

05 November 2019

# Pensions and Lifetime Savings Association (PLSA)

North London Group

# DB endgame

**Keith McNally, Senior Solutions Director - Pensions**

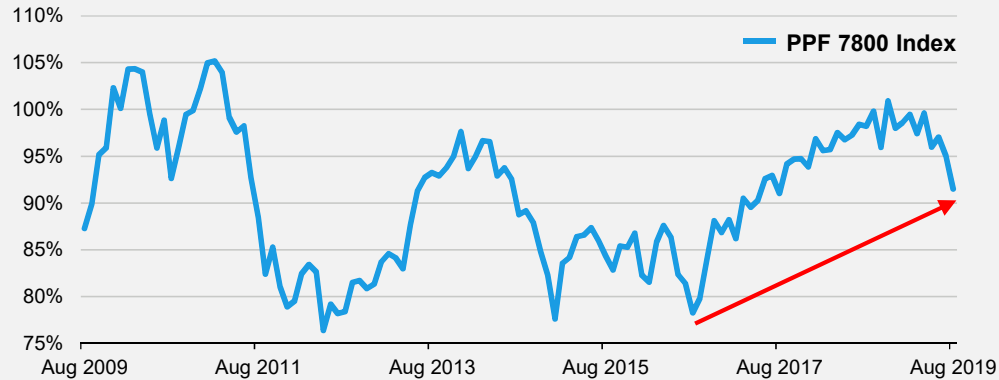
**Timea Varga, Senior Solutions Specialist - Pensions**

# Market background and DB endgame options

# The UK DB pension scheme landscape

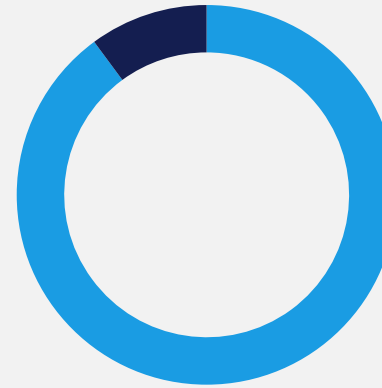
## A sharper focus on the endgame

### Funding levels gradually improving but remain volatile



Source, PPF 31 August 2019

### Pension schemes are maturing

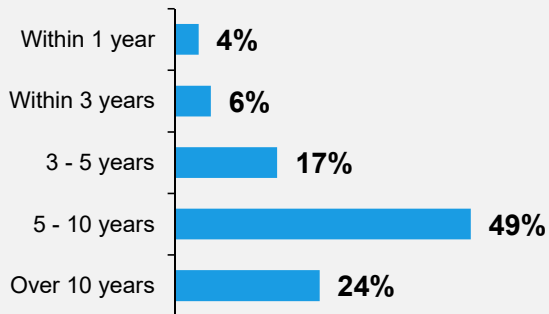


90%

of UK DB pension schemes expected to be cashflow negative by 2028

Source: Mercer, European Asset Allocation Survey 2019

### When will schemes reach their endgame?



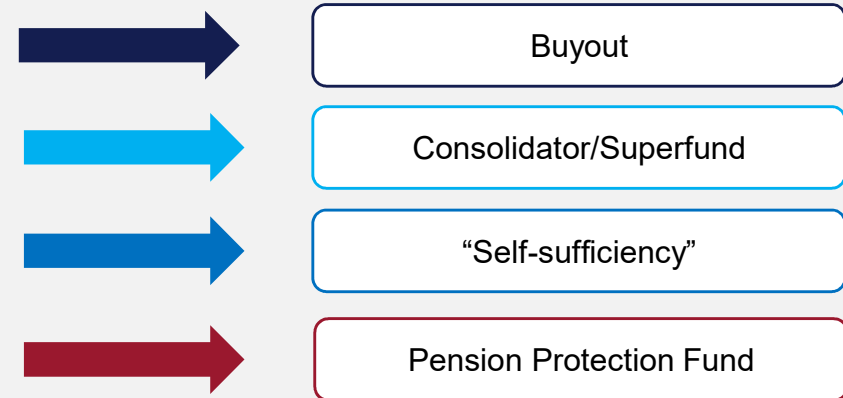
When will you reach full buy-out or self-sufficiency?

>75%

Expect to reach their long-term objective within next ten years

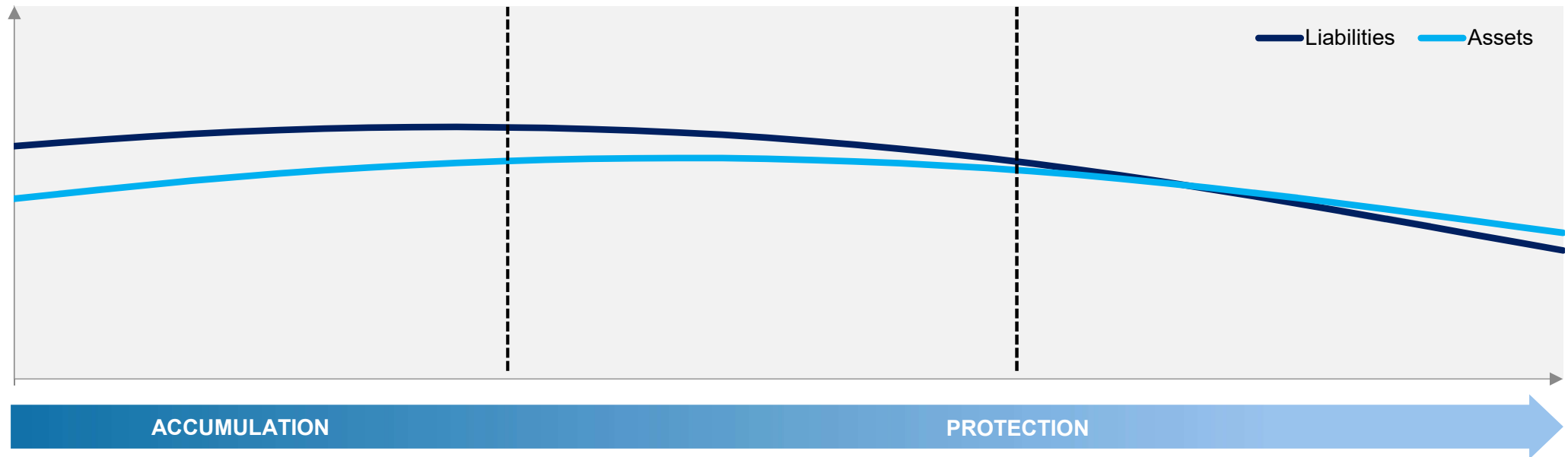
Source: LCP pensions de-risking report 2019

### What are the options for the endgame?



# Investing for the endgame

## A changing focus as schemes move along their de-risking journey



**Growth:**

- Typically a requirement for growth to close funding deficit

**Preservation:**

- Increasing hedging level to reduce interest rate and inflation risks

- Income:**
- Matching cashflows not a significant focus

**Growth:**

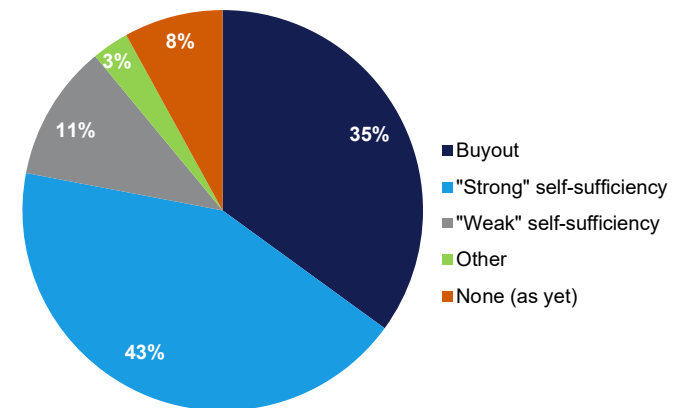
- Lower growth requirements as funding level improves

**Preservation:**

- Hedging precision has increased with a high level of interest rate and inflation protection

**Income:**

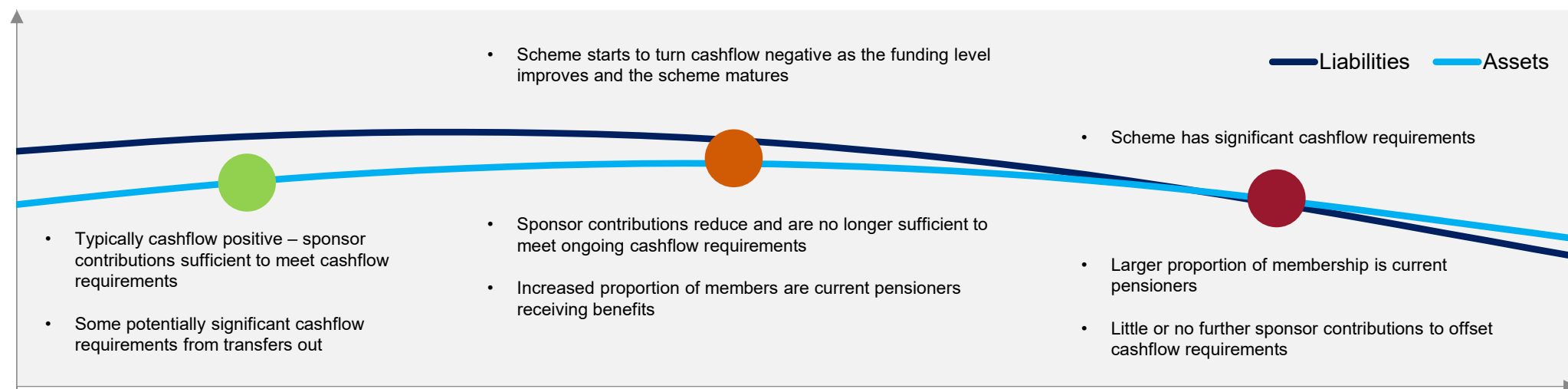
- Higher focus on “sequencing risk” and cashflow matching (e.g. pensioners)



Source: Aon Hewitt, Global Pension Risk Survey 2019  
For illustrative purposes only.

