Schroders

Thought Leadership

Three key questions to ask in an effective investment review

Navigating an investment strategy review can be a daunting task. To help trustees, we have distilled down the process to the three key questions we believe they need to focus on

03/06/2016

Trustees receive an update on how well funded their scheme is every three years during the actuarial valuation. To produce this valuation, the scheme actuary estimates what all the scheme's future benefit payments are worth in today's money using a discount rate.

An important focus of the valuation is the technical provisions funding level. Trustees must negotiate a deficit recovery plan with their sponsor if there is a deficit on this basis.

However, reaching full funding on a technical provisions basis isn't enough to secure members' benefits in the long term. This is because the technical provisions basis usually assumes the scheme's assets grow faster than the liabilities.

This means the assets must continue to outperform the liabilities to remain fully funded on this basis.

Trustees should have a long-term goal beyond full funding on the technical provisions basis: one where members' benefits are secured without the need for further outperformance. This can be measured by using a second, more prudent basis for determining the liabilities, with no outperformance built in.

The discount rate is crucial. The higher the discount rate, the lower the liability value and vice-versa.

To determine the discount rate, the actuary makes certain predictions about the period until pension payments are due:

A typical UK defined benefit scheme has a very long time before it must meet its liabilities (around 20 years). This makes those liabilities very sensitive to slight changes in the actuary's forecasts of interest rates, returns and inflation.

The aim of the investment strategy review is to decide how much investment risk to take, and where to take it.

Trustees often focus on the assets, but a much bigger risk often lies with the unhedged liabilities. This is because, as discussed above, they are so sensitive to changes in expected future interest rates and inflation.

The average scheme is only covering (hedging) about 31% of these risks with liability matching assets.

The current asset allocation of UK DB schemes on a simple average basis can be seen in the char on the left below. The righthand chart breaks down the sources of funding level risk assuming 31% is covered by matching assets.

It is clear that the risk from the liabilities is greater than the risk from all the growth assets added together. So while the average scheme may have spread the risks from its growth strategy using a range of assets, it is still taking a very concentrated bet on interest rates and inflation through its uncovered liabilities.