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Investing in the future

European Asset Allocation Insights 2021

UK DB De-risking Trends

Contents

Welcome

Mercer's UK *Asset Allocation Insights 2021* provides a comprehensive overview of the de-risking behaviour of UK defined benefit (DB) pension plans, with responses from c. 460 plans with assets of over £400 billion.

What has happened since last year's survey?

2020 was a year lacking in precedents. Global economic activity fell to the greatest extent since the Great Depression. The UK was one of the worst-hit economies due to three nation-wide lockdowns and heavy restrictions in between. Much of the lost activity has been recovered throughout 2021, however, due to arguably the most successful vaccination roll-outs globally.

The initial market panic was met by monetary support of an unprecedented magnitude. The Bank of England revived its quantitative easing programme. UK real yields fell to the lowest levels ever recorded. Long-dated nominal and inflation-linked bonds posted double-digit returns over the year, with returns on investment grade credit also in the high single digits.

For UK pension plans less than fully hedged, funding positions deteriorated as falling yields drove up liabilities. However, this was partly reversed in the first half of 2021.

DB pension plans have not materially changed their longer-term strategies in the wake of COVID-19. Most are still aiming to de-risk gradually over time as their funding position improves. The majority of closed plans have an ultimate objective of buy-out, with the expectation of an extended "self-sufficiency" period beforehand. Some plans also choose to be funded on a self-sufficiency basis for the long term as an alternative to buy-out.

The proportion of cashflow-negative plans has increased further over the year, reflecting that only a minority of plans are now open to new accrual. Appropriate cashflow management strategies and the need for a broader range of income-producing assets are key challenges for the majority of closed plans.

The COVID-19 shock will have also had a negative impact on covenants in certain sectors that might become more visible over the coming year, as government support is withdrawn.

Accompanying reports

This report is accompanied by three sister reports: one on the asset allocation trends within DC plans, one on the broader asset allocation trends within DB plans, and a sustainable investment report. All sister reports cover both the UK and Europe.

Key findings

Nearly all DB plans in our survey to be cashflow-negative within 10 years

Almost 80% of plans are cashflow-negative. This is expected to rise to just under 90% in five years and 98% within the next 10 years. Most plans are still disinvesting assets to fund cashflow, but there has been an increase in plans requiring income-generating assets to distribute that income as opposed to reinvesting it. Negative cashflow adds another layer of complexity to investment and hedging strategies due to the dual imperatives of capital preservation and cashflow management. Few plans use a formal cashflow-matching approach. Cashflow negativity creates sequencing risk in that if a large disinvestment is required following a market fall, such as during March 2020, this can result in asset sales at depressed prices and a permanent crystallisation of the loss (See Cashflow Position on page 6).

Most plans still looking to de-risk

The direction of travel for most plans is still to de-risk gradually from growth assets into liability-matching assets as and when opportunities arise and increase hedge ratios opportunistically. This helps prepare the plan for the endgame which is, in most cases, to move to a self-sufficient position and eventually buy out benefits with an insurer. This is the journey plan for 44% and 34% of survey participants respectively (See De-risking on page 8).

Little difference in strategy between strong and weak covenants

Covenants of many plans may have deteriorated as a result of the COVID-19 fallout, particularly among sponsors in the transportation and hospitality sectors. Plans with covenants described as “weak” or “tending to weak” have only a marginally smaller allocation of 13% to equities, compared to 17% for plans with a covenant described as “strong” or “tending to strong” (See Sponsor Covenant Strength on page 7).

Mid-sized plans ahead of the pack on LDI

The majority of UK pension plans use liability-driven investment strategies (LDI) to hedge their liability risk with >80% of plans between £50 million and £2.5 billion indicating that they have an LDI framework in place. This proportion is much lower for the largest and smallest plans. For large plans where hedging is not in place, this is due to many of them being government-sponsored and/or open plans, and therefore not necessarily on a de-risking path. Conversely, for the smallest plans, governance and minimum investment sizes may be an obstacle (See Use of LDI by Plan Size on page 10).

