

Impact on pension fund investment strategy

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Shalin Bhagwan, member of the IFoA's Finance and Investment Board, provides notes for those involved in the stewardship of pension fund investment strategy.

For the second time in just over decade, pension funds find themselves faced with a challenging set of circumstances, one that is characterised by not just risk, but also opportunity.

This note is aimed at all stakeholders involved in the stewardship of a defined benefit (DB) pension fund's investment strategy, including trustees, sponsor representatives, fund managers, advisors and in-house investment teams.

What are some of the key investment considerations for pension funds at the current juncture?

- **An integrated investment strategy** – A significant number of pension funds have not yet paid sufficient attention to formulating an integrated funding, investment and covenant risk management strategy. This crisis is likely to further expose the need for such an integrated plan. This crisis should encourage pension funds and their advisers to look closely at their long-term objectives for their pension fund and consider whether their fund's objectives integrate well with their funding and investment objectives and, as importantly, that these assessments have been made in the context of their sponsor covenant risk.
- **Liability hedging and return seeking portfolios** – Whilst recognising that such a simplistic bifurcation of the investment universe does not work the plethora of investments held by pension funds, the short-term focus should be on the practical aspects of ensuring that allocations to liability-hedging and return-seeking assets (however defined) are, and will continue to be, sufficiently robust to withstand different stressed market conditions. The medium- and longer-term focus should consider the role, objectives and allocations to each type of portfolio, the continued appropriateness of past decisions in light of changed circumstances and what, if any, changes should be made in the future.

We elaborate on these points below by setting out the key issues using a framework that tabulates each of the key investment risks faced by a defined benefit pension fund.

We underline the text of those actions that should be considered immediately.

Cashflow and liquidity risk management

- Against a backdrop of a rapidly maturing DB pension fund universe, focusing on integrated risk management means recognising any linkages between the sponsor's

context and the pension fund's investment strategy.

- The sudden fall in market values during the COVID-19 crisis will have highlighted the risks of being a forced seller at depressed market values. For some pension funds, reducing income from sponsor contributions due to diminishing new benefit accrual further exacerbates liquidity needs.
Pension funds may need to be self-sustaining in terms of managing their liquidity needs to pay pensions. These funds may wish to review their existing strategic asset allocation decisions as well as the associated investment mandates to gain a better understanding of how the mandates deliver the required liquidity.
- Longer-dated bonds (and other assets) with low coupons and large redemption payments, may not align with shorter-term cashflow requirements. Equally shorter-dated bonds may reduce interest rate and inflation hedging ratios below the desired levels.
- However, there is greater breadth of debt instruments at the shorter-end and so shorter-dated investments to meet shorter-dated cashflows may create the opportunity for higher yields in debt instruments by accessing a wider variety of credit instruments. This may create opportunities to further reduce equity mark-to-market volatility by de-risking out of equities and deploying cash raised to higher yielding, collateral-backed debt instruments with secure, contractual cashflows.

Interest rate and inflation risk

- Interest rate and inflation risk management should focus on understanding and managing the fund's exposure to unexpected changes in interest rates and inflation. The sizing of this risk is the most important strategic decision to be reviewed and monitored.
- Rather than trying to "call the market", the focus should be on understanding the fund's risk tolerance to various outcomes and the impact on the fund's long-term funding objectives and any knock-on impacts on the sponsor and the sponsor's covenant.
- Basis risk may arise from the choice of hedging instrument (swaps vs gilts) and so this should be assessed and monitored so that the choice of hedging instrument (asset) vs the choice of discount rate (liabilities) is an active decision with due consideration of the basis risk.
- The ongoing discussion around possible statistical changes to inflation measures (Retail Price Index "RPI") should be taken into account in any decision to change the inflation hedge ratio so that the scheme is not inadvertently left with a hedged position which is significantly away from its targeted strategic ratio.
- Curve risk arises from mismatches between the tenor of the hedging instruments and liabilities and, although second-order, should be reviewed for its contribution to risk.
- Larger schemes can construct bespoke hedging programmes and so when considering the level of rates, it is important to draw a distinction between spot rates and implied forward rates. Low spot rates may be a function of, ultra-low short-term interest rates and higher forward rates; this paradigm for considering rates may create opportunities for hedging in forward rates.
- Does the change in macro-economic outlook mean we need to revisit previous strategic decisions about the appropriate level of interest rate and inflation hedging?
- Decisions to re-risk are more difficult than decisions to de-risk and should be considered as part of a holistic review of the long-term funding objective, other investment risks and

the sponsor covenant.

