Pension Investment and Governance Survey 2018

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Launch >

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Introduction

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We are delighted to present the results of our first Pensions Investment and Governance Survey.

The objective of this survey is to gain insight into how pension schemes have changed or are planning to change their investment strategy, risk management and governance structure in the context of a challenging pensions landscape.

One of the most interesting findings is that there is widespread agreement that valuation methods need to be more closely aligned to a scheme's investment strategy. A full summary of our key findings are highlighted on the following pages. Please contact us if you would like to discuss the results in more detail.

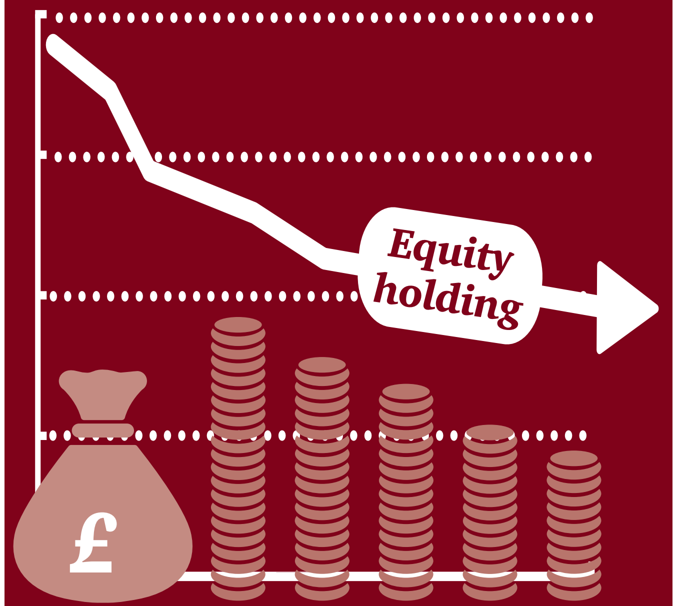
We plan to run this survey on an annual basis to highlight any changes in direction or strategy within this marketplace.

Note: All of the survey data was analysed at a total level, and no comments could be attributed back to an individual. PwC adheres strictly to the Market Research Society's guidelines (a copy of which can be found at *http://www.mrs.org.uk/standards/codeconduct.htm*).

Headlines from the survey

1 A continued reduction in equity allocation despite 10 years of strong growth and returns

We continue to see UK DB pension funds reduce their equity holdings as funding levels improve, with 60% of participants moving out of equity in the past year.



2 A preference to change investment strategy to address liquidity needs, which supports greater appetite for illiquid matching assets

80% of participants who thought they could become cash flow negative over the next five years stated they were considering changing their investment strategy.

This supports our finding that while matching assets such as gilts remain a core asset class for funds as they continue to mature, there is greater appetite for what we would term 'matching plus' assets. A third of participants increased their holdings in illiquid matching assets over the year – roughly the same proportion that increased their allocation to LDI.

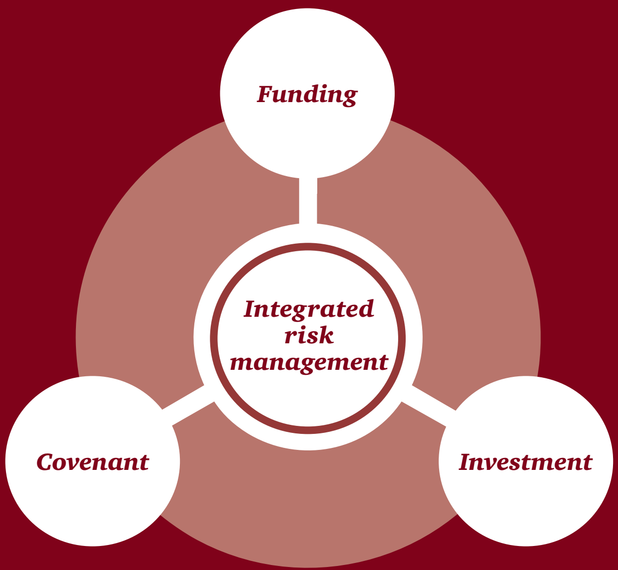
3 An increased concern around governance although more could be done on Fiduciary Management oversight

Our survey shows that about 70% of respondents review their investment strategy at least annually. We believe this is a sign of an increased focus on schemes having a robust governance process in place. However, only 50% of respondents who have Fiduciary Management conduct an annual or more frequent oversight of their provider.

Headlines from the survey (contd.)

4 *There is still someway to go until schemes operate a truly integrated risk management framework*

Over half of our respondents are still managing funding, investment and covenant separately or don't monitor IRM currently.



5 *Majority of the schemes seemed to be comfortable continuing to run their assets and were less reliant on corporate sponsor*

Nearly two thirds feel that their current investment strategy is on track to reach full funding within agreed recovery periods, without additional support form their sponsor. The response supports our finding that two thirds are targeting full funding on the self sufficiency basis to de-risk the scheme.

6 *Most of the schemes believe that greater considerations should be given to other valuation methodologies*

More than 70% of respondents believe that now may be the time to consider alternative valuation methodologies given the fluctuations in gilts and swap yields in the last few years.

