THE TRUSTEE MAGAZINE
ENGAGED INVESTOR

December 2012

TRUSTEE GUIDE

TO THE FUTURE OF UK PENSION FUNDS

After the fall

The Top 100 pension schemes laid bare

Top 100 pension schemes' data analysis – the findings: **p2**

Schemes may be missing a trick by shunning shares: **p4**

Professor Andrew Clare on funds' flight to safety: **p11**

Top investment managers gaze into the crystal ball: **p14**

Altered state

Pension schemes have found themselves in a new and uncertain world, says Louise Ashford, opening Engaged Investor's analysis of the top 100 schemes

In the past five years investors have witnessed a series of paradigm shifts in the world economy, each sending tremors through the stock market. Britain's largest pension schemes have reacted by employing a variety of different investment strategies according to their own – or their asset managers' – world views. Many schemes have suffered great losses; others have seen these difficult years as an opportunity to diversify into new asset classes, with varying degrees of success.

Engaged Investor has taken a fine-tooth comb to the UK's top 100 pension schemes and discerned some significant patterns of behaviour. We have examined data from AP, which scours pension schemes' annual reports and extracts the most pertinent information about the top schemes' size and investment strategy over the years. Where data is sometimes incomplete across the top 100, we have taken a sample from smaller sub-groups of schemes. This will be clearly specified when it is the case.

Some trends will come as no surprise to readers, while others may be more unexpected. We've spoken to some of the country's top asset allocation experts to help complete the picture.

The decisive shift from equities to bonds has been well observed, and this is backed up in the research. Out of the schemes, 32 reported allocations for bonds and equities in 2008 and in the most up-to-date Pension Funds Online database information available.

These schemes have cut back their allocation of domestic equities from £50.9bn to £44.8bn between 2008 and this recent data, while that for overseas shares was down even further, from £47.9bn to £28.8bn. By contrast, allocations for domestic fixed interest doubled from £16.5bn to £33.5bn over the same period, although overseas gilts barely budged from £4.1bn to £4.3bn.

However, these headline pictures mask changes within schemes. Some of the largest, including BT and the Railways Pension Scheme, have weighted their asset allocation more heavily towards overseas assets in the hope of finding better performance in countries such as China, which have few of the structural debt problems so endemic in European markets.

Schemes have also broadened their minds in terms of the types of investments they are prepared to consider.

Schemes are becoming more interested in alternative assets, with interest growing in timber, frontier emerging markets and emerging markets private equity, to name a few. Part of this interest reflects schemes' desire to hedge inflation risk.

We examine the results of a specific asset class, real estate, which is often described as an alternative, on page 32.

Yet the UK's top schemes continue to diverge in some aspects of their investment strategy, making them difficult to characterise. For example, some have remained fairly heavily invested in equities; others have decided to use liability driven investing strategies, with mixed results. What is clear throughout the findings is that the past five years have been extremely difficult for most schemes. ■

SPECIALREPORT

Investment

Assets under management 2006-10

Figure 1

At the tail end of the Noughties boom, major pension schemes' total assets under management increased rapidly before falling post-recession, Engaged Investor's analysis of the Top 100 funds shows. The 67 schemes, which have reported results across the five years from 2006 to 2010 shows that AUM increased from £312.6bn to a zenith of £409bn in 2008, before slipping back to £383bn two years later.

Frances Hudson, global thematic strategist at Standard Life, says that "one of the fall-outs from the crisis was that people put a premium on liquidity for safety reasons". She also blames new regulation for fostering a culture of short-termism by marking down investments that aren't liquid. Pension funds traditionally take a longer view on investment and increasing liquidity should be counter-intuitive says Hudson. This could explain the continued decline in the overall value of assets under management.

Bonds & Equities

Top funds' exposure to domestic fixed interest assets doubled overall between 2008 and 2011, Engaged Investor's analysis of the top 100 schemes' data shows, reflecting a widespread lack of confidence in European markets. Of the 32 schemes that reported data on bonds and equities allocations for the two years, holdings of domestic fixed interest doubled from £16.5bn to £33.5bn, although overseas gilts barely budged from £4.1bn to £4.3bn.

Some schemes' allocation to domestic fixed interest far more than doubled: for instance, Royal Mail's increased from £1.8bn in 2008 to £8bn, according to the scheme's latest reported figures on Pension Funds Online. "It's still predominantly UK government bonds that pension schemes are interested in," says John Dewey, BlackRock's managing director of multi-asset client solutions. Combined allocations for fixed interest and equities fell from £121.8bn to £111.7bn (see right) for the 32 schemes.

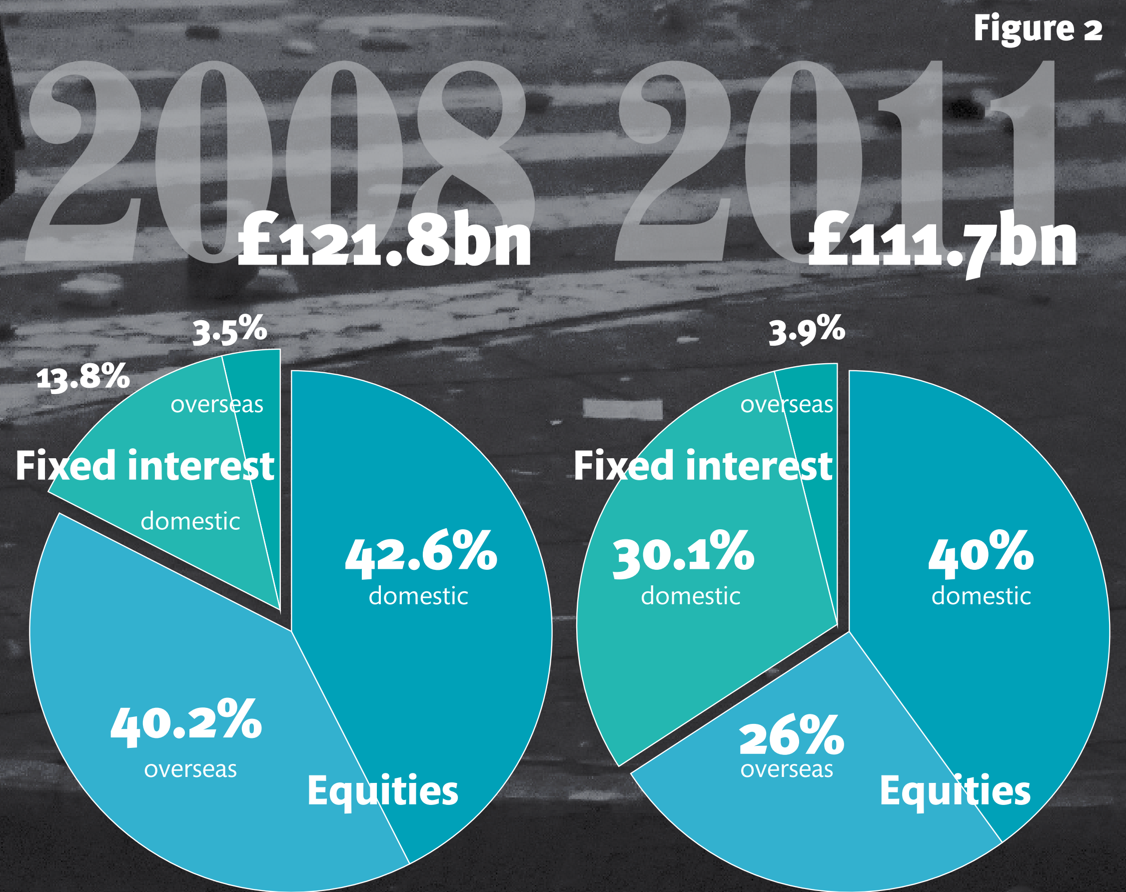
In a time of uncertainty, pension schemes have looked to hedge their liabilities by buying traditionally safe assets, such as UK government bonds. "What you've seen is a move into fixed income as pension funds have become much more alive to the risk of their portfolio. They're looking to hedge that risk and have become less tolerant in terms of risks relative to that notional benchmark," agrees Paul Niven, director and head of multi-asset investment and deputy head of investment solutions at F&C Investments.

