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AVIVA INVESTORS RESEARCH REPORT: INVESTING FOR OUTCOMES

How pension schemes in the United Kingdom
are responding to today's challenges

December 2015

Contents

Foreword	3
Introduction	4
Executive summary	6
Method	8
Research findings	8
Conclusion	22
Acknowledgements	23



FOREWORD



EUAN MUNRO

Chief Executive Officer

This research encapsulates the key challenges facing pension schemes today and underlines the importance of an outcomes-oriented approach.

In an effort to tackle volatility, funding pressure from corporate sponsors, and how to choose the best investment solution to meet specific needs, pension schemes are evolving their approaches to investment to meet their obligations to members. They are increasing allocations to alternative income sources such as infrastructure and real estate debt, and investing in multi-strategy solutions designed to limit the impact of market volatility.

These are necessary steps, which are nonetheless testing within the context of a demanding regulatory environment. I am confident that by working together, pension schemes, insurance companies and asset managers such as Aviva Investors will successfully achieve the outcomes that matter most: sustainable, cost-effective investment solutions that address both short-term challenges and long-term liabilities.

UK pension sponsors have invested more than

£500 billion

into their defined benefit (DB) pension schemes since the year 2000

INTRODUCTION

UK pension sponsors have invested more than £500 billion into their defined benefit (DB) pension schemes since the year 2000, and deficits have increased by around the same amount, from £250 billion that year to over £900 billion in 2015.¹ For the first time, UK private sector DB schemes collectively have liabilities of over £2 trillion, significantly in excess of the UK's GDP of £1.8 trillion.²

For mature DB schemes, investment time horizons are shortening and many are obliged to pay out more in benefits than they receive in contributions – a situation that is expected to intensify as the pension freedoms lead to an increase in flows from DB to defined contribution (DC) arrangements. As these schemes begin to disinvest more of their assets, the timing of returns becomes critical.

However, as Calum Cooper, partner at Hymans Robertson³ points out, while deficits have increased, pension scheme asset bases are also at their highest levels, following a period of strong performance across most asset classes. Over the last five years assets have grown by over 40% from around £900 billion five years ago to around £1.3 trillion today. He suggests: *“In the current environment, this leads to two pressing actions for both trustees and corporate sponsors of pension schemes. First, review your investment strategy with an eye to income requirements from your assets to pay pensions... without this focus, there is a very real risk of a downward spiral: cannibalising your capital. The second action is to look for opportunities to reduce risk.”*

Our research examined how UK DB, DC schemes and their advisers are responding to today's investment challenges, the decisions they are making, and what the future holds; and while every scheme and covenant is different and there is certainly no one-size-fits-all solution, the research discovered that there is perhaps more consensus on the optimum investment approach than might be assumed.

DB schemes are faced with the need to balance caution with a need for return. Recent research⁴ on asset allocation investment trends indicates that the search for yield is leading to unconstrained multi-asset funds and that over the last two years investors are seeking outcome-based investment strategies over asset class-based strategies – a finding strongly reflected in our study. DB investors are moving away from the traditional equity/fixed income mix towards infrastructure and real estate (for capital growth, inflation protection and regular income), traditional passive funds, global equities, low-variance equities and alternative credit (for high yield); and DC schemes are moving towards advice-embedded products and increasingly favour diversified income and diversified growth funds including target-income, target-date and target-risk funds.

In our research there was broad consensus that an outcome-oriented approach is the most likely to result in a successful solution, that is, an approach which in the words of one respondent *“gives managers a broad range of assets from which to achieve a target return profile, whether it be income or growth,”* and which in turn *“gives them much more ability to use their skills and effectively play between the silos”* to reach the outcomes desired.

¹ Hymans Robertson <http://www.hymans.co.uk/blog/taking-control-of-your-db-scheme-s-cost-and-risks.aspx>

² <http://www.hymans.co.uk/news-events/newsroom/pension-liabilities-outstrip-uk-gdp-for-the-first-time-says-hymans-robertson.aspx>

³ <http://www.hymans.co.uk/news-events/newsroom/pension-liabilities-outstrip-uk-gdp-for-the-first-time-says-hymans-robertson.aspx>

⁴ CREATE-Research, 2015: Asset Allocation: Survival of the Fleetest, https://gallery.mailchimp.com/91b3217e695da9172b863da52/files/Asset_allocation_trends_2015.pdf



EXECUTIVE SUMMARY

Our research examined attitudes among pension scheme trustees, managers and consultants to investment decision-making, in particular, how DB schemes are meeting their liabilities, and the role of multi-asset and multi-strategy funds in DB and DC schemes. Sixty-one senior pension professionals took part in the research during September and October, 2015.

- Within today's current low inflation and low yield environment, the control of volatility, management of risk, and longevity are high on the agenda for DB schemes.
- As most corporate DB schemes are now closed (at least to new members) and relatively mature, schemes are adjusting from cashflow-positive to cashflow-negative positions, and moving toward more defined horizons for either self-sufficiency or buy-out.
- 63% of DB scheme respondents were targeting self-sufficiency, 11% buy-out, and 26% were undecided.
- Of these, 73% were looking at a time horizon for achieving their objectives within the next 20 years, and 21% at a 21–30-year timeframe.
- There was general consensus that schemes' investment decisions should not be driven by comparative benchmarking: they agreed that the only benchmark that matters is the ability to meet their liabilities in the broadest sense, cited by 83% of respondents.
- The majority (59%) of scheme investment strategies differentiated between long and short term liabilities in terms of the investments held.
- Liability matching was reported as a dominant objective within portfolios and liability-driven investment (LDI) is a strategy commonly used by schemes to achieve desired outcomes, e.g. to match liabilities, control volatility, hedge against uncertainty and/or protect positions.
- As part of their LDI/matching strategy, schemes currently take a diversified approach: 73% allocated to credit assets, 63% to multi-asset/multi-strategy funds, 53% to real assets, and 47% to infrastructure. Future allocations to these asset classes are set to continue, in particular to infrastructure (cited by 74% of respondents) and real estate (68%).
- The traditional growth and LDI model still has salience, particularly for schemes with long time horizons or that need to recover from deficit positions. It was rare in our research for schemes to employ an LDI mandate across their entire portfolio although indications were that the distinction between their growth portfolio and liability matching is becoming increasingly blurred.
- 90% of respondents surveyed maintain a traditional two portfolio (growth and liability-matching) model compared to 10% who manage their complete portfolio to an LDI mandate.