# Investing for the endgame

## Changing cashflow requirements



## What are the different approaches?

### Regular disinvestments

Cashflow needs are met by regular redemptions of units in the strategy  
 Risk of being a forced seller in down markets and crystallising losses

### Investing in income generating asset classes

Cashflow needs are met by taking distributions from assets that generate income  
 Income can be generated from a wide range of assets including growth assets such as equities and property

### Cashflow matching

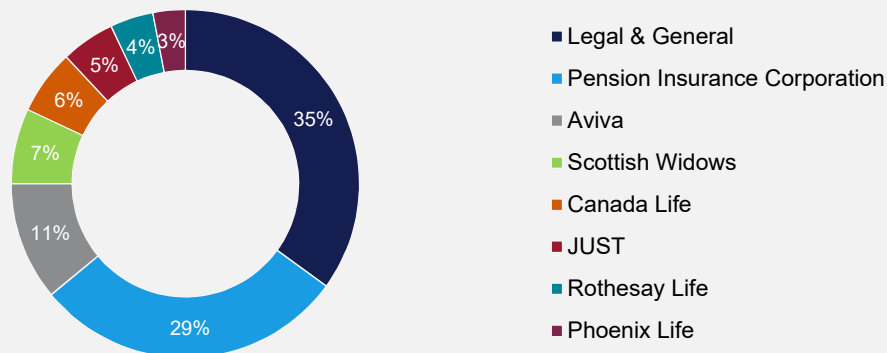
Assets are managed such that coupon and redemption payments are structured to meet required cashflows  
 Typically managed on a buy and maintain basis

For illustrative purposes only.

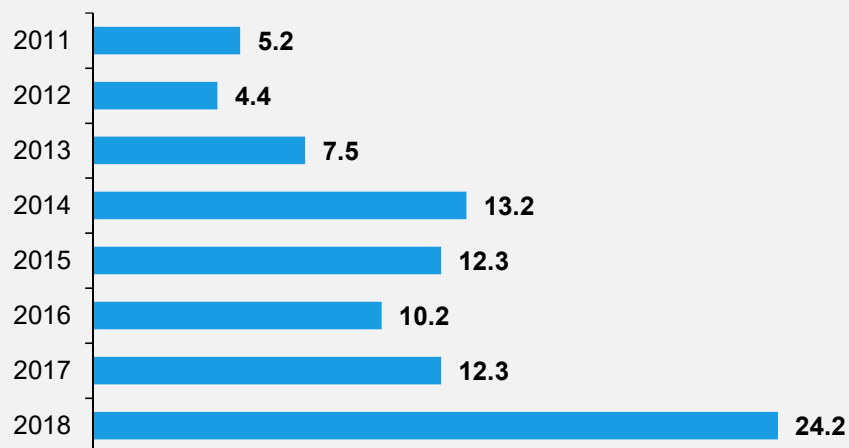
# Insurance company buy-in and buy-out activity

Record year for insurance transactions... but when will demand outstrip supply?

## 2018 transaction volume by insurer



## Volume of buy-ins and buy-outs (£' billion)



LCP pensions de-risking report 2019

## Practical considerations

Affordability?

Challenges for small schemes?

Insurance market capacity?

Investment strategy considerations?

- Timescales for buy-in/buy-out?
- Creating "insurance-friendly" investment portfolios
- Hedging insurance company buy-in/buy-out annuity pricing
- Identifying opportunities within illiquid assets

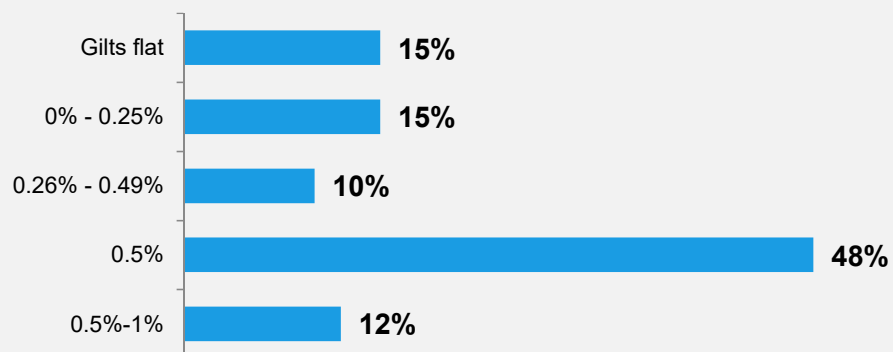
# “Self-sufficiency” or “low reliance” approach

## Keep on running...

“Under a self-sufficiency approach, the **ongoing reliance** on the sponsoring employer is **kept at a minimal level**. This requires a **low-risk investment strategy** to minimise the chances of the employer having to make good any investment losses. Typically, the investment approach may be **similar to that of an insurance company** under the buy-out approach, but **without the solvency requirements** of an insurance company **and the need to make a profit for shareholders.**”

*The Pensions Regulator, “Understanding DB pension scheme funding”, April 2018*

### Self-sufficiency basis (assumed margin over gilts)



Source: Mercer, European Asset Allocation Survey 2019

### Practical considerations

Continued reliance on employer covenant

Running costs?

Longevity and other risks

Investment strategy considerations?

- Creating a “low reliance” investment strategy
- Exploiting the illiquidity premium
- Utilising flexibility pension schemes have over insurers
- Important to take a holistic view of investment risks



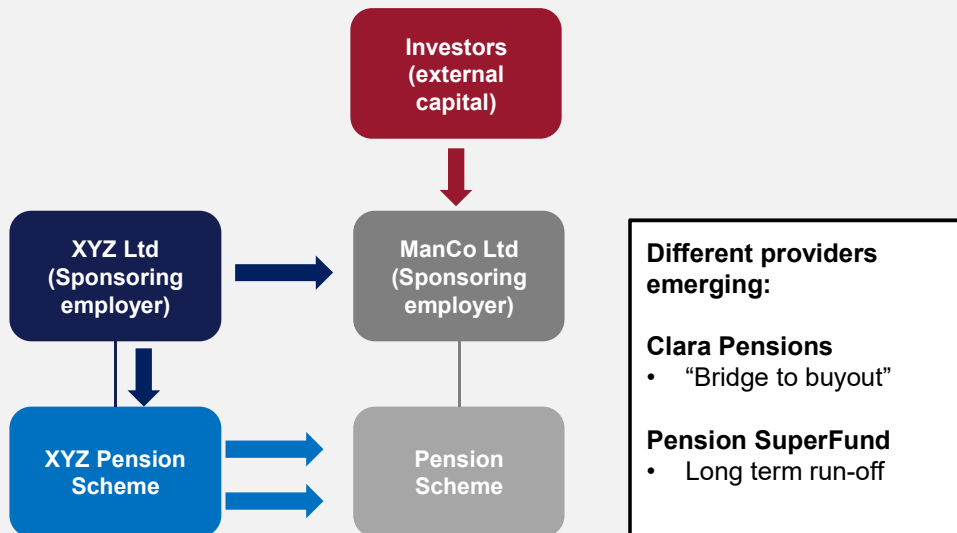
# Alternative endgame options emerging...

## The rise of superfunds?

### What are the main characteristics of a “superfund”?

- Occupational pension scheme set up to effect consolidation
- Link to ceding employer is broken on transfer to a superfund
- New “covenant” is a capital buffer provided by external investors
- Mechanism for returns to be payable to external investors

*DWP – consolidation of DB pension schemes consultation*



### Practical considerations

Awaiting formal regulations (post DWP consultation)

Different models and approaches being proposed

Consideration of covenant being “given up”

Is it suitable for your scheme? (Proposed “Gateway”)

- Exclude schemes that have ability to buyout at the point of transfer
- Exclude schemes assessed able to afford buyout in the 'foreseeable future' (defined as next five years); and
- A move to a superfund would need to be based on evidence it enhances the likelihood of members receiving full benefits.