The sharp downswing in the pension schemes' allocation to overseas equities from £47.9bn to £28.8bn, is the surprise finding of this survey. The popular assumption is that schemes have moved their money into overseas equities as a result of the lacklustre performance in the UK equity market, but this is not the case.

There are a few possible explanations. These results are for the 32 schemes surveyed here, which could represent a minority. Many schemes which recorded a drop in their allocation to overseas equities in this period moved money into other asset classes.

Some of the biggest schemes – the Universities Superannuation Scheme and BT's pension scheme among them – did move substantial sums into overseas equities between 2008 and 2011, following the more widely reported trend away from UK assets.

Figure 2



Safety game

Pension schemes may be missing a trick by shying away from equities, says Mark Leftly

This summer marks the fifth anniversary of the point at which the credit crunch started – widely considered to be the trigger for the global financial crisis. There were signs of the forthcoming problems – such as defaults on sub-prime mortgages – in the months before BNP Paribas announced a "complete evaporation of liquidity" in the market on 9 August 2007.

Initially, the FTSE 100 proved resilient, and continued trading at far above 6,000 points and the benchmark index even grew 2.1% that year. However, the year since have not been kind to equities. The FTSE was ravaged the following year, with the collapse of Lehman Brothers acting as a symbol of the dreadful corporate bets that bankers had wagered.

And every time the FTSE seems to recover, a new crisis emerges, such as the Greek sovereign debt disaster or JP Morgan's 'London whale' trader causing at least $2bn of losses for the US bank and hitting investor confidence.

The upshot for pension funds has been a thorough review of asset allocation, with investments in risky equities significantly reduced to stem the possibility of losses. Engaged Investor has analysed the investment data of the top 100 pension funds for the past five years and found that the balance between equities and fixed income has shifted sharply in favour of the latter.

The correlation between bonds and equities has seen a dramatic shift in favour of the former – the share of assets under management accounted for by fixed interest has doubled, with shares seeing a corresponding decline (see fig 2, page 29). Investment in index-linked gilts is also up, as is real estate. City sources acknowledge that the figures accurately reflect the shift that they have experienced in recent years. One pension fund trustee notes that equities have slipped from dominating his portfolio at 75%, to just a quarter of its assets today.

The £6bn Marks & Spencer defined benefit scheme is a good example. In 2006, assets were skewed towards equities and corporate credit, but the new head of investments, Brian Kilpatrick, moved M&S into areas with more stable returns, such as reinsurance and private equity.

Today, equities makes up just 13% of its portfolio, many stakes having been recently offloaded as part of a £1.3bn shift to UK gilts, now the asset class with the highest allocation at 29%. One asset manager jokingly describes this lack of equities exposure as "almost criminal" – stable but risk-free investments also mean less potential upside.

However, M&S is also a DB scheme that, like the vast majority in the FTSE, has been closed to new entrants for a number of years and is effectively in run-off. It has 125,000 members, but only around 14,000 are still working.

DB pension funds value stability over the potential to build up surpluses, as they need to be certain that they can fulfil their obligations in the short term. There is something close to an end-date for their schemes, so the trustees have to make sure that the economics are sound, even if that means sacrificing potentially lucrative investments. The reasoning seems sound when looking at one of the biggest FTSE stocks, BP.

The oil giant has attracted billions of pounds of pension fund money, with at one point, for example, the Daily Telegraph newspaper's pension fund allocating 4% of its assets to the company.

Managers were attracted to BP with good reason: the dividends were enormous, accounting for one pound in every six that pension funds were paid out from their stock investments.

However, the Gulf of Mexico spill in 2010 wiped off nearly half the value of BP's stock in just three months, while the dividend was temporarily suspended and has yet to hit its previous heights. BP was one of the soundest equity investments a pension ▶

Investment

Domestic index-linked gilts

Figure 3

Biggest risers & fallers

Figure 4

Barclays
Grew by £11.99bn

HSBC
Grew by £8.59bn

Royal Mail
Grew by £4.20bn

Rolls Royce
Grew by £3.89bn

MPS*
Fell by £2.56bn

BCSSS*
Fell by £2.76bn

BT
Fell by £3.09bn

*MPS = Coal Pension Trustees Mineworkers' Pension Scheme

*BCSSS = Coal Pension Trustees British Coal Staff Superannuation Scheme

Who's in?

Schemes that have entered the top 100 since 2008

- GlaxoSmithKline Pension Fund
- Rolls-Royce Group Pension Scheme
- Santander Pension Fund
- Pension Protection Fund
- British American Tobacco DB Section
- Centrica Combined Common Investment Fund Ltd
- Alliance Boots Defined Benefit Scheme
- Esso UK Ltd (Exxon Mobil Pensions)
- Effem Holdings Ltd (Mars UK Ltd Pension Plan)
- Nationwide Building Society Pension Fund
- Smiths Group plc Smiths Industries Pension Scheme & TI Group Pension Scheme
- Babcock International (Group, Devonport Royal Dockyard, and Rosyth Royal Dockyard and VT Group Pension Schemes)
- Siemens plc Defined Benefit Scheme Siemens Transmission & Distribution Ltd Pension Scheme
- Pernod Ricard (Allied Domecq Pension Fund)
- Middlesbrough Council (Teesside Pension Fund)
- Morrison Supermarkets plc (The 'Morrison' and 'Safeway' schemes

Who's out?

Schemes that have left the top 100 since 2008

- Scottish Public Pensions Agency
- Civil Aviation Authority Pension Scheme and National Air Traffic Services Pension Scheme
- Nestlé Ltd Pension Fund
- British Energy Generation Group of ESPS
- FirstGroup plc (The First UK Bus Pension Scheme)
- EDF Energy (EDF Energy Generation and Supply Group of the ESPS)
- Lafarge Pension Plan
- Vauxhall Motors Common Investment Pool
- Cable and Wireless Defined Benefit Section
- Scottish Power Pension Scheme
- RHM Pension Scheme
- Merchant Navy Officers Pension Fund
- Total UK Pension Plan
- Norfolk County Council Pension Fund
- Xerox Pensions Ltd Final Salary Scheme
- Royal Insurance Group Pension Scheme

