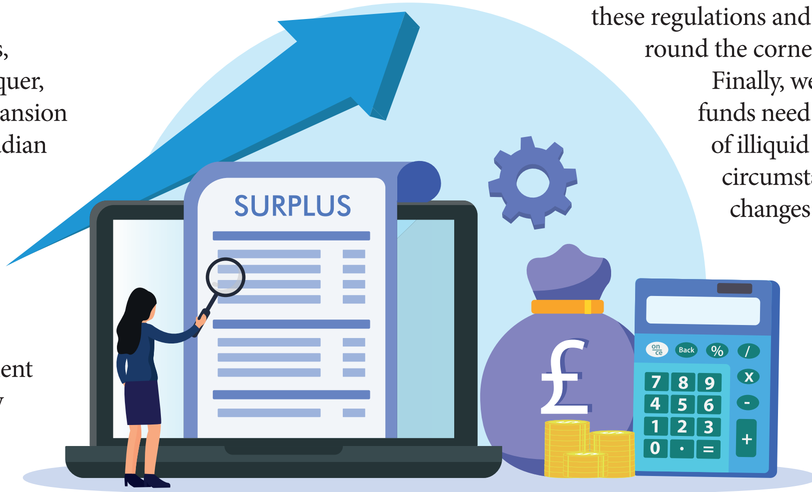
Of surpluses and spreads

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

In association with LGIM

[1] Source: The Purple Book 2024