# Investing for the endgame

# Navigating to your endgame

Different skillset is required when investing for the endgame



ACCUMULATION

Investment growth, and removing “unrewarded risks”

Full breadth of return generating assets, plus LDI  
focused on removing funding deficit



PROTECTION

Minimising risk, and increasing certainty of outcome

Predominantly low risk, income yielding, assets  
focused on your ultimate endgame objectives

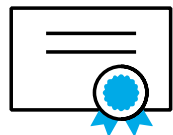


Partnering with an “expert in these waters”

Source: Aberdeen Standard Investments, 30 June 2019

# Navigating to your endgame

Different skillset is required when investing for the endgame



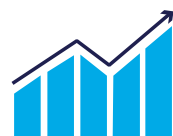
**Buy & Maintain Credit** with a strong track record of avoiding downgrades and defaults



**Alternative sources of contractual income** to access illiquidity premia and diversify risk exposures



**ESG\* Embedded** across investment capabilities to generate the best long-term outcomes



**LDI and derivatives expertise** for hedging residual risks including interest rates, inflation and currency risks



**Insurance heritage** and a track record of delivering **holistic pensions solutions** through connected teams



**Genuine partnership** working with a manager who helps you understand your options and who will implement the optimal solution for you

Source: Aberdeen Standard Investments, 30 June 2019. \*Environmental, Social and Governance

# Significant allocation to public Fixed Income assets

## Crucial to select a manager with a robust Buy & Maintain credit process

### Cornerstone of any CDI investment portfolio is a significant allocation to public and private debt

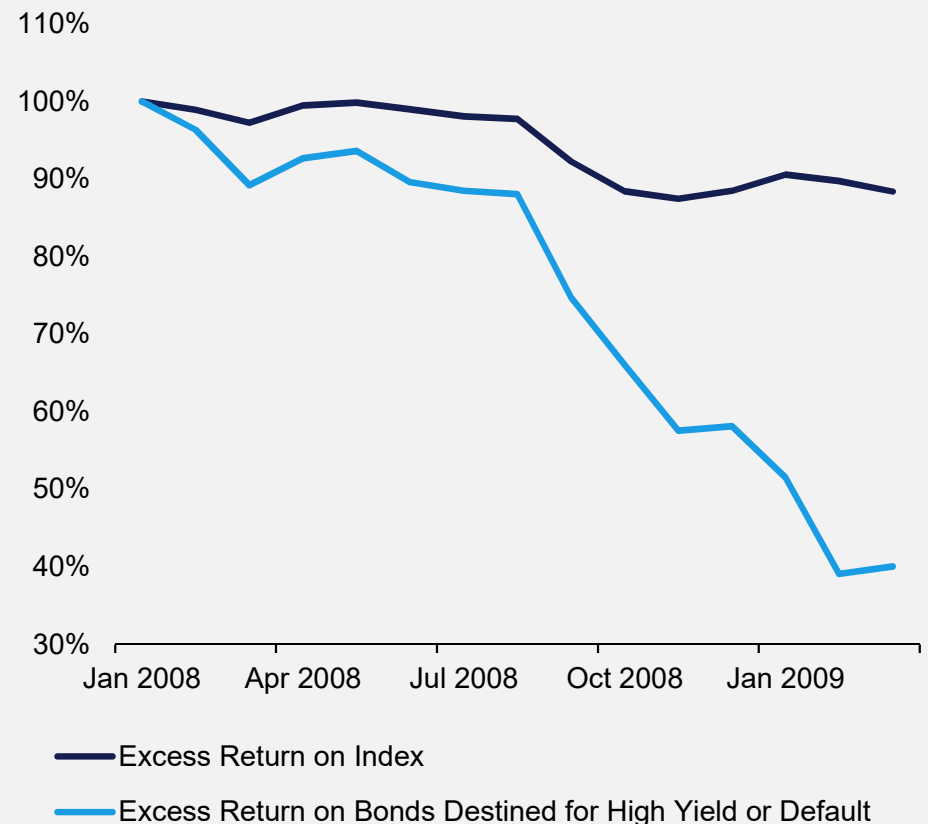
- Crucial to understand and manage risks
- Essential to have a fixed income manager with a robust credit research/fund management process

### Interaction between CDI and LDI

- CDI manager needs well established systems, processes and delivery mechanisms to provide data and work with LDI manager
- Potential benefits in managing LDI and CDI holistically – however it is much more important to first select the best CDI manager

**Primary focus should be on finding a manager with a robust Buy & Maintain credit process and a strong track record of avoiding downgrades and defaults**

Relative Performance of Index vs. bonds that downgraded or defaulted in the last credit crisis



For illustrative purposes only.  
Source: Aberdeen Standard Investments, April 2019

# The benefits of a holistic approach across Public & Private Credit

## Optimising your Fixed Income allocation

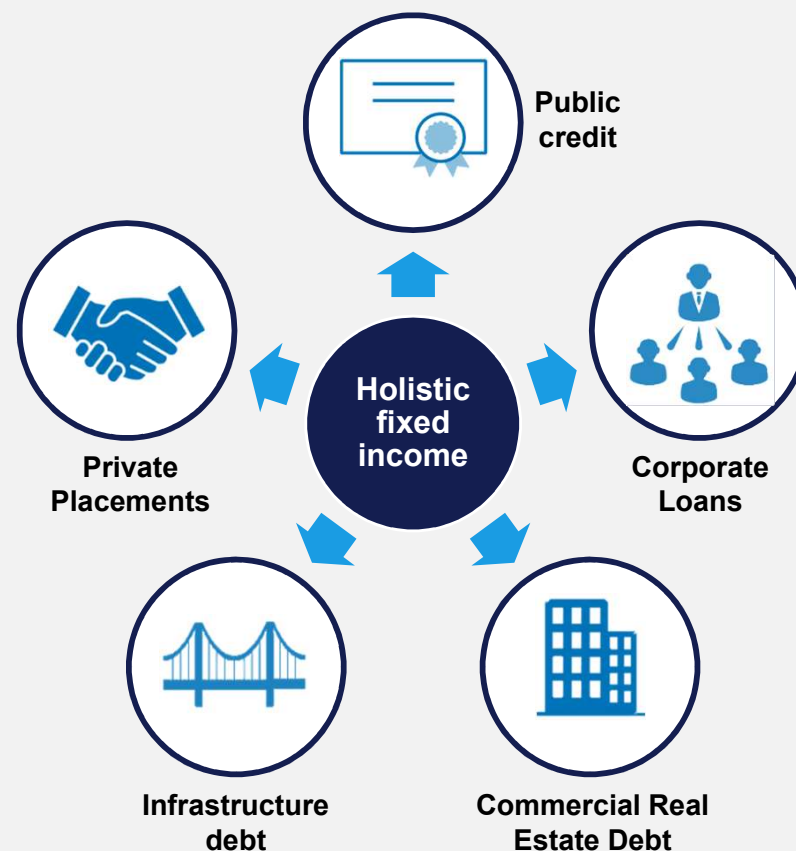
### Benefits of a holistic approach to investing in private credit

- **Flexibly allocate** across sectors with most attractive characteristics at time of investment
- **Reduce resourcing and governance** required to manage fund investments

### Benefits of a holistic approach across public and private credit

- **Ability to optimise exposure to sectors and risk factors:** flexibility to ensure that you maximise the return you receive for taking exposure to a specific sector or risk factor
- **Efficient implementation:** ability to optimise exposure to an individual credit name or minimise yield drag whilst building up private debt allocations

### Holistic fixed income approach can improve diversification

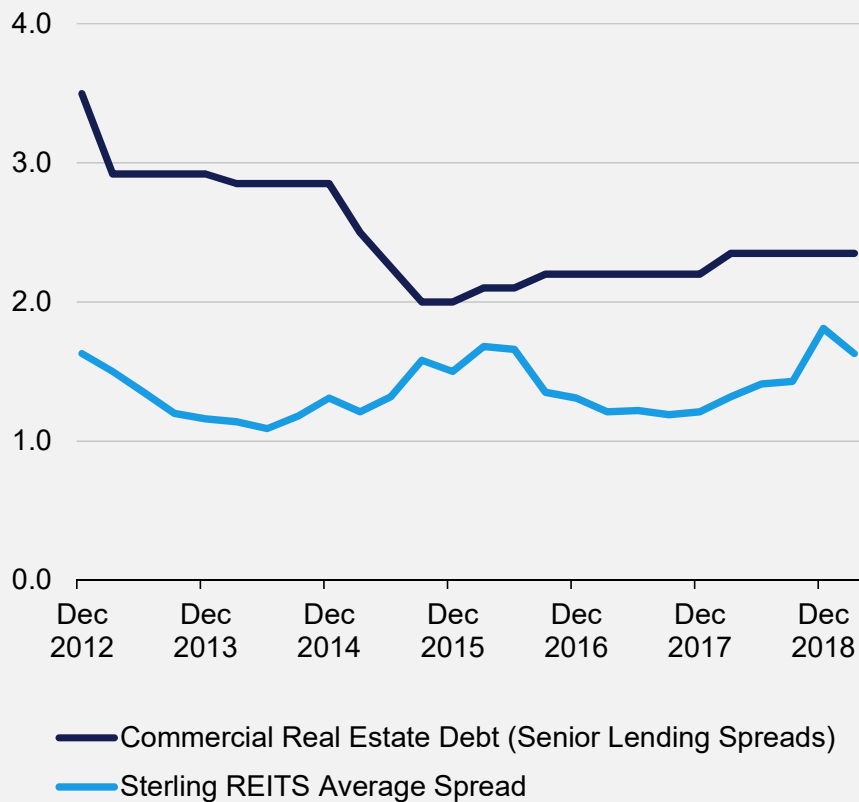


Source: Aberdeen Standard Investments

# The benefits of a holistic approach across Public & Private Credit

## Optimising your Fixed Income allocation

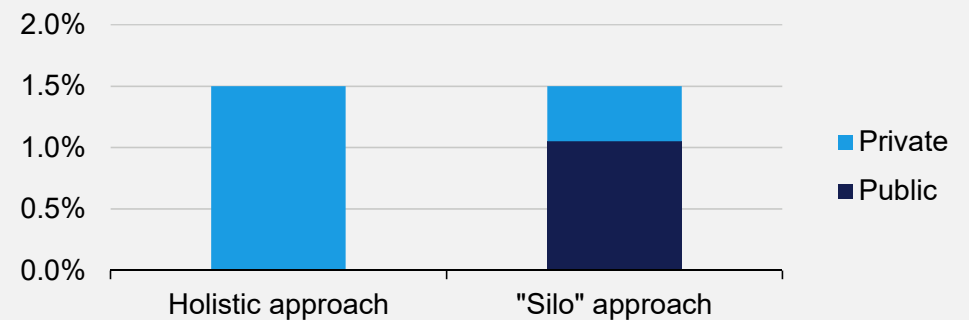
### Example: Optimising exposure to property risk