Actions for DB plans to consider

Cashflow-driven investment framework

Avoiding permanent losses of capital is critical for plans in negative cashflow territory, and selling tradeable assets such as equities and corporate debt in times of market stress should be avoided at all costs. Increasing allocations to income-generating assets should be considered. Although many income-generating assets are semi-liquid in terms of invested capital, they also suffer less mark-to-market capital volatility. Adopting a formal "waterfall" approach to cashflow management through a cashflow-driven investment framework is one way of balancing the competing imperatives of avoiding losses of capital and generating income.

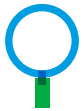
Covenant review post COVID-19

Plans should consider a post-COVID-19 covenant review where this has not already been done, especially in those sectors that have been most adversely affected. With little difference in investment strategies between weak and strong covenants, alternative solutions to covenant risk should be explored to support the investment risk being taken, such as external capital support or tail hedges as part of an integrated risk management framework.

De-risking trigger framework

Almost half of all plans still have no formal de-risking trigger framework in place. Plans should consider the benefits of such a framework, enabling a more pro-active approach of journey planning and providing a framework that allows them to react promptly to short-lived opportunities to de-risk. We have written a separate paper on how de-risking frameworks work in practice. This is available on request.

Pooled LDI solutions for smaller plans



Size precludes many plans from accessing the benefits of bespoke LDI. Such plans should explore whether they could still benefit from a pooled LDI fund that mimics the average liability profile of UK plans. They will thus highly correlate with the plan's liability movements even without precise matching.

Cashflow position

Figure 1. Proportion of plans that are cashflow negative (%)

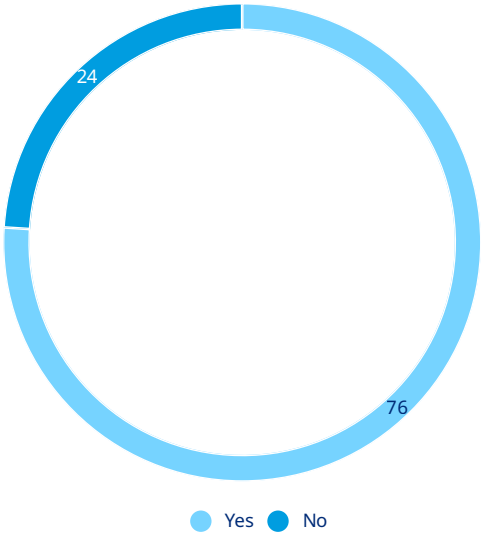


Figure 2. Expected time for cashflow-positive plans to become cash-flow negative (%)

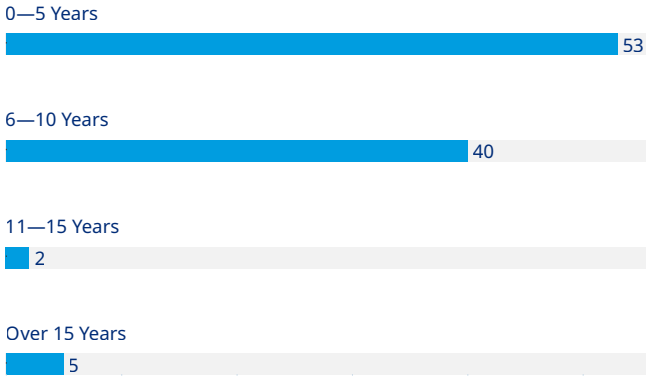
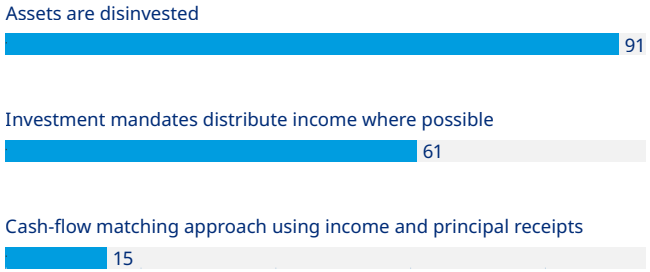


Figure 3. Methods of meeting cashflow-negative outgoings (%)



Again in 2021, a higher proportion of plans have reported being cashflow-negative at the time of the survey (76%, versus 66% in 2020). Of the cashflow-positive plans, the proportion (93%) expecting to become cashflow-negative within the next 10 years has also increased compared to last year.