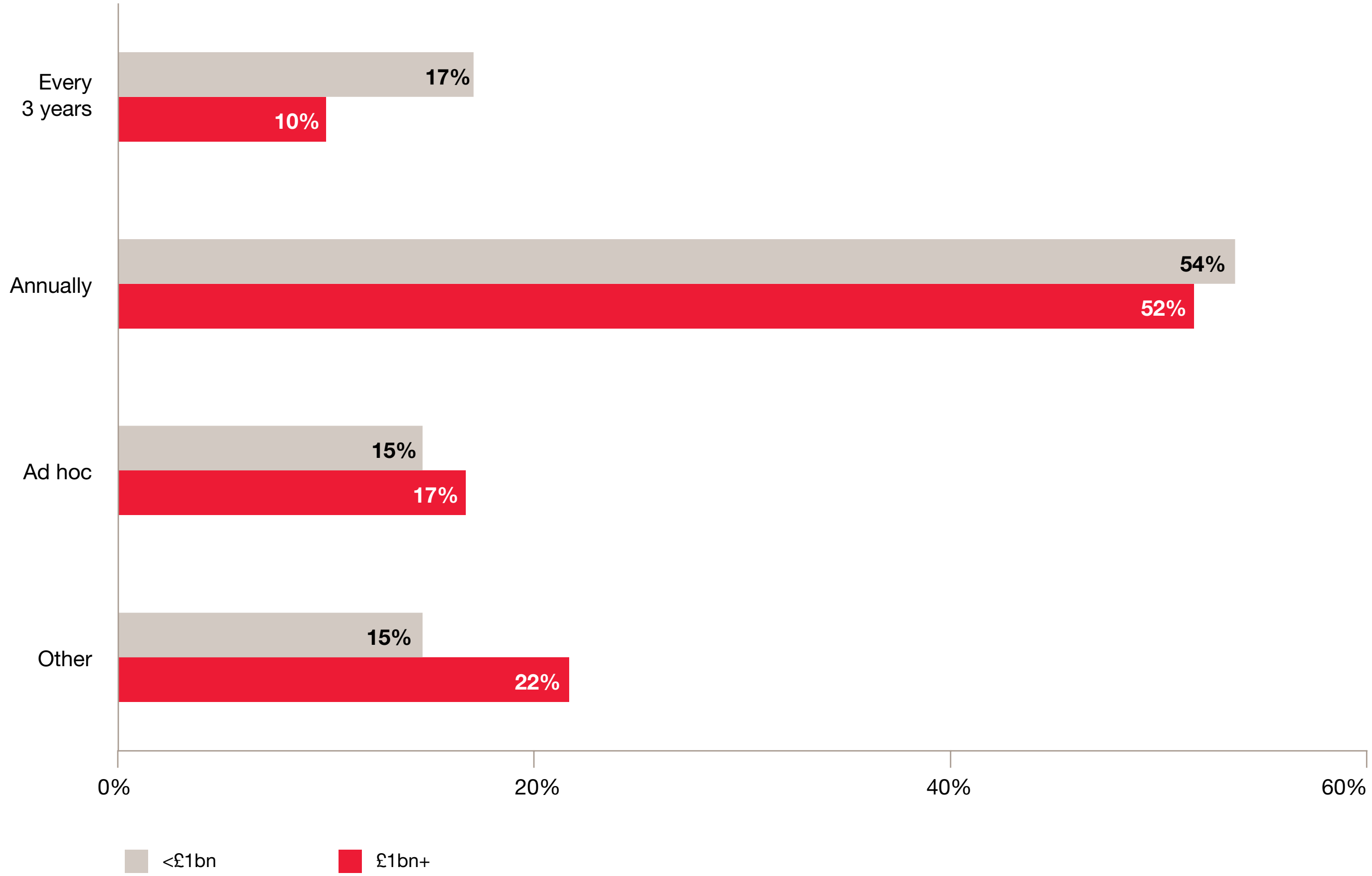
1. Investment strategy review

Q How often do you review your investment strategy?

Almost 70% of respondents conduct reviews of their investment strategy on an annual or more frequent basis, with the larger schemes (over £1bn) conducting reviews more frequently.

Of the 19% of participants who answered 'Other', most noted that they conducted more regular monitoring through monthly or quarterly meetings, with some noting that this area was constantly challenged and under review.

This highlights how investment strategy is becoming more of a concern and lever for Trustees and employers to meet their Scheme's obligations.



2. Integrated risk management

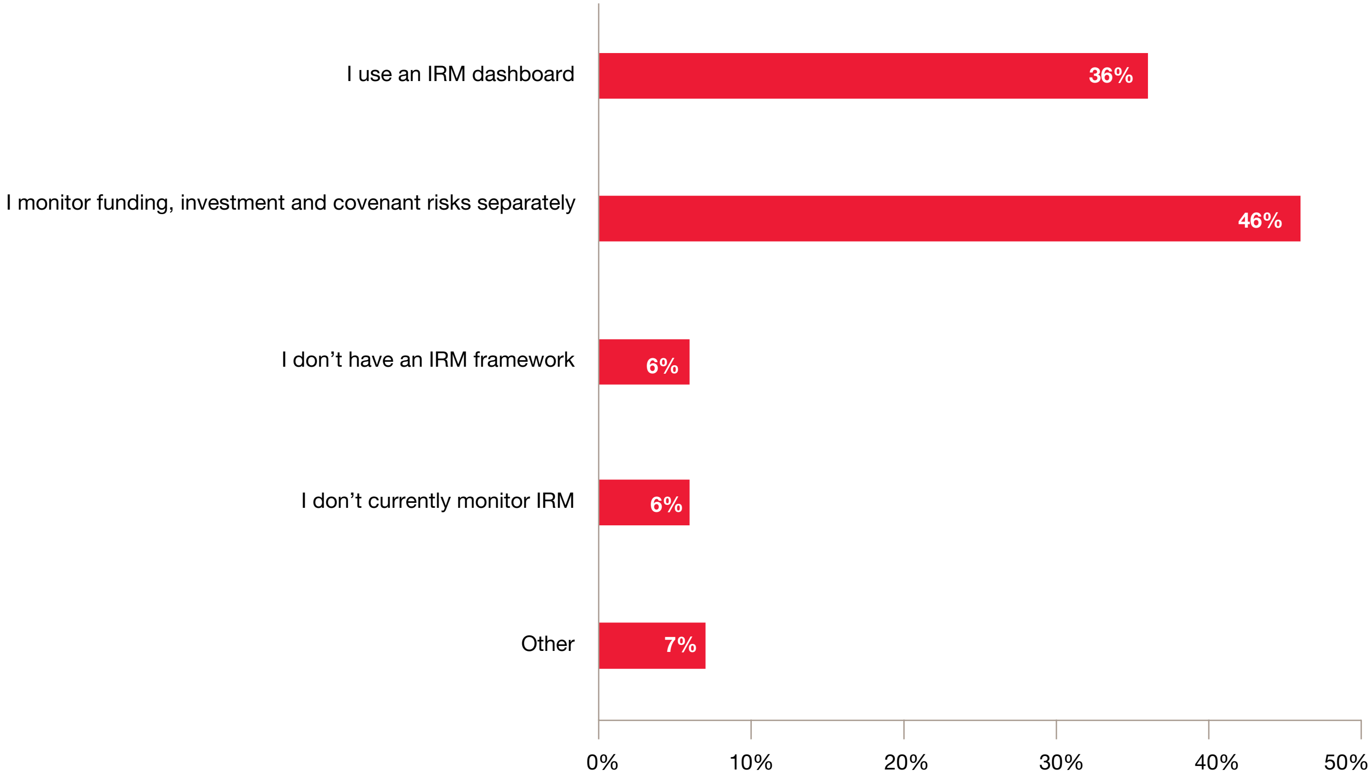
Q How do you monitor whether your integrated risk management (IRM) framework is helping you manage your scheme effectively?

