Thought Leadership

Three ways to head off threats to your funding ratio

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There is no question that equities can provide strong growth over the long term and generally offer healthy returns during buoyant markets.

However, the market turbulence at the beginning of the year will have reminded many trustees of how volatile equities can be and the effect that can have on funding ratios.

There are many techniques to manage equity market risk, but most tend to be onerous from a governance standpoint and are typically short term, while their objectives may not be aligned with the specific pension scheme's longer-term needs.

Our decision tree below outlines three techniques which address these limitations and aims to provide a clear framework for deciding which technique may be most appropriate.

This strategy may be suitable for schemes looking for an alternative to an option strategy that requires a payment to be made at the outset.

It systematically allocates from equities to cash when markets become volatile and/or losses begin to be incurred, with the aim of limiting losses over a predetermined period.

The investor "pays" for the downside risk management by forgoing a certain amount of equity growth potential.

2. Smart calendar collars

For schemes that also require protection against sudden market dips, "smart calendar collars" provide downside risk management while still not requiring an initial cash outlay.

This option-based strategy means that the investor effectively pays for the downside risk management by forgoing upside if markets rise above a predetermined level.

3. Managed volatility with put options

For schemes that want to keep the upside and are prepared to pay cash for it at the outset, this approach combines volatility management with an option strategy.

The volatility of the equity portfolio is managed to a target, say 10%. If volatility rises to 15%, a third of the equities would then be sold for cash to bring volatility down to the target.

By the same token, if volatility falls below 10%, equities can be bought to bring it back closer to the target level.

The resulting reduction in volatility reduces the cost of the put options used to provide a protective floor under the portfolio.

This means that, over the long term, the premium paid for the options is significantly less than would be the case in a traditional options-based strategy.