Most plans rely on disinvestments to meet cashflows, at least in part. However, we are seeing an increase in plans meeting cashflows in other ways, such as having assets distribute income or cashflow-matching of income and principal repayments of debt instruments.

Respectively, 61% and 15% of plans reported using these methods (versus 57% and 13%, in 2020). We expect more and more plans will use a full cashflow-driven investment framework as they move closer to full de-risking. Of course, there will also be plans using a combination of all of the above.

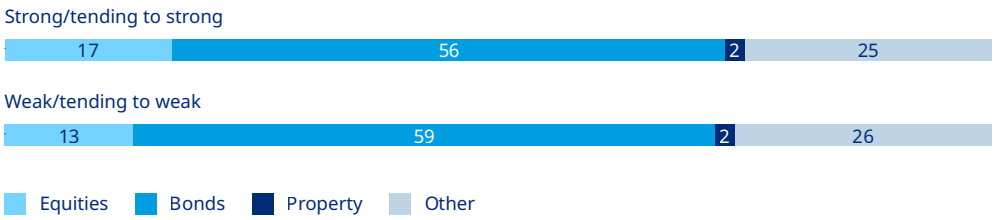
Sponsor covenant strength

We asked participants to report the strength of plan covenants. When a large organisation or business supports a plan, the covenant describes its legal obligation and financial ability to support the plan, now and in the future. The strength of the covenant thus influences the plan's ability to take on risk, with stronger covenants associated with a greater willingness and ability to lend support to plans.

The results — largely unchanged from last year — show only a marginally smaller allocation to equities for plans with covenants described as "weak" or "tending to weak" than for plans with a covenant described as "strong" or "tending to strong" with an average of 13% in equities, compared with 17%, which suggests that there is scope to integrate covenant more in investment strategies via an integrated risk-management approach.

Whether we see an impact in the form of deteriorating covenants on the most vulnerable sectors, such as transportation and hospitality, will depend on the resilience of the global economic recovery and on seeing a sustained reopening that will lead us back to normal. Two technical elements could dampen this: some plans may only review their covenant position on a triennial basis, whereas others may disappear from the survey via insolvency.

Figure 4. Broad strategic allocation covenant strength (%)



De-risking

Figure 5. Long-term funding objectives (%)

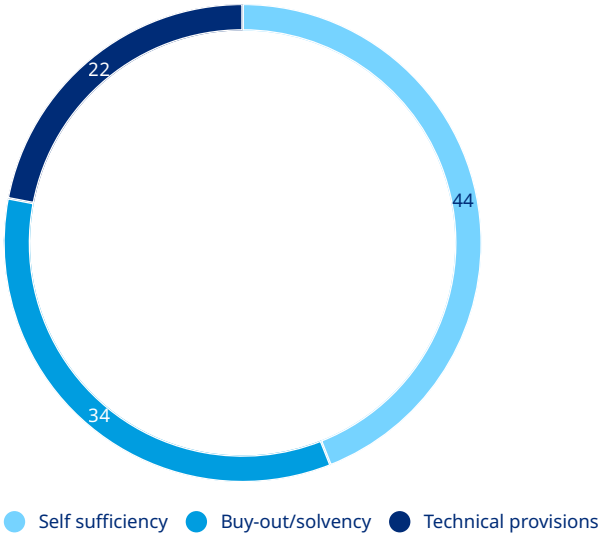


Figure 6. Self-sufficiency basis (%)