Real estate

An asset class

Figure 5

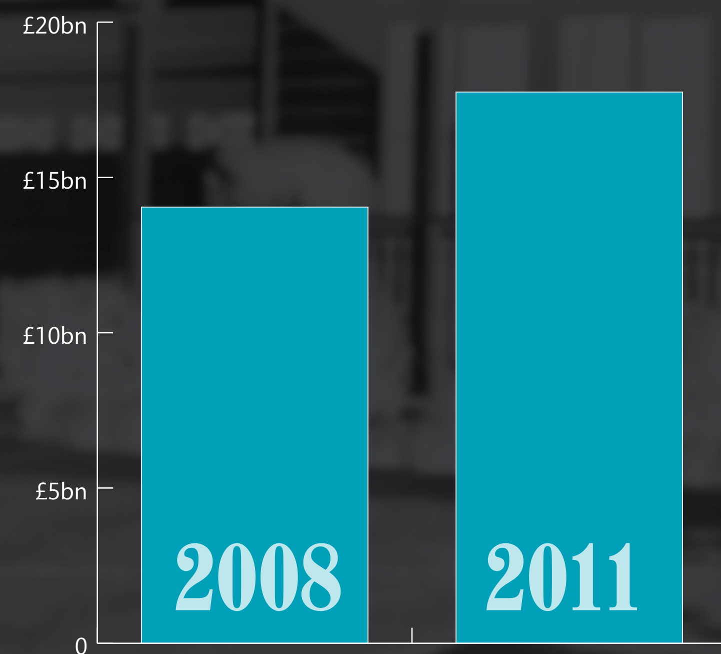
£3.6bn

TThe biggest current allocation (BT Pension Scheme) to domestic real estate by a top 100 scheme

£857m

The biggest current allocation (BBC Pensions Trust) to overseas real estate by a top 100 scheme

Source Pension Funds Online



The 2007 credit crunch hit commercial property faster and harder than any other part of the economy. However, pension funds have not lost their faith in bricks and mortar judging by Engaged Investor's analysis of the top 100 scheme data.

Out of the top 100 schemes in 2008, 33 have reported allocations to property for that year and in Pension Funds Online, which contains the latest data. These schemes reported a combined allocation £14bn to domestic and overseas real estate in 2008, a total which has increased to £17.75bn, according to the latest Pension Funds Online. Overseas real estate remains a minority sport, played by just a handful of the third of the top 100 under the microscope.

The biggest investor in this asset class out of the 33 schemes remains the BT fund, which has £3.6bn invested in domestic real estate together with a further £305m in overseas property. However, bucking the wider trend, the UK's biggest fund has reduced its weighting towards real estate, which stood at £4.3bn in 2008 – more than half the total that it invested in UK equities- with a further £119m in overseas bricks and mortar.

This shift out of real estate by the UK's most heavyweight fund suggests that smaller funds across the rest of the top 100 have been building up their exposure to property.

For F & C head of multi-asset investment and deputy head of investment solutions Paul Niven, the shift into property is part of a broader move by schemes towards more diverse portfolios. He says: "You've seen a move into alternatives – obviously property to some extent as well and absolute return types of products."

Pension Corporation co-head of business origination David Collinson sees the shift into property as part and parcel of an increasingly risk-averse approach to investment by funds, particularly those defined benefits schemes which are closed to new entrants or even future accrual.

He says: "If they have negative cashflows they will need to sell assets to pay pensions, but they don't want to be forced to sell in a distressed market." Property leases are long term, low risk investments which offer a stable income stream and some inflation protection he adds.

fund could make, yet it still proved a flawed move for many fund managers.

Concerns over volatility

Julian Le Fanu, a policy adviser at the National Association of Pension Funds, points out that this trend away from risky assets goes back a little further than five years, as big corporates started closing those hugely generous, financially draining DB schemes.

"The move from the risk of equities into fixed income is quite a long-term thing, over 10 years," Le Fanu argues. "The decisions about the overall structure of the asset allocations come very much from the sponsoring company, because the company stands behind the obligations and the trustees have to consult with them.

"If the company is thinking that there is volatility with assets, they will worry about their triennial valuations: that equities could be low, that they will have to put extra money into the scheme," he says.

A trustee might think it is the right time to put some of the fund into equities, but the company will only be thinking that there is an end date in sight. The company's board is unlikely to risk a deficit, no matter how great the probability of a surplus, if it can be assured that the scheme is fully funded in safe fixed-income assets.

However, most City pension and asset management experts seem to agree that the shift has sharpened since 2007, which is unsurprising as it became clearer just how volatile the market had become. Indeed, the NAPF's own survey of its members shows that DB trustees have reduced their schemes' allocation to equities from 21.1% in 2009 to just 14.3% last year, while UK index-linked gilts have grown by 3.2% in the same period to 16.4%. And, despite historically low interest rates, the NAPF survey reflects our own survey that shows cash to have roughly doubled in recent years.

Getting the timing right

There is a problem here, though, in that there are fundamentally strong companies whose stocks have been badly hit by the crisis. These undervalued equities are great opportunities for pension funds, as the share prices seem sure to increase, but they are opportunities that trustees are ignoring as they flee to safety. Hargreaves Lansdown investment manager Ben Yearsley says: "The general rule is that people will go into bonds at the wrong time. They're reactive – when bonds are up, people go following them and vice versa. You can apply this to individual investors too, they invest most when markets are at their highest rather than lowest levels. They would be better to buy [in a bear market] and hold."

Paul Mumford, a fund manager at specialist long-only equity boutique Cavendish Asset Management, points to telecoms giant BT, which put a £2bn top-up into its pension fund in March, as a scheme that "got out of equities at the bottom of the market".

He believes that pension funds continue to be too scared of volatile assets at just the time when their losses should become gains.

For DB schemes, he suggests, that's fine, as they need the certainty mentioned above. But in money purchase schemes there is likely to be conflict between the views of its more demographically balanced membership.

"Is this way of de-risking the right way?" asks Mumford. "The money purchase funds are a different kettle of fish, because this isn't a defined liability at the end of the day. There is a broad variety of people making contributions. The younger members will be interested in getting the most growth out of the investments, whereas the older people want to iron out fluctuations."

Mumford also points out that bonds are not inherently safe. Forgetting the sovereign bonds that have proved so costly, such as Portugal's slide to 'junk' status, corporate bonds always come up with a risk the firm could go under and interest rate hikes can badly hit their values.

Partnering for success

The need to maximise returns while successfully managing risk can be a difficult balancing act, so fund managers are increasingly using the expertise of specialist partners, says **Ian Mizrahi**

Pension fund managers are embracing innovation in their approach to investment and are making use of new intellectual capital and resources that are available to professional investors in order to deliver better investment outcomes.

Mainstream asset managers are increasingly investing in new asset classes, regions and instrument types, while deploying techniques and technologies that were once the domain of those operating at the alternative end of the spectrum.

The desire to enhance or diversify returns and improve risk management is motivating pension fund managers to consider new models to achieve these ambitions, and to ask how best to understand and harness the benefits of new approaches.

Broadening the investment universe

Investors are now looking for additional sources of value across a broader universe of exposures and instruments, such as commodities, emerging markets and derivatives, as well as the ability to go long and short and use options to reduce volatility and help protect capital.

Pension funds are increasingly investing in these non-traditional asset classes. However, establishing these capabilities in-house can be challenging. It requires a combination of investment and trading expertise, a more complex risk management and operational control framework, ISDA agreements and legal and operational know-how to make it work.

An alternative approach to accessing greater markets is to partner with a specialist asset manager, with the aim of offering a platform that pension funds can leverage to invest across all asset classes. This can free the pension fund to focus solely on investments and asset allocation, leaving the front-to-back implementation to a third party.

Nimble investment

A greater capacity to react quickly to market events and take advantage of opportunities or amend risk profiles promptly is another practice that pension funds are increasingly seeking to adopt. Traditional models built on sub-advisory mandates and investments into third-party vehicles can create significant lead times to adjust exposures.

To enable faster implementation of investment views, pension funds are now using tactical asset allocation overlays that sit over the strategic portfolio but are composed of highly liquid or unfunded investments, such as exchange traded futures and other derivatives.