Source: Aberdeen Standard Investments

### Example: Optimising Exposure to an Individual Company

- Individual company issues both public and private debt – there is a positive credit view on both the public and private issues
- Suppose from a holistic perspective the optimal allocation for this issuer is to allocate to the private debt
- Portfolio restrictions – max allocation to individual name of 1.5%
- **Holistic approach to fixed income**
  - 1.5% allocation to private debt
- **"Silo" approach** (with say 70% public and 30% private allocation)
  - 1.05% allocation to public debt (70% x 1.5%)
  - 0.45% allocation to private debt (30% x 1.5%)



Source: Aberdeen Standard Investments

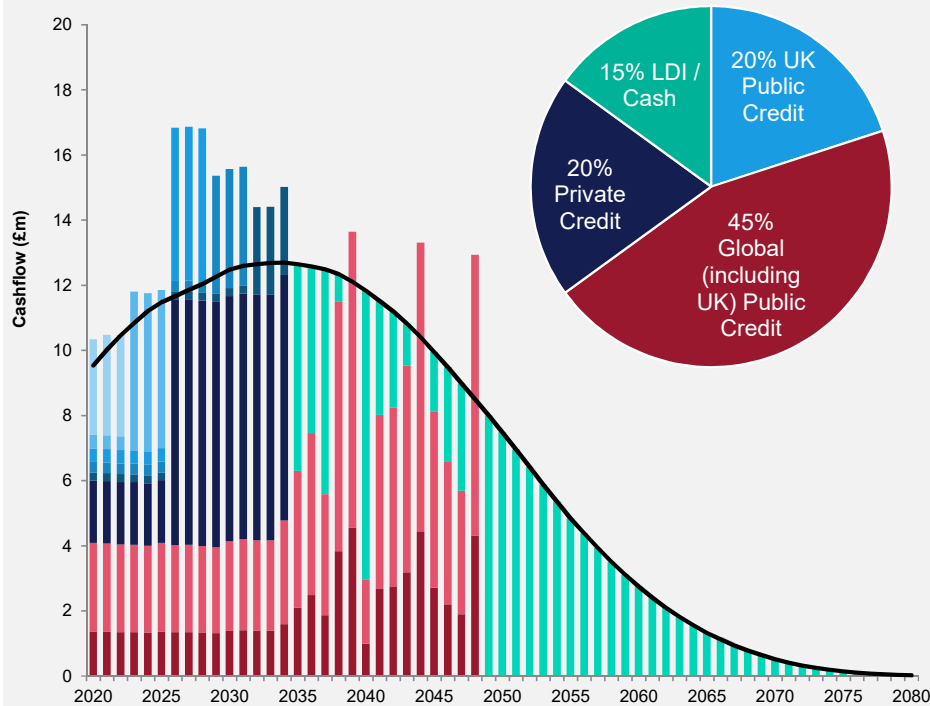
Investing for the endgame  
(considerations for smaller  
schemes)



# Navigating to your endgame

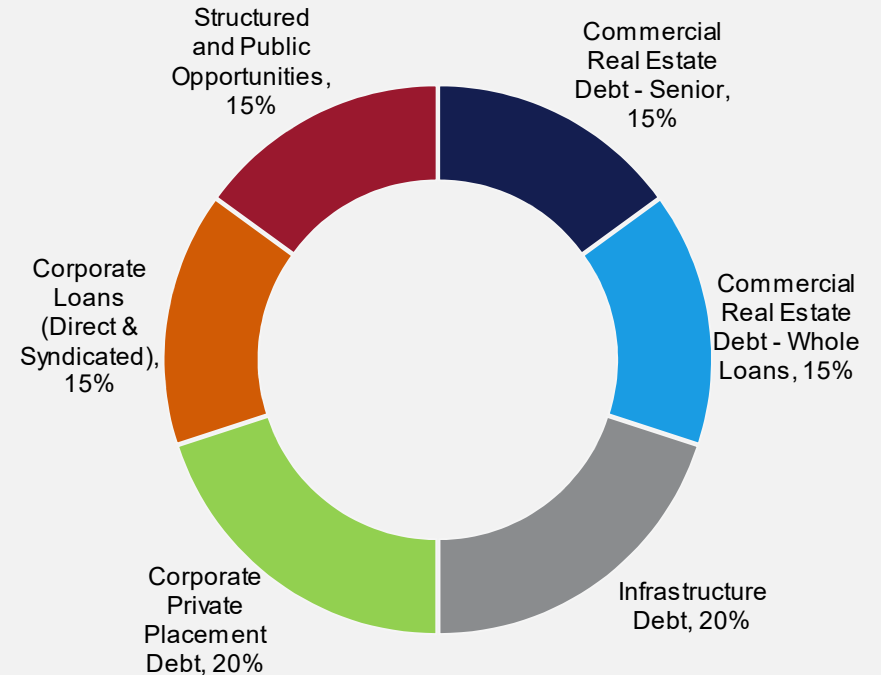
## Pooled investment solutions for smaller schemes

### Holistic pooled fund solution to meet cashflow requirements



- **Pooled buy & maintain funds** with focus on contractual income
- **LDI funds** to hedge residual risks
- **Well diversified global credit exposure**
- **Ensure sufficient liquidity** to meet unexpected cashflows

### Pooled diversified private credit fund targeting illiquidity premia

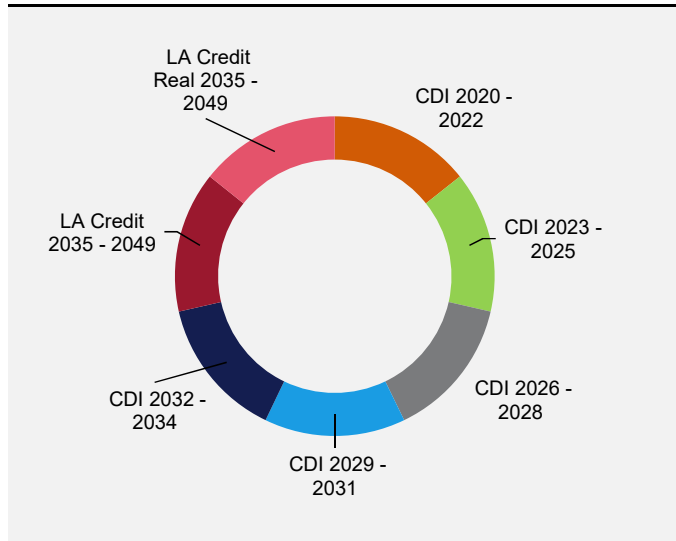


- **Expected yield:** 4-5% <sup>2,3</sup>
- **Expected spread** c. 280-300bps <sup>3</sup>
- **Quality:** Investment grade focus, senior, secured
- **Fund liquidity:** Quarterly subscriptions and redemptions <sup>4</sup>

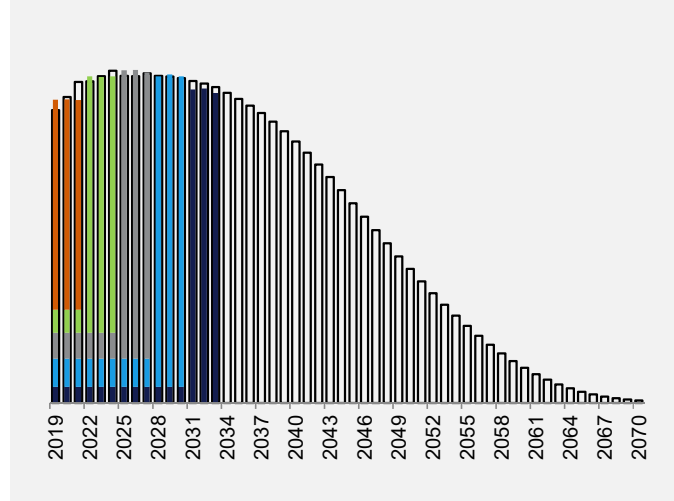
Source: Aberdeen Standard Investments, 30 June 2019. Past performance is no guide to future results. <sup>1</sup> Characteristics are indicative, and subject to change. <sup>2</sup> For the GBP share class. <sup>3</sup> Based on current and anticipated market conditions. Yield and spread level that is expected once the portfolio is fully invested, which could take 9-12 months following launch. Gross of fees and expenses. <sup>4</sup> Subject to there being offsetting subscriptions in the first 5 years, and subject to a fund-level gate thereafter.