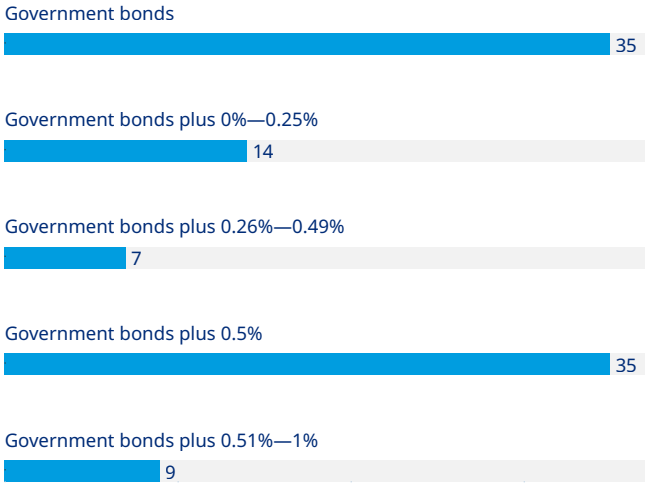
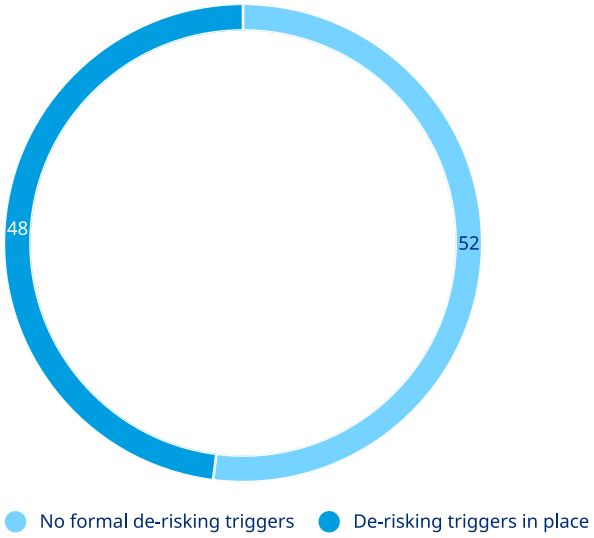


Figure 7. Implementation of de-risking (%)



The following six charts provide detail on the ongoing de-risking of UK DB plans revealed by the survey over a number of years. The allocation of such plans is now commonly guided by a strategic "journey plan", in part because many plans have closed (to new entrants and future accrual) in recent years. When, as is often the case, a plan is underfunded, a journey plan is designed to align future investment strategy with the gradual recovery of the funding position. The number of DB plans that have moved to having buy-out/solvency as their long-term target has remained unchanged compared to last year at 34% (see Figure 5). This level of funding is the most prudent/highest, as it means targeting a level of overfunding that accounts for the premium an insurer will charge to assume all of the pension plan liabilities.

When plans target a "run off" strategy (sometimes called "self-sufficiency"), the associated basis on which the liabilities are valued varies by plan, but usually reflects a modest premium above the risk-free rate (see Figure 6). Compared to last year, there have been some changes, with a large increase in plans moving to gilts flat, the same proportion as those plans using a 0.5% premium, which was by far the most popular target last year.

We have seen a continued slight increase in the number of plans that have formal de-risking triggers in place, with 48% of plans having them (versus 46% last year). This is a result of plans emphasising de-risking as they enter the final stages of their journey.

