome this challenge by investing in DGFs. These products have seen huge growth in the past decade; the market has grown from around £2bn* in 2006 to around £250bn* at its peak in 2017. This has been from both DB and DC schemes.

Benefits

By the very nature of these products, they give schemes access to a wide range of asset classes and investments meaning they provide the broad diversification needed. Further, given the increasing pressure on trustee time, the low governance aspect of this approach can bring real benefits to schemes. It also enables smaller schemes access to investments that would otherwise not be possible due to minimum investment sizes.

Challenges

Despite these benefits and their huge growth, DGFs have been subject to much criticism in recent years. The performance delivered has generally been disappointing and not what schemes thought they would get. Are investors really getting value for money?

We believe the best solution involves active asset allocation and diversified investment across a range of active, best in class managers/products. We believe that the level of diversification in many DGFs is lower than anticipated. Our analysis suggests that the majority of returns can be explained by exposure to equities and traditional bond markets. In addition, we do not believe that any single manager can be good at asset allocation, portfolio construction and across all investments. Many DGF managers are generalist managers and large elements of their portfolios are made up of ‘in-house’ products. In the current low return environment, and with the heightened volatility being faced, trustees should look to invest in solutions that seek out strategies that offer a diverse range of best in class return drivers. On top of this, many DGFs have high fees (up to 0.8% in some instances), making them poor value for money given the historical returns.

*Source: eVestment

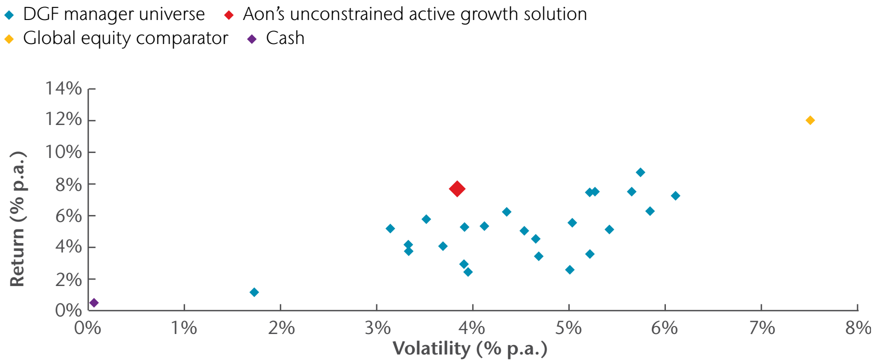
Recap: what are DGFs?

Diversified Growth Funds (DGFs) are single pooled funds that invest across a wide array of asset classes, changing their asset allocation in anticipation of, or in response to, changing market conditions. There are a number of different approaches but their broad aim is to produce returns above inflation or cash (over a period of three to five years) with lower volatility than equities. They have typically quoted targeted returns around LIBOR +4% upwards or “equity-like returns”.

The chart to the right shows the performance of the DGF manager universe (represented by the blue diamonds) over the last five years. Compared to equities (represented by the orange diamond), DGF's have delivered lower returns, albeit with lower volatility. A solution that accesses both active asset allocation and best in class managers (represented by the red diamond) has achieved better outcomes over this period.

Aon's unconstrained active growth solution vs DGF manager universe

5-year performance versus volatility



Source: Aon, eVestment. Date: 30 September 2018. Returns in GBP. Buy rated manager returns are gross of management fees. Aon unconstrained growth strategy returns are net of underlying manager fees and gross of Aon fees. Some managers have been excluded as they do not have a 5-year track record. Past performance is not a guide to future returns.

Alternative solutions

While DGFs offer a simple low governance way of adding diversification to portfolios, and allow schemes to 'Get Simple', simple is not always best and the drawbacks of such an approach need to be considered. Other approaches may be more suitable and there are different solutions schemes could consider from an investment strategy and governance perspective. Schemes can choose to:

1. **'Get Help':** this can involve delegating some or part of the scheme's assets to a fiduciary manager who implements and manages the investment portfolio on a daily basis (designed specifically to meet each scheme's strategy / objectives). This frees up trustee time to focus on the high-level strategic decisions that will have a greater impact on long-term performance, and it enables the high levels of diversification sought after.

2. **'Get Busy':** this option means trustees do just that, they get busy themselves. This means investing significant time and resources into the pension scheme to allow a more sophisticated investment strategy to be implemented, monitored and refreshed. This means trustees can gain access to both active asset allocation and best in class managers. However, it increases the governance burden so does not overcome the 'low governance' challenge.