These overlays enable managers to change the overall risk profile of their portfolio in minutes or hours (depending on the size of the portfolio), after the investment decision has been made. If the pension fund wants to make a permanent reallocation between asset classes, the transition can take place more slowly, adjusting the overlay and the main portfolio in tandem. This approach provides continuity in the overall asset allocation and avoids taking on unintended risks or trading costs.

Specialist partners can implement the overlay to match the level of ongoing interaction that a pension fund wants. Some may want to make the investment calls on the tactical asset allocation themselves on an ongoing basis, while others may prefer to focus on the strategic portfolio and rely on specialists to manage the tactical overlay. Both solutions rely on experienced cross-asset investment management teams using flexible and scalable platforms. In addition, portfolio look-through capabilities are essential, as they enable pension fund managers to access a consolidated, granular view of their portfolio across all investments, including the overlay.

Tailored risk solutions

Given the significant uncertainty that markets have been experiencing, many pension funds are actively looking at more sophisticated approaches to risk management, such as tail risk hedging and principal protection strategies. They are also increasingly focused on ways to immunise the portfolio against unwanted or unrewarded risks, such as credit risk or foreign exchange, or the new generation risk factors driving markets nowadays such as market sentiment, political risk, funding and illiquidity.

Designing and implementing a strategy to address these risks can be challenging. Its effectiveness depends on the ability to draw together position level data, generate an aggregate view of portfolios and having the necessary quantitative systems to perform risk-factor analyses and present the information in a meaningful way.

Finally, it requires the risk management expertise to design and implement hedging strategies that meet the specific risk objectives of the scheme.

Many pension fund managers are starting to address these issues in-house, using their own capabilities, while others are teaming up with specialist managers. Third-party managers can provide the benefit of new generation risk technology and help pension funds design and implement customised solutions to meet their overall risk and investment objectives. Finally, comprehensive reporting and performance attribution of hedging strategies are essential for the continuing development and success of any risk management scheme.

Conclusion

The breadth of investment, the speed of implementation and active downside risk management are key ingredients for enhancing investment value. There are, however, significant challenges in developing some of these capabilities in-house. Partnering with the right specialist managers can offer flexible solutions that allow pension funds to manage these challenges. ■

Ian Mizrahi is Head of Portfolio Management and Structuring, Funds and Advisory at Barclays.

Liabilities

Contribution levels

Figure 6

The number of active members is down and pensioners up – that's the perhaps unsurprising conclusion from Engaged Investor's analysis of the Top 100 pension schemes. For the 55 of the biggest schemes, which reported membership figures in 2008 and in the Pension Funds Online database, the total number of members rose from 4.75m to 5m. But within that overall figure, the past four years has seen an increase in the number of pensioners from 1.8m to 2m. Over the same period, the total of active members has dropped from 1.6m to 1.4m. The balance is accounted for by deferred members.

However, there were some apparent anomalies where the total number of members decreased significantly between 2008-11, such as BT, which saw a fall of 13,486 in its membership over this period.

Engaged Investor also crunched the numbers on the 41 Top 100 schemes for which annual contribution data is available for the four years from 2008-11.

This shows that contributions from the sponsors of the schemes dipped in 2009 but rose in 2010 and again in 2011, reflecting ongoing difficulties schemes faced in achieving stable funding levels. Contributions fell by 5.9% in 2009 from £8.4bn to £7.9bn, but recovered in 2010 by 12.2% to £8.9bn. This increase accelerated to £10.3bn in the latest set of Pension Funds Online figures – a 22% increase compared to 2008. Of the selection of schemes under the microscope, Diageo increased the most over the four years, almost quadrupling its contributions. There were some notable exceptions, however – between 2008-11 Marks and Spencer's contributions dropped by £340.3m.

Kevin Le Grand, chairman of the Society of Pension Consultants, explained the overall rise by saying: "It is probably down to two factors, which I'd say are increases in average longevity figures and having to compensate for poorer investment performance."

He added: "There's been a big effort by a lot of companies to try to reduce the deficit. Anecdotally, a lot of companies are holding on to a lot of cash and it may be that [the contributions increased] around about the time that they were deciding that they could actually spend some of this cash on reducing the deficit in the pension scheme."

Scheme membership make-up

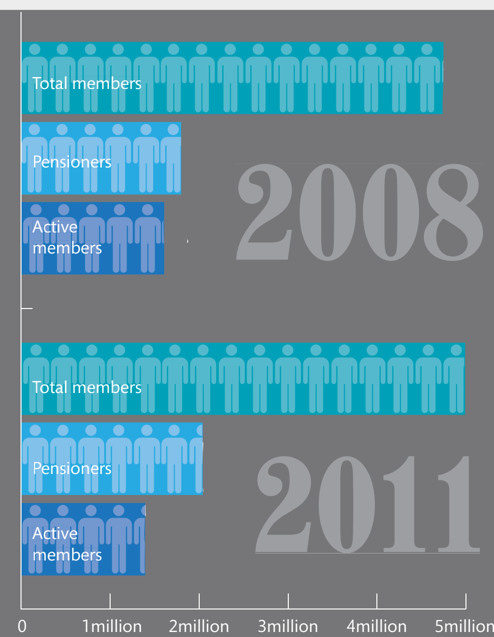


Figure 7

A role for infrastructure

Looking ahead, though, the likes of Mumford, who believe that a pension fund's average equities allocation should be in the region of 35-40%, are likely to remain disappointed.

A spokeswoman for the Association of Investment Companies says: "Anything with the word 'income' in it is impressive to the market and trading at a premium at the moment, as people are desperate to get hold of asset classes [with predictable returns] such as private equity and infrastructure."

This should be good news to the government, which is banking on pension funds to back a large chunk of its £200bn infrastructure programme to kickstart the British economy. However, the evidence is not clear, as most research shows that infrastructure, such as private finance initiative (PFI) projects, remains only a few percent of funds' asset allocation.

More importantly, it is unlikely that pension funds will invest in major capital projects at just the time the government wants them to, which is during the construction phase. This is the period that is generally considered the riskiest part of the infrastructure process, as there can be problems with delays and fluctuations of building materials and labour costs forcing projects over budget.

Indeed, under the old PFI schemes, many investors were looking to come in a few years after the school, hospital or road had become operational, when there is evidence that it is a safe, stable income stream. As a result, the secondary market, when a construction firm or infrastructure specialist fund sells on their equity stakes, is far more vibrant.

In November, 2011 the NAPF signed a memorandum of understanding with the government to form a 'pool' of its members' resources in order to encourage at least £20bn of pension fund money into the government's infrastructure programme.

However, most pension fund managers privately admit there is a lack of historical evidence that investing in infrastructure early would be anything other than risky, meaning that the typical allocation of around 2% to the asset class is likely to remain the norm.

It would seem to be more likely that managers will play it safe with traditionally stable assets that have performed well throughout the financial crisis – such as the top-rated sovereign bonds – rather than move into anything without results or classes as unpredictable as the stock market. ■

Mark Leftly is associated business editor (Sunday) of The Independent

Managing asset risk

The growth of liability-driven investment reflects an increasing focus on solutions that help funds to control uncertainty, says **Mike Walsh**

The understanding and management of risk has become more important to pension schemes over the past two decades. This trend is most prevalent in the area of liability-driven investment, with the expansion of solutions to manage the risks faced on both sides of the pension scheme balance sheet, ie, liability risk and asset risk.