Figure 8. Timeframe for de-risking (%)

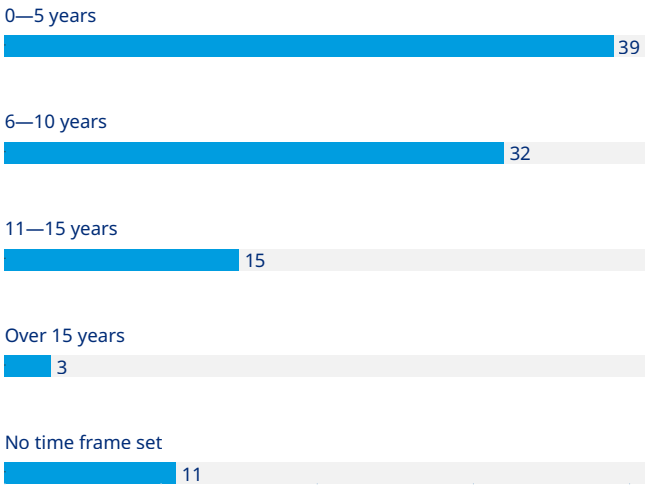


Figure 9. Is de-risking delegated? (%)

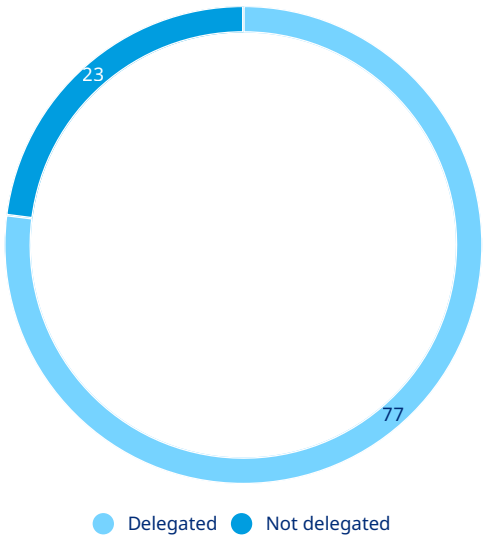
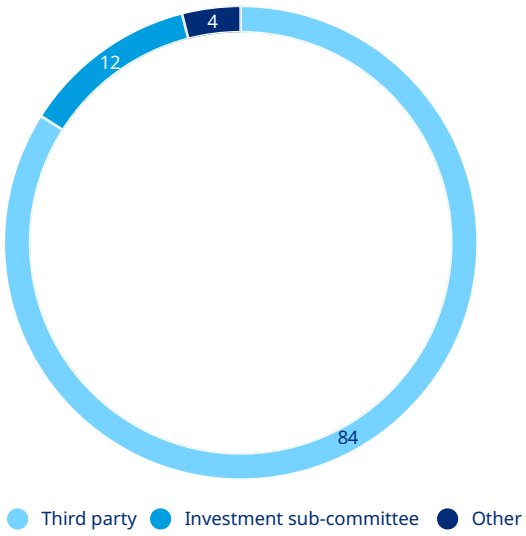


Figure 10. Who de-risking is delegated to (%)



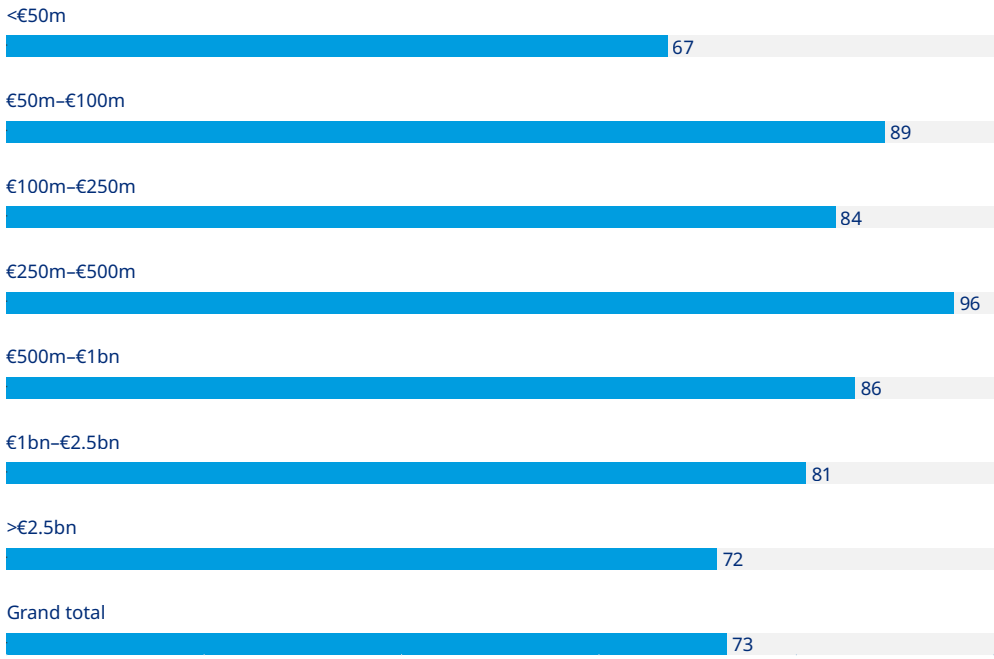
The number of plans looking to de-risk in the next 10 years has remained at similar levels as last year, likely due to the strong year for growth assets in 2020. Only 14% of plans have no timeframe for de-risking or a timeframe longer than 15 years, compared to 11% last year. This was due to new participants with no de-risking plan coming into the survey.