# A range of options to meet cashflow requirements

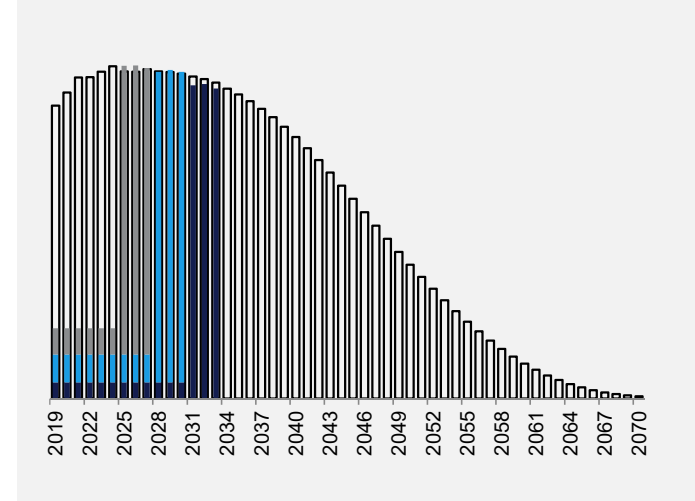
## Scheme specific income solutions



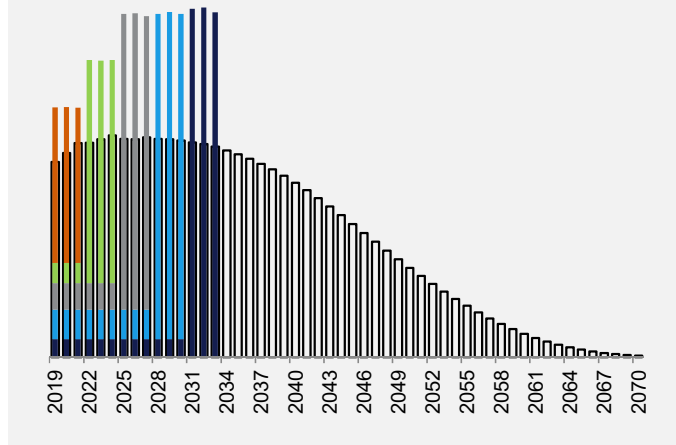
Full cashflow match for 15 years



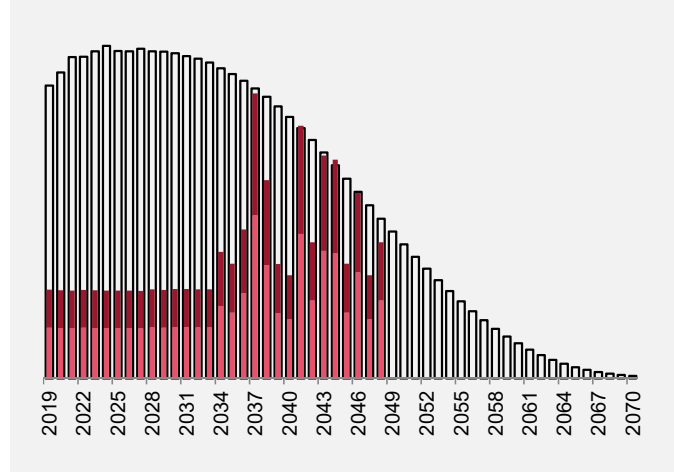
Allow for agreed deficit reduction contributions



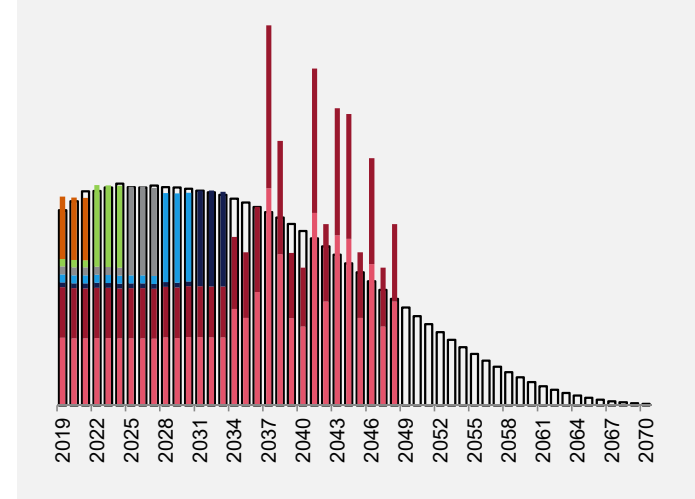
Excess cashflow over 15 years to meet unexpected cashflow requirements (e.g. transfers) and reinvest in future CDI funds



Income through exposure to long-dated buy & maintain credit (with option of inflation hedging)



Full cashflow match for 30 years utilising full suite of funds



# Case Study

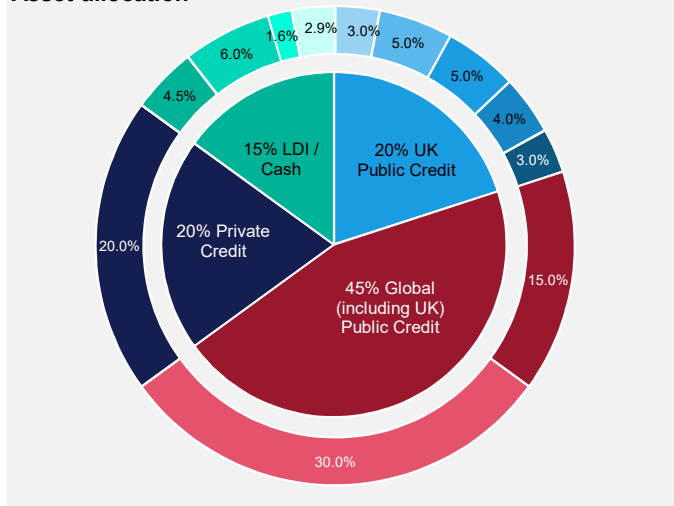
## Endgame solution



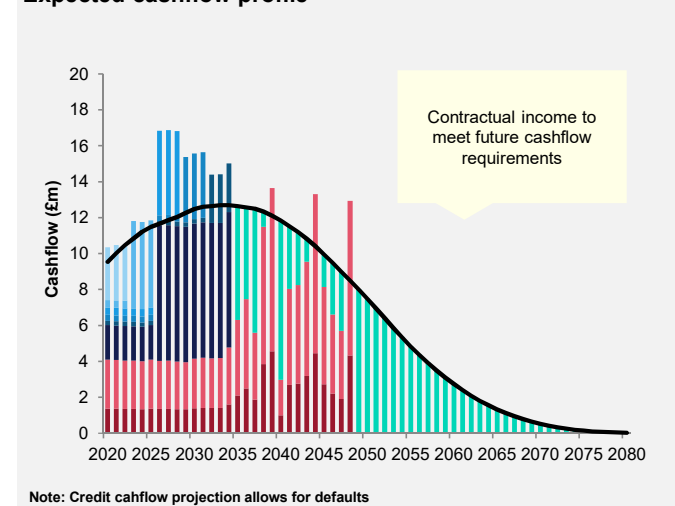
### Scheme overview

- Scheme is **closed to new entrants and accrual**
- Total assets: **£300m**
- Fully funded on a **gilts + 0.5% basis**
- Scheme duration: **17 years**
- Inflation proportion: **60%**
- The pension scheme is well funded and maturing over time. The trustees wish to adopt an “endgame” investment strategy to provide a high level of certainty of being able to meet all future benefits while minimising downside risk / reliance on the sponsor

### Asset allocation



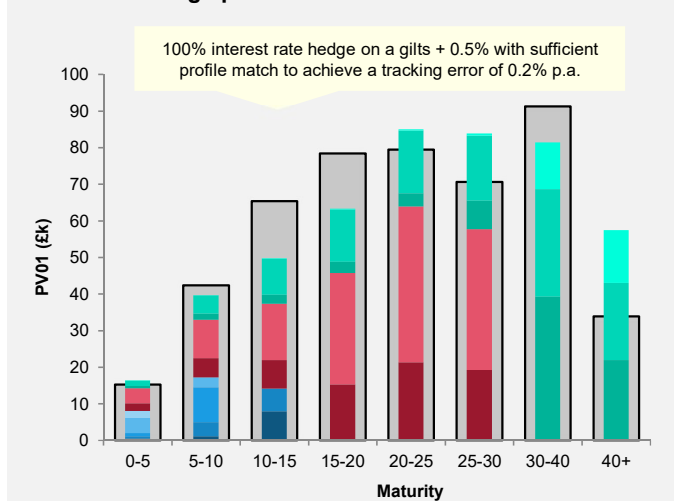
### Expected cashflow profile



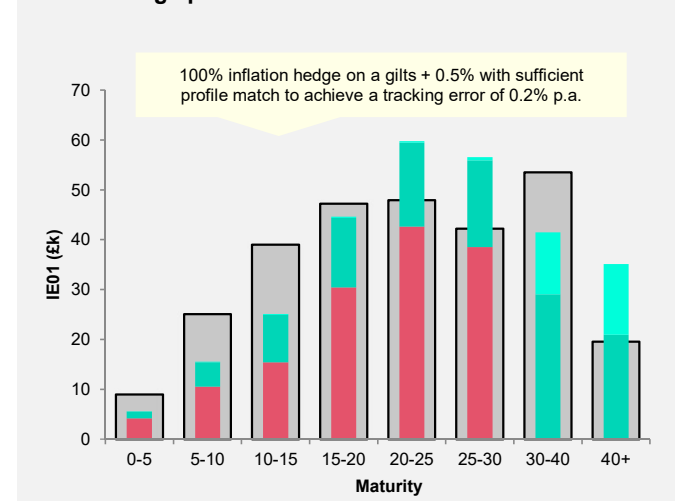
### Investment strategy consideration / objectives

- Focus on contractual income assets to meet future liability cashflows with limited reinvestment risk – reducing sequencing risk (including a prudent allowance for defaults)
- No exposure to traditional growth assets (e.g. equities) to reduce reliance on the sponsor
- Use LDI to hedge residual interest rate and inflation risk – low tracking error of hedge vs liabilities
- Well diversified global credit exposure (investment grade) including private credit allocation to exploit illiquidity premium
- Ensure sufficient liquidity to meet unexpected liability cashflows e.g. transfer values and potential LDI recapitalisation events
- Clear journey plan to naturally de-risk over time to reduce credit exposure and potentially buyout the scheme in the future

### Interest rate hedge profile



### Inflation hedge profile



Source: Aberdeen Standard Investments, 30 September 2019 For illustrative purposes only.