- In their focus on outcomes, scheme managers and trustees are allocating to a wide range of asset classes that cut across traditional growth/LDI boundaries. As one respondent put it, this requires “putting the necessary plumbing in place” to establish clear investment objectives, and developing relationships with managers who have the appropriate skills and flexibility to respond to opportunities swiftly when the conditions are right to do so.
- Sophisticated manager skills are in demand: ‘seeking skill’ was widely reported in our research and suggested a growing recognition among schemes of the importance of advice-led diversification within investment strategy in order to achieve the outcomes required.
- Our research found that employers have no appetite to introduce, or engage with, post retirement solutions for members of DC schemes: they clearly draw the line at retirement.
- Nonetheless, they take their responsibilities very seriously and have embraced the need to ensure that DC members are empowered to make appropriate choices at retirement.
- To this end, employers in our research were evolving and expanding lifestyle DC offerings to provide choice for those wishing to take the traditional annuitisation option, full or deferred drawdown, and putting in place appropriate investment strategies to achieve each outcome.
- Multi-strategy target return funds were perceived to be a perfect fit for the accumulation stage within a default strategy: scheme managers reported that it is more important to control volatility than ‘chase’ returns.
- Multi-strategy target income funds were reported as having an important role to play as self-select funds, offering members choice and opportunity to draw down income, or stay invested through retirement.



METHOD

This report is based on research carried out by Gabriel Research & Management Ltd. The qualitative research comprised in-depth interviews with 21 senior investment decision-makers, trustees and industry consultants. Interviews took place between 18 September and 10 October 2015. A further 40 senior pension and investment professionals responded to an online survey between 28 September and 13 November 2015.

RESEARCH FINDINGS

Corporate DB schemes in our research were mainly closed, at least to new members. They were generally targeting self-sufficiency (63%) rather than buy-out (11%), with time horizons that varied from 15 to more than 30 years.

Local Government Pension Schemes (LGPS) were also represented in the research: as a sector in which schemes are still open to new members, their investment challenges resonate with those in the private sector to some extent, but they also have particular forces to contend with, most notably pressure from the government to create pooled or collective investment vehicles.

Not surprisingly, respondents reported that investment objectives and strategy were dictated by the relative maturity of scheme; the length of time available to, for instance, address deficits, react to positive/negative cashflow positions, or move into an LDI position to increase the certainty that the pension scheme goals would be met: typically, improving the funding level while reducing risk. These challenges were considered to be especially onerous within the current environment in which interest rates and gilt yields remain low.

KEY CHALLENGES

Respondents identified their key challenges as:

- Meeting covenant target frameworks and managing deficits
- The search for yield
- Longevity
- Managing:
 - cashflow and liquidity
 - inflation risk
 - volatility when investing in growth assets
 - stability of contribution rates over the long term
 - liability risk in a low interest environment, which puts upward pressure on liability valuations.

THE SEARCH FOR YIELD: LOOKING BEYOND TRADITIONAL ASSET CLASSES

John Jones, Senior Adviser at AllenbridgeEpic Advisers said: *“Ten years ago, funds were heavily invested in equities compared to fixed income. The trend over the last decade or more has been to move out of equities into alternative investments – however that’s defined – also, out of UK equities into global equities. Everybody is searching for yields and obviously with interest rates as they are that has changed the funding level for funds because of the impact on the discount.”*

John Chilman, Group Reward & Pensions Director at FirstGroup noted: *“The main challenge we face is trying to convert the scheme to deliver an absolute return on the return-seeking side and increasing our matching as we improve the funding, either through investment or through additional contributions paid to the scheme. This is within a context where there aren’t many opportunities to get good returns out of asset classes at the moment. We think gilts are horrendously overvalued; we are looking at alternative long-term income-generating asset classes with a similar profile that will give us an enhanced return.”*

Low gilt yields, the impact this has on matching liabilities, and the importance of looking beyond traditional asset classes were reported as key challenges by almost all respondents. Chetan Gosh, Chief Investment Officer for Centrica Pension Schemes commented: *“The major strategic challenge is about the degree that we choose to hedge or match against our liabilities given that gilt yields are so low. You want to match more to reduce funding level volatility but you don’t want to do it at any price – everything is overvalued at the moment.”*

“You want to match more to reduce funding level volatility but you don’t want to do it at any price”

Chetan Ghosh, CIO, Centrica Pension Schemes

Karen Shackleton, Senior Adviser at AllenbridgeEpic Advisers said that for local authority schemes, *“a primary concern is the deficit management of an open scheme and the recovery plan towards that.”*

John Jones (AllenbridgeEpic Advisers) added: *“Local authorities were always cash positive, but some are now cash negative or approaching that position, so in terms of the investment strategy they will focus more on income generation than they would have done in the past in order to meet their liabilities.”*

This low yield, low discount-rate environment is inflating the present value of liabilities or as one consultant put it: *“most asset prices are being inflated by too much money chasing too few assets... most schemes are not fully funded and the only way to square the circle is to look for alternative sources of growth.”*

Most DB schemes are in the risk management phase of managing liabilities. Inder Dhingra, Independent Trustee and Director at Law Debenture Trustees said: *“The key challenge is what type of investments complement a good risk management framework. DB pension schemes are very much in the risk management phase of managing liabilities and typically focused on credit and contractual cashflow-type returns rather than pure equities. Although equities do have a part to play, portfolios are nowadays much more diversified.”*

In addition to the acknowledged importance of diversification, our research respondents talked about the current economic environment leading them towards an investment approach that was increasingly focused on outcomes in the most holistic sense.

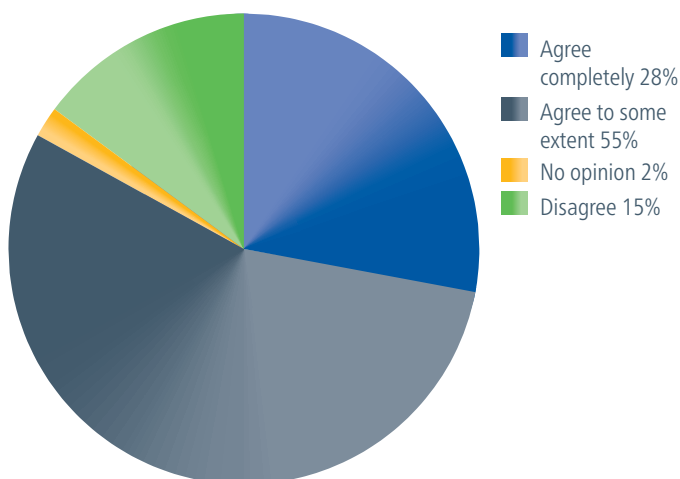
THE GROWING IMPORTANCE OF AN OUTCOME-ORIENTED APPROACH

The majority of respondents (83%) agreed that pension schemes should not be driven by benchmarks: the only benchmark that matters is matching their liabilities, or as Charles Coase, Independent Trustee and Trustee Chairman, Aviva Staff Pension Schemes Ireland, said: *“the only benchmark that really matters is paying out the benefits when they fall due”*; but how are today’s pension schemes achieving this? And what are their priorities?