The number of plans delegating their de-risking has remained around three-quarters this year. Most plans with such a framework have delegated implementation, the vast majority of whom have selected a third party, such as a fiduciary manager, who will typically monitor the plan's funding level and automatically de-risk its portfolio in line with a set of pre-agreed funding-level triggers.

Use of LDI by plan size

The vast majority of UK plans have LDI mandates. The main exceptions are the smallest plans, where there can be governance and implementation challenges. Additionally, local government plans are less likely to adopt LDI, and these form a significant proportion of the survey participants above £1 billion in assets. These plans are open and thus have a longer timeframe than most plans, as well as a stronger covenant, and can thus allocate more to riskier growth assets.

Figure 11. Percentage of plans that have LDI portfolios (by plan size)



Liability hedging arrangements

Figure 12. Interest rate and inflation hedging ratio as a percentage of assets (%)

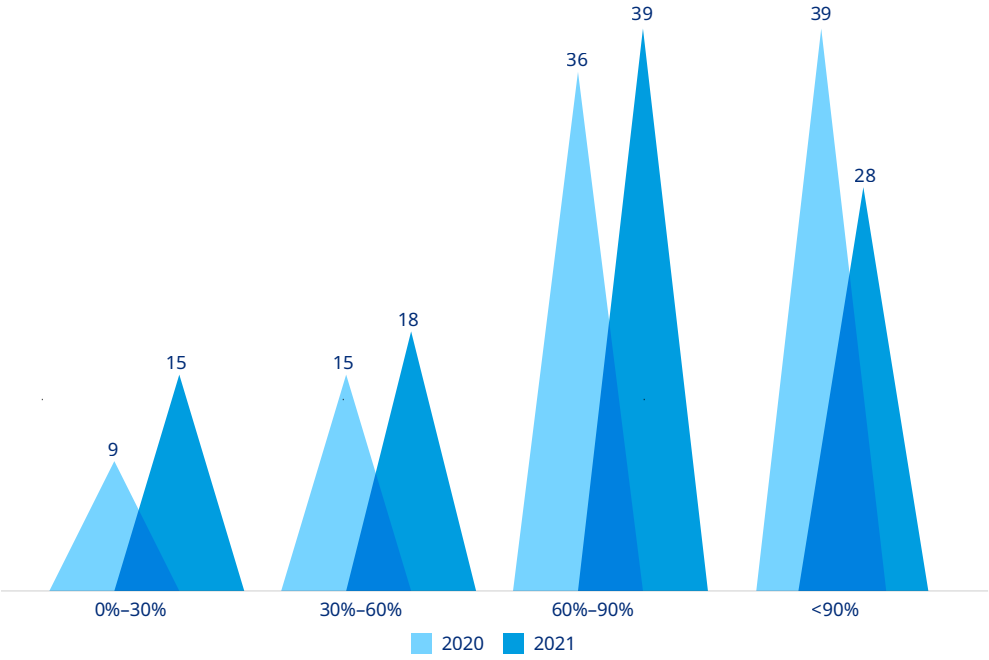


Figure 13. Vehicles used for liability hedging (by number) (%)