3. **'Get Low Cost':** while not reflecting our best ideas, a low cost alternative would be to invest in a multi-asset portfolio using a highly rated passive manager with a broad range of building blocks. Most packaged passive multi-asset strategies rarely tilt allocations between asset classes and are typically more expensive than investing in the underlying asset classes. It is also important to note that portfolio diversification may be less with this approach.

The solution trustees choose is specific to their unique situation and will depend on factors such as their size, the issues they face, the amount of resource they have at their disposal, and their appetite for adopting more innovative or technical solutions. Some schemes may be happy to 'Get Busy' while for others, delegation to a fiduciary manager will be the right route.

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Are you currently invested in a DGF for your DB or DC scheme? Are you happy with their performance and the role they play in your portfolio? Have you looked at other DGFs or considered other alternative options, including fiduciary management?

2. Optimising the equity portfolio

Traditionally, trustees have relied heavily on equities to deliver higher expected returns and help improve the funding position of their pension scheme. As schemes have begun to see their funding levels pick-up, many have started to de-risk their scheme's assets by moving away from equities towards less volatile assets. However, many trustees still need to retain some of their equity exposure to maintain expected returns.

Assessing your equity portfolio

After de-risking, trustees should consider a number of aspects when assessing their remaining equity assets. These include:

- Beliefs around active vs passive investing
- Whether the governance framework is still appropriate (and what level of governance are the trustees wanting moving forward)
- Views around diversification (this is still important to consider regardless of portfolio size)
- Fee / cost budgets

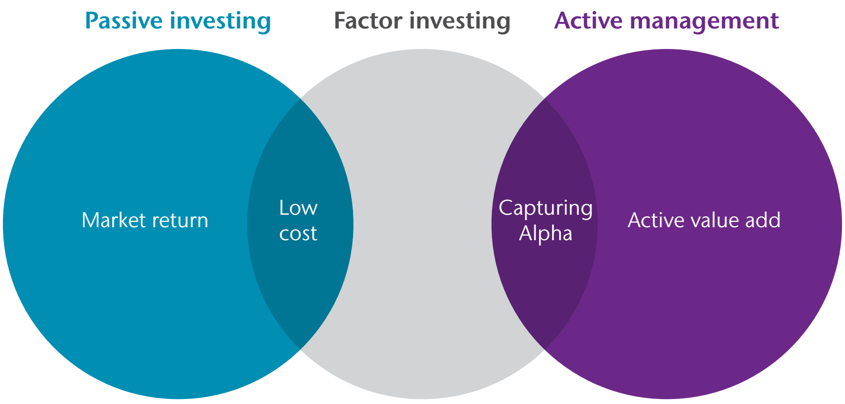
As trustees seek lower cost and better value for money investment solutions, a significant number of schemes are moving away from active equity management into passive management ie. market-capitalisation weighted index strategies. However, many trustees invest in passive funds without always considering whether this is the best approach. When investing in a market cap approach, trustees are effectively investing in the largest, most popular, and therefore potentially overpriced, companies. As these increase in value, an even higher proportion is invested in them. For instance, you could allocate sixty times more to Company X than to Company Y. Although trustees may benefit from the price increase, these are potentially the holdings that may suffer the greatest losses when market bubbles burst. Therefore, schemes invested in passive market cap funds may not be achieving the returns and the value for money they were looking for.

Factor investing

For schemes looking for a low-cost approach, we think there are better solutions worth investigating; factor investing, for instance. Factor-based investing is a low-cost, rules-based approach that focuses on specific market risk factors, such as low volatility, value, quality or momentum, in order to improve long-term returns. Factor investing is often viewed as a middle way between active and passive management, offering a more robust approach to investment than passive, without the higher fees associated with an active approach.

If you would like to hear more about Aon's Multi-Factor Investing Solution, please contact your consultant.

Equity investing approaches



Source: Aon

Factor investing offers a number of benefits. These include:

- **Better diversification:** stock price is not the main determenant of allocation sizing so stock level risk is greatly reduced and bubbles are far less likely to occur in certain companies.
- **Better risk-adjusted returns (historic returns above market cap):** factor investing seeks to allocate capital based on academically accepted, identifiable risk factors beyond the standard market risk factor (beta). By gaining exposure to these additional risks, additional returns are expected in the long term.
- **Low cost and greater value for money:** many of the principles found in factor investing are evident in active equity portfolios. However, by constructing the portfolio based on systematic rules, the cost of the solution is greatly reduced compared to active counterparts.