Just over a third of respondents use an IRM framework to manage their scheme, with the majority monitoring risks separately or outside of an IRM framework.

Most respondents who answered ‘Other’ consider IRM at Trustee meetings but monitor the risks separately in the interim periods.

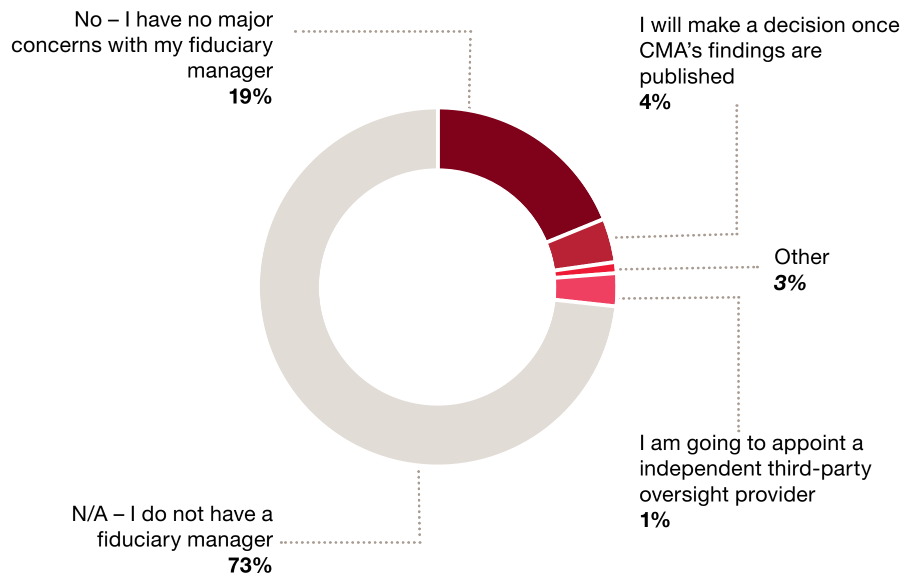
This suggests that there is still some way to go until schemes operate a truly integrated risk management framework, as over half of our respondents are still managing funding, investment and covenant separately or don’t monitor IRM currently.

This is surprising given recent tPR guidance, which has encouraged schemes to take a holistic look at how risks around employer covenant, funding and investment strategy are all linked and inter-dependant.

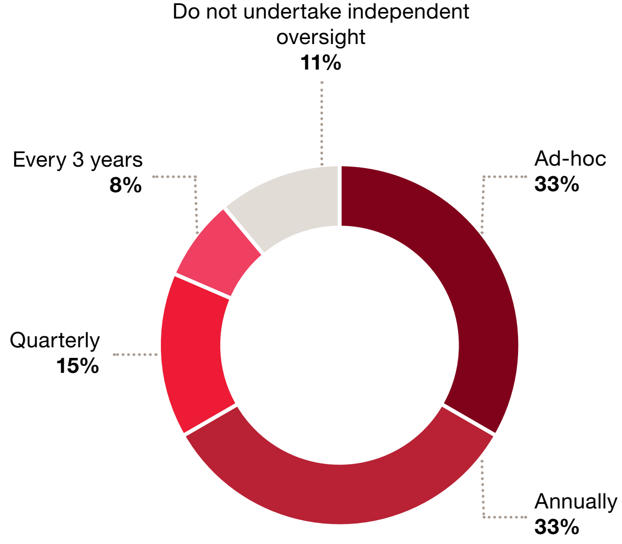


3. Fiduciary management review

Q Are you looking to undertake an independent review of your fiduciary manager in light of the Competition and Markets Authority (CMA) review of the fiduciary management industry?



Q How often do you conduct or plan to conduct independent oversight of your fiduciary manager arrangement?