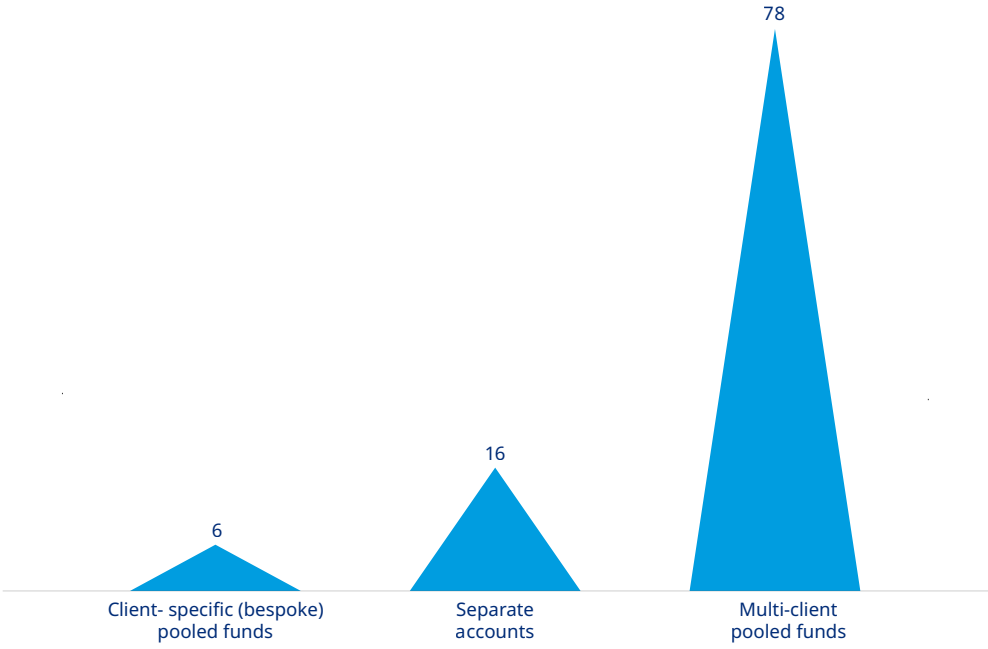


Figure 12 shows the proportion of surveyed investors in each hedging bucket. The reduction in plans with very high hedge ratios (over 90%) can be explained by the wider coverage of this survey, with a few new entrants this year that have lower hedge ratios. Additionally, a few plans in the 2020 survey have been able to complete a buy-out and have therefore dropped out of the survey. On aggregate, more than two-thirds of plans in our survey have a hedge ratio of 60% or more.

By number of mandates, pooled vehicles remain the most popular means for implementing liability hedging (see Figure 13), as they offer a solution for smaller investors. However, as larger plans mostly use separate accounts or bespoke pooled funds, the majority of LDI assets by value are held in these mandates.

Figure 14. Plan to make any changes to your interest rate hedge ratio, given the low current environment, over the next year (%)