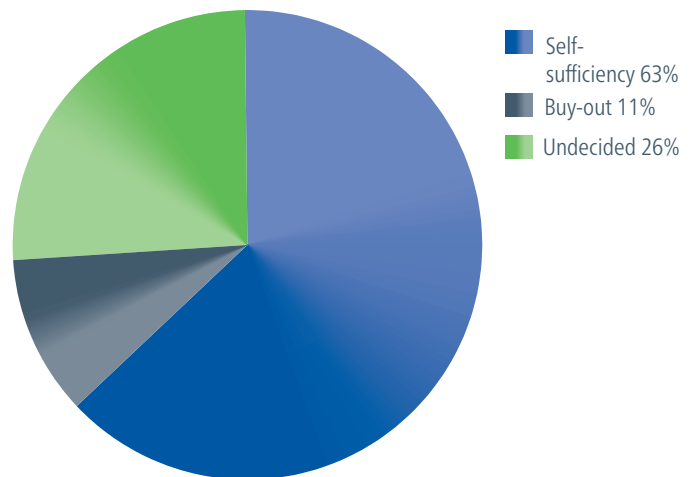
David Kidd, Director of Law Debenture Pension Trust Corporation observed: *“There is a big focus on the end game – is it going to be buy-out or self-sufficiency and how long a period of time is it likely to be until the scheme sponsor gets there? Secondly, the extent to which the policy is to be one of gradual de-risking with more and more LDI and fewer growth assets.”*

Sixty-three per cent of the DB pension schemes that took part in our research were targeting self-sufficiency, 11% buy-out and the remaining 26% were undecided. Of these, 74% were looking at a time horizon of achieving their objectives within the next 20 years, and 21% within a 21 to 30-year timeframe.

There is an argument which says that pension schemes should not be driven by benchmarks: the only benchmark that matters is matching your liabilities. Do you agree?



What end goal are you targeting for your scheme?



“Schemes which, either through having better support and expectation of support from the sponsor, or a different member and liability profile so that they can take a longer term view, are better positioned to solve today’s problems”

Christine Farquhar, Research Consultant,
Cambridge Associates

Matching specific liabilities then, is what DB scheme managers and trustees are charged to do, especially in maturing schemes, and respondents unanimously agreed that there is no point outperforming a benchmark if fund managers cannot meet their promise to pay members their pensions.

Matt Fuller, Pensions Investment Manager at Kingfisher Pension Scheme, summed up: *“It’s cause and effect: we are driven by the cause, and the effect is a consequence of the views and actions the Trustees take; we aim to hedge at appropriate rates and at appropriate times for the Scheme in its de-risking journey. It’s about insulating the risk.”*

Alastair Russell, Pension Investment Governance Director at EDF Energy said: *“The philosophy we have adopted is to put in inflation and interest rate hedging to the maximum sensible, according to our funding level. We then have a shortfall on the funding level and need to use assets wisely enough to grow to close the gap in light of the covenant that is available.”*

However, some would argue that other considerations also come into play, especially in relation to longer term investment horizons, cashflow positions, and the need to ensure good value in their investment choices.

Stephen Crosbie, Head of UK Pensions at Syngenta said: *“The trustee is not interested in the short-term position; as long as it has got the cash to pay pensioners then it is targeting fully-funded state, so its interest is the long term.”*

Marc Boone, Global Head of Pension Asset Management at HeidelbergCement, agreed: *“I do benchmark against the liabilities, but at the same time plugging in a number of investments to essentially buy the beta of those investments, we need to benchmark against something other than the liabilities to ensure we are getting reasonable performance.”*

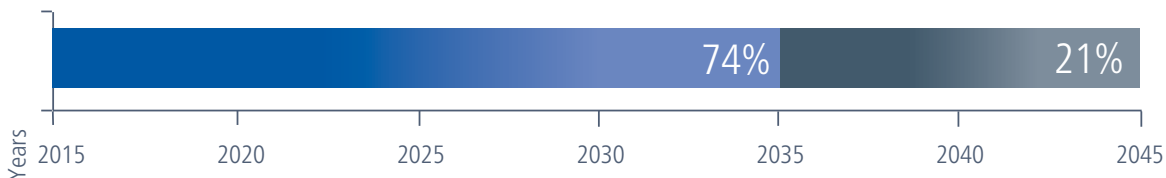
Andrew Parker, Director, Law Debenture Pension Trust Corporation, underlined the importance of recognising that liabilities extend beyond matching assets to meet pension payments: *“Simply matching assets to pay current pensions is not usually the whole picture. There are liabilities which are still growing or which are still indeterminate so you do need to monitor periodically what the scale of liabilities is, and therefore what returns you need to achieve to meet those aside from just purely having enough matching assets to pay existing pensioners.”*

But the instinct to compare against benchmarks is strong and in our research, was particularly apparent among Local Government Pension Schemes.

Phil Triggs, Strategic Finance Manager (Pension Fund & Treasury) at Surrey County Council observed: *“Our most important objective is to achieve 100% funding over the long term. Secondary to that is to out-perform the investment return benchmark. Matching liabilities with assets is paramount. We have seen a change over the last few years where the pension fund committee now regularly considers the entire spectrum of the pension fund and liabilities, not just assets, and the funding level is monitored very carefully.”*

Benchmarking investment performance within an asset class, however, was deemed necessary and crucial to informing

What time horizon are you looking at for achieving your objectives?

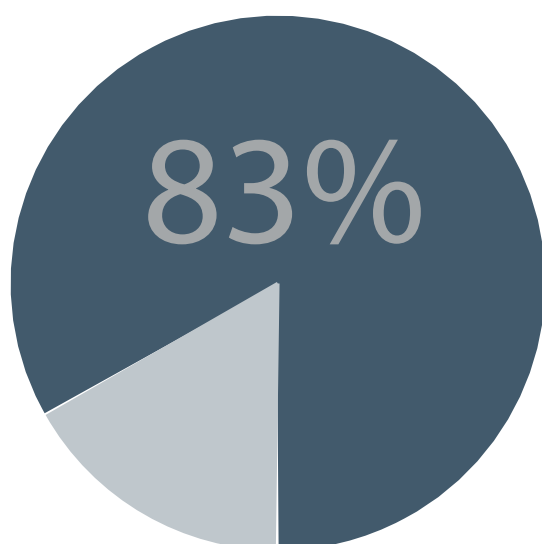


74% were looking at a time horizon of achieving their objectives within the next 20 years, and 21% within a 21– 30-year timeframe.

manager selection and investment decision-making, as David Kidd (Law Debenture Pension Trust Corporation) suggested: *“It used to be only ten/fifteen years ago that every pension fund would be looking at what every other pension fund was doing and you would get overly concerned about being in the top quartile etc. That is becoming less and less common. But I do think within asset classes it is very, very important to look at benchmarks.”*

83% of respondents agreed that pension schemes should not be driven by comparative benchmarks: *“The only benchmark that really matters is paying out the benefits when they fall due.”*

83% of respondents agreed that pension schemes should not be driven by comparative benchmarks.



