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Flight Planning & De-risking

BACKGROUND

Pension schemes have experienced an extremely bumpy ride over the past few years. Record low bond yields and capricious market conditions have contributed to relentless funding level volatility and soaring deficits. This has made the role of pension trustees, who are often resource-constrained, even more difficult and has highlighted the need for robust governance structures and a more proactive approach.

Despite this difficult environment, there are practical steps that pension schemes can take to help achieve their goals whilst minimising funding volatility. These include investment-based de-risking, in its various guises; re-risking and insurance-based de-risking in the form of buy-ins and buy-outs. In this document we compare the different approaches available to pension schemes, in addition to highlighting some of the key considerations around implementation.

DE-RISKING – THE FEEL-GOOD APPROACH

De-risking refers to a strategy whereby risk is progressively removed from a portfolio as it moves closer to its target funding level. Although there are many permutations of investment-based de-risking, they essentially collapse into four key options as detailed below:

Time-based

A scheme sets out a proportion and timing of switching from growth to matching asset classes, e.g., 70% equities/30% fixed income to 60% equities/40% fixed income over a set timeframe, such as 12 months.

Market-based

An example could be where switching a portion of the portfolio from equities into bonds is triggered by the relative outperformance of equities over bonds, e.g., if the FTSE All Share (index for equities) outperforms the FTSE Over 15 Year Gilt Index by 10%.

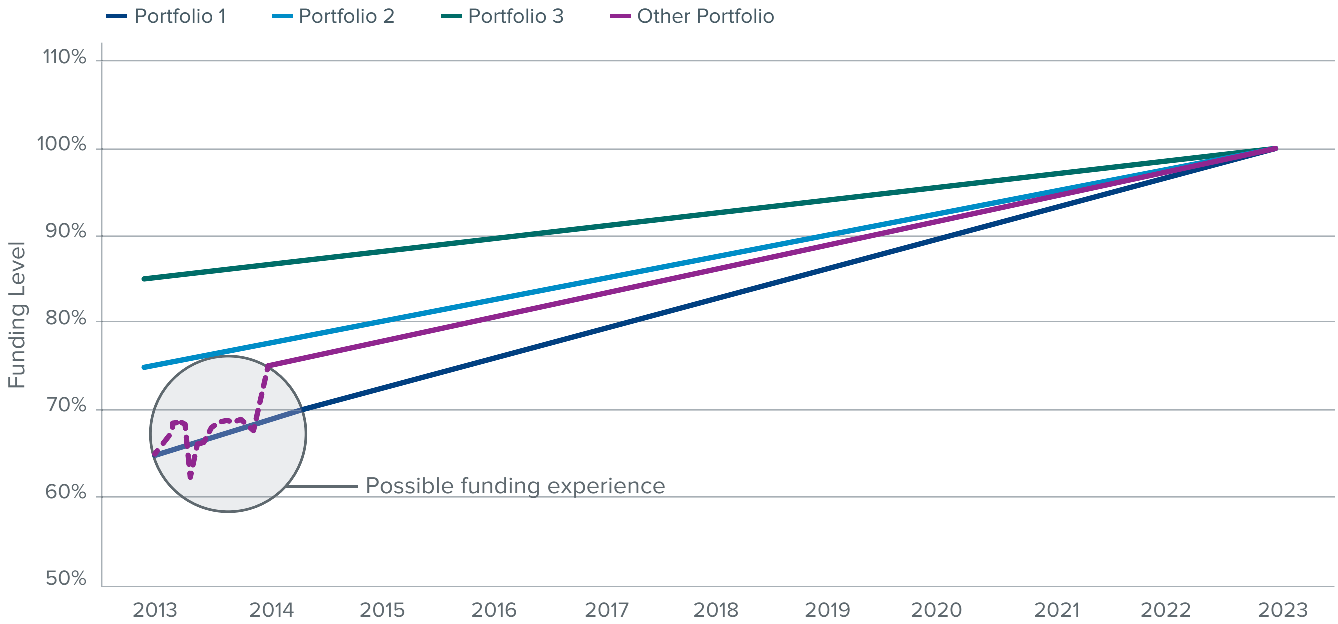
Fixed Funding Level-based

This option involves de-risking at predetermined funding levels. For instance, a scheme that is 65% funded may decide to wait until it is 80% funded before de-risking and then only de-risk again once it reaches 90%.

De-risking relative to expected funding levels

A scheme sets out an expected path to full funding and takes action to either de-risk or re-risk (i.e., taking on more risk) according to whether the scheme is above or below the expected path.

FLIGHT PLANNING—AN ILLUSTRATION



For illustrative purposes only. Portfolios used do not represent any actual Investments and are for Illustrative purposes only.

