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# DB investment focus:

## Investment strategies under the microscope

LGIM head of solutions Will Riley and head of delegate solutions, Tim Dougall

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# Of surpluses and spreads

**There's much to be optimistic about for UK DB pension funds that can take their pick from buyout, run-on or both**

The UK is going global… in a sense. Rachel Reeves, Chancellor of the Exchequer, unveiled in her recent Mansion House speech plans to create Canadian and Australian-style megafunds to power growth in the economy.

In addition to the strong focus on the DC market and Local Government Pension Schemes there was also a nod to insurers, regarding investment in productive assets under the new Solvency UK regulatory regime.

Defined benefit (DB) pension funds were not, however, mentioned at this stage. Therefore, it seems likely that formal feedback around surplus extraction will come in 2025. Nonetheless, with DB assets of c.£1.2 trillion and over a third of schemes (by value) being in surplus on a buyout basis, as at 31 March 2024[1], we would make three key points:

1. On surplus extraction, we recognise the necessity of mutually agreeable guardrails for sponsors and trustees, but expect there to be practical, workable solutions. We touch on these below.

2. It is news to no one that traditional investment grade spreads are low versus history. But, we believe, there is much more beneath the surface to unpick and consider.

3. Delegation and how much? We think the trustee governance structure must carefully consider what strategic decisions to retain and what to outsource – from the new funding code, to a framework for capturing any sell off in credit spreads, to the transition of a private markets portfolio, to a buyout provider.

For pension schemes de-risking or looking for extra returns to generate surplus, what to do about tight credit spreads? Pension funds are fortunate to be long-term investors who can weather mark-to-market volatility. Our research, backtested to 1973, suggests that a relatively simple buy and hold credit investment is challenging to beat on a risk-adjusted basis because spreads can remain low for longer-than-expected periods, and tend to come with less risk. As such, even at lower credit spreads, we believe long-term credit investments still have their place.

That said, we do find there is room to add incremental value though a more proportionate strategy which could, for example, use shorter dated credit (be that traditional investment grade, securitised or private assets) to maintain carry.

## Liquidity and resilience

The new funding code is live and effective for pension fund valuations from 22 September 2024. For their low dependency investment allocations, DB pension funds will have to demonstrate investment strategies that are sufficiently liquid to meet cashflow requirements and highly resilient to short-term adverse changes in market conditions. Our observation is that governance structure will be key. A delegated approach could be the way to go to meet these regulations and anything else round the corner.

Finally, we think pension funds need not be wary of illiquid assets if circumstances or strategy changes and a buyout or buy-in is being executed. Private market transitions mandates can build on similar concepts used in public market transitions whilst allowing for key differences. LGIM is able to manage these exercises under the rigour of an investment management mandate, adding value and reducing costs in the process.

To sum up, there is much to be optimistic about for DB pension funds that can take their pick from buyout, run-on or both. As long-term investors, DB funds are able to take a strategic approach to surplus generation and asset allocation whilst taking advantage of flexible solutions to deal with private and illiquid assets. We can support all levels of delegation models to fit with trustee governance structure and objectives.

**Written by LGIM head of solutions Will Riley**

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[1] Source: The Purple Book 2024

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# No more natural guard rails?

## Lessons from the new DB funding code

Imagine a bowling game with guard rails to help guide the ball down the lane.

When DB pension schemes were early in their lifecycle, the equivalent of these guard rails was time. Schemes had many years to let expected asset returns help them recover from any funding deficits before pensions had to be paid out. Even better, contributions paid in to fund new accruals had the effect of gently steering the funding level back towards 100 per cent. Just like a young bowler who could rely on guard rails to reduce the risk of a bad outcome, pension schemes in their early years were more innately resilient to short-term fluctuations and risks.

**Avoiding going off the rails**

However, as pension schemes have matured, the natural guard rails have been removed. With schemes having to pay out an increasing proportion of their assets each year to pay pensions, any short-term fall in funding levels can quickly accelerate. There's no longer the luxury of time for the funding level to recover. Just as a bowler needs to hone their technique and precision to achieve a good outcome without guard rails, we believe pension scheme trustees and sponsors must now adopt a rigorous risk management approach to ensure their schemes remain financially stable.

With its new DB funding code of practice that came into effect in September 2024, The Pensions Regulator made it very clear that the natural guard rails are gone, and it's time for pension schemes to up their game.