“Each year of additional life expectancy takes 3% of the funding level and adds 0.8% to the future service rate”

LONGEVITY – NO EASY ANSWERS

Longevity was cited as a significant risk by all DB schemes that took part in the research. Assessing mortality rates as part of a triennial valuation and setting a prudent assumption has given way to more sophisticated self-sufficiency strategies and for some, hedging through insurance and reinsurance transactions.

Since the BT pension scheme set a precedent in 2014 by establishing an in-house insurance company for the purposes of hedging longevity risk, something it might have struggled to achieve but for the size of the scheme, solutions have become more readily available to smaller schemes that want to remove longevity risk by transferring to a third party.

However, while longevity hedging is perceived as one of the key ways to de-risk a scheme, and the number of providers to the UK market is increasing, this solution is not without controversy. Among the doubts cast over this strategy are whether longevity is as problematic as actuaries suggest: some would argue that in the UK it has peaked and that longevity risk may in fact be diminishing.

The costs involved in employing actuaries, lawyers and other advisers – not to mention the demands it makes on scheme trustees and managers in terms of time – are deemed prohibitive for all but the largest schemes although economies of scale might be afforded by pension funds joining together and aggregating risk.

Looking ahead, mitigating longevity risk is expected to become more affordable as solutions move from being bespoke to more commoditised.



90%

of respondents surveyed maintain a traditional two portfolio (growth and LDI-based) model compared to



10%

who manage their complete portfolio to an LDI mandate.

THE ROLE OF LIABILITY-DRIVEN INVESTMENT

We asked respondents for their views on the way in which liability-driven investment or 'dedicated portfolio' strategies are evolving, and their experience of these strategies.

The majority of DB scheme respondents in our qualitative research reported that LDI is firmly embedded in their investment armoury as a means of helping them achieve desired outcomes, be they matching pension promises, controlling volatility, hedging against uncertainty or protecting positions.

Robert Jurkowski, Pensions Investment Manager at BOC Pensions said: *"Downside risk is our main focus. We are always probing the portfolio for our tolerances for risk and we run our regular risk analysis to assess our sensitivity. Unsurprisingly, our biggest exposure is to rates, followed by equities. Given that, we adjust our LDI hedging accordingly as well as diversifying our growth bucket."*

As an over-arching total portfolio strategy, LDI has not yet gained currency. Our research found that the classic strategy of rebalancing the growth-seeking, liability-matching elements of portfolios over the lifespan of the scheme until it becomes a target matched portfolio, remains typical of schemes.

90% of respondents surveyed maintain a traditional two portfolio (growth and LDI-based) model compared to 10% who manage their complete portfolio to an LDI mandate.

Alastair Russell (EDF Energy) commented: *"We've allocated 75% of our assets to the growth portfolio and 25% to the LDI portfolio. In effect, we're managing this to an LDI mandate. Because a portfolio that targets on an overall basis – gilts plus 'x', the 'x' is needed to close the gap over the deficit repair period but the whole portfolio, had we been fully funded, would target gilts, plus a little bit. The corporate and trustee have agreed to maintain the growth target until we are fully funded with the LDI hedging ratio increasing as funding improves. It doesn't make sense to pay someone to pull together a portfolio when we are already running ours in this way; it would just introduce another layer of cost to achieve the same outcome."*

Marc Boone (HeidelbergCement) said: *"If you look at it as an external observer then you would say that our approach is the traditional LDI and growth model. That is probably how our investment consultant looks at it. I personally look at the whole portfolio just because equities, to some extent, provide a liability cover, especially in the later years. So, for example, we do a lot of inflation coverage in the short term with bonds and then rely on the equities to deliver some of the inflation coverage in the long term."*

LDI has not been adopted by local authority pension schemes to the same extent but this is expected to change.

“Surrey has ventured into LDI as a means of achieving the long term funding objective”, said Phil Triggs (Surrey County Council). “We are comfortably cash flow positive so can easily meet the short-term liability targets. The number of LGPS funds that have ventured into LDI is still in single figures. I feel that this will increase substantially over the medium term. Currently, Surrey matches a proportion of its pension liability, but this will increase as the trigger point for leverage is reached. By using leverage, the fund can still focus on the need to maintain growth assets in the portfolio. Future infrastructure asset strategies will assist in the generation of CPI-proof income flows.”

Andrew Parker (Law Debenture Pension Trust) believes that LDI will have an increasingly important role to play: *“These assets reflect the liabilities of the scheme and they move in line with them. If there is a big hike in interest rates or a big drop-off in the returns from matching assets like bonds, then LDI helps assets move with the fluctuations in liabilities caused by market changes so you don’t get a bigger deficit caused by returns moving one way and liabilities not adjusting. However, you do need a mixture of type of asset: some people have gone 100% hedged, that is probably excessive, but most schemes still need some growth capability, so it could easily be a 80/20% or 90/10% split.”*

Robert Jurkowski (BOC) agreed: *“Even in our de-risking scenario, we will maintain some element of growth exposure to allow us to harvest a premium for addressing our longevity. So managing the complete portfolio to an LDI mandate would be unlikely.”*

Complexity was revealed as another potential barrier to the adoption of an out-and-out LDI approach.

As one consultant put it: *“There’s a fear of over-diversifying, choosing the wrong combination of assets, and then having to explain to people ‘why’ when they ask: ‘Why didn’t you just buy equities?’”*

Trustee board, investment resource and skill all have roles to play, as Inder Dhingra (Law Debenture Pension Trust) suggested: *“It comes down to the individual trustee boards and how comfortable they feel in looking after the assets, managing the portfolio. Growth pot, liability pot, managing them together; it could all work but you need a very good risk management framework to make it all work effectively together.”*

The danger of becoming locked into unattractive interest rates was also reported as a potential problem.

Chetan Ghosh (Centrica Pension Schemes) said: *“The downside to LDI is the connotation that you have to hedge all of your liability value and by doing that you are basically locking into extremely unattractive interest rates. We think there’s a big danger in an approach where the philosophy drives you into wholesale leverage into an over-valued asset.”*

It was rare in our research, for schemes to employ an LDI mandate across their entire portfolio although indications were that the distinction between the growth portfolio and liability matching appears to be becoming increasingly blurred: scheme managers and trustees talked more in terms of desired outcomes explaining that the asset choices they make to achieve these may cut across traditional growth/LDI boundaries. As one respondent put it, this requires “putting the necessary plumbing in place” to establish clear investment objectives, and develop relationships with managers who have the appropriate skills and flexibility to respond to opportunities swiftly when the conditions are right to do so.