If employed in silo, the first three options offer limited value. A time-based approach, agnostic of market conditions, risks rebalancing the portfolio at the wrong time. Market-based approaches may misjudge the funding level impact of a relative outperformance of equities over bonds. Using a fixed funding level-based approach largely relies on market conditions improving. So perhaps the most effective method is the last one, **de-risking relative to expected funding levels** *(illustrated in the diagram above),* as it incorporates the key elements of time, market conditions and funding level to produce a flight plan bespoke to the unique requirements of the scheme.

In the example above, the expected flight path (portfolio 1) to full funding on a technical provisions basis is indicated by the dark blue line. This is based on a starting point of 65% funded in 2013 with annual deficit repair contributions of £250,000 per annum and expected return consistent with achieving full funding by 2023.

In practice we would not expect the evolution of the funding level to be smooth along the blue line. The purple zig-zag line shows a possible path for the funding level into higher levels that trigger de-risking into lower expected risk portfolios (portfolios 2 and 3).

De-risking has a feel-good factor to it: As the funding level is improving, expected risk is reduced in the scheme by reallocating from growth to matching assets. Furthermore, with a higher funding level and consequently lower deficit, the sponsor anticipates lower or no future repair contributions.

Key points

- Regular monitoring of the funding level is important for effective de-risking
- Funding targets should be specific to each scheme

RE-RISKING – SOMETIMES A NECESSARY EVIL?

In contrast to de-risking, re-risking has anything but a feel-good factor to it, and yet there are market factors that have the potential to trigger a possible re-risking scenario. These include falling equity markets, downward pressure on long-term interest rates and rising long-term inflation.

Re-risking can be a difficult decision to arrive at and one that can be further complicated by a plethora of possible associated dilemmas.

Examples

- The trustee board may not feel comfortable about buying into a falling market
- The negative market conditions that triggered re-risking may be impacting the sponsor. Can the trustees afford to take on more risk when the sponsor is in such a bad financial position?

CONSIDERATIONS OF RE-RISKING

Once a decision to re-risk has been made, trustees need to carefully consider the practicalities of implementation. These include determining an appropriate level to which the scheme should be re-risked. For example, should the scheme be re-risked back to the allocation at the start of the flight plan, beyond this level or just back to the previous point of de-risking?

Trustees also need to consider whether re-risking should be an automatic process delegated to their chosen advisor or if they would prefer that the Trustee, company representatives and advisors come together to review the position when a re-risking trigger is breached?

Different schemes may require different approaches to re-risking. Is the adviser capable of implementing what has been prescribed as appropriate for the scheme?

Key points

- Circumstances may arise that necessitate re-risking
- Dilemmas and practicalities surrounding re-risking will need to be addressed
- The approach to de-risking is different to re-risking
- Regardless of the complexities of the process, it is important to incorporate re-risking into the flight planning process

BUY-OUT/BUY-IN

Buy-out is commonly regarded as the ultimate de-risking exercise as it involves transferring the obligation and responsibility for meeting scheme liabilities to an insurance company, thus removing all of the risk. However, soaring deficits caused by the financial crisis and the "new normal" of low interest rates and volatility have made buy-outs prohibitively expensive for many schemes. This should not, however, deter them from factoring buy-outs intothe flight planning process.

Likewise, buy-in constitutes a positive step in terms of risk reduction for a scheme. Buy-in is an investment decision and involves purchasing an insurance contract that matches the benefit contributions which the scheme pays out to members. This can reduce investment risk, longevity risk, interest rate risk and inflation risk.
For these reasons it fits naturally with the concept of de-risking.

IT'S ALL ABOUT EXECUTION

As we have shown, there are practical steps that trustees can take to help reduce funding volatility and achieve their long-term funding objectives. SEI recommends an integrated approach in which the full range of de-risking, re-risking and insurance options are incorporated into a fully bespoke flight plan. However, the effective execution of any such plan can be problematic for many trustees who are constrained by a lack of resources, be that of their own time or expertise.

HELP IS AVAILABLE

These commonplace issues are driving an increasing number of pension schemes to look to delegated approaches, such as Fiduciary Management, otherwise known as Delegated or Implemented Consulting.
A fiduciary manager can assist trustees by providing investment advice and implementation that links both assets and liabilities. This includes taking responsibility for continuously monitoring the funding level and de-risking or re-risking along the flight path as opportunities arise. The beauty of this arrangement is that trustees retain strategic control of the scheme but have the comfort that day-to-day investment responsibilities are being undertaken on their behalf within clearly defined parameters.

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For more information visit:
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