THE INSIGHT SHARING PENSIONS AND LIFETIME SAVINGS ASSOCIATION

PLSA DB FORUM

LONG ROAD TO BUYOUT: HOW TO MAKE THE RIGHT INVESTMENT CHOICES

At our recent DB Forum in London, we heard how the LDI crisis has supercharged the focus on asset allocation and liquidity to get ready for the endgame, and how schemes have improved digital member communications.

Increased funding on the back of gilt yield rises has put some defined benefit (DB) pension schemes on a better footing to go to buy-in or buyout, while other schemes are still pursuing run-off for the foreseeable future.

But some challenges have come to light given the increased demand for buy-in and buyout following last year's gilts and liability-driven investment (LDI) crisis, which will have implications for investment strategy.

These issues were discussed at the PLSA's DB Forum held in London in May under Chatham House rules.

An asset manager said their UK pension clients are at various stages of the journey towards their endgame: some are still quite early on, some are very close to buyout or are entering it, while others are in run-off mode.

The speaker explained that the big story from last year was a lot of funds accelerated very rapidly, and perhaps unexpectedly, towards their endgame. The idea of whether you should set a long-term buyout objective or self-sufficiency/runoff objective didn't really impact your investment decision when you're still so early in your journey, because you just needed to generate the returns.

But once the endgame gets closer it becomes important to look at the investment choices you make when you want to prepare for a buyout transaction, or to run off the scheme.

Given the rise in funding level, funds may consider whether to continue with the current level of deficit and contributions, and perhaps have negotiations around those contributions.

Regardless of whether schemes aspire to go to buy-in or buyout, or run off the fund, cash flow management comes to the fore. There has been a focus on cash management in recent years, but it has accelerated during the past few months, particularly since the LDI crisis.

The asset manager said trustees need to think about how they are going to deliver cash flows, not just sometime in the future, but tomorrow, next month and the month after that. They need to do that effectively from an operational and investment strategy perspective.

Since the gilts crisis, there is also now more discussion over using the traditional gilts plus approach to measuring liabilities to align with the investment strategy.

An attendee explained that this is an appropriate yardstick during accumulation, when generating returns to meet liabilities is the aim. However, a dynamic discount rate could offer a refined option when approaching the endgame.

A trustee who also spoke at the DB Forum said their pension scheme is looking at run-off. They have a long-term objective of 100% funding on a low dependency basis, using a discount rate of gilts plus 0.5%.

This requires managing the risks along the way, which are predominantly interest rates, inflation, liquidity, and having an appropriate collateral multiple. All that needs to be managed alongside Integrated Risk Management, funding investment strategy and employer covenant – and the associated challenges.

Individual circumstances should be properly understood to determine the appropriate long-term objective.

The same trustee said as the scheme's long-term objective is to run-off until the very last pension is paid out, they start thinking like an insurance company. They need to think about interest rate risk, inflation risks, longevity risk, and that means investing in a similar way and it's about looking at cash-generating portfolios of assets that match your cashflows.

BE PREPARED AND GET YOUR HOUSE IN ORDER

Being prepared is essential when thinking about going to buy-in or buyout in the future to make sure schemes have their house in order – such as getting up to date with pension administration tasks such as GMPs.

A sponsoring employer suggested that if you've got a lot of boxes somewhere in the basement with a lot of individual member cases, then maybe digitise those and generally get your house in order. Whether you're going to buy in three years' time or not, these need to be sorted out anyway.

Schemes should work very closely with their advisors because sometimes opportunities might come about when they are least ready.

The employer explained that during the pandemic, their advisors said 'there is an opportunity for you to buy in', and at the time the employer didn't think about it too seriously, but they still got their house in order.

The panellists all agreed that having a close partnership with the sponsors is also very important.

The sponsoring employer commented that many sponsors might not want to have a pension scheme on their balance sheet. We know that investors generally would look at a DB pension arrangement and frown upon it.

One trustee said that even if you're looking to run-off the scheme and not go to buyout, it's still very important to have a close partnership with the sponsor in order to be aware of what is right for your own circumstances.

A lot of that is around the sponsor and the strength of the company. Some sponsors really don't see the need to buy out and are quite happy having that level of risk on the balance sheet.

LIQUIDITY ISSUES AFTER GILTS CRISIS

One of the challenges for schemes currently is dealing with the aftermath of the gilts crisis. The trustee said their DB scheme was prepared because it had stress tested what ended up happening during the LDI crisis and had a collateral waterfall, which meant they could meet all their cash requirements. But they now have a higher amount of illiquid assets in the portfolio than they feel comfortable with.

It's important to think about how you 'right size' that level of illiquid assets and get back to a more normal portfolio, which is ironic when there's so much pressure from government to look at more investment in illiquids.

They described how to get to where they want to be, that they are running with less hedging than they would have had before the LDI crisis, and waiting until they have built enough buffer before heading back towards our long-term target inflation interest rate.

The panel said given these issues, it is important to be as liquid as possible in the run-up to buyout. Although theoretically there are a similar set of attractive physical assets for insurance and pensions, this is very difficult to come across in reality. While that may be changing, and there are some other mechanisms that provide a way to deal with liquidity for pension funds, the preference would be to pick what makes a scheme more attractive to an insurer.

COMMUNICATIONS AND ENGAGEMENT

Alongside these challenges, DB schemes are grappling with how to communicate and engage effectively with their members.

During the final session at the DB Forum, which gave trustees in the audience a chance to share their views, we heard how many schemes have limited resource and lack in-house admin teams. This means they are very restricted in terms of what communications they can produce.

Community engagement is a key priority for schemes, and many said they would like to do more.

A Facebook group provided a sounding board for some pensioners, and a fully functioning website that is simple to use also went down well with members.

Member panels, where members are invited to give direct feedback on the level of communications, were hailed a success.

One scheme said it has been cautious about straying too much into the social media/ Twitter sphere, although it does have a Facebook group that members can join. They do occasionally use Twitter to push out messaging, but there is often confusion among members about who the disputes about the pension scheme are between. For example, disputes are between the employers and unions, not between the unions and trustees.

Some trustees in the audience noted the best thing they have done is to tailor communications, while creating engaging material. One example was a quick-fire rapid response to the pension tax changes earlier this year and being able to mobilise that and go to members about something that's live.

But another scheme said one of the difficulties in communicating with members around the tax changes and being agile is providing them with reassurance.

Segmentation is a key focus for schemes in their communication strategies, and one scheme noted it is important to try to sell the benefits of a portal to members, which will probably generate much better results rather than trying to do one-size-fits-all.

The biggest challenge with member engagement is how to approach them and in what format as not all are tech-savvy, particularly the older generation.

However, many schemes agreed it is important to test your hypothesis with members before rolling it out, and not to make assumptions about your membership. A trustee said before they started their digital journey, they had an assumption that older members perhaps might not want to go digital, but when they tested it, they were surprised at the level of digital sophistication members have.

We heard how it is important to keep an open dialogue and engage with employers and providers to get feedback to continuously evolve scheme communications. It can sometimes be tempting to decide as schemes that this is what members want, and this is what's good for them. But this is about the members – that's why it's worth spending a bit more time investigating and finding out what they want and what works for them.