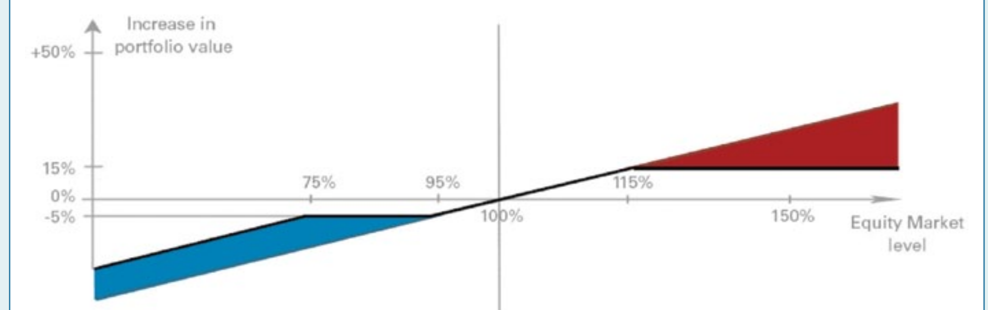
The typical focus of LDI solutions has been on the liability side, recognising and managing interest rate and inflation risk. Increasingly, it is equally important for an LDI provider to have experience in managing broader asset risk, such as equity exposure.

Equities still account for a significant portion of assets for many pension schemes and while they have the potential to produce significant growth over time, historical returns show that equity markets can suffer from extreme periods of volatility. Rather than leaving these swings to fate, more schemes are seeking ways to control their exposure. This means they can benefit from equity market gains yet restrict losses – particularly as their funding levels improve.

Equity options allow a scheme to place a ceiling or a floor on the returns from an equity portfolio. However, buying protection via options outright may be unattractive to schemes as it requires an upfront payment for what is effectively an insurance contract. Fortunately, as a wide range of such structures are available, a scheme can both buy and sell options such that the net initial cost is zero.

A common example of this is known as a put-spread collar. Figure 1 shows the pay-off profile of a typical equity protection strategy (with a term of one year) adopted by a scheme in order to reduce the variability in expected returns.

Figure 1: Put-spread collar payoff



Source: LGIM, for illustrative purposes only

The blue section represents downside protection, meaning the potential reduction in portfolio value avoided by using equity protection. The red section represents the increase in portfolio value given up in order to fund the structure (the equity protection).

The parameters of such strategies can be tailored to reflect the desired term and acceptable range in equity market movements for an individual scheme. LGIM's philosophy of providing affordable, risk-aware solutions to all clients means such equity protection can be accessed by even the smallest schemes via cost-effective equity protection pooled funds.

A great example of how our clients are using these structures is where they have seen an improvement in their funding level through equity market rallies but are still some time away from their next formal investment strategy review. In the interim, they have looked to utilise equity options as a means to lock in some of the asset gains until such time as the longer-term strategy is defined.

While the principles behind an equity protection solution are relatively simple to understand, implementing them is far more complex. A successful execution relies on the skill of the team effecting the structure. As such, pension schemes are finding that partnering with a manager who understands their longer-term strategic goals and developing a scheme-specific solution is a more rewarding approach than focusing on products that are neither tailored to their specific scheme circumstances nor adaptable to their evolving needs. ■

Mike Walsh is Head of Solutions Distribution at Legal & General Investment Management.

Managing risk in emerging market allocations

Emerging markets can offer good investment potential, just as long as the risks are managed carefully, explains **John P. Calamos, Sr.**

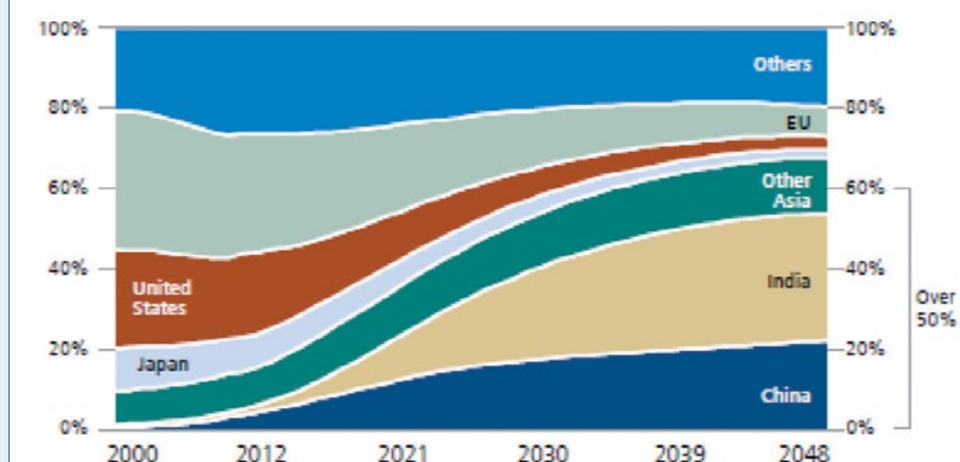
The rise of emerging markets (EMs) is well recognised as a scenario that presents many investment opportunities. The expansion of a middle class is fuelling demand for technology, consumer products, infrastructure, health care and education, and creates new revenue streams for companies that meet those needs.

The migration of populations to cities and the growing role of EMs in the global economy has also resulted in significant infrastructure demands.

Historically, many have viewed EMs as tactical allocations. Given the magnitude and durability of the trends supported by EMs, we believe investors should also look to EM allocations strategically.

However, the economic and political uncertainties in EMs can produce unwelcome volatility, which runs counter to strategic allocation. There are ways to increase emerging markets exposure while potentially dampening the risks associated with EM investing.

EM Consumption Drives Revenue Opportunities for Global Companies



Other Asia is defined as Asia excluding Japan, India and China. Source: Homi Kharas, "The Emerging Middle Class in Developing Countries." OECD Development Centre. 26 Jan. 2010. Web. Mar. 2011. http://www.oecd-ilibrary.org.

Managing emerging market risk

Capital moves quickly across borders to where it is treated best, and a number of emerging markets are increasingly embracing economic freedoms.

In India, we view proposed tax reforms and the opening of more sectors to direct foreign investment as favourable signs. Similarly, the creation of the Hong Kong offshore dim sum bond market is very encouraging, as this fast-growing market can potentially change the way companies finance their growth.

Despite these macro positives, volatility remains high. Economies are often evolving against the backdrop of political and social conflict. The challenge facing investors is how to harness the opportunity of EMs with less risk. Tactical asset allocations require accurate timing to achieve investment results, and this can be difficult. In contrast, a strategic allocation relies on a risk-managed approach. There are periods when a higher-risk tactical allocation may outperform, but those returns are very dependent on market timing.

Our risk management encompasses multiple factors. Because the volatility risk of investing directly in EM companies needs to be actively managed, we proceed cautiously in regard to these direct investments. We focus on a company's source of revenues, not where it is domiciled. We seek opportunities in global companies that generate significant revenues in emerging markets; in some portfolios, we include US-based companies. These companies may not have headquarters in developing nations, but they provide services and products that are in great demand there.

To further manage risk, we utilise equity-sensitive convertible securities. As convertible securities combine the opportunity for equity participation with potential downside protection, we view them as lower-volatility equity securities.

We also seek to mitigate risk by identifying long-term trends. It is not unreasonable that the pace of economic growth in EMs will ebb and flow. However, we must not lose sight of global long-term trends which, by definition, transcend market volatility.

Conclusion

We believe there are ways to access emerging market growth while mitigating risk, thereby supporting the case for EMs as a strategic asset allocation. We believe EM risk can be managed through the careful selection of equities of companies that have revenue streams generated from EMs, as well as through the selective use of convertible securities. ■

John P. Calamos, Sr. is CEO and Global Co-CIO at Calamos Investments.