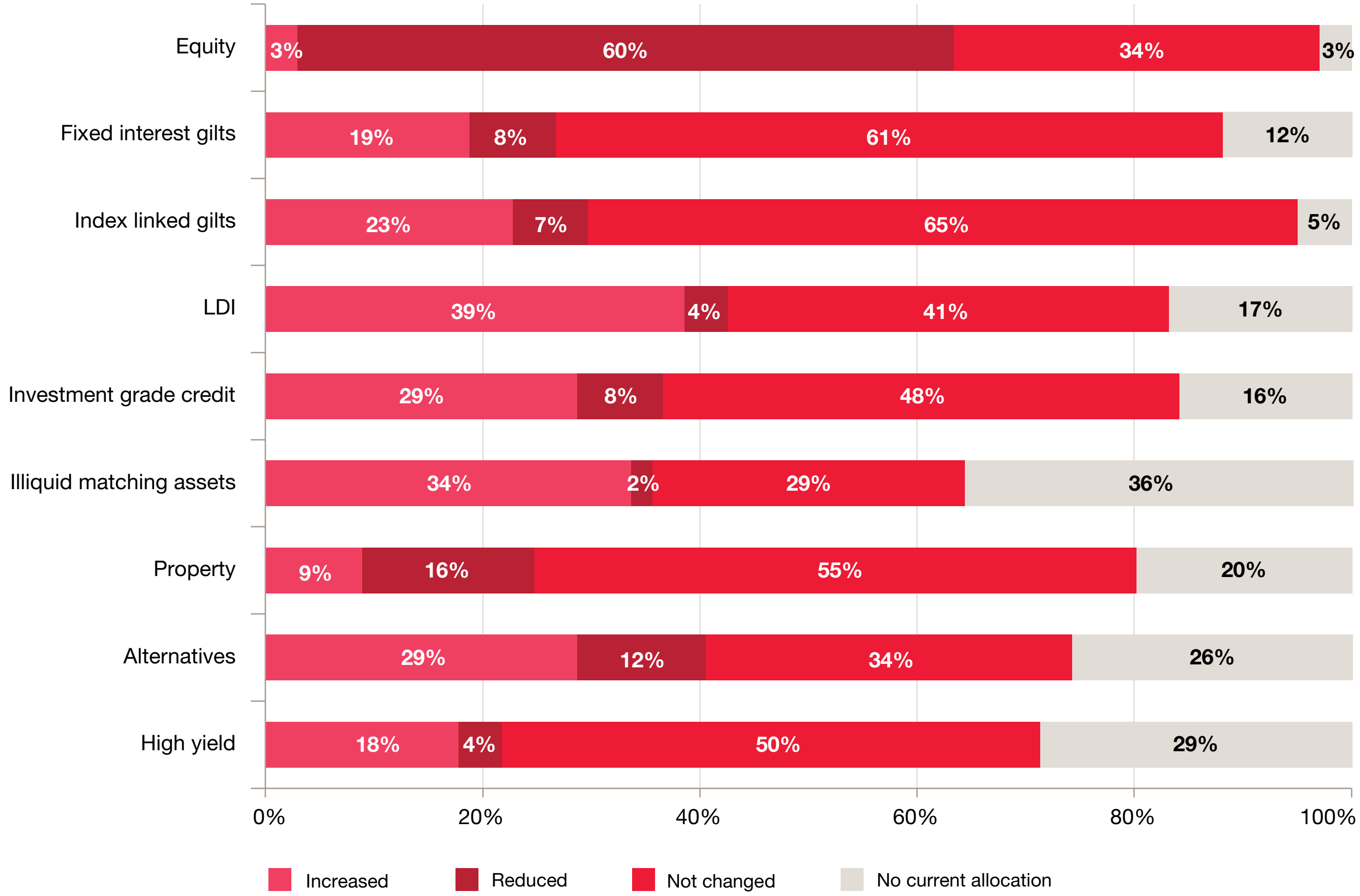


Of those participants who do have a fiduciary manager arrangement, only half of them conduct oversight of their fiduciary manager every year.

Unsurprisingly as full fiduciary management has only been adopted by around 10% of the market, the majority of our participants (c.70%) did not respond to this question. We would expect an increase in schemes' fiduciary manager oversight given the recent CMA review.

1. Changes in scheme portfolios

Q How has your investment strategy changed in the last 12 months, if at all?



60% of respondents have reduced equity holdings in the last 12 months and moved into LDI and illiquid matching assets.

As schemes increasingly close to future accrual and their liabilities mature it is not surprising that the majority continue to move out of riskier assets like equity, whilst increasing their allocation to LDI and matching assets.

In the light of the current low yield environment, schemes continue to look for lower risk, higher yielding assets, hence the increased interest in illiquid matching assets and alternatives alongside the more traditional LDI and IG credit assets.

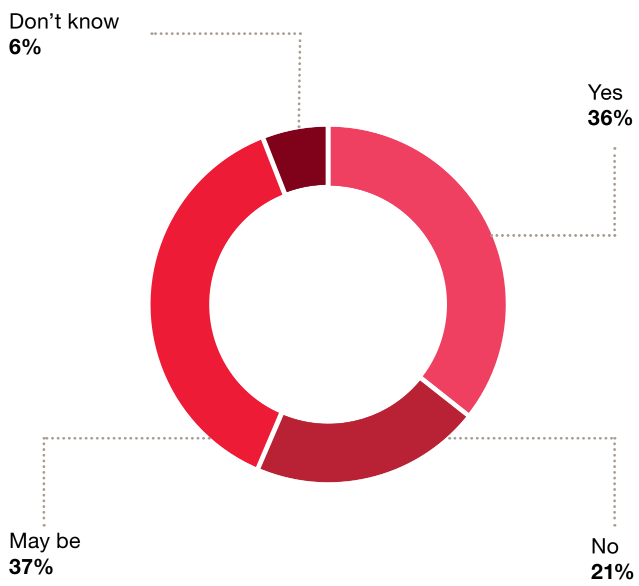
2. Valuation methodology

Q Given the fluctuations in gilt and swap yields in the last few years, do you think greater consideration should be given to other valuations methodologies (e.g. asset led discounting, cash flow valuation approaches)?

Just above 70% of the respondents believe that now may be the time to consider alternative valuation methodologies.

This is understandable given that falling gilt yields have increased deficits for many schemes with a mismatch between assets and liabilities[1].

The response may also be influenced by tPR's 2017 and 2018 annual funding statements, which recognise that there is a debate on how valuation discount rates are set and that tPR is not prescriptive about the approach trustees take to setting the discount rates. This is provided there is a sound rationale for the approach that is clearly documented and does not contravene legislation.



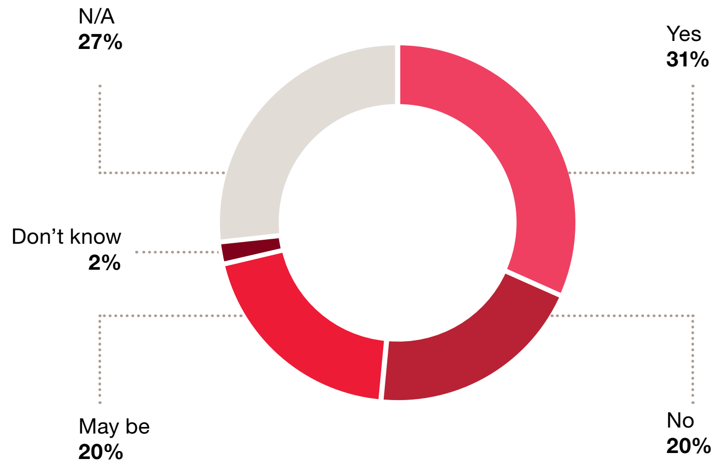
[1] Source: 2017 PwC Pension Scheme Funding Survey. This survey shows that over 90% of schemes had a funding deficit as at 2017.

3. Addressing cash flow negative future

Q In the next five years, if your scheme is forecast to be cash flow negative i.e. lacking sufficient income from investment and contributions to pay member pensions, are you planning to change your investment strategy to address this?

More than two thirds of respondents thought they might be cashflow negative in the next 5 years and of these, about 70% were going to consider changing their investment strategy to address this.

We think this will be an area of focus for schemes going forwards to avoid liquidity issues and forced selling of assets.