Alastair Knowles, Head of Board Support, BAA Pension Trust, Heathrow Airport Holdings said: *“What we would like to do is use a liability based benchmark and, instead of targeting our managers on different benchmarks depending on which asset class they’re in, actually allocate by outcome, say, we have a liability of ‘x’ and we need ‘x’ plus 4.5% to bridge the deficit.”*

John Chilman (FirstGroup) highlighted the need for managers to demonstrate skills across multiple asset classes: *“We are considering moving even less into equities and more to skill-based managers that have the opportunity to swing more widely between asset classes. In particular, we are looking at managers that can work across the whole spectrum as opposed to giving a mandate that says, ‘you’re our global equity manager’ or, ‘you’re our fixed income manager’ – a mandate that allows them to use their skill and optimise opportunities.”*

Karen Shackleton (AllenbridgeEpic) was clear about the benefits of this approach: *“It gives you flexibility to move nimbly and dynamically when market conditions dictate that it is favourable to do so. If you suddenly see an opportunity to de-risk you want to do so without having to go to an equity manager in the growth portfolio and saying, ‘Could you liquidate this because I want to put it into my LDI portfolio?’ It is all done seamlessly within the same provider.”*

“An LDI mandate gives you the flexibility to move nimbly and dynamically when market conditions dictate that it is favourable to do so”

Karen Shackleton, Senior Adviser, Allenbridge Epic Advisers



THE IMPORTANCE OF MANAGER SKILL AND AGILITY

A clear trend toward ‘seeking skill’ was evident from our research. Pension managers, trustees and their advisers expect investment managers to be able to move seamlessly between asset classes and act swiftly in response to market movements when required.

For some, the investment philosophy was deemed more important than the execution method. John Chilman (FirstGroup), for example, said: *“We buy the philosophy rather than become too concerned about how it is implemented, provided it can be implemented efficiently and in a timely manner. We like a mix of macro-type ideas and philosophies, to give us some degree of diversification. We appreciate that occasionally, particularly in times of stress, you can get correlation of all your managers so your direction diversification benefits are sometimes lost. We have to a bit careful there. We are open to any sort of approach provided it is understandable and explainable to a lay person. There also needs to be a clear articulation of how it [the strategy] could behave in certain market climates: the scenario planning in terms of the ‘what ifs’ is of great interest to us.”*

Calum Brunton Smith, Principal Consultant, Investment Advisory at KPMG talked about the benefits of managing a portfolio to an overall LDI mandate: *“For larger schemes, with relatively strong funding positions, it makes a lot of sense. Rather than saying we are going to move money out of growth assets into bonds over time, actually what you’re saying is we are going to set up a secure income-type strategy today that explicitly meets the pension payments as these fall due. We trade the policy of hope (of significant upside over the short to medium term) for the certainty of outcome without increasing cash funding costs. For smaller schemes it is more of a challenge – particularly where funding positions are weaker.”*

HOW LIQUID DO SCHEMES REALLY NEED TO BE?

“Liquidity in pension schemes, unless you are very, very mature, is overplayed”

Alastair Russell, Pension Investment Governance Director, EDF Energy

“Generally speaking, schemes don’t make as much use of their illiquidity opportunity as they could”

Charles Coase, Independent Trustee and Trustee Chairman, Aviva Staff Pension Schemes Ireland

“Liquidity is something which isn’t necessarily very well understood within some trustees’ roles”

Giles Payne, Director, HR Trustees

Pension funds have for a long time grappled with the challenge of ensuring that the assets they hold not only maximise returns but also can be bought and sold at a price and time that suits them. Today’s fundamentally more diversified portfolios offer better prospects for an appropriate liquid, illiquid balance. Assets once thought of as opportunistic have become core components in fixed-income portfolios and more active strategies (including private credit and direct-lending strategies) blur the lines between traditional and alternative investments.

A number of factors influence the appetite for schemes to embrace illiquid assets within their overall portfolios: the time horizon to maturity, the implications for an insurer if a buy-out is planned, and appetite for this kind of perceived risk.

For respondents in our research who were targeting buy-out, there were concerns about how insurers might react and the extent of illiquidity (such as infrastructure debt) considered viable.

Matt Fuller (Kingfisher Pension Scheme) noted: *“If we can get illiquid assets that an insurer is going to take on as part of a buy-out then essentially we would never have to sell, we could potentially transfer them across to the insurer; but what we see as being an ‘insurer-friendly’ asset today may not be in, say, five or ten years’ time when we’re actually looking to transact. We have to be careful about the types of illiquid assets we go into.”*

Giles Payne (HR Trustees) said: *“There is a fear around the conversion of illiquids when the intention is to buy out in the next ten years or so. But equally you need to look at exactly how you might expect to dispose of these assets and not just say ‘they are illiquid’. They may still be desirable in the marketplace and it may take some planning but you don’t do a buy-out in the space of one or two weeks, you do it over quite a long time and if you can plan to dispose of those assets, generally speaking you can.”*

As more and more DB schemes approach maturity, the role of illiquidity contracts.

David Kidd (Law Debenture Pension Trust Corporation) observed: *“The use of illiquid assets is totally related to the time periods involved: for instance a private equity investment with a lifespan of seven, eight, nine years is entirely suitable for a fund with twenty years to run. The shorter the maturity of the scheme, all other things being equal, the less likely it is that illiquid investments will be made.”*

Understandably, many respondents erred on the side of caution in relation to their liquidity needs.

“Pretty much all the schemes I am with have more liquidity than they need” said Inder Dhingra (Law Debenture pension Trust), *“because they’ve come from an historical position of investing in purely liquid assets or very liquid assets. The approach I adopt is that if I can project forward one or two years of cash flows in the scheme and have very high confidence that I can meet all my outgoings then I would feel comfortable maintaining some level of illiquid position.”*

Not everyone had faith that illiquid investments would deliver the stable, predictable cashflows they need. Robert Jurkowski (BOC) observed: *“We have a preference for what I would consider to be liquid growth assets as opposed to illiquid assets. That doesn’t preclude us from utilising allocations to hedge funds, for example. We are actually managing down our equity real estate allocation but conversely we have made a substantial allocation to commercial real estate debt. So in effect we are participating in lending and the tenure of those loans in three, four or five years. We are being paid an illiquidity premium over gilts of 250 to 300 basis points and aim to capture that illiquidity premium. Relative to infrastructure and/or equity, it is not appropriate for this particular pension fund given that we find sufficient assets to help us, particularly on the income side. Also, the cash flows from infrastructure are quite ‘lumpy’ as well.”*

For smaller schemes, gaining access to illiquidity premia can be perceived as complex and potentially costly. Calum Brunton Smith (KPMG) commented: *“For smaller to medium sized schemes, say under £150m in size, complexity is probably a more important barrier. That’s why solutions such as diversified growth funds and diversified credit funds have done very well on that small to medium scheme base, because it gives a much cleaner way of accessing diversified strategies.”*

John Chilman (FirstGroup) said: *“Illiquidity is a premium that is not dependent upon market conditions so we are looking at increasing our exposure to illiquid assets. We’ve also looked into some more esoteric markets like ground rents.”*