For more information, please visit www.calamos.com/EMopportunity.

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice. Past performance is no guarantee of future results. Investing involves risk, including potential loss of principal. Diversification does not insure against market loss.

CALAMOS®

Taking cover

A flight to safety is the key lesson from Pensions Insight's Top 100 schemes analysis, finds **Professor Andrew Clare**

The Eurozone crisis continues to mesmerise and terrorise the markets in almost equal measure. As a direct consequence of these concerns, liabilities of the average pension scheme have risen. If this were not bad enough, since June 2011 the fall in discount rates had already increased these liabilities by between 15 and 20 percentage points. This repression of long term interest rates over the last year would be like waking up tomorrow to find that the nominal value of your mortgage had risen by around 25%, despite the fact that you had not missed any of your mortgage payments!

Of course, interest rates have been on a downward trend for some time now, and this trend has put increasing pressure on pension fund trustees to find assets that will keep pace with the rapid increase in the marked to market value of their liabilities. Pension liabilities are now widely viewed as being bond-like – indeed they are bond-like by definition if the discount rate applied to them is derived from bond yields(!) – as such the net move out of equities and into fixed income investments has continued unabated over the last few years.

> "Holdings of gilts and index-linked gilts have risen as a proportion of total assets. Some of this rise has been due to a genuine increase in allocations to UK government bonds"

Holdings of gilts and index-linked gilts have risen as a proportion of total assets, a trend confirmed by Engaged Investor's analysis of the top 100 scheme's holdings. Some of this rise has been due to a genuine increase in allocations to UK government bonds, either because of a desire to increase these holdings

outright, or because such holdings are needed as collateral to back swap positions. But a substantial proportion of the increase in these holdings is also simply a direct consequence of the increase in the market value of gilt and index-linked portfolios as the yield curve has fallen.

Although trustees might prefer to hold UK government bonds, their high prices and low yields make them very unattractive in an investment context. The main fixed income destination for pension assets over the past few years has therefore been the sterling investment grade corporate bond market, which EI's analysis confirms.

But recent concerns about too much exposure to this one market has encouraged some schemes to diversify their exposure to corporate credit risk through allocations to both US and European investment and sub-investment grade bond markets. And given the healthy finances of some developing countries' companies, some schemes have also made tentative allocations to emerging market government and corporate debt markets.

"Pension scheme trustees have tried to reduce the equity risk in their portfolios and to increase the liability matching qualities of their asset portfolios by investing in bonds and bond-like assets."

But as well as getting their fixed income "fix" from bond markets, trustees have been seeking out and investing in asset classes with "fixed income characteristics". These are referred to as "liability-linked assets" because they generate cash flows that closely resemble the characteristics of liability outflows. Most are based upon the cash flows generated either directly or indirectly from property. It seems that trustees have rediscovered property as an attractive asset class, judging by the results of this analysis.

On the whole pension scheme trustees have tried to reduce the equity risk in their portfolios and to increase the liability matching qualities of their asset portfolios by investing in bonds and bond-like assets. This broad trend, which will continue for the foreseeable future, has helped to reduce the impact of falling discount rates to some extent. But most schemes continue to rely heavily on the cash flow from their most valuable asset: the employer scheme covenant. Over the past few years sponsor contributions have increased substantially, and if the Eurozone crisis propels us into a deep recession, discount rates will plummet further and sponsor contributions will have to rise further still. ■

Andrew Clare is co-author of 'The Trustee Guide to Investment' and Professor of Asset Management at Cass Business School

Where will we be in 2017?

The trends set in the past five years are likely to set the pace for the next five but, **Mark Homer** warns, we need to factor in a great deal of uncertainty if we are to make the right long-term decisions

An awful lot can happen in five years. The introduction of auto-enrolment, an ongoing uncertain economic outlook and changing trends in investment may mean private sector pensions becomes a very different world in a relatively short time.

The decline of final salary schemes is well publicised. 2011 Pensions Regulator figures show only 16% of defined benefit schemes remained open to new members and 24% were closed to future accrual. Add the continuing pressure on scheme funding and the shift towards defined contribution, and it is perfectly conceivable that **by 2017 at least 95% of final salary schemes will be closed to future accrual, with fewer than 100 remaining open.**

Following negative press and progressively closer regulatory scrutiny, enhanced transfer values are likely to become less common. So, while active membership decreases, the 'deferred member problem' grows. However, we may be able to better manage pensioner liabilities. **By 2017, an ongoing low interest environment could see a rise in pension increase exchange exercises.**

In an attempt to limit future pension liabilities, it has become increasingly popular to move from a final salary scheme to a career-average revalued earnings (CARE) one without switching to DC. However, generally, moving to CARE only makes a difference if salaries increase at a rate greater than inflation. In the current environment, where average salaries are not keeping pace with inflation, CARE may be just as expensive as final salary with the same accrual rate. **By 2017, will employers have found that CARE has not been the solution they thought it would be?**

In the rush to move to CARE or DC, it seems cash balance schemes have often been overlooked. These offer members a defined amount of money for their pension pots, for example 15% of salary, and each year's payment is revalued up to the date they retire. At this point the member uses their pot to secure a retirement income by purchasing an annuity, sometimes at rates guaranteed by the employer, or by using drawdown, etc.

Cash balance started to be seen in the UK in the 1990s but, in an era of final salary scheme surpluses, the balance of risk in a pension scheme was not at the forefront of people's minds. **By 2017, we may have realised that cash balance was the solution we missed as we made the move to DC.**

The fact that the vast majority of open private sector schemes will be DC seems to be assured. Between now and 2017 all but the smallest and newest UK employers will have implemented auto-enrolment. This alone is accelerating the move to DC, with the National Employment Savings Trust and other specialist providers joining insurance companies in the group pensions market. **By 2017, 80% of DC schemes could be contract based and the flurry of activity around mastertrusts may have fallen away.**

According to the Office for National Statistics, the average total contribution rate in DC schemes in 2011 was 9.4%. This is simply not enough. With relatively low contributions and possibly poor investment returns, **by 2017 pension pots may be too small and everyone may accept that they cannot retire until they are at least 70.**

Setting aside the biggest economic uncertainty – the eurozone crisis – inflation is already challenging and could rise significantly. If gilt yields also rise, a small improvement in annuity rates may lead to a rapid increase in pension buyouts as trustees and sponsoring employers look to de-risk their schemes. **By 2017, will the buyout capacity in the insurance market be saturated?**

Trends in scheme investments always occur as prevailing economic conditions change. Will the fashion for liability driven investment continue or will there be another new 'big idea'? **By 2017, will pension fund assets be more heavily invested in infrastructure, alternatives and social housing bonds?**

The popularity of delegated investment mandates and fiduciary management, which are typically used to ensure trustees do not miss opportunities to lock in investment gains when working to a set de-risking plan, is increasing. **By 2017, with more plans on a flight path to full funding, delegated investment could be in place in the majority of DB schemes.**

The concept of lifestyling, developed as a response to the October 1987 equity market meltdown, is now commonly used in DC schemes as the default. However, it is still early days to know whether it works, particularly for individuals with significant DC savings. **By 2017 will we have realised that lifestyling doesn't work?**

Whatever the future holds, including the chancellor's continuing changes to the tax efficiency of pensions, there will certainly be ongoing challenges for employers, employees and the pensions industry. Perhaps the biggest question in 2017 will be 'what happens to pensions in the public sector?' ■

Mark Homer is Scheme Manager at PS Independent Trustees.

