



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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