And Alastair Russell (EDF Energy) observed: *“To the extent that there is a premium for illiquidity, we are happy to exploit it. Liquidity in pension schemes, unless you are very, very mature, is overplayed. But we are cash neutral so we do not need to disinvest to meet liabilities.”*

Stephen Crosbie (Syngenta) said: *“Illiquid assets are important. The ones that we have entered into more recently are for producing income. We have had swap options and a currency overlay programme in place, but the trustee board doesn’t like the market rates on the swaps and it doesn’t like the market rates on bonds, so we looked at other investment opportunities and have gone into care homes and another type of property lease investments from which we are expecting bond-like income.”*

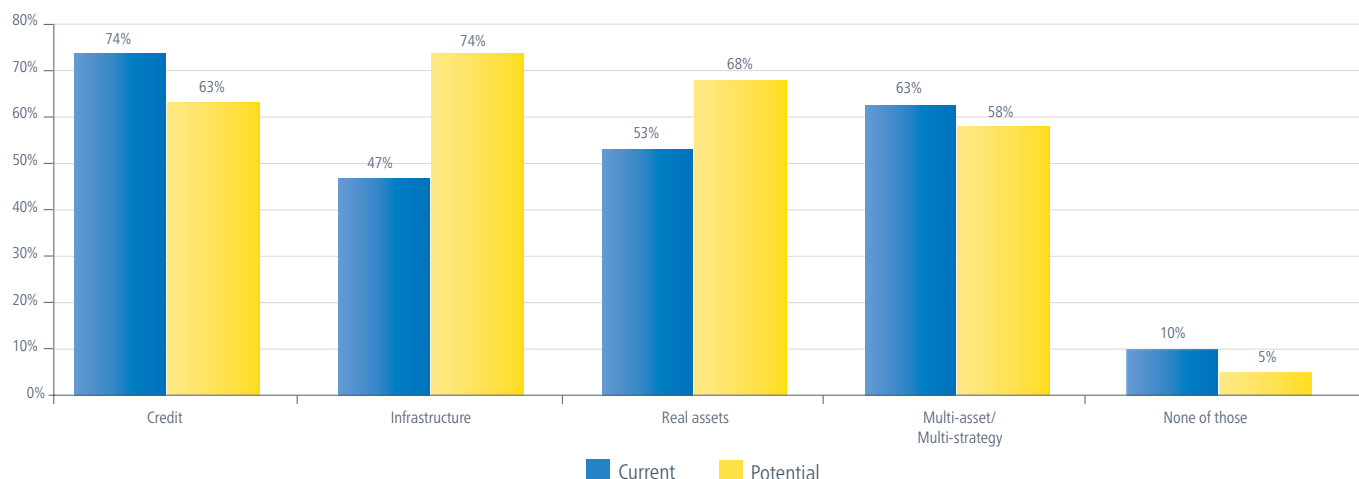
For cashflow positive schemes, where liquidity is not required, the potential for illiquidity premia is very attractive, as Phil Triggs (Surrey County Council) explained: *“Liquidity is not of great importance currently, given our comfortable cash flow positive status. Private equity is the most illiquid category at the moment. There are plans to add more. It is an attractive asset class, but there are some distractions, such as national asset pooling, which prevent resources from being spent on the research and implementation work.”*

Karen Shackleton (AllenbridgeEpic Advisers) agreed there is opportunity, providing the conditions are appropriate: *“As long as it’s thought through, illiquidity is something that a pension fund, particularly an open scheme with long term liabilities, should be considering as a means to get a good risk-adjusted return. But it has to be done with your eyes wide open as to what that will mean you can and cannot do quickly if you need to.”*

Scalability in the allocation to illiquid assets is important too, as Christine Farquhar (Cambridge Associates) said: *“One needs a critical proportion within the portfolio to make a difference, and to be worthwhile. Over the long term, the numbers prove that investors who can allocate let’s say 15 or 30% to illiquid assets, have secured better longer term returns. If you’re restricted to 5% it doesn’t make a big difference at all. If you can do that [commit to 15-30%] then we seriously think you should do it. We’re not just talking about those long-dated private equity strategies with a very long investment period followed by an equally long (or longer) harvesting period, but the illiquidity premium that exists in some floating rates or fixed income strategies, some real estate strategies. Those are the opportunities which, combined, we think are very helpful and probably could be of benefit to more pension schemes.”*

Twenty-nine per cent of respondents surveyed on line indicated that they were likely to consider moving to a single LDI-driven mandate. As part of their LDI/matching strategy, 74% were likely to consider allocating to (or would continue to allocate) to infrastructure, 68% to real assets, 63% to credit assets, and 58% to multi-asset/multi-strategy funds.

**Do any of the following asset classes currently play a role as part of your LDI/matching strategy?
Which of these do you consider to be attractive asset classes within your LDI/matching strategy in the future?**



Respondents reported that their LDI or matching strategy can contain, for example, credit as well as the traditional gilts and bonds, but it is unlikely that more illiquid classes such as infrastructure would be regarded as LDI. Infrastructure, real assets and private equity were more likely to be regarded as growth assets rather than LDI mainly on grounds that they cannot always deliver certainty of income; as one respondent commented: *“We are happy to invest in long lease property and other such assets with the properties to return something linked to inflation or otherwise, but we see those as growth assets.”*

Robert Jurkowski (BOC) noted: *“We have used credit within LDI, i.e. we get a spread pick-up over gilts; conversely we get some interest rate sensitivity i.e. we measure the interest rate sensitivity of our liabilities on a DVO1 basis relative to our hedge position using our assets; but that DV01 is fairly short dated, i.e. only six or seven years. So credit plays a part, but not a significant part, in the overall hedging programme.”*

Marc Boone (HeidelbergCement) said: *“Infrastructure is considered too inflexible: back in 2008 my trustees thought returns were too low and prices too expensive. Since then we’ve looked at a few opportunities but the consultants have steered the trustees away.”*

“If I look at the journey we’ve had in LDI over the last five or six years”, observed Calum Brunton Smith (KPMG), *“we would certainly consider incorporating any assets where cashflows were relatively certain and visible. We have used long lease property in the past, but don’t always use it on the basis that it doesn’t mark-to-market in the same way liabilities would. Over the long term, anything that contributes duration could be considered as part of the hedge.”*

In as much as insurance companies have to invest to meet their short term and long term liabilities, DB pension schemes might argue that their short term (i.e. cashflow) needs are built into their overall strategy: there is no differentiation in terms of asset allocation or investment strategy, especially among schemes that are open and therefore cashflow positive. Schemes in, or moving toward, cashflow-negative positions do of course need to ensure that their strategies allow for sufficient liquidity to meet their needs.