Shape of things to come

As these uncertain times show no sign of abating, the Engaged Investor team canvassed a range of investment specialists for their views on what the future holds

It's not such hard work following trends once they have been established. And insightful commentary is devalued as the time it focuses on recedes into the past. The real challenge is looking ahead, squinting, and imagining where the peaks, troughs and steady flats will fall in the finance land of the future.

Now that we have trawled through five years' worth of pension data it's time to ask the experts what schemes should prepare themselves for from markets and other investors. We cupped our ear to a broad range of voices across the City – from insurers and asset managers to academics – and found a plethora of predictions.

All agreed that the traditional model of investment would continue to be supplanted by growing diversification, within both portfolios and asset classes.

Infrastructure cropped up as an alternative investment area with its promise of inflation-protected income streams and government backing. Likewise, commodities and property, with their more stable returns, look as if they have potential as schemes desperately try to match their bulging liabilities.

Most thought that the shift from disappointing equity markets to more stable fixed-income holdings would continue unabated. However, the reputation of corporate bonds has risen as a result of the perceived increased risk around government finances.

Cass Business School's Professor Andrew Clare said at May's Engaged Investor Trustee conference, that the FTSE100 was likely to remain at its current level for most of the next decade, which converged with the thoughts of other professionals who forecast a rising reliance on actively managed funds as tracking indexes becomes ever more unreliable.

It was predicted that equity weightings would still be high, but gradually moving in favour of overseas stocks.

While many expect growth in developing economies to slow, the potential for massive new consumer markets and increased political stability will only make emerging markets more attractive for funds searching for proven, sustained progress. ■

Paul Niven, director and head of multi-asset investment and deputy head of investment solution, F & C

"As it stands, pension schemes are still reasonably concentrated in terms of the risk that they hold in equities overall. Therefore I think that that process [of diversification] is going to carry on further, whereby they will move towards some other asset categories to diversify their portfolio."

"There is also an increased awareness that you can't necessarily rely on strategic asset allocation to deliver returns. You can't just put your risk budget into a view on the likely long-term moves in equity markets, for example, simply because the certainty in terms of pay-off from that investment is actually quite low. Investors are responding to that by managing their market exposure more actively over the cycle, so you're seeing more active asset allocation decisions being implemented, either at the portfolio level or in terms of specific strategies. Again, I think that's a trend that's likely to continue because people recognise they can't just sit on the portfolio and wait for it to perform. It needs to be actively managed in terms of the allocation components."

David Collinson, co-head of business origination, Pension Corporation

"Pension funds are getting more risk averse. There is a strong incentive to buy assets that more closely resemble their liabilities and produce an income stream. Most schemes have closed to new entrants, and some have closed to future accruals. If they have negative cashflows they will need to sell assets to pay pensions, but they don't want to be forced to sell in a distressed market."

Decisions that last a lifetime

Clear information on all retirement options will help scheme members make the right choices – and the most of their pension, says **Katie Hooper**

So much effort is devoted to getting people into pensions these days, yet what about helping them on the way out? It's an easy aspect to brush aside. Retirement processes have no regulatory deadlines or auto-enrolment timeline to meet.

This is perhaps why the National Association of Pension Funds and Pensions Institute commissioned a report earlier this year entitled 'Treating DC Scheme members fairly at retirement?'.

It outlined a number of retirement concerns and warned annuities are the "weak tail" in defined contribution (DC) pension provision. Making poor retirement choices could cost scheme members up to 40% of their pension. What's more, once an annuity is set up it cannot usually be cancelled so that poor decision (and resultant income loss) could last a lifetime.

The NAPF report explains unless a scheme member is lucky enough to be pointed in the direction of a specialist annuity broker covering the whole of the market; they are unlikely to secure a good outcome. A specialist annuity broking service has benefits for the scheme too: it can help ensure a Trustee's fiduciary duties are met; it boosts income from the pensions members have been saving into all those years, and means they are not simply cast adrift when they reach retirement.

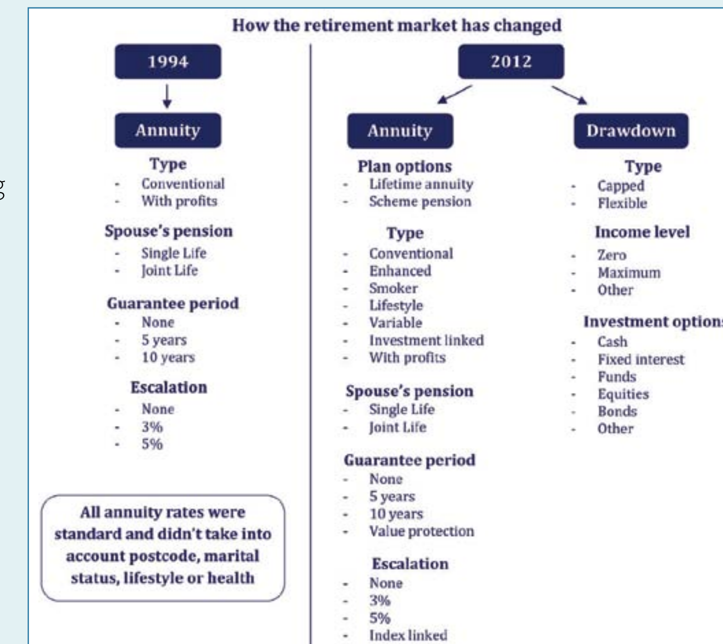
A fast-changing at-retirement space

The way we retire is changing. Annuities are now only half the picture at retirement. Gone for most are the days when employees walked out of the office on the dot at age 65. A traditional annuity – a secure income paid for life – will still be the choice for the majority, but an increasing number of retirees will be drawn to flexible alternatives that keep their options open.

It's true what you read in the papers about annuity rates. They are at an all-time low. Some of today's retirees are looking for other options particularly if they have other income to fall back on.

Then there is the changing market itself. In 1994, less than 20 years ago, the choice was simple. Many of today's options didn't even exist. A specialist retirement service will explore all the options.

Scheme members will base their buying decisions on the information they are sent in the run up to retirement. It's an essential browsing phase. Making these alternatives readily available for retirees to explore is a key quality to look for in a retirement service provider. The quality of information available, the breadth of options on offer and an ease of comparison are crucial.



Top pension schemes should look for a **full retirement service** with all the options available on display to encourage browsing and active comparison. Members should be offered information and education on annuities, enhanced annuities, drawdown and flexible drawdown, or a mix and match approach.

How the Hargreaves Lansdown retirement service can help:

- At retirement we search the open market to find scheme members one of the **best annuities available in the UK**. We show a range of different incomes and annuity options for comparison.
- 48% of our clients secure enhanced annuities[1]
- There is no default to fall into, and no barrier to entry. We offer a service for members with **pension funds of all sizes**.
- The service is available online using live annuity rates. We provide clear simple explanations in plain English. We provide support and help by phone, via post, online, or by email.
- For those members who do not want to buy an annuity we can provide specialised help on alternatives. We can also offer advice if required.

The NAPF report concludes: *"We found excellent examples of good governance at both ends of the spectrum"*. **Which end of the spectrum are you?** ■

Katie Hooper is Head of Corporate Annuities at Hargreaves Lansdown.