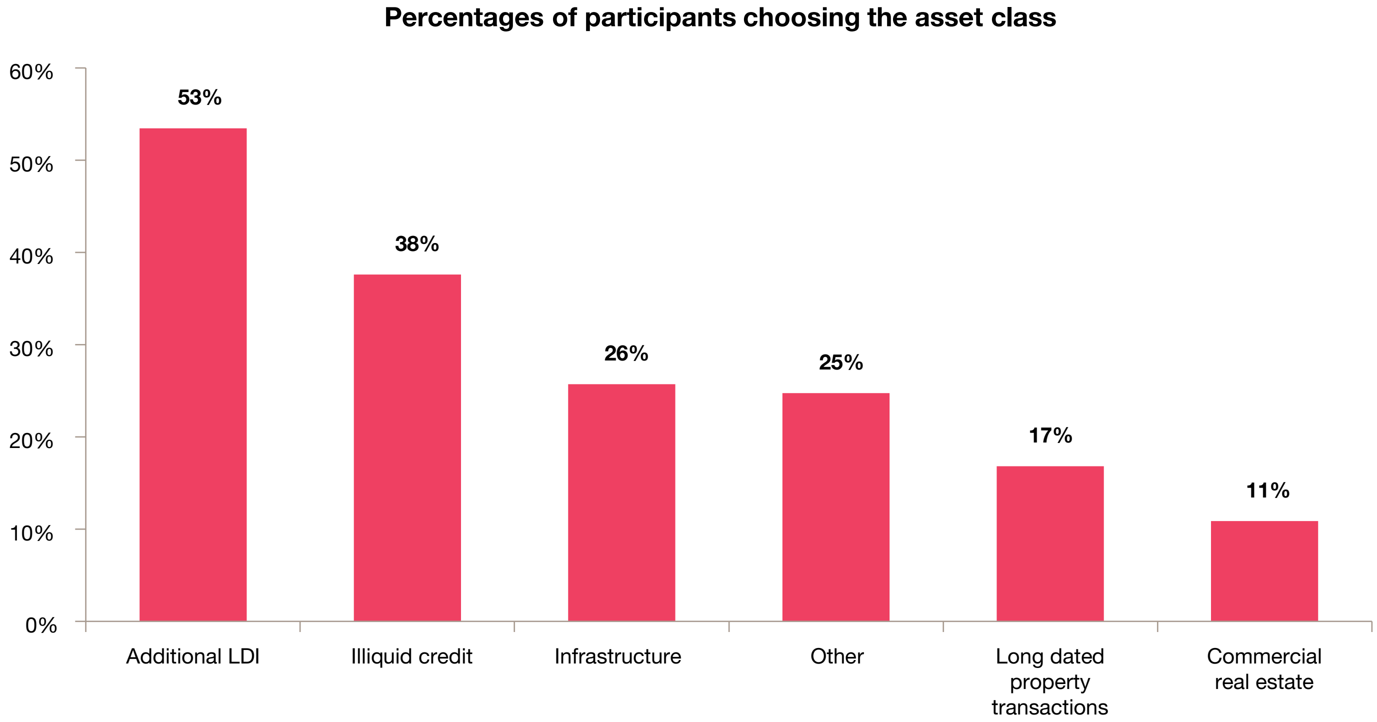


4. Preferred matching assets

Q In order to better match your cashflows, which of the following assets is your scheme most likely to invest in (multiple choice)?

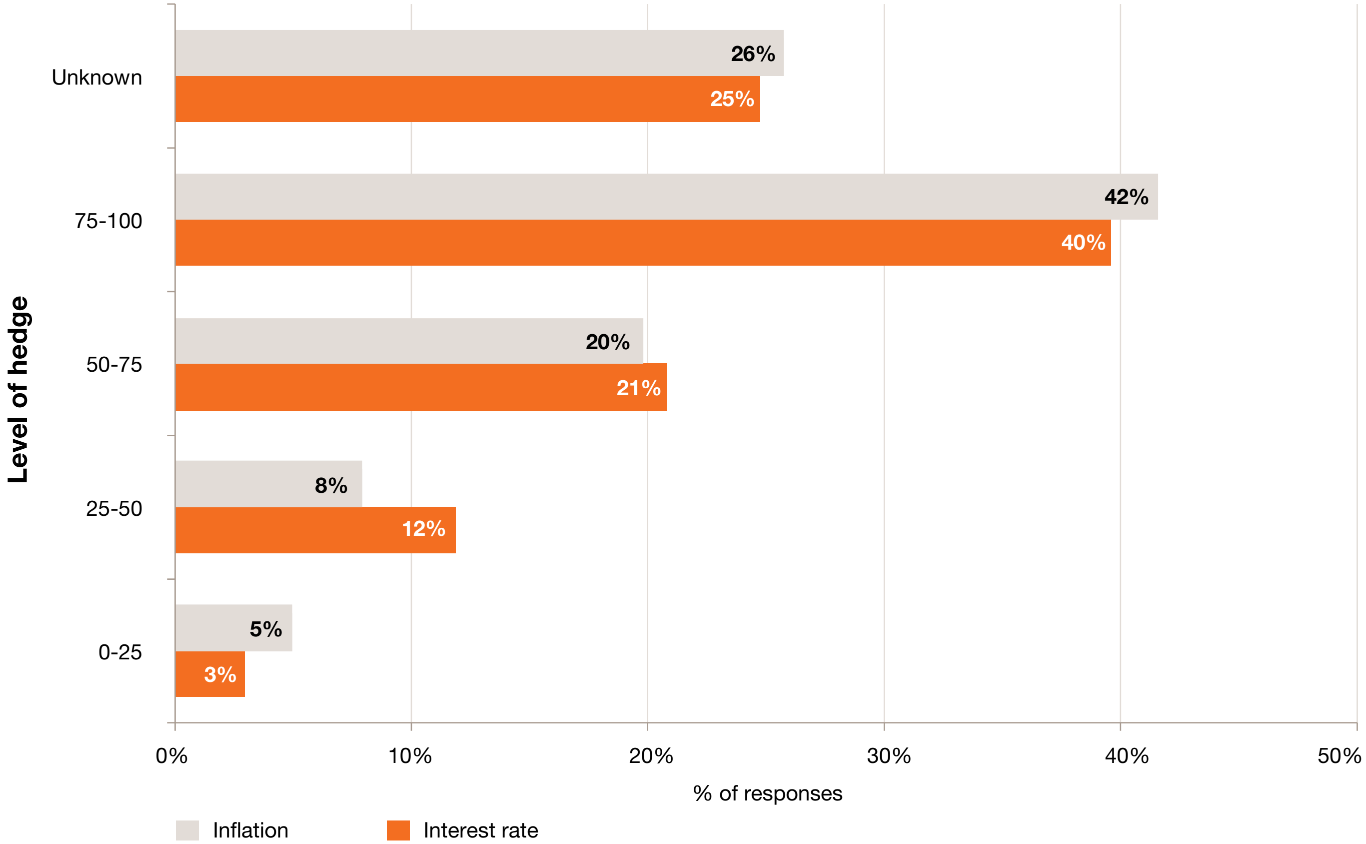
LDI and credit were the most popular cashflow matching assets with our respondents. In the 'Other' category, respondents referenced buy-ins, secure income funds, corporate bonds and synthetic equity.