David Kidd (Law Debenture Pension Trust Corporation) said: *“Short term needs are accommodated within an overall strategy; you’ve got one basic issue: have we got enough money coming out of the scheme to pay the pensions? I don’t think short term liabilities matter that much.”*

The pension investment professionals we talked to were unanimous in agreeing that for a scheme that was cashflow negative, there would need to be a plan in place to fund the drawdowns required, and sufficient liquidity within the strategy to meet that; but they would not construct a strategy specifically using short term investments to meet short term cashflow requirements.

Over half (59%) of scheme investment strategies did not differentiate between long and short term liabilities in terms of the investments held.

ASSET ALLOCATION IS MOVING AWAY FROM THE TRADITIONAL MIX TOWARDS MULTI-ASSET STRATEGIES

Our findings strongly support the recent research paper *Asset-Allocation: Survival of the Fleetest*⁵, which says that investors have become asset class agnostic and are displaying a preference for unconstrained multi-asset class funds.

Phil Triggs, Strategic Manager, Pensions & Treasury, Surrey County Council, commented: *"We are substantially invested in growth assets, to recover a deficit dating back to the pension contribution holiday back in the early nineties when many local authorities took the chance to concentrate on a lower funding target rather than the 100%. We are still conscious of the need to have growth assets but we appreciate that, as we've seen since the start of August, there is a risk of volatility. The fact that we have invested in diversified growth funds, (12% of portfolios) demonstrates our belief that those strategies offer a degree of comfort on the volatility."*

"Giving managers a broad range of assets from which to achieve a target return profile, whether it be income or growth, gives them much more ability to use their broad range of skills and effectively play between the silos"

Giles Payne, Director, HR Trustees

MULTI-STRATEGY IS A KEY ENABLER IN THE CONTROL OF VOLATILITY

Volatility in the capital markets always has the potential to be disruptive and continues to raise questions for the way in which DB schemes balance risk and reward. Is their allocation to equities and other growth assets appropriate? Do they have in place protection against interest rate, inflation and other risk?

Our research found that DB schemes wanted to be sure they could control volatility as they moved towards their funding targets. They recognised that a multi-strategy investment approach better enables them to achieve this.

Matt Fuller (Kingfisher Pension Scheme) said: *"Schemes that are in their de-risking phase can't accept the volatility of high equity and low equity returns, so a solution that manages volatility more closely as you get towards your funding target makes sense."*

Christine Farquhar (Cambridge Associates) observed: *"In the greater scheme of things a multi-strategy target return fund, partly because performance expectations are based on the team's experience of managing these instruments in a real world environment, if it's got a single performance objective, that is helpful."*

⁵ CREATE-Research, October 2015

Calum Brunton Smith (KPMG) said: *"I think they [multi-strategy solutions] have got a place in sub £250 million pension schemes and for some of the bigger pension schemes I've seen them being used as well; they're an efficient way of getting a tactical tilt into your portfolio."*

Multi-strategy funds offer diversification, control over volatility and consistency of return: *"What you actually want is good capital preservation, absolute return and reasonable long-term return", said Charles Coase (Aviva Ireland Staff Pension Schemes). "Properly designed and executed it is a valuable volatility dampener in the overall portfolio."*

The appeal, and perceived relevance, of a multi-strategy solution was cited as most relevant to:

- Small to medium-sized schemes
- Schemes in the de-risking phase

"Multi-strategy funds make a lot of sense for smaller pension funds because you get a lot more diversification benefit for your small investment"

Inder Dhingra, Trustee, Law Debenture Pension Trust Corporation

Calum Brunton Smith (KPMG) also observed: *"For the smaller schemes, which make up the significant majority of the UK market, these funds are certainly not the panacea that they're made out to be but they are really good options to bring in some added diversification with a single allocation. Quite frankly, many schemes don't have the appetite or governance budget to deal with making multiple credit and growth strategy allocations. For those reasons, a multi-strategy fund can offer a good solution to access a broader opportunity set, and yes there is a premium in terms of cost but it is typically not exorbitant and is not dissimilar to what many schemes would pay for an active equity strategy."*

Our research found that multi-strategy funds (typically in the form of diversified growth funds) are playing a central role in the accumulation strategy for DC schemes, and target return funds can offer valuable returns, one-stop diversification and much needed control over volatility.

Managing volatility and diversification were seen by respondents as the most attractive aspects of such solutions, challenges which were considered more important than "chasing growth" in the accumulation stage.



“It is even more important for DC funds to have the best investment ideas, thinking and access to illiquidity. Multi-strategy funds are increasingly seen as the best way to go”

John Chilman, Group Reward & Pensions Director, FirstGroup

Multi-strategy solutions were appreciated for their implicit versatility. Robert Jurkowski, (BOC Pensions) remarked: *“The reason why we introduced the DGF into the DC side was to dampen downside within the growth component.”*

Matt Fuller (Kingfisher) noted: *“Something that can manage volatility in those early stages and more so in the latter stages as well would have a place.”*

Alastair Russell (EDF Energy) commented: *“In setting up the DC section, we will have a cash fund, equity funds, credit funds, and my personal preference would be to include a DGF style fund as well”;*

And Marc Boone (HeidelbergCement) said: *“Having a reasonable chance to make a good return over long periods of time is important but having adequate diversification to minimise the pitfalls that might greet us from time to time is just as important.”*

THE ROLE OF THE EMPLOYER IN DC TODAY AND THE FUTURE OUTLOOK

Employers are paying close attention to their DC strategy in the wake of the new pension freedoms. Our research found that their typical response has been to revise the DC proposition in order to give members more choice and flexibility on retirement by offering two or three lifestyle options with different outcomes:

1. The traditional default model targeting 25% cash, 75% annuitisation on retirement.
2. The drawdown option: for members who wish to stay invested and draw down over time.
3. The cash option: for members who wish to withdraw on retirement.

This evolution of DC strategy places a responsibility on the employer to provide good, fit-for-purpose investment options in each case, and to play a part in communicating to, and educating members on, the choices available and what the implications might be. We asked respondents how they saw their DC offering evolving in the future, about their perceived responsibilities, the importance of choice, flexibility to self-select, and pricing.

We asked to what extent the following factors will influence the evolution of respondents' DC offering in the next few years; the findings are ranked in order of importance:

1. Target returns in the accumulation phase
2. Pricing
3. The need to:
 - Consider/offer annuity-alternative products
 - Offer post-retirement solutions
 - Give members more choice/flexibility to self-select

Matt Fuller (Kingfisher Pension Scheme) observed: *“You are asking people that haven’t made a choice in relation to pensions probably for the bulk of their career, to answer difficult questions, ‘What do you want to do in retirement? Do you want to draw it down as cash? Do you want to enter drawdown over a few years? Do you want to buy an annuity?’ There is more responsibility on Trustees and employers to explain some of the benefits (or otherwise) to members in relation to the actions they take and also the tax consequences.”*

“Trustees are very well aware that the world is changing,” said David Kidd (Law Debenture Pension Trust Corporation) *“that the market place is changing and members are asking more questions. To give you one illustration of that, there has been an absolutely enormous change in the budget that trustees are setting for the DC element of their schemes. I have got one scheme where we are going to be spending four times as much money on DC next year as we did last year on consultancy, on communications, which is very important. Having got the building blocks in place correctly, how we communicate with members is a huge challenge for trustees and for the company because sometimes companies have got a very strong view, which is why we want to make sure this is part of our overall reward programme; we want to make sure the pensions element is at least as good as other elements of the programme.”*

WHERE DOES RESPONSIBILITY BEGIN AND END?

