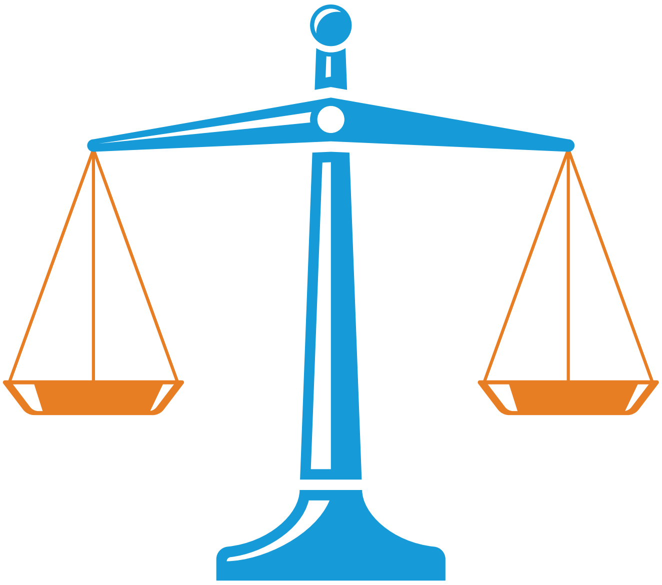
The great DB balancing act

December 2015



Meeting their investment objectives within a persistently low-rate, low-growth environment is an ongoing challenge for today's defined benefit (DB) schemes. This article examines how dynamic liability-driven investment (LDI) and diversified growth strategies can help, and highlights the importance of looking beyond the traditional asset mix.

Although the number of defined contribution (DC) pension scheme members has caught up with the number of DB members for the first time, DB assets still make up 53% of total institutional assets managed in the UK. Private sector DB is 82% of the total DB market and represents 43% of total institutional assets. The value of these assets is over four times bigger than the DC market; importantly, they are still growing consistently and are expected to be greater than DC for at least the next 10 years.[A] Managing these assets and meeting their investment objectives within a persistently low-rate, low-growth environment is an ongoing challenge for today's DB schemes.

Low cash and bond yields, which over the last 15 years are down from approximately 5% to 2%[A], and the correlation between bonds and equities mean investors need to look beyond the traditional asset mix. Managing volatility has added to the challenges and seen an increase in the use of LDI and diversified growth strategies, in an attempt to smooth and stabilise the journey towards self-sufficiency or buy-out.

Solving the de-risking challenge

UK bond yields are expected to remain low with demand far outstripping supply. Estimated index linked Gilt issuance, which some would argue is lower than it should be, is not expected to help. These conditions can be especially difficult for smaller schemes, which are typically less diversified. Larger schemes (£100m plus) are often far more comprehensively hedged than small schemes. In 2015, 95% of schemes with assets in excess of £1bn had an interest rate hedging strategy in place, compared with only 62% of schemes with assets of less than £100m.[B]

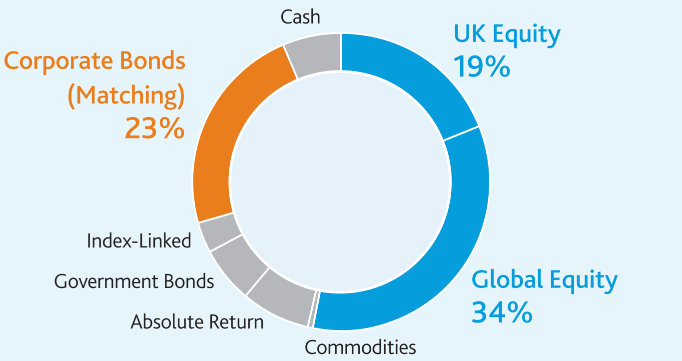
Understanding the fundamental risks embedded in the liabilities themselves, such as inflation and interest rate risks, is an important step in the de-risking process. It is important to minimise this risk, but not at any cost. Rather than investing to generate returns in absolute terms, Aberdeen believes that pension schemes should invest with a view to meet the scheme's liabilities. This generally means increasing the level of interest rate and inflation exposure within the asset portfolio towards the level of interest rate and inflation exposure implicit within the liabilities.