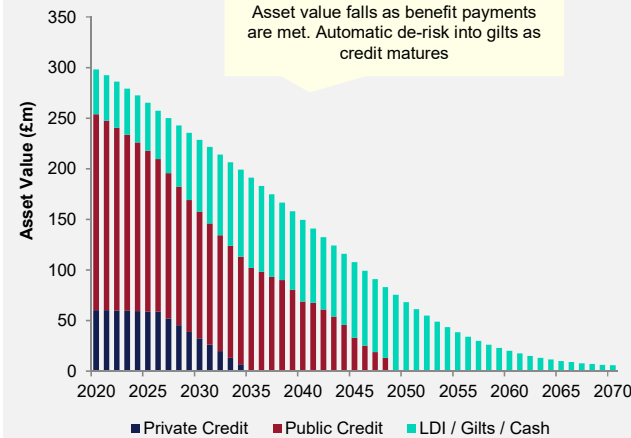
# Case Study (cont.)

## Endgame solution

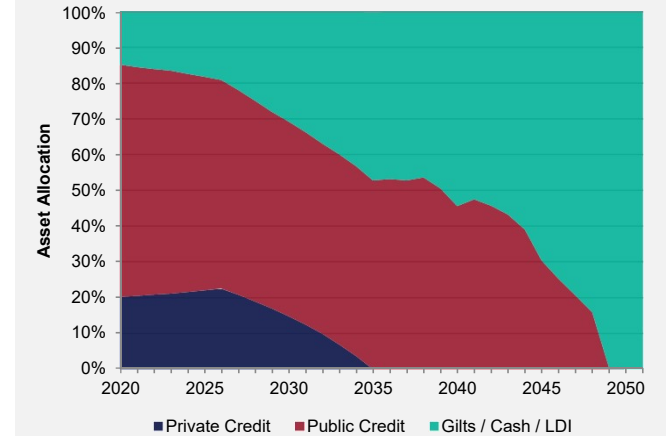
### Evolution of the strategy over time

- Income and maturity payments from credit assets are used to meet liability payments over time. Any excess income is invested in cash and gilts, to be drawn down as required to meet future cashflow requirements
- By not investing excess cashflow in credit, the strategy naturally de-risks towards a 100% allocation to gilts and cash
- Analysis suggests that no future investment in credit is required – this should be monitored over time. If, for example, the expected liability cashflows increase due to an increase in longevity, an allocation could be made to corporate bonds in the future to provide additional yield / income vs gilts / cash. This is illustrated in the liquidity projection

### Asset value projection



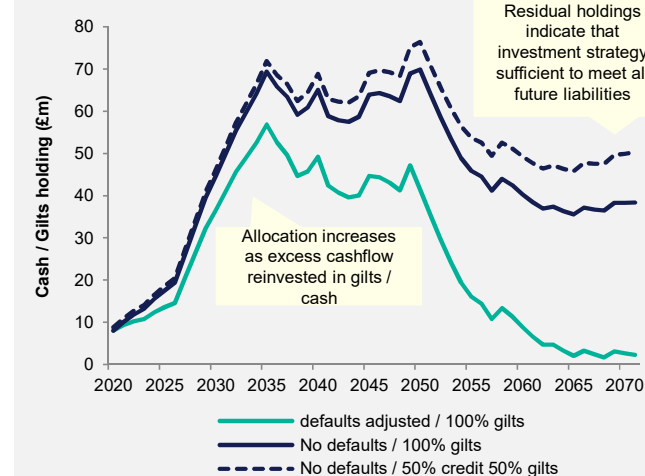
### Automatic de-risking over time (excess cashflow reinvested in gilts)



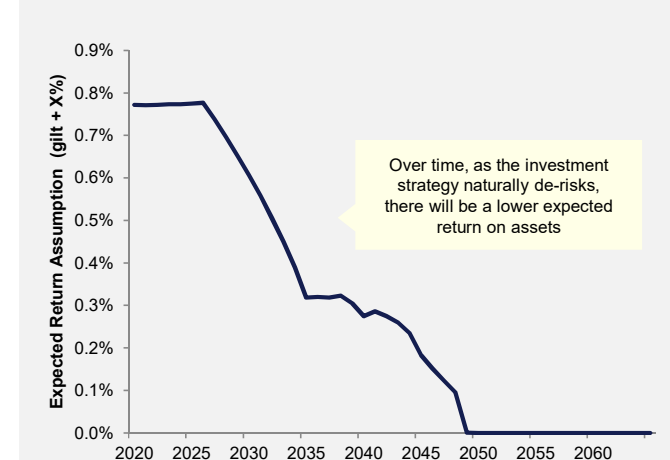
### Summary

- ✓ Tailored endgame investment solution – low cost and low governance solution
- ✓ Well diversified global credit portfolio tailored to the scheme's future cashflow requirements
- ✓ Exposure to multi-sector private credit to exploit illiquidity premium and provide additional diversification
- ✓ Sufficient income and liquidity to meet expected liability cashflows and cash buffer to meet unexpected cashflow requirements e.g. transfer values / recapitalisation on LDI funds
- ✓ Full interest rates and inflation hedge to match scheme's risk profile
- ✓ Clear and transparent journey plan towards full gilt-based strategy
- ✓ Modelling implies no requirement for future credit investment

### Liquidity projection



### Expected return on assets in modelling



Source: Aberdeen Standard Investments, 30 September 2019 For illustrative purposes only.

# Navigating to your endgame

## Summary

### Increased focus on the endgame

- A different investment approach and skillset is required
- Innovation of pooled fund solutions for smaller schemes

### Demand for buyouts expected to continue to increase

- Capacity considerations?
- What practical steps can you take to prepare for a buyout?

### Consolidation expected to be a feature of the future landscape

- A range of innovative options will emerge
- Crucial that these meet the genuine needs of pension schemes



# Responsible Investment & Environmental Social Governance (ESG)

Bill Hartnett, Investment Director, ESG

# Agenda

This session will cover the below topics:

1. What is Responsible Investing?
2. ASI's Approach

# Responsible Investing

## Why it is so topical....

Our primary goal is to generate the best long-term outcomes for our clients & fulfil our fiduciary responsibilities

Financial Regulation  
*e.g. Pensions SIP and the UK Stewardship Code 2019*

Cross-industry regulation that affects the companies we invest *e.g. Global insurance regulation*

Market forces do not always produce sustainable outcomes  
*e.g. climate change, inequality, resource consumption*

Recognition of external costs, e.g., carbon causing economic and political turmoil

As well as micro risks ...shown by corporate collapses resulting from poor oversight of ESG issues

## Why this plays to ASI's strengths

Active stewardship and ownership helping agitate change beneficial to companies and their investors

ESG investment heritage since 1992

One of the largest ESG investment teams globally, with an innovative hub and spoke operating model

ESG considerations in all our investment decisions; ASI use financially material ESG investment information to improve risk/return profile

Bespoke, thematic and sector-level ESG investment research

Sophisticated product design tailored to client needs (ethical & faith-based, SRI, climate & impact solutions)



# Impact on Risk-adjusted Returns

Leading academic & industry thought on the relationship between responsible investing and performance

**“the orientation toward long-term responsible investing should be important for all kinds of rational investors in order to fulfil their fiduciary duties<sup>1</sup>”**

*Morgan Stanley Institute for Sustainable Investing*

**“it is possible to employ systematic strategies that both improve ESG ratings and outperform a global benchmark<sup>3</sup>”**

*MSCI*

**“ Research conducted on the performance of nearly 11,000 mutual funds from 2004 to 2018 shows no financial trade-off in returns of sustainable funds compared to traditional funds, and they demonstrate lower downside risk<sup>2</sup> ”**

*Friede, Busch & Bassen*

Exhibit 1: ESG Tilt and Momentum Strategy Active Performance vs. MSCI World Index



<sup>1</sup> Friede, Busch & Bassen, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies"

<sup>2</sup> Morgan Stanley Institute for Sustainable Investing, "Sustainable Reality"

<sup>3</sup> <https://www.msci.com/www/research-paper/research-insight-can-esg-add/0182813629> For illustrative purposes only.