*To chat about this further you can call us on **0117 314 1783** or simply email us at **corporate@hl.co.uk** with your phone number and a good time to call.*

This article is not advice and you should not take any action without first seeking specialist advice. You might be interested in viewing our annuity website www.hl.co.uk/annuity – it shows how our service is already helping thousands of retirees each year. Hargreaves Lansdown is independent and not owned by or tied to any insurer, employee benefit consultancy, or bank. More DC scheme members use us for their retirement than any other annuity broker[2]. **To get in touch, call Katie Hooper on: 0117 314 1783**

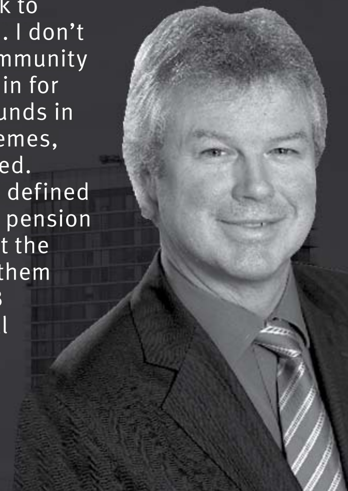
[1]Source: 12 months to 1 July 2012, HL individual clients with an annuity purchase price of £10,000 or more.
[2]Source: MyTouchstone.

HARGREAVES LANSDOWN

Mike Turner, head of global strategy and asset allocation, Aberdeen Asset Management

"The bonds to equities switch is the big trend. I think we're now in a self-sustaining momentum. The industry tends to gravitate around one central paradigm, which at the moment is for pension schemes to de-risk. It's early days but I think you'll find more and more of it happening, not only here but in other parts of the world, such as the US.

"Certainly, consultants are looking at diversified growth funds (DGFs) more closely and beginning to talk to trustees about them. I don't think the trustee community has wholesale gone in for diversified growth funds in defined benefit schemes, but some have started. DGFs appeal both to defined contribution and DB pension schemes. I think that the DC world has taken them up more than the DB world. The jury's still out, but there are a few that have done the job and others that haven't done it so well."



Frances Hudson, global thematic strategist, Standard Life Investment

"With an ageing population and a move away from defined benefit pensions, bonds will be more popular. There will be a long-term trend shift towards bonds, partly because of regulation. The regulations coming in under Solvency II give a higher rating to bonds, which is unfortunate at the time when bonds are giving negative real yields."

John Dewey, managing director, in BlackRock's multi-asset client solutions group

"There is less focus on equities. Typically, clients are looking to get geographical exposure from what equities they hold. Increasingly, clients are looking at newer strategies to generate returns; one example is hedge funds. Given events of the past few years there is now a lot of focus on due diligence in that area.

"The bigger funds are seeking newer, more innovative investments, like renewable energy. There's a lot of discussion about infrastructure and its potential to give long-term, inflation-linked returns, which is what pension schemes ultimately want.

"One of the big surprises over the past few years is that diversification hasn't really worked. We've seen an environment where assets have moved in line with each other so portfolios were more risky than people thought. In consequence, our clients are keen to hunt out the genuine diversification and look for things that don't just look different but actually perform differently.

"I think we're going to see a continuation of the volatile environment, it really pushes people to focus on their risk. We don't expect yields to rise any time soon. I think we'll see a gradual reduction in risk and a move from equities to bonds while making both sides work harder to chart a course through difficult conditions."

Colin Tipping, director, unit linked investments, Friends Life

"We are hearing interesting thoughts around the idea of outcome-oriented investing. People are not so much thinking about what goes into the mix but about the ultimate target. What are investors really looking for? Certainty of income in retirement. We're seeing interesting ideas from the US around the idea of managing away the upside: people being prepared to sacrifice the upside for more certainty on the downside.

"There is still way too much focus on what goes into the investment mix and maximising the size of the pot, and not enough thinking about what that means in terms of income. We're seeing interesting ideas about how to lock down profits on the way through, the emergence of defined contribution banking, collective DC. It's becoming less about the investment thesis and more about locking down income at a future point in time.

"My challenge to the fund industry is – where's the innovation? You can have very high-level academic [investment] theses but turning them into something that works at a scheme member level will always be the challenge."

Current issues in pension scheme financing

Employer covenant risk is a factor that needs to be considered at a time of corporate volatility. **Donald Fleming** looks at what needs to be done to maximise the security of member benefits

Corporate defined benefit pension schemes make up some two-thirds of the UK's top 100 schemes but, of these, only half are supported by FTSE 100 sponsors and the rest are now largely in the hands of overseas parents and mainly closed to new entrants. Over a single generation there has therefore been a fundamental shift in the nature of the 'covenant' risk borne by the largest UK pension schemes, which presents considerable challenges to both UK pension trustees and to senior company management.

Gazelle (a specialist pensions advisory firm) researched what has happened to the companies that made up the FTSE 100 Index in 1985. While 7% have defaulted and 26% experienced financial stress in the period since then, the surprise was the exceptionally high incidence of corporate change: 83% experienced one or more major corporate transactions – with over half being due to takeovers.

We conclude that a differentiated approach to covenant risk is appropriate for such schemes, and perhaps there are lessons to be learned by regulators, too.

From the pension scheme perspective, there has quite rightly been increased focus on how the change in covenant will affect the security of members' accrued benefits, while from the overseas acquirer perspective the UK pension is often regarded as a legacy financial issue that is but one competing interest among many stakeholders worldwide.

However, care must be taken with generalisations: while all FTSE 100 employers have now closed their schemes to new entrants, a number of the top 100 schemes are supported by overseas groups and remain open, suggesting in some cases a levelling-up to multinational benefit structures.

For much of the past quarter century lack of transparency and differences in valuation approaches have meant that pensions risk and covenant risk have been mis-priced by investors and the pensions community alike. Regulation has begun to change this: the 2004 Pensions Act and formation of The Pensions Regulator in 2005 introduced some 'pricing' of covenant into takeovers through the clearance regime; and the proposed changes to the Takeover Code , by formalising trustee rights to engage in takeover bids, should increase valuation transparency.

However, market practice is still unsettled and in many cases the full impact of covenant change is not fully priced into transactions, with the result that the true cost of scheme funding is often unwittingly borne by one or other set of shareholders.

The sponsor covenant is, according to current regulatory formulation, viewed in terms of the financial strength that derives from the legal support structure (participating employers, guarantees) rather than including, as formerly, intangibles – 'willingness and ability' to support the scheme. One challenge therefore is to give due credit in valuation to informal business, management, treasury and structural linkages that run through complex but fundamentally healthy organisations.

A subsequent study by Gazelle of the top 100 pension schemes indicates that those in the hands of overseas parents following takeovers are supported by companies that are not just leading national 'blue-chips' in their own countries, but also globally.

One conclusion that we at Gazelle have drawn from our research and our experience from advising some of the UK's largest schemes is that, for larger schemes supported by major corporations, The Pensions Regulator may be too focused on default outcomes and protecting the Pension Protection Fund compared to the challenges to pension funding presented by corporate and business change. The current proposals by the European Insurance and Occupational Pensions Authority (EIOPA) in relation to the 'holistic balance sheet' approach for occupational pensions also reflect a similar static approach to covenant.

The danger is that simply looking at covenant in terms of attachment of pension schemes to historic participating employers, rather than addressing the challenge of how to look dynamically at the covenant as an ultra-long term funding relationship may well, over time, 'erode' covenant support by confining it to mature and declining businesses rather than building funding support from growing business units.

Given the long-term nature of pension liabilities, the need to build a sustainable funding structure is crucial. ■

Donald Fleming
Managing Director
www.gazellegroup.co.uk

GAZELLE