Traditional solutions, which rely on only one metric (i.e. time-based or market-level-based triggers) to manage the transition from growth assets into the LDI hedges can be too restrictive and result in missed opportunities. Instead, schemes need to employ a dynamic de-risking framework that takes into account funding level, allowing them to capture market opportunities whenever they occur, maximising the chances of closing the funding gap. Provided three key elements are in place – diversified exposure to growth assets, a bespoke matching portfolio and a dynamic flight plan framework – a scheme has the ability to efficiently navigate a flight plan from an underfunded status to fully funded and fully hedged position.

[A] Source: Spence Johnson Ltd. Investment Product Market Intelligence 2015, Diversified Growth Funds, A new landscape is emerging
[B] Source: Spence Johnson analysis 2015; Aon Hewitt (DB336)

Figure 1

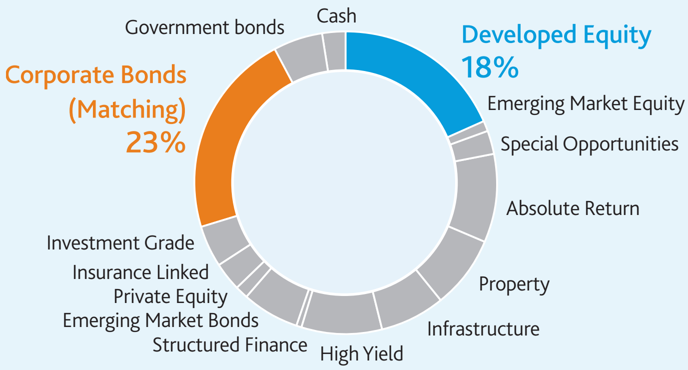
Concentrated risk



Typical asset allocation:

- Not very liability-like
- Concentrated risk exposures
- Return is highly volatile

Diversified risk



More robust allocation:

- Increase the diversification of the growth assets
- Return is less volatile

Source Aberdeen Asset Management as at 30 June 2015
For illustration purposes only

Consider growth, not just matching, assets

Investors often tend to focus on fixed-income matching assets, but managing risk also means looking more closely at the growth portfolio. Figure 1 illustrates a balanced fund (concentrated risk) and a diversified growth fund (diversified risk), which has many more sources of return. This broadly diversified portfolio targets a return of cash plus 4.5%, from varied sources, and aims to achieve this with less volatility than equities.

Time to think more like insurers?

Traditional sources of matching assets are expensive but there are more attractively valued alternatives. At Aberdeen, we are working with pension schemes and their consultants to implement strategies that increase allocation to a diverse range of matching assets as funding levels improve. Among these are: investment grade credit, infrastructure, social housing, renewable energy, direct lending and less liquid credit. These may be viewed as ‘dual nature’ assets, contributing long-dated interest rate and inflation exposure to the matching portfolio and risk premia to the growth portfolio – sources of return such as illiquidity, credit, commodity and other uncorrelated returns specific to the type of opportunity, in other words, more diversification. Some of the largest UK pension funds have recently adopted this type of approach to managing a portfolio of ‘dual nature’ assets versus a liability profile, but this is something insurance companies have been doing for many years.

The rise and rise of diversified growth funds (DGFs)

