Endgame the focus for pension scheme investment

Why are pension schemes reducing their equity holdings and embracing alternatives and illiquids?

Over half of UK DB pension schemes have reduced the level of equities in their portfolios over the past two years, while diversification into alternative growth assets has increased as schemes sharpen their focus on their chosen endgame.

This was one of the key UK findings from Aon's *2019 Global Pension Risk Survey*. The survey charts the actions, plans and concerns of UK DB pension schemes. The 2019 UK survey had 170 respondents, representing schemes of a broad range of sizes.

The survey's overall trends – of maturing pension schemes and reducing time to reach long-term targets – have had a clear impact on schemes' investment strategies. This year's survey demonstrates many of the trends we saw two years ago – notably de-risking and diversification. But this year the difference lies in the pace of change and the level of activity – schemes have firmed up their views and acted decisively.

This has been very much driven by schemes' own circumstances, but typically actions have fallen into two categories: schemes that have reduced equity exposure but increased liability hedging to reduce overall volatility, and those that have diversified from equities into alternative growth assets. We have also seen continuing interest in illiquid asset classes as schemes look to alternative investment ideas.

Wind the clock back 10 years and equities were typically 50 per cent of a scheme's investment portfolio. That has changed, with allocations now far lower and with 40 per cent of respondents expecting to reduce that figure further over the next year.

Nevertheless, they still need to maintain investment returns, which is where the growth in use of alternative growth assets comes in. We saw further evidence of this, with schemes indicating that they expect to increase their exposure to assets such as private credit (47 per cent), bulk annuities (33 per cent), real estate (27 per cent) and infrastructure (29 per cent).

De-risking trends

The survey highlights a reduction in time for schemes reaching their long-term target and makes it clear that most changes in schemes' investment approaches are driven by their aims of de-risking in its different forms, with 35 per cent of schemes targeting buyout and 43 per cent seeking self-sufficiency. In many cases, this is taking the form of increasing liability-driven investment (LDI), with 50 per cent of schemes adding to their LDI portfolios over the last year – and making a big impact on risk reduction.

We have long advocated pension schemes hedging their liability risks, so it is pleasing to see in the survey that nearly 90 per cent of schemes have hedged over 40 per cent of their interest rate risk, with 45 per cent of respondents now hedging over 8 per cent (up from 30 per cent in the 2017 survey).

This change has meant that more and more schemes have insulated themselves from the fall in gilt yields that we have seen in recent times and the adverse impact it would have had on their funding levels. The investment gains that this approach has enabled means that some of these schemes now have their endgame in sight.

Delegation increasing

This year's survey also asked schemes which elements of their investment strategy and implementation they had delegated or planned to delegate in the future. As in previous years, this is an area in which attitudes are evolving, with the number of schemes open to delegating manager selection and monitoring on the increase (almost two-thirds of schemes) and around a quarter of schemes now operating full fiduciary mandates.

Life is not getting any easier for scheme trustees or sponsoring employers. It is therefore maybe not surprising that we have seen a notable increase in activity over the months since the Competition and Markets Authority (CMA) review findings were published. The survey suggests – and we expect – that many more schemes will continue to assess the relative merits of fiduciary management as a way of implementing their investment strategies in the future.

For a copy of the research please email talktous@aon.com

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