In our view, the regulator has rightly highlighted the importance of improved risk management for mature schemes, with a focus on ensuring that assets backing liabilities offer high resilience to short-term adverse changes in market conditions and can match cashflows. The new funding code is less prescriptive than many had initially feared, but as a result the regulator has placed a greater governance burden on trustees, asking them to justify that their specific strategy is fit for purpose.

**Bespoke bowling options**

The flexibilities afforded under the new funding code are important, however, as what is suitable for one scheme may not be suitable for another. The regulator has focused heavily on the importance of different employer covenants, and while some schemes remain in deficit, others are now in surplus. Many will want to work their surplus assets harder to seek to deliver an increased cushion against adverse events, improve member benefits, or reduce the cost of pension provision for employers. While some schemes are looking to improve portfolio liquidity ahead of a potential buyout, others are targeting run-on, and may be comfortable seeking to harness an illiquidity premium.

For schemes targeting run-on, even temporarily, the regulator's warning around the need for good governance and high-quality risk management appears to have been heard. Employers are increasingly appointing professional trustees to help manage their schemes, who are in turn looking to beef up investment governance arrangements. An increasing number of larger and mid-sized schemes are looking to appoint an OCIO provider or single implementation manager, while take-up of a fiduciary management governance model continues to be popular among smaller schemes.

Whether small or large, we believe mature pension schemes can learn from the experience of life insurers, who are used to managing risk closely relative to cashflow-negative liabilities in their annuity 'run-on' portfolios. While important differences in regulatory regimes remain, with its increased focus on cashflow matching and risk stress testing, the latest DB funding code aligns approaches more closely for pension schemes and insurers.

**Striking the right strategy**

There's a lot of information for trustees, sponsors, and consultants to absorb in the new funding code, and for many the devil will be in the detail. But as the next actuarial valuation cycle approaches, we'd encourage trustees to first take a step back and think about their overall governance and strategy, and whether they're ready for the new challenges that managing a mature pension scheme can bring.

Now that DB schemes have matured, those natural early-year guard rails have gone. Just as professional bowlers do when seeking to improve their average score, schemes need a strategy that avoids the gutter balls.

Written by LGIM head of delegate solutions, Tim Dougall

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Tim Dougall

# Reviewing DB investment strategies

**_Pensions Age_ speaks to LGIM head of delegated solutions, Tim Dougall, about The Pensions Regulator (TPR)'s latest DB funding code and how this is prompting DB schemes to take a good look at their investment approaches**

**TPR's latest DB funding code came into force late last year – how greatly has it differed from its previous funding code, and what key elements within this should trustees focus on?**
The new funding code more explicitly sets out how pension schemes should de-risk towards a low-dependency funding basis, and towards a low-dependency investment allocation by the time the schemes is significantly mature.

Those are the key elements within it – for DB schemes to define their long-term objectives, aiming for a low-dependency funding target and low-dependency investment allocation, and then the scheme's journey plan to get to its end goal, which will be closely linked to the strength of the employer covenant.

There's a very strong focus on sponsor covenant strength within the new DB funding code, and how that needs to support the investment risk taken within a pension scheme. So, it's all more explicitly linked.

Another key difference compared to the previous funding code is that there is now a fast-track route to TPR approval, and a bespoke route. The fast-track route enables TPR to automatically filter out scheme valuations that don't require more scrutiny.

The regulator then offers the bespoke option for DB schemes that want to do something slightly different with their investment or funding strategy.

Overall, there's a greater focus on risk management and stress testing the portfolio and investment strategy. I think this is appropriate as schemes are getting more mature and so their risk tolerance decreases.

**In the funding code, the regulator has placed a greater governance burden on trustees, asking them to justify that their specific strategy is fit for purpose. What does this mean in practice?**
All else being equal, mature DB schemes have a lower risk tolerance than immature pension schemes because of their larger cash outflows. If a deficit arises, the scheme still has to pay out assets to meet unfunded liabilities, which acts to push the funding level lower still. Mature schemes also generally have less time to make good on deficits through investment returns. I think that's a big part of why the regulator is doing this.

The regulator is asking DB schemes what their long-term objective is, what their long-term investment allocation is going to be, and how they are going to get there. It is asking trustees to set that out explicitly and agree it with the sponsor. There's a lot more scrutiny of all the different elements, for good reason, I think. Overall, it means good governance and good risk management become increasingly important as these schemes mature.

