Overcoming deficits and paying pensions – Challenges for providers and trustees

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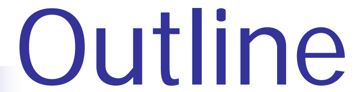


Outline

- Pension reality
- Moving away from traditional investment thinking
- Alternative investment approaches
- Challenges

UK pension reality

- UK liabilities much higher than other countries
  - Revaluation, spouse cover, inflation linking
- Final salary pensions cost >20% of salary says Regulator
- Employers now view pensions as company ‘cost’ not company ‘benefit’
  - Average job tenure 5 years – open ended commitment
- Employers looking for a way out!

Some history

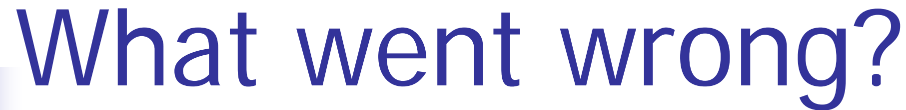
- Final salary scheme ‘surpluses’ gone
  - Dealing with deficits
- Actuarial valuations were easy
  - Just assume all OK based on long-run expected returns
- Accounting valuations now
  - Liabilities rising c.5% pa (bond discount rate)
- Need higher returns than this to plug deficit

Why deficits matter so much

- Corporate activity threatened by pensions
  - These are real liabilities
- Regulator requires higher investment standards from trustees
- Can't afford big losses now
- Constraint on investment

Investment history…

- Historic over-reliance on equities for high returns – one beta source
- Focus on outperforming markets or manager benchmarks
  - Fine in bull markets but…!
- Assumed rewards for taking equity risk would be high enough to meet pension liabilities
  - Unprotected against sharp setbacks – no insurance
- Seemed to work well for decades – old fashioned thinking



What went wrong?

- Investment returns underperformed rising liabilities
- Equities carry unrewarded pension risk - mismatch risk
  - Risk premium expected to match pension costs
- Sensitivity to interest rates and inflation not recognised
  - 1% fall in interest rates -> 20% rise in liabilities
  - 1% fall in interest rates -> 5% rise in assets
- In deficit, can't afford big setbacks but need returns

Muddled thinking on risk

- Traditional attitude: Manage returns and **TAKE** risk
  - Passive acceptance or even welcoming of risk
  - Don't worry about setbacks – no downside insurance
  - Ignored unrewarded risks

- Modern approach: Manage returns AND **MANAGE** risk
  - 'control risk' in measured, managed way
  - Minimise unrewarded risks – relative to liabilities
  - Asymmetric returns - protect downside, retain upside

Need to consider carefully

- Expected returns not the same as 'achieved' returns
- Just because equities outperform bonds on an 'expected' basis, does not mean outperform liabilities
- Certainly not consistently or reliably
- Once scheme in deficit, sharp stock market fall or liability rise could be fatal – risk for PPF
    - Switch to bonds to reduce risk?

Switching to bonds dangerous

- Bonds reduce 'risk' as measured by <u>volatility of return</u>
  - But in exchange for much reduced upside potential
- Investment risk for pension funds not just about volatility
  - It's about not being able to pay the pensions
- Pension liabilities are 'bond-like' but are not bonds
  - Bonds most likely to underperform liabilities
- Bonds still contain unrewarded risk
  - Salary inflation, lpi, longevity, duration, capital loss

Regulator and PPF unhappy

- Not enough gilts – bubble
- AA corporate bonds >15 year duration only 8% of market
  - Have to sacrifice quality
- Switching to bonds doesn't match liabilities anyway
  - Could actually make deficits worse
- Even if bonds did match liabilities, it's not enough
  - Reducing deficit requires *outperforming* liabilities

Boots experience

- John Watson – FT letter Feb 2005
- *'Investing in bonds does not guarantee pensions will always be paid'*
- *'Investing 100 per cent of the scheme's assets in bonds is not risk-free'*
- Boots fund had £56m deficit in May 2006

LDI

- LDI is not just about cash matching or piling into bonds
- Deliberate decision framework to take risk in a controlled way, in pursuit of required returns
  - e.g. Gilts +1.5-2% + extra ?
- Even schemes in surplus may want extra returns above bonds to cover unexpected liability changes/longevity
- Trustees need risk management or minimisation
  - Not elimination

Challenges for trustees

- New skills required of advisers and trustees
- Much more complex, lot of change, governance
- Positive absolute returns over time
- Alternative assets
  - Currency overlay, hedge funds, private equity, real estate, infrastructure

Improve portfolio efficiency

- Many sources of investment inefficiency in global markets
  - Diversification, low correlations – free lunch
- Seek diversified sources of beta return
- Seek sources of alpha from talented managers
- Trustees should take risks they expect to be rewarded for
  - Minimise risks not expected to generate returns

Also need downside protection

- Especially if sponsor weak
- Derivatives can offer efficient and effective insurance against worse deficits
  - Swaps to help match inflation, duration
- Deficit – non-bond diversification
- Longevity – higher consistent returns

Swaps and derivatives very useful

- Swaps and derivatives can help minimise unwanted risk
  - More liquid and flexible than bonds – still need upside
- Can better match liability profile – durations, lpi
- UK trustees slow to adopt derivatives:
  - 14% UK, 50% Holland, 70% Sweden, 100% Denmark
- Providers to help with transition to modern approaches
  - Complexity is fact of life

Complexity of swaps and derivatives

- High governance budget essential
- Administrative nightmare
- Valuations, collateral, pricing, ISDA
  - Mistakes can be costly
- If can't do in-house, look to outsource to experts

Challenges for providers

- Understand trustee problems
  - Deficits + weak or reluctant sponsors
- Help pension funds with some insurance policy
- Asymmetric returns – alternative approaches
  - Minimise downside risk vs. liabilities, keep upside
- Help with complexity of swaps
  - At reasonable cost?

What can be done?

- Traditional approaches unlikely to work reliably or consistently
- New strategies not easy
- Challenges for pension industry to help trustees with new investment approaches
- Who has the expertise and ability to help?