The benefits of this approach have led to significant growth; in 2017, global assets invested in factor investing were estimated to be $1.9 trillion*. This trend is set to continue, and assets invested are expected to increase to over $3 trillion* in the next five years.

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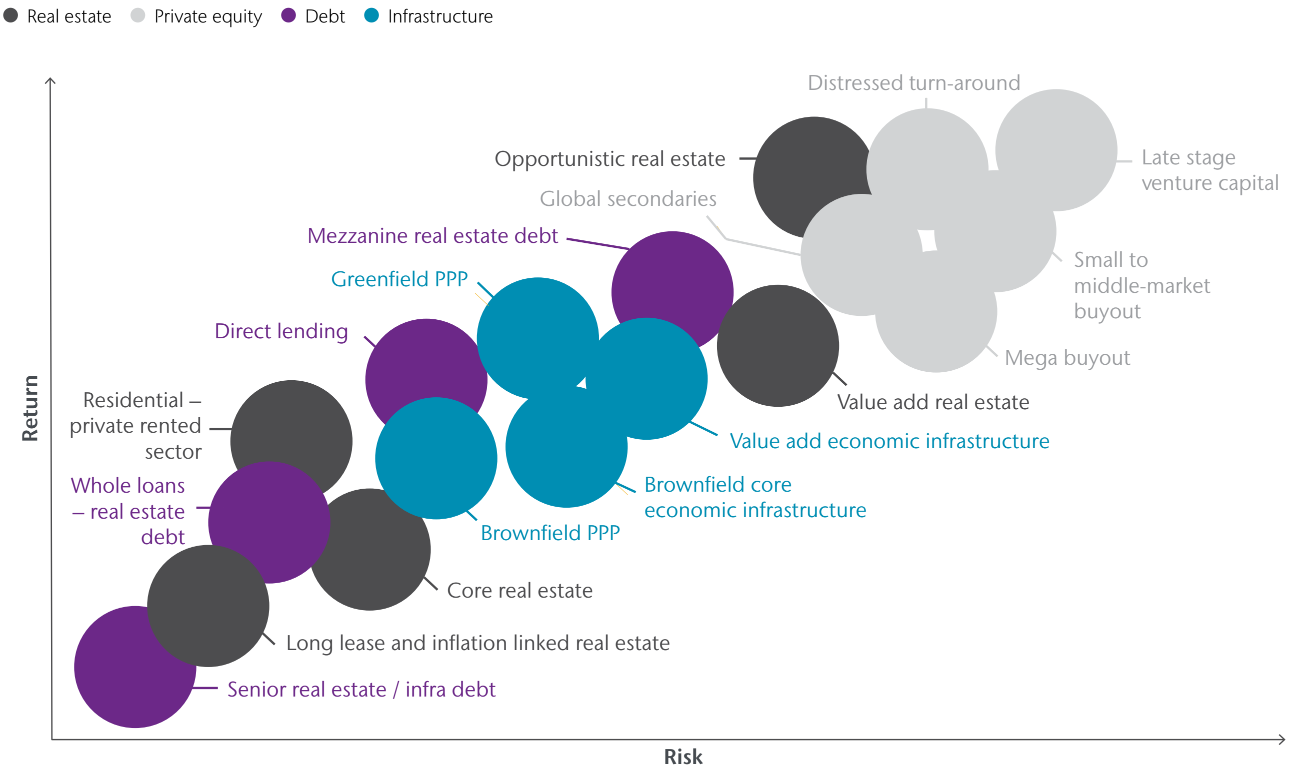
Are you looking at de-risking your equity portfolio or have you recently de-risked? Have you decided what to do with your remaining equity allocation to ensure it delivers the returns you need, value for money and that it remains diversified? Have you considered factor investing as an option?

*Source: Blackrock "Factor Investing: 2018 landscape".

3. Seeking new sources of returns

In the low-return environment, schemes are finding it harder to generate the returns they need to improve their funding level while maintaining a diversified portfolio. This has seen pension schemes on the hunt for new sources of returns outside of the more traditional asset classes, such as equities. This search has resulted in an increasing allocation of illiquid alternative assets. Alternatives as an asset class comprise a huge universe of different asset types including real estate, infrastructure, timberland, farmland and private debt (as shown in the chart).