# Navigating the Terminology

Being able to differentiate between these commonly used terms is key

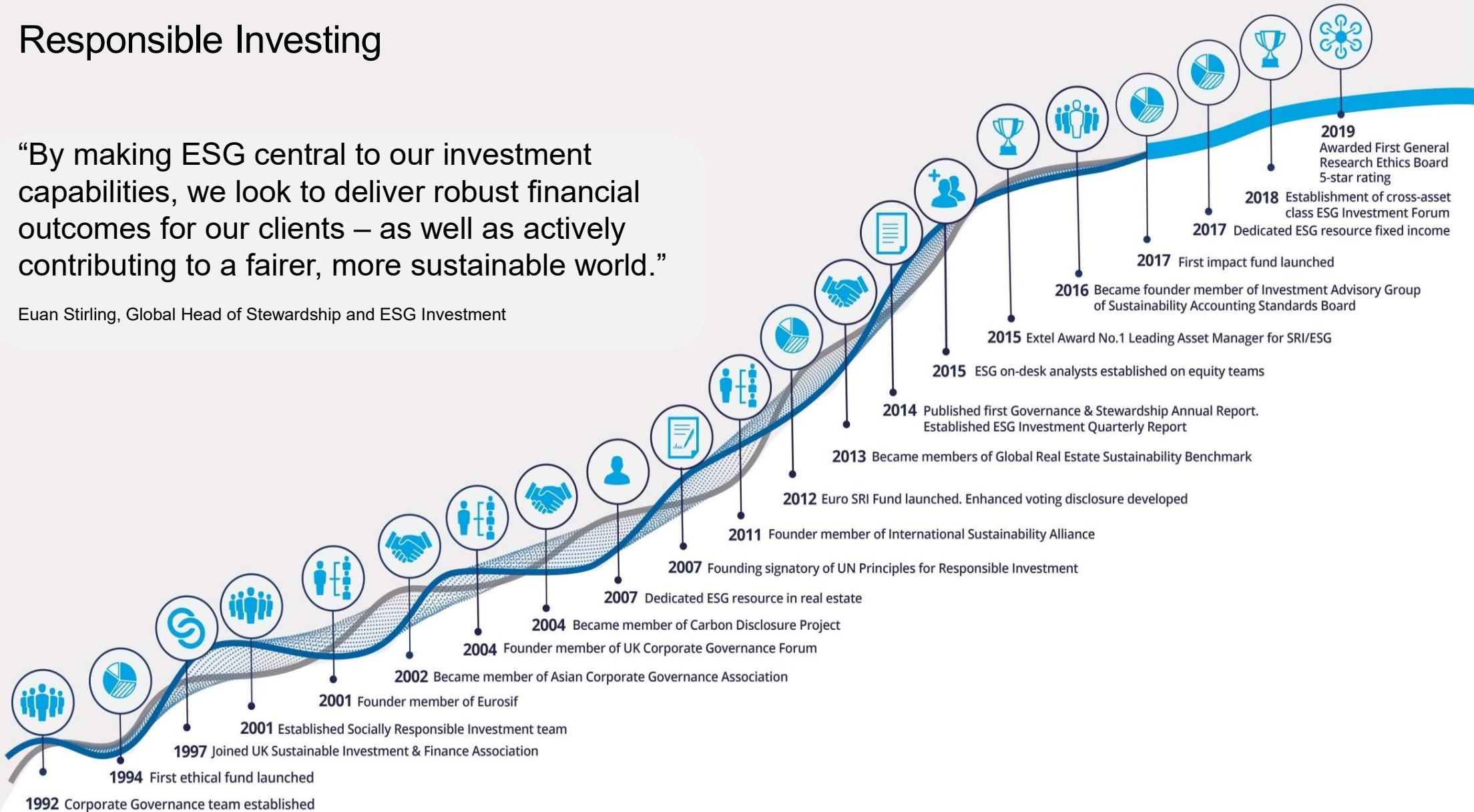


<http://gsiareview2012.gsi-alliance.org/#/8/>

# Responsible Investing

“By making ESG central to our investment capabilities, we look to deliver robust financial outcomes for our clients – as well as actively contributing to a fairer, more sustainable world.”

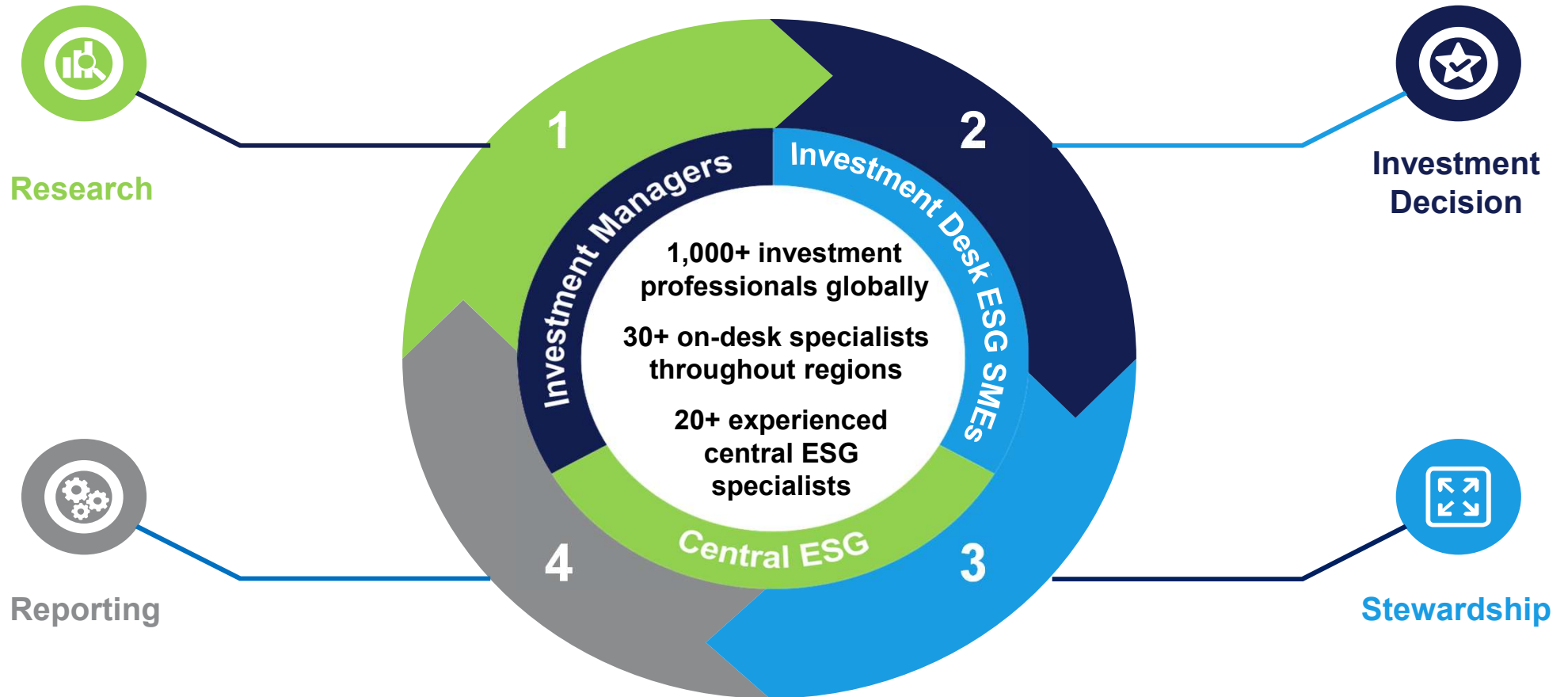
Euan Stirling, Global Head of Stewardship and ESG Investment



Source: Aberdeen Standard Investments, September 2019

# Investment Process

Continuous assessment of Responsible Investing opportunities and risks across all asset classes



Source: Aberdeen Standard Investments, September 2019

# Investment Capabilities

ASI has a long standing heritage when it comes to ESG Investment analysis, that is spread across all investment teams with the central ESG Investment team coordinating efforts, driving the agenda and consulting where necessary

20+

**Central ESG  
Stewardship Team  
Members**

The team is responsible for coordinating integration across the investment cycle and is **one of the largest ESG teams globally**:

- Bespoke, thematic and sector-level ESG research
- Coordinating integration **strategy**
- Engaging with **policy-makers** around the globe
- Input on **product** design
- **Vote** on all active and passive strategies
- **Engage** with companies to improve their practices
- Support **client queries and meetings**

30+

**Investment Team ESG  
Specialists**

Each asset class has individuals within their team who have supporting integration as part of their role, which can include:

- **Providing guidance** on micro ESG issues and themes
- Focus on a specific region to help fund managers to understand ESG risks **impacting their portfolios**
- **Coordinating activity** across investment teams, and facilitating communication between the desk and central ESG team

1,000+

**ESG-trained  
Investment  
Professionals**

ASI provides **tools and training** to all investment teams to allow them to make the most informed investment decisions possible. Individual teams also have specific responsibilities which support the integration process:

- **Research Institute** – provide information on ESG topics
- **Client Solutions** – work with clients to provide holistic ESG portfolios
- **Investment Governance** – ensure all asset classes are adhering to an appropriate investment strategy and risks are monitored effectively

Source: Aberdeen Standard Investments, September 2019

# Responsible Investment Principles

**We generate returns for clients led by our four Stewardship & ESG Investment Principles**

We will put stewardship and ESG considerations at the heart of:

## **Our investment process**

Integrate and appraise environmental, social and governance factors in our investment process to generate the best long-term outcomes for our clients

## **Our investment activity**

Actively take steps as stewards and owners to protect and enhance the value of our clients' assets