Whilst LDI remains the most popular matching asset, with over half of respondents investing in this, we are seeing an increased interest in alternative asset classes such as illiquid credit, infrastructure and property. However, schemes are still not utilising the full range of assets that an insurer would.



1. Hedge ratio of schemes

Q Please state the scheme's current interest rate and inflation hedging ratio to the value of liabilities.



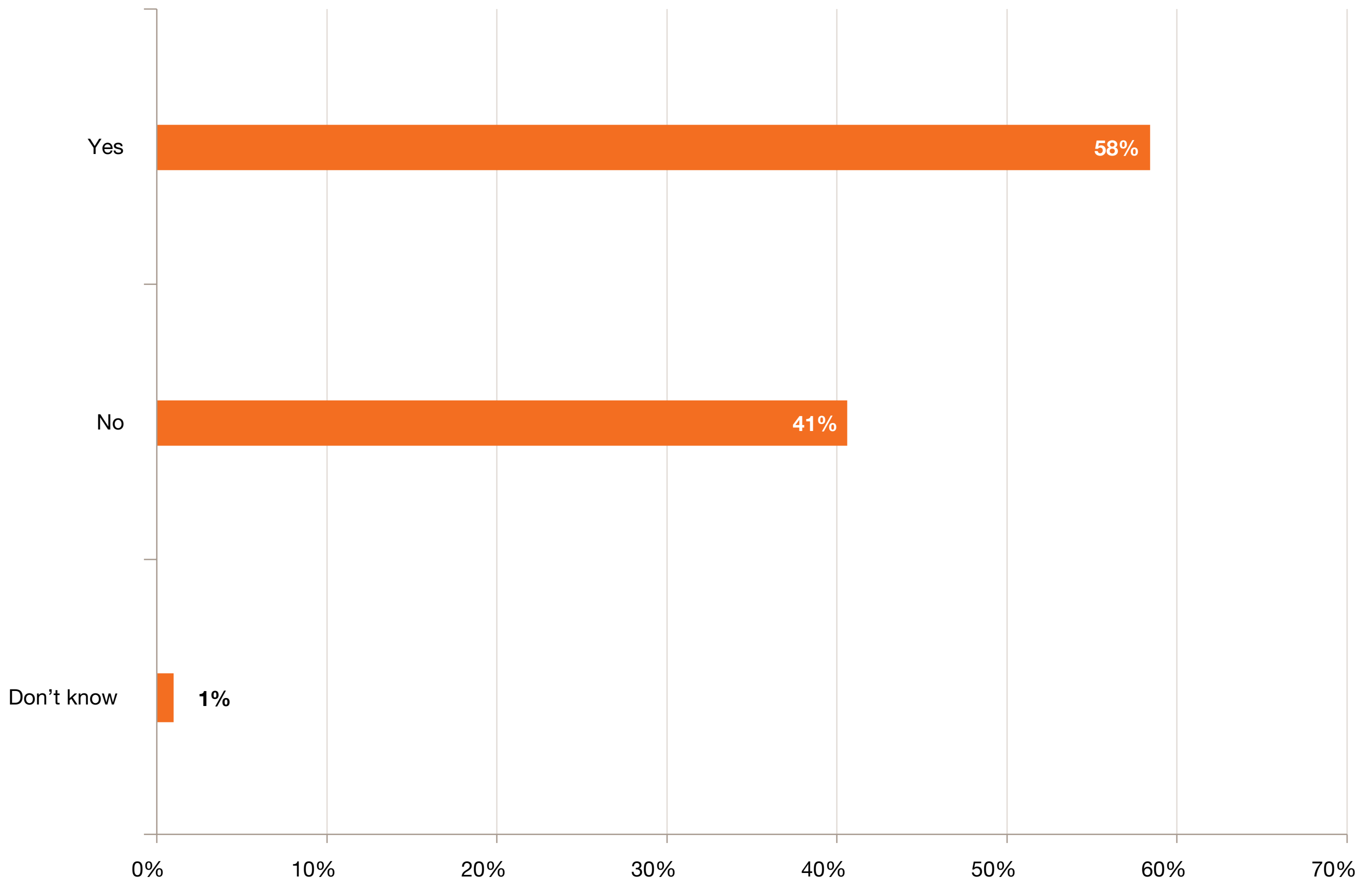
60% of respondents said that their schemes are at least 50% hedged. Excluding the respondents who said 'unknown', this figure increases to 80% of respondents being at least 50% hedged.

Around 40% participants said that they were at lest 75 – 100% hedged.

Hedging level continues to increase as schemes mature, although this needs to be monitored in the context of alternative valuation methodologies.

2. Risk budget

Q Have you agreed a risk budget (e.g. level of Value at Risk) that is acceptable to both the sponsor and the trustees?