- Hedging (or increasing hedging) of interest rate and inflation risk at historical low levels of interest rates (or high market-implied breakeven inflation rates) has been a perennial debate. It is up to each pension fund to size their risk appetite in line with fundamental considerations such as their financial ability to withstand further adverse changes in rates and inflation and the strength of their sponsor covenant rather than attempting to “call” the future direction of interest and inflation rates.
- The Bank of England has indicated that it is keeping all policy options on the table with regard to the level of short-term interest rates and is reviewing research from other central banks on the so-called zero-lower bound (ZLB) for interest rates. Pension funds would be encouraged to consider the possible impact on funding levels not just from a change in policy but from the market beginning to price in such a possibility. On this latter point we have now witnessed the first issuance of short-end gilts at negative rates. Negative rates have also been visible in the interest rate (vs SONIA) swap market. Contingent protection strategies, such as the use of swaptions, could be considered by larger pension funds.
- For larger pension funds, the use of swaptions can help protect against further falls in interest rates and can also be used to construct zero-premium strategies by monetising any specific interest rate levels at which the fund would consider increasing its hedging; bought receiver swaptions protect against falling rates whilst sold payer swaptions monetise any interest rate hedging trigger levels. As with any options strategy, the usual considerations apply, including being aware of bid-offer spreads; the cost from the passage of time (time-decay) and understanding that in addition to the “moneyness” of your chosen strategy, option pricing (and mark-to-market values) are driven by the volatility (or vega) assumption and so modelling the impact on the scheme from a particular option strategy should focus on the expected behaviour (change in market value) of those options through time rather than focusing only on the behaviour of those options at expiry.
- Bifurcating interest rate and inflation hedging decisions are often discussed but since most pension fund liabilities are “real” in nature, hedging either one of interest rate or inflation risk, without hedging the other, may increase, not decrease, the volatility of the scheme’s funding level. A fall in breakeven inflation rates may well be accompanied by a fall in interest rates leaving real rates unchanged. Having hedged, say, inflation risk only, a fall in market-implied breakeven inflation rates means the scheme will not benefit should such a fall be accompanied by a corresponding fall in interest rates. This would leave the fund exposed to a potential worsening of its funding level. That said, some funds may wish to evaluate whether, in view of, the increased uncertainty around future outcomes for most macro-economic variables such as inflation, it may make sense to hedge inflation risk independently of interest rates. Again, this should be linked back to risk budgeting and scenario testing the fund’s resilience to withstand unexpected changes in interest rates and market-implied inflation rates.

Equity risk

- Equity risk is expected to be rewarded over the long-term but here again it is important for pension funds to size their risk budget according to their (and their sponsor’s) ability to tolerate large drawdowns with the consequent implications on funding plans and covenant risk.
- Short-term actions should focus on understanding the scheme’s ability to continue to withstand further bouts of equity market volatility with a particular focus on downside risk.

- A variety of downside risk-mitigation techniques are available and should be considered but with a proper cost-benefit analysis.
- Diversification of the (listed) equity risk premium may be an appropriate longer-term course of action for pension funds that are still open to new members and/or future accrual.
- Sizing of the equity risk budget and the ability to tolerate further volatility should be assessed.
- The sell-off has been accompanied by a material rally so consideration could be given to whether downside hedging strategies may be appropriate at the current juncture.
- Noting that decisions about where to find value in markets will typically be the domain of the appointed (active) asset manager, this may be an appropriate time to review the performance of any active managers to assess their performance but also their plans to capture future market opportunities. As we emerge from this crisis, the active decisions taken by managers and the additional outperformance generated will need to be weighed against the additional fees being paid to active managers to assess whether the fund is receiving value-for-money.

Credit spread, default and downgrade risks

- Credit spreads have widened out to a level not witnessed since the GFC but for most holders of credit it is not the mark-to-market losses that will be the primary concern but rather the outlook for downgrades and defaults.
- For those pension funds with significant exposure to credit, the impact of wider credit spreads may have a material impact on the discount rate being applied to the liabilities, through the assumption of the additional spread over gilt yields used to set the discount rate. It will be important to ensure that this calibration is reviewed to ensure an appropriate view of the funding level.
- Counterparty credit risk may be another source of risk for those with bilateral, over-the-counter derivative trades.
- There is some evidence to suggest that the “credit premium puzzle” is linked to the inability to properly diversify idiosyncratic risk. Linked to this observation, one mantra amongst seasoned credit investors is to consider that it is the issuer that you least expect to run into trouble that may end up causing the most concern. Furthermore, that this issuer may run into trouble at a time that you least expect and before you are able to react and avoid the negative consequences. The best protection against this risk is diversification; across a myriad of dimensions (sector, country etc). This crisis has illustrated this well, with seemingly “safe” sectors materially impacted e.g. infrastructure even if the actual pass-through to actual asset values has so far been muted. Funds should be encouraged to review their approach to credit investing with a focus on diversification. Together with their advisers they could explore how to add further diversification e.g. by adding unlisted credit to listed credit exposure or diversifying their existing holdings by sector, rating and/or country. Together with their asset managers, they could explore the ability to increase the scope of the manager’s existing mandate to take advantage of opportunities created by the crisis or to increase the manager’s flexibility to hedge downside risk e.g. using single-name CDS or other credit hedging instruments.
- Investment-grade mandates should be reviewed for their ability to be continued holders of “fallen angels” rather than having to fire-sell those assets, especially if they are

assessed to be “money good”.