## **Our client journey**

Clearly define how we act in our clients' interests in delivering our stewardship and ESG principles and transparently report on our actions to meet those interests

## **Our corporate influence**

Actively advance policy, regulation and industry standards to deliver a better future for our clients, the environment and wider societal stakeholders

**Agreed by the ESG Investment Forum & incorporated into each strategy**

# Global ESG Investment Research



Source: Aberdeen Standard Investments

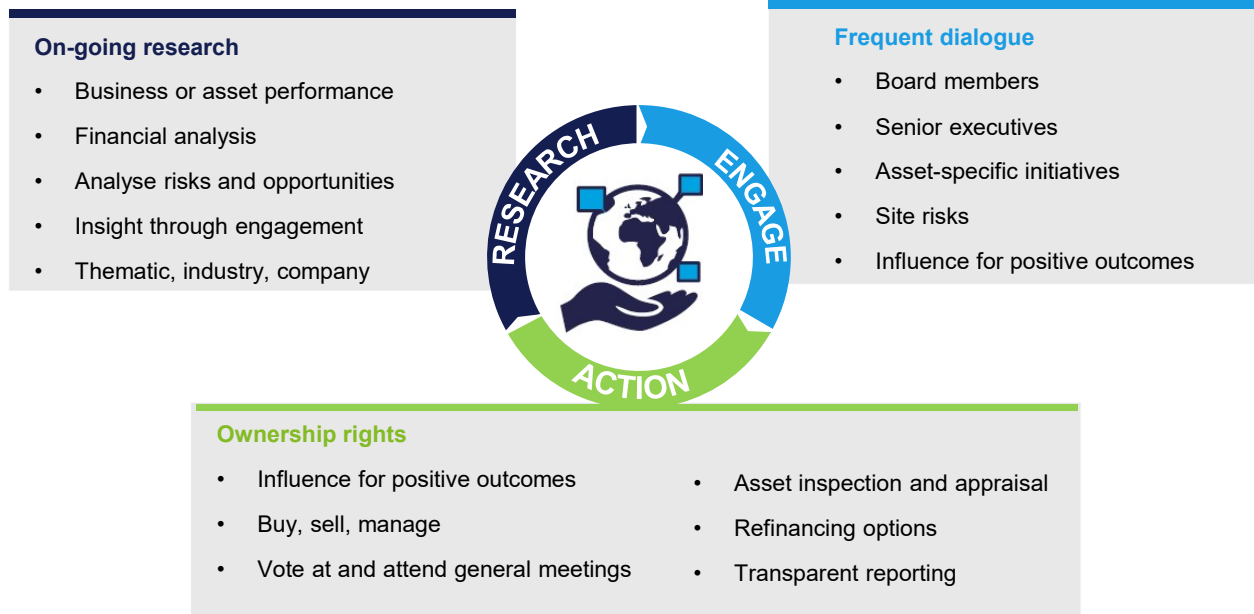
# Active stewardship and ownership following ESG philosophy

## ESG Investment at the heart of research

### Clear ESG philosophy



### Active stewardship and ownership



Source: Aberdeen Standard Investments

### ESG assessment and engagement enhances returns



# Engagement

## Portfolio Managers & the central team meet with company leadership to encourage sustainable practices



### Recovering from climate catastrophe

At their AGM on 21 May 2019, BP were asked to set targets around the carbon emissions related to its products (Scope 3 emissions). Their response was that it could not be held responsible for Scope 3 emissions. In our view, this is something that is possible and will be necessary to limit global warming to well below 2°C. We voted against this resolution in order to give BP the opportunity to define meaningful targets. We expect more transparency from BP on this going forward.



### Getting a full picture of the supply chain

Adidas relies on leather and other raw materials within its products, so we analysed their supply chain to determine any environmental risks. As a result we suggested firmer auditing of suppliers and a review of certain policies. Adidas's public reporting has improved and they continue to improve risk management.



### Before the fall

We voted against the company's remuneration plans through 2016 and 2017 as they sought to introduce additional elements to the CEO at a time when the financial and share price performance was particularly weak. This proved to be a classic warning sign for the troubles that escalated into the cause of the company's collapse which resulted in the largest peacetime repatriation of UK citizens.



### Mitigating child labour risks

We were concerned about Microsoft's supply chain and its partnership with an organisation that had ties to child labour issues in the Congo. After speaking to the company we learned that the partnership has helped to determine the root causes of child labour in mining and addressed the problem at its source.



### Damn Tragedy

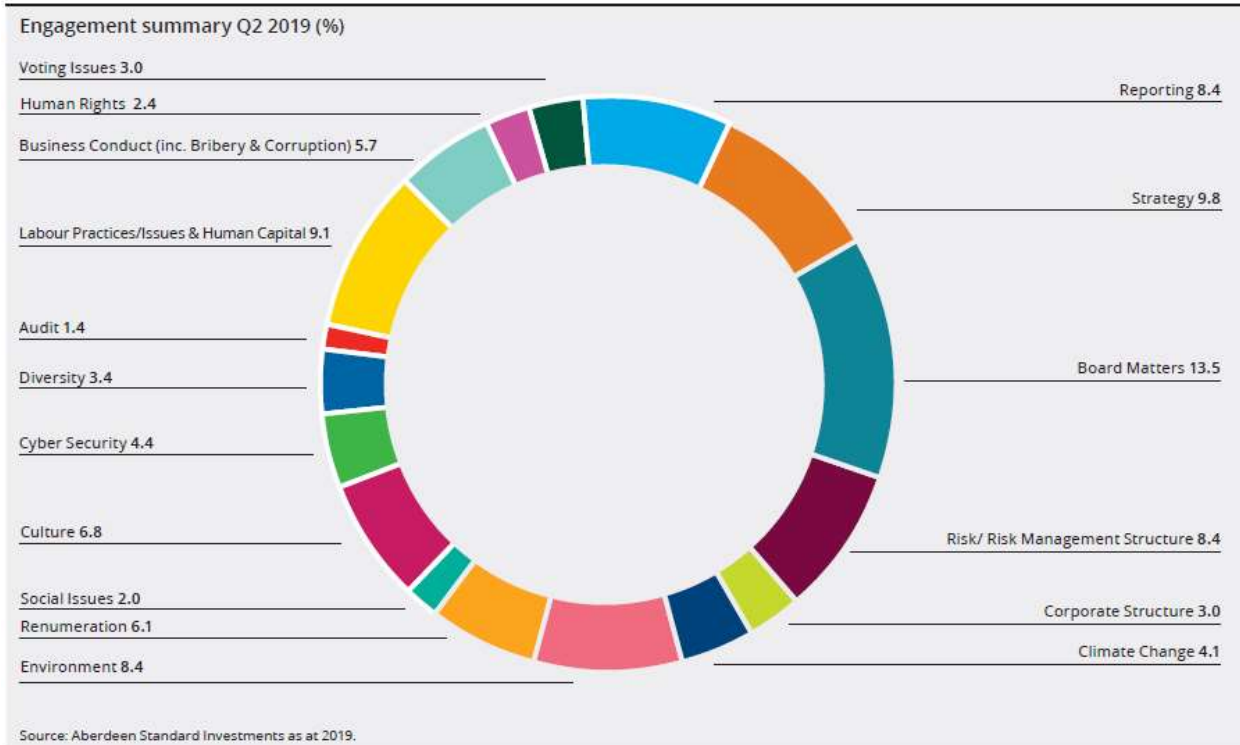
ASI is undertaking ongoing engagement to improve governance and safety standards following two catastrophic dam collapses in Brazil that have left 100s dead, communities devastated, the company paying huge fines and huge loss of reputation.

# Stewardship

Voting responsibly is a core activity of the ESG Investment & Stewardship team

Voting summary Q2 2019

	Total
Shareholder meetings at which our clients' shares were voted	3,072
Percentage of meetings with at least one vote against or abstention	58.9%
Number of resolutions voted	38,113
Percentage of resolutions voted with management recommendations	85.6%
Percentage of resolutions voted against management recommendations	11.7%
Percentage of abstentions	2.6%



- During Q2 2019, Aberdeen Standard Investments met with and discussed ESG issues with over 100 companies. The chart and table opposite offer examples of companies that we engaged with and the specific ESG topics discussed
- Engagement and voting are key ingredients of our approach to strong stewardship and we report both of these elements on a quarterly basis
- Engagement allows ASI to gain better insights on ESG matters and to drive positive change from the investments we are making, through encouraging strong governance and risk management assessments

# Policy Work: Affiliations & Memberships

The below shows some of ASI's affiliations and the initiatives ASI are signed up to



# Responsible Investment Approaches

ASI has a number of solutions aligned to different investor preferences



## Values Investor

For clients with particular ethical or religious views who do not wish to invest in certain types of companies.

## Sustainable Investor

For clients who want to reduce exposure to the long term risks associated with ESG factors and companies which fail to meet recognised sustainability standards while seeking improvement in business practices / approach through targeted engagement.

## Thematic Investor

For clients seeking to benefit from exposure to a specific ESG theme in their portfolios.

## Impactful Investor

For clients seeking to make a positive difference and a return through exposure to companies that intentionally deliver products or solutions that have a measurable beneficial social or environmental impact or have a material alignment to one or more of the UN's SDGs.



Ethical Fund Range  
Enhanced Index Range



Sustainable & Responsible  
(SRI) Fund Range



Carbon Mitigation Strategy



Sustainable Development Funds  
Impact fund range

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