**As UK DB schemes are reaching their 'mature' stage, the funding code has emphasised the importance of resilience to short-term market shocks. As we know from past experience, resilience requires sufficient portfolio liquidity to ensure a scheme can meet its cashflow requirements during this time. How can trustees monitor their investment strategy to ensure it remains flexible enough for this?**
Trustees need to think both about solvency risk and the liquidity risk in their portfolio, among other types of risks as well.

The solvency risk is whether assets are falling in value relative to liabilities, and the liquidity risk is whether the scheme can buy and sell assets when it needs to.

DB schemes need to think about the value of their assets relative to liabilities when they're setting an appropriate return target. They also need to consider their overall risk tolerance, to make sure that they are taking the right level of risk, and making sure that they are diversifying rewarded risk and seeking to protect against unrewarded/ poorly rewarded/ long-tail risks.

They also need to manage liquidity risks, and to do that, they need to think about both the predictable and the unpredictable cashflow requirements and cashflow availability in their portfolio. Stress testing their liquidity is very important.

A DB scheme has its regular liquidity requirements to meet cashflows to pay pensions, but then there is the liquidity requirement to meet collateral calls within its LDI portfolios. And trustees

need to think about how a large move in gilt yields could be supported by scheme assets in different liquidity scenarios.

How can trustees do that? They can either set up that framework themselves and think about the monitoring of that. Or, increasingly, trustees are thinking about outsourcing some of their investment risk management and investment governance to fiduciary managers or outsourced chief investment officers (OCIOs).

**A great deal of focus within the UK pensions sector lately has been on the government's aim to make use of pension schemes to invest in 'productive assets' for the potential benefit of the UK economy. What role can productive assets play in a DB scheme portfolio?**

The UK government wants DB schemes to invest in a range of UK assets. Yes, they want DB schemes to invest in UK equities, UK private equity, infrastructure, things like that, which I think would probably be classed as productive assets. They also want schemes to support the gilt market, and some of the government's consultations were around the need to balance those two things.

While there's a discussion around whether schemes should invest in UK growth assets or have a globally diversified growth asset portfolio, the key challenge is that, now DB schemes have matured and their risk tolerance has decreased, actually they're investing less in growth assets overall.

So, the first question for DB schemes is how much should they be investing in growth assets overall. And then within their growth asset portfolio, how much is invested within the UK?

And what can the government ask DB schemes to do about this? Well, there's a number of different routes to investing in UK productive assets. So, for example, a lot of schemes are now closer to buyout, and if those assets are transferred to the insurance sector, then you'll find that those insurers will be investing a significant proportion of those assets into productive assets themselves. Not necessarily equities, but insurers will generally have scope to invest in less liquid assets, and will typically focus on assets that deliver cashflows.

Or, if DB schemes have a material surplus, then that does increase their risk tolerance again and so they can invest their surplus assets in growth assets. If we do see more schemes running on with a material surplus, then it may be the case that some of that surplus portfolio could be invested into a diversified growth portfolio, including a range of UK productive assets.

**How can DB trustees balance risk and still take on growth in today's investment environment?**

Maximising return and minimising risk is about maximising portfolio efficiency. That's really the holy grail of investing, to generate the highest level of return possible with the lowest level of investment risk.

Obviously, it's a very complex challenge with lots of potential levers that investors can pull. Trustees can work through that themselves, but as it becomes more challenging for mature schemes, more institutional investors are outsourcing a lot of that overall portfolio management and investment risk management to fiduciary managers and OCIOs.

**Many DB schemes are now operating in the enjoyable position of being in a funding surplus, but circumstances can always change. How can trustees ensure that their investment strategy is flexible enough to change tack if required to move to a different endgame plan?**

The important thing is to sit down and think about strategy, and now's a great time to do it, because you've got the regulator asking schemes to think about their strategy as part of their next valuation.

Where are they aiming for? What is their long-term target? Are they aiming for buyout? Or long-term run-on? Or something in between?

Clarity around that will help trustees to plan their investment and funding strategy. This, for example, could be thinking about how flexible their investments need to be right now. Should they be investing in illiquid assets because they know they're definitely targeting run-on, or do they need to be thinking about reducing the illiquid allocation so they can prepare for buyout?

The other thing that can help with that is outsourcing some of the overall portfolio management. Get a good fiduciary manager or OCIO provider, as they'll be able to help with planning around those goals and ensuring that the portfolio is sufficiently flexible on day one. It will also mean that the scheme has the investment governance framework in place to move quickly and capture opportunities as they arise.

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