Employers responding to our research were clear about their responsibilities to their members stopping at the point of retirement. There was no appetite to take on the accountability risk of advising members on their retirement investment/drawdown decisions or to offer post-retirement solutions to members who may run out of money during their retirement.

Andrew Parker (Law Debenture Pension Trust Corporation) noted: *“The single most important thing for employees in the 30 to 40 age range is for the people running their pension arrangements to engage with them and for them to get a clear understanding in what saving for their retirement will mean.”*

“We are happy to help and encourage people as much as we can whilst they’re working for us, and all the way up to the point of retirement,” said Matt Fuller (Kingfisher Pension Scheme). *“Once they get there then we will signpost them to different areas and give them the education or communications that we can, but then it is up to them at that stage to make their own choices – we didn’t want to offer, for example, drawdown through the scheme. I think the majority of pension schemes are happy to take members up to the point of retirement but there are few occupational schemes that are taking them beyond that.”*

“The old days of benevolent employers thinking very long term into the retirement benefits for their employees, are drifting away”

Inder Dhingra, Independent Trustee and Director, Law Debenture Pension Trust Corporation

Charles Coase (Aviva Ireland Staff Pension Schemes) said: *“In the short term, we expect that people retiring out of the DC scheme will take their tax-free cash but in another ten, fifteen or twenty years’ time clearly people will not have the DB underpin so they might, at that point, take a certain amount of the pot as a guaranteed income for life and leave the rest invested for drawdown.”*

Andrew Parker (Law Debenture Pension Trust Corporation) agreed: *“The current DC retirees population may well have DB legacy accruals tucked away in their back pockets from previous employment; so they are unlikely to be representative of what is going to happen in years to come for those retiring from a DC environment.”*

PRICING AND THE CHARGE CAP – HELPING OR HINDERING?

While diversification, low volatility, member choice (which often means less not more) and effective communication and education, are features of good practice in DC default strategy, a significant barrier exists in the form of the 0.75% charge cap for investments. Given the weighting for DGFs and multi-strategy funds these become unaffordable options and, until pricing structures are re-aligned it is unlikely that DC default strategies can take full advantage of the opportunities for growth offered by such investment solutions.

Robert Jurkowski (BOC) said: *“One of the big issues is trying to drive down cost on platform funds. There are some areas that we would like to access but it’s not possible for a manager to provide that product at less than 75 basis points.”*

Calum Brunton Smith (KPMG) commented: *“Within the DC market, the main barrier for diversified growth funds is the charge cap within default strategies – which typically accounts for around 90% of DC plan members. The cap limits the ability for a default strategy to invest in sophisticated DGFs due to cost. This is somewhat frustrating as DGF is a fantastic vehicle for many DC members, but we are already seeing innovation to manage down the costs of accessing this type of strategy.”*

“We’ve had to change our provider because of the cap,” said John Chilman (FirstGroup). *“This was not due to our investment cost being high. It was due to the admin cost being high because this is a new DC fund and there is a very small amount currently being paid in. In certain cases it would be better if there was more skill applied in more areas but I don’t think you can do it within the cap.”*

CONCLUSION

Investment decision-making by today's UK private and public pension schemes is evolving in order to strike the right balance between return-seeking and liability-matching assets – moving away from a traditional, siloed asset mix towards more holistic, outcome-oriented strategies. This approach, in the words of one respondent “gives managers a broad range of assets from which to achieve a target return profile, whether it be income or growth”, and which in turn “gives them much more ability to use their skills and effectively play between the silos” to reach the outcomes desired. Re-thinking risk and return, seeking illiquidity premia, and investing in multi-strategy solutions designed to limit the impact of market volatility were acknowledged as important steps towards achieving these aims. In this regard, sophisticated manager skills are in demand: ‘seeking skill’ was widely reported in our research and suggested a growing recognition among schemes of the importance of advice-led diversification within investment strategy. The traditional growth and LDI model still has some salience, particularly for schemes with long time horizons or that need to recover from deficit positions, but the distinction between a growth portfolio and liability matching is becoming increasingly blurred and the argument for a different approach is gaining traction.

Commenting on the findings, Mark Versey, Chief Investment Officer, Global Investment Solutions, Aviva Investors, commented:

“Rather than looking at LDI independently from growth portfolios, we think it is right for pension schemes to consider an outcome-oriented approach. This replaces a two-portfolio model and the extensive use of individual indices to measure performance that this entails and instead uses a single portfolio model and a much more meaningful benchmark: the scheme’s actual liabilities. This enables trustees to consider risks taken on interest rates and inflation in the same context as risks taken on equities, real estate, alternatives and all other market risks in meeting future liabilities, and changes can be implemented far more quickly and meaningfully.”



ACKNOWLEDGEMENTS

Mike Anthony, Independent Trustee, Capital Cranfield Trustees Ltd

Marc Boone, Global Head of Pension Asset Management, HeidelbergCement AG

Calum Brunton Smith, Principal Consultant, Investment Advisory, KPMG LLP (UK)

Steven Catchpole, Head of Pensions Investments, Aviva PLC

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Christine Farquhar, Research Consultant, Cambridge Associates LLC

Matt Fuller, Pensions Investment Manager, Kingfisher Pension Scheme

Chetan Ghosh, Chief Investment Officer, Centrica Pension Schemes

John Jones, Senior Adviser, AllenbridgeEpic Investment Advisers Ltd

Robert Jurkowski, Pensions Investment Manager, BOC UK and Ireland

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Alastair Knowles, Head of Board Support, BAA Pension Trust, Heathrow Airport Holdings

Gavin Orpin, Partner and Head of Trustee Investment Consulting, Lane Clark & Peacock LLP

Andrew Parker, Director, Law Debenture Pension Trust Corporation PLC

Giles Payne, Director, HR Trustees Ltd

Alastair Russell, Pension Investment Governance Director, EDF Energy PLC

Karen Shackleton, Senior Adviser, AllenbridgeEpic Investment Advisers Ltd

Mark Thompson, Chief Investment Officer, HSBC Bank Pension Trust (UK) Ltd

Phil Triggs, Strategic Finance Manager, Pension Fund & Treasury, Surrey County Council

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J5860-RA15/0836/29022016