- Review the credit portfolio for names likely to default and take that into account in cashflow and funding plans. In many cases, it will be too late to sell out of these stressed names and an evaluation should be made of the relative merits of staying the course to maximise your recovery versus selling the security.
- Review counterparty credit risk on bilateral agreements, including collateral arrangements. Ensure regular posting of collateral based on up-to-date mark-to-market values and that threshold amounts, minimum transfer amounts and other credit-risk mitigants in your derivative documentation remain appropriate. Review legacy downgrade triggers and take appropriate action.
- There are opportunities to be had in credit, across global investment grade, high yield and structured credit, and these should also be considered. Stock picking will be key but liquidity is thin making preferred names difficult to source in any size.

Currency risk

- For those with currency hedging programmes, hedging back to sterling, margin calls will have been significant and fluctuated dramatically.
- Any decision to not hedge currency risk introduces volatility against the (sterling) liability benchmark. This is not to suggest that this risk could not be a rewarded risk. Funds would be advised to consider their risk appetite for such currency risks, especially any unintended currency risk. Whilst the poor performance of sterling through this crisis may have been an unexpected benefit for unhedged exposures, this could easily change. It is important to be clear about the level of exposure to currency risk that is considered desirable and how best to achieve that exposure.
- Ensuring access to sufficient cash and collateral has been important as is ensuring an appropriate “waterfall” for accessing additional collateral in the event of significant margin and collateral calls.
- For those investing in overseas corporate bonds, the currency hedging programme will need to be adjusted due to changes in expectations of interest rates, currency (spot and basis) and credit spreads.

Collateral

- Collateral sufficiency and waterfall arrangements should be revisited to ensure they remain appropriate, with attention given to the operational aspects where especially where collateral is being held with a party different to the one responsible for posting it therefore requiring the possible liquidation and/or transfer of assets and associated settlement considerations.
- Collateral received will need to be efficiently managed and appropriate attention paid to any basis risk between interest received and the return interest amount.

Longevity swaps

- Linked to the previous point on collateral sufficiency is the potential to have to increase collateral postings on any longevity swaps that a pension fund may have executed.

- To the extent that reinsurers revalue these swaps to allow for a deterioration in longevity then the value of these swaps to the pension fund will decline, triggering the need for the pension fund to post additional collateral. Collateral sufficiency will have to be revisited although for schemes that have hedged interest rate and inflation risk, falling yields means that both physically held gilts and any collateral on leveraged hedging programmes are likely to have increased thereby increasing available collateral.
- The financial soundness of the pension fund remains unaffected by a change in the value of the longevity swap since the longevity swap immunises the pension fund against both improvements and a deterioration in longevity. Clearly it is also true that in the event longevity is ultimately repriced lower, the financial position of the pension fund would have improved had it remained unhedged for longevity risk.
- If the crisis is a catalyst for a repricing of longevity hedging (i.e. a reduction in the cost) then this may present an opportunity for pension funds that wish to commence or add to a longevity hedging programme.

Direct infrastructure and property equity

- Market values update only slowly so it is important to stay in close contact with asset managers on the likely impact on the portfolio. Key areas to be covered:
 - Portfolio exposure to affected economic sectors.
 - Estimated impact on future cashflows, valuations, expected returns, term of investment (e.g. extension of closed-ended funds).
 - Covenant breaches (e.g. failure to meet borrower covenants on any loans against the asset) and mitigating actions taken.
 - Impact on ability to repay borrowings.
- Assess the impact on the fund's strategic asset allocation from the so-called "denominator-effect", where falls in listed asset values may mean that strategic asset allocation limits to private markets may be breached since private market asset values are slower to respond. These breaches will need to be reviewed from a governance point of view but also to avoid any unintended rebalancing.
- Assess the impact on the fund's ability to meet cashflow payments assuming any funds (e.g. open-ended real estate funds) were gated.

Infrastructure and real estate debt

- Prices are increasingly stale, liquidity non-existent and spreads likely to have widened, potentially by more than corporate credit markets even if this may not be immediately apparent in market values. Sectoral considerations:
- *Transport*: likely to be heavily hit.
- *Energy*: usage likely to be reduced since businesses such as manufacturing are significant users.
- *Hospitals*: potential challenge for some operational covenants.
- *Defence*: no obvious impact.
- *Real estate*: in some sectors tenants are not paying rent which has moved some CRE loans into technical default and so proactive steps are needed to avoid actual default working closely with lenders on bridging measures.

All of this may mean revisiting assumptions for expected returns from the credit portfolio. This should be done net of expected losses with revised probability of default and loss given default (LGD) assumptions as required.

- “Work-outs” may be needed which may call for specialist expertise. This may be especially challenging for funds managing investments in-house with limited work-out capabilities.
- There may be attractive opportunities arising from the crisis. Bank funding spreads have widened out, making bank funding more expensive with some bank lenders in infrastructure potentially widening spreads for new borrowing out by some 50-100bps p.a. Alternative lenders may find themselves able to play an increasing role in the coming months potentially presenting attractive opportunities.
- Previous comments on the value of diversification, especially in credit portfolios, are also relevant.