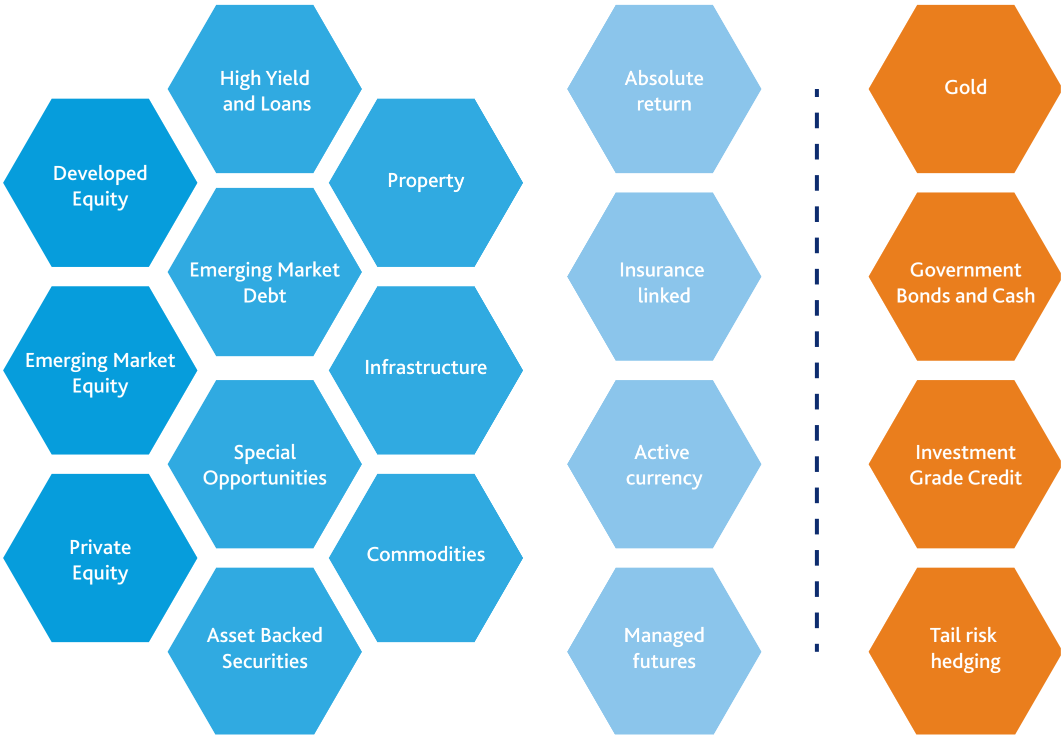
One of the main advantages of DGFs is that they offer efficient access to different asset classes under one umbrella. Instead of relying solely on the equity risk premium, investors gain exposure to other return premia such as credit, illiquidity, insurance and investor skill without having to invest in and monitor separate specialist managers. DGFs encompass a wide variety of strategies but with a common goal: smooth, consistent growth; equity-like returns with significantly lower volatility.

‘Core’ DGF solutions typically incorporate a wide range of asset classes (traditional and alternative) and harness the full benefits of diversification. This also gives them a lot of scope to add value from flexible asset allocation given the range of different asset classes to choose between.

‘Hedge Fund-lite’ strategies – named as such because they have many of the characteristics of macro hedge funds – adopt more complex investment tools and techniques. The end result is typically a more idiosyncratic performance pattern that is heavily reliant on manager skill.

Figure 2

A broad opportunity set



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From the broad range of asset classes available to investors, the blue boxes illustrated above are among those that Aberdeen believes have the best potential for attractive returns, and which have different return drivers.

These assets may be used as part of a diversified portfolio to seek attractive returns, delivered in a much smoother fashion than the traditional asset mix alone. The orange boxes represent lower returning asset classes. Typically, these will not form a core part of a diversified growth portfolio but may be used as a safe haven in certain circumstances, or when they offer an attractive tactical opportunity.

DGFs have an increasingly important role to play in today's persistently low-rate, low-growth, volatile markets and are expected to continue to go from strength to strength in terms of the way that they evolve (deploying a variety of asset classes and strategies) and in gaining popularity.

Summary

- De-risking is not just about matching assets, consider growth assets too
- Growth and matching assets come in many forms and diversification is vital; the traditional asset mix is no longer sufficient
- A genuinely diversified approach can help deliver sustainable growth and reduce deficits
- A flexible approach will be valuable over the long term – plan the journey to full funding
- Use a dynamic process, manager skill and agility, to ensure that you are in a position to capture opportunities at the right time

The value of investments and the income from them can go down as well as up and investors may get back less than the amount invested

This article has been produced based on presentations which took place during a Pensions Intelligence Seminar on 12 November 2015.

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