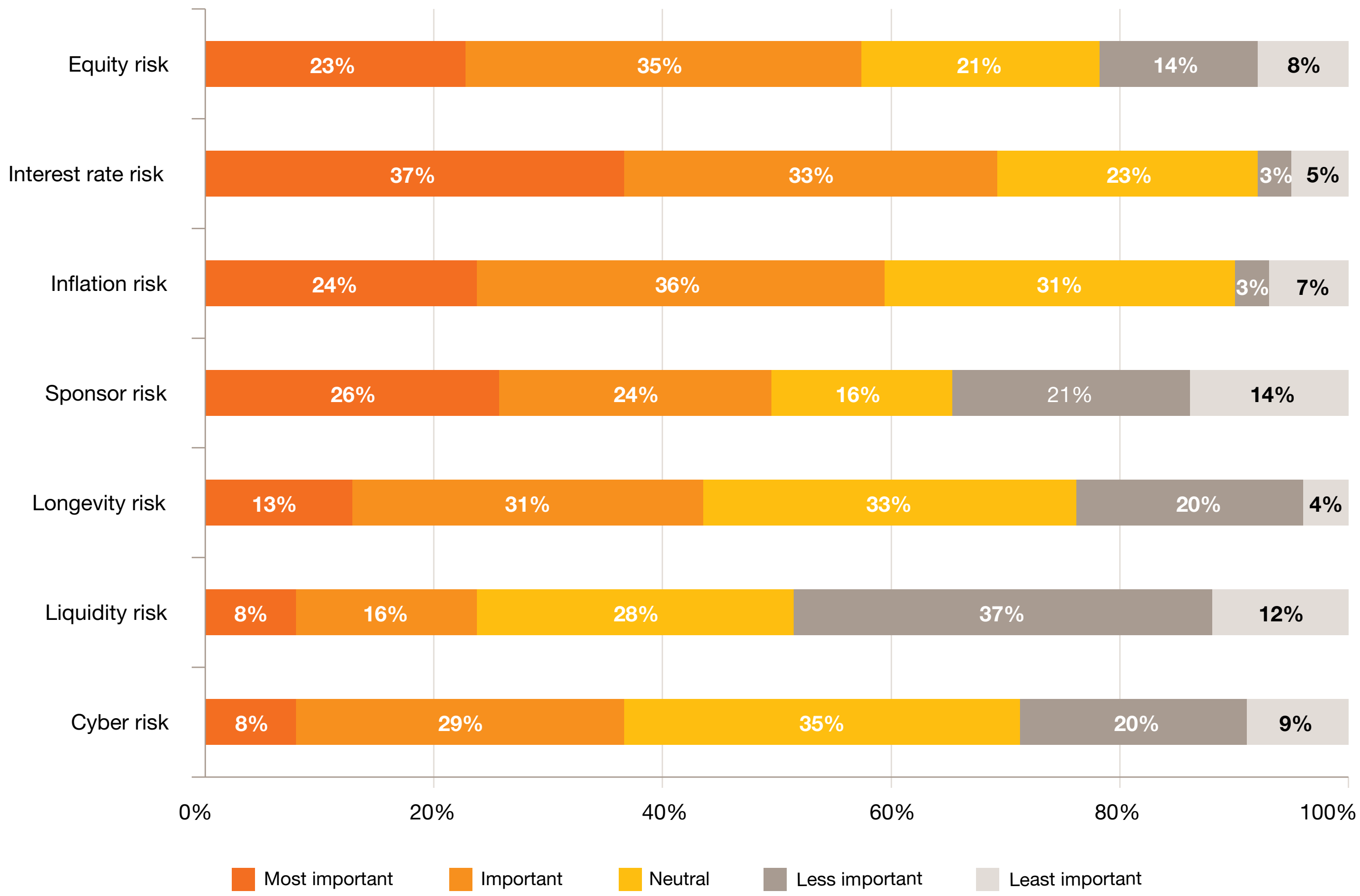


Nearly two thirds of respondents have agreed a mutually acceptable risk budget between the sponsor and trustees.

This suggests that close cooperation between trustees and sponsors is becoming more prevalent. This is something we encourage our clients and prospects to work at and maintain. This also reflects tPR's increasing emphasis on a good working relationship between trustees and sponsors.

3. Key risks and their importance

Q How important do you think the risks below are?



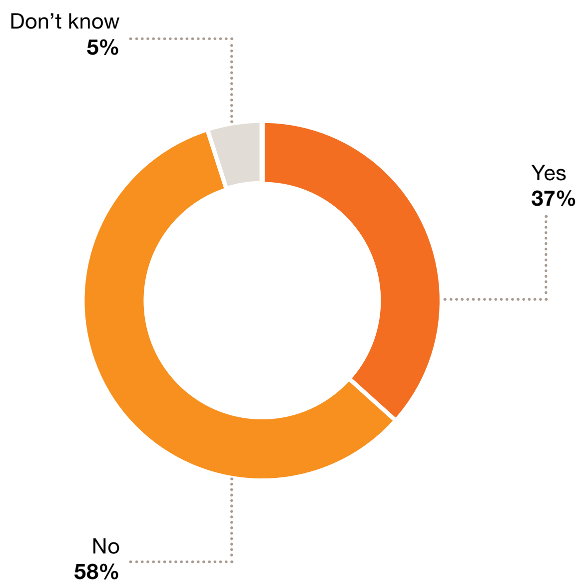
Almost 40% of respondents rated interest rate risk as their most important risk, followed by around a quarter rating inflation, sponsor and equity risk as their most important.

The importance of interest rate risk suggests that the traditional gilts plus valuation methodology is still prevalent. Equity risk only ranks as the fourth most important which highlights the move away from this asset class.

Whilst the majority of respondents didn't think liquidity or cyber risk were important, we expect these to be increasingly important areas in the future.

4. Contribution levels

Q Do you foresee additional contributions from the sponsor, over and above those already committed, to enable the scheme to reach its objectives?



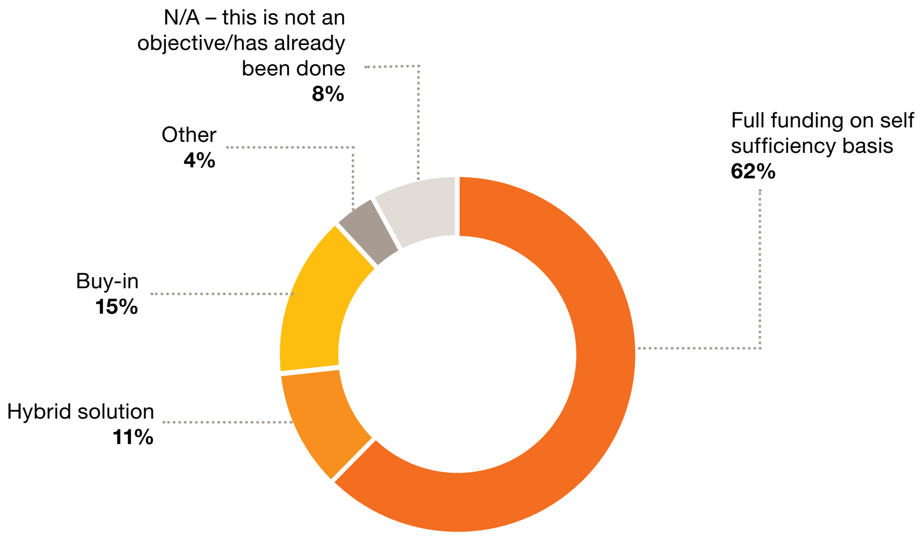
Nearly two thirds feel that their current investment strategy is on track to reach full funding within agreed recovery periods, without additional support form their sponsor. The response supports our finding that two thirds are targeting full funding on self sufficiency basis to de-risk the scheme.

This suggests that recovery plans are mostly seen as being realistic by respondents and return expectations are being met in practice, which is consistent with our findings in the next page around schemes' preferred end game strategies.