A huge universe of alternatives



Source: Aon

Increasing allocation

Pension scheme investment into alternatives (excluding property) has increased significantly over recent years, from a zero allocation 20 years ago to around 9% more recently (as shown in the chart). This trend is set to continue with research suggesting DB schemes are planning to increase allocations into alternatives by up to 50%* over the next three years. We see this demand being attributed to three main things:

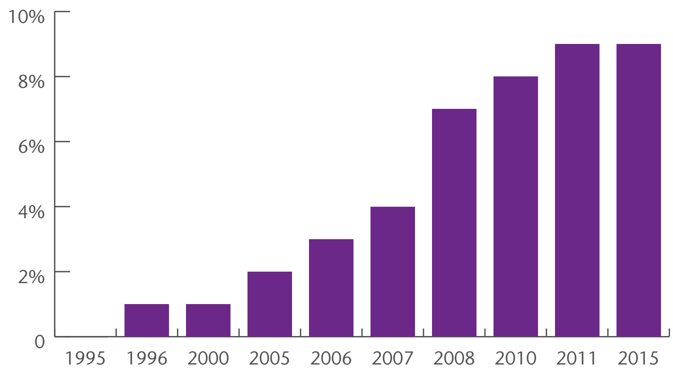
1. **Attractive return potential:** increasingly, schemes are moving away from traditional asset classes and looking elsewhere for higher returns to close their funding gap. Alternatives provide attractive levels of return, both on a standalone basis and relative to other asset classes.

2. **Diversification:** schemes are looking to reduce their equity exposure and introduce other sources of return. Alternatives have low correlation to traditional asset classes and diversification into alternatives can help reduce overall portfolio volatility, making funding levels more stable.

3. **Income generation:** many schemes are cashflow negative and/or have long-term horizons, meaning they will need monies to pay out pensions for many years. Alternatives can provide steady income streams and contractual cash flows that can be utilised to meet the outflows of a scheme.

We are also seeing this growth in interest and demand for alternative opportunities from our own clients. This is one of the reasons why Aon acquired The Townsend Group in 2017.

Allocation to alternatives



Source: UBS Pension Fund Indicators. Average UK DB pension scheme asset allocation.
Alternatives does not include property

Townsend are a global investment platform exclusively focused on real assets, such as Real estate, Infrastructure, Timberland and Agriculture

* Source: Aviva Alternatives Income Study 2018

Role of alternatives

The characteristics of different alternative asset classes vary enormously, so it is crucial to understand the role you expect them to play within the overall portfolio. Alternatives such as listed real estate, distressed debt and Infrastructure equity can offer growth opportunities and better risk-adjusted returns, which can be appropriate for schemes looking to improve their funding levels.

Many schemes are also facing the prospect of member payments exceeding contribution income ie being cashflow negative. Alternatives such as direct lending, bank capital relief and infrastructure equity offer contractual cash flows and income.

A number of alternatives can also be considered as part of a scheme's portfolio as they look to move towards their desired end-game. If trustees are aiming for self-sufficiency, the long-term nature of this strategy allows them to develop a greater cashflow focus and a range of illiquid investment options will be open to schemes. Infrastructure and long-lease property can provide some inflation linked cashflows and can help to improve overall efficiency of the portfolio. If, however, trustees are targeting buyout, potentially with buy-ins along that journey, their strategy is likely to be more constrained, and investment in alternative illiquid assets may need to be limited.

Alternatives can play a number of different roles in your pension scheme portfolio, depending on where you are on your journey and what you require them to do. The type of alternative assets you may wish to invest in will be determined by multiple priorities including required return, liquidity, and time horizon, as well as your beliefs and other objectives.

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Do you have an allocation to alternatives within your portfolio? Are you planning to increase your exposure over time? Have or would you consider investing in income-generating illiquids for example?

Accessing the alternatives

Alternative investments have typically been utilised by larger pension schemes. Minimum investment sizes and higher governance requirements made it difficult for smaller schemes to gain access, although there are now several ways in which smaller schemes can access alternatives, including via diversified pooled funds or limited partnerships.

Summary

UK pension schemes continue to navigate a multitude of challenges. Each pension scheme is unique in nature, and trustees and sponsors will encounter different issues along their journeys. We believe that one size (or solution) does not fit all and different schemes require different approaches to address some of the issues highlighted in this paper.

We understand the risks and challenges you face. Importantly we can help you overcome these. We work in partnership with all our clients to deliver truly bespoke solutions to meet their unique requirements. As part of this, we are proud to offer our clients choice and flexibility on how they choose to implement these solutions. For more information, please contact your usual Aon consultant.

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About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

For further information on our capabilities and to learn how we empower results for clients, please visit http://aon.mediaroom.com.

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