This is positive given the increase in deficits in recent years and implies that trustee/sponsor cooperation is good.

5. Preferred end game strategies

Q If transferring all your scheme's obligations to an insurance company is expensive or not an objective, which of the following alternative strategies would you consider to de-risk the scheme?



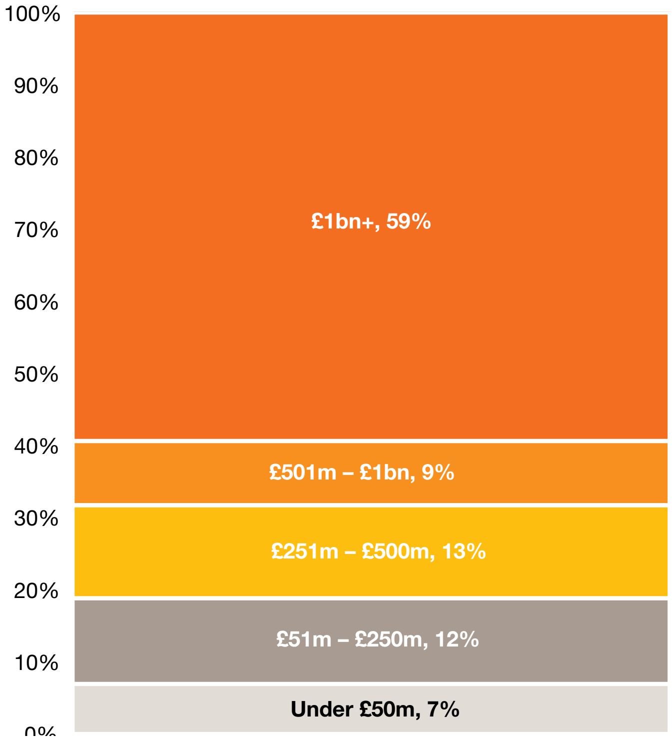
Almost two thirds of respondents are considering self-sufficiency, with 11% considering some sort of hybrid solution. The respondents who selected 'Other' would consider acting like an insurer through cashflow matched strategies or more modest gradual de-risking like transfer exercises.

This suggests that the majority of schemes would be comfortable continuing to run their assets and are less reliant on corporate sponsors.

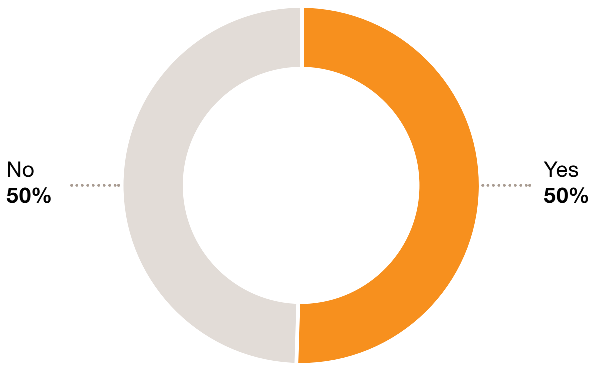
We're starting to see an increase in alternative solutions in the market, particularly as schemes look for alternative ways to manage their liabilities without having to fund to full buyout. This is supported by the 15% of participants who are considering hybrid or 'other' solutions.

Appendix: Survey participation information

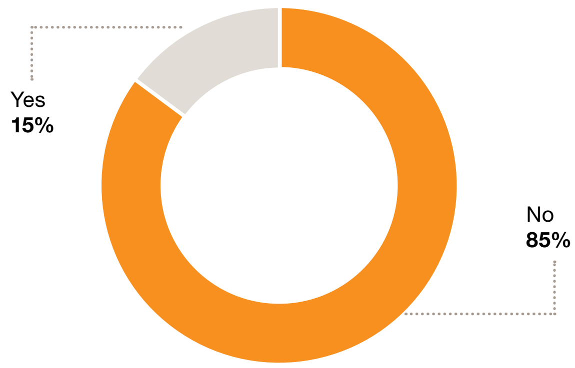
Size of scheme
(Participating schemes have a total of over £264bn[2] AUM)



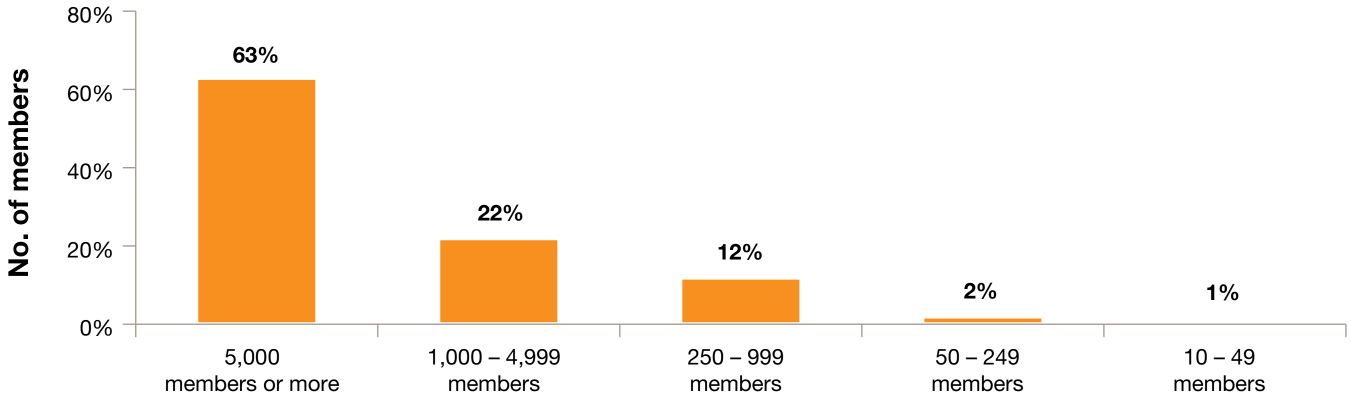
Scheme open to future accrual?



Scheme open to new members?



Note: this is similar to the Pension Protection Fund's (PPF) Purple Book 2017's statistics that 61% of schemes are open to accrual and 12% of schemes are open to new members.



[2] Estimated figure using the Pensions Fund Online Blue Book

The demographic of our respondents are broadly consistent with the results of the PPF Purple Book. Therefore we believe the surveyed schemes are a reasonable representation of UK defined benefit pension schemes as a whole.

Note: Our survey included 101 respondents with total AUM of over £264bn.

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