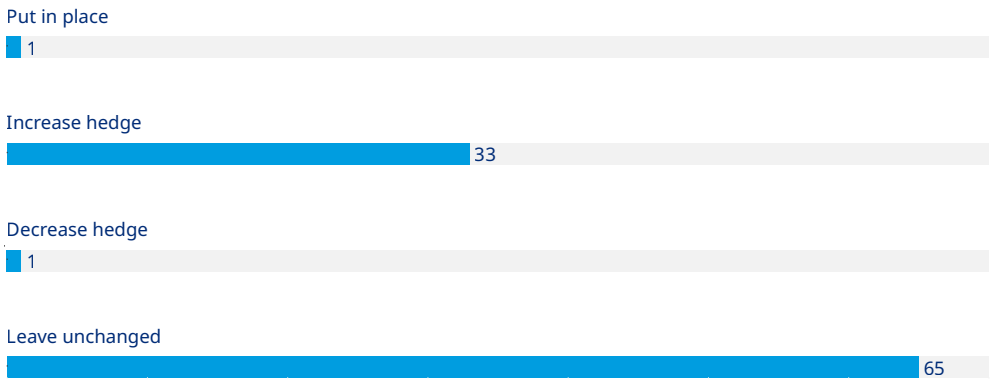
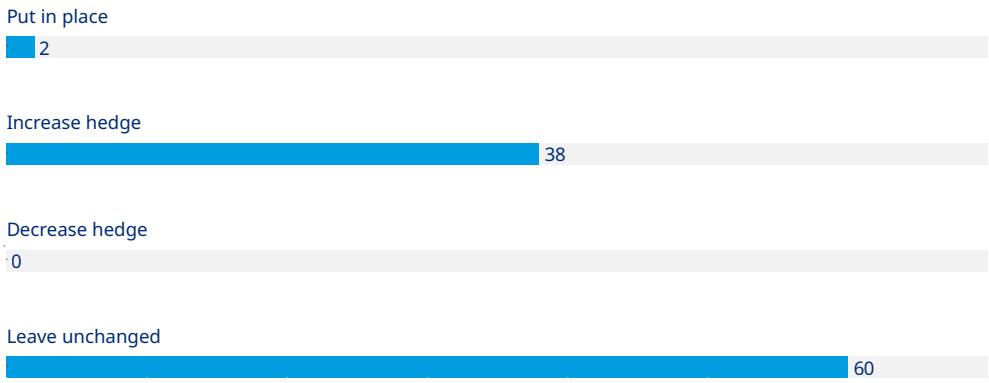


Figure 15. Plan to make any changes to your inflation hedge ratio over the next year (%)

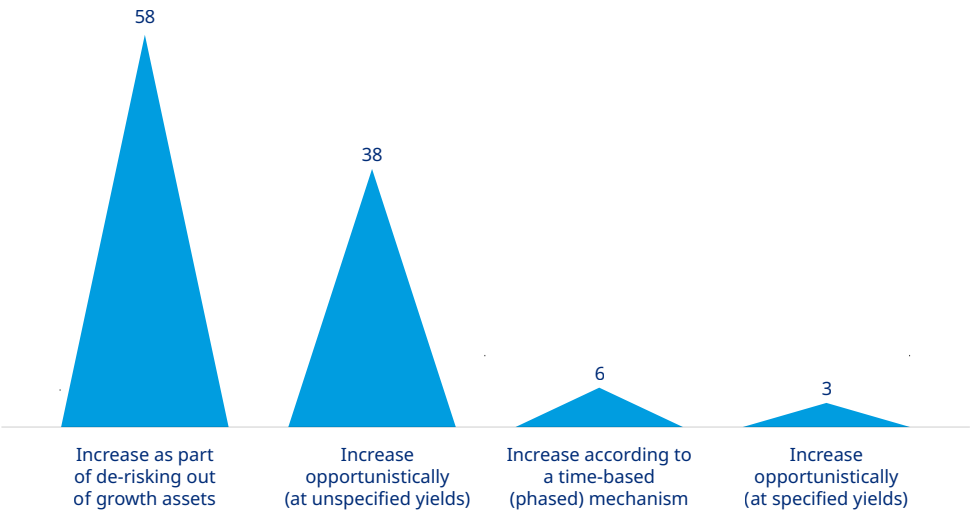


Figures 14 and 15 show that most investors are not planning to make any further changes to their hedge ratios over the next year.

However around a third of investors are actively considering increasing hedge ratios. This might have to do with this part of the survey having been completed after Q1 2021, when interest rates had recovered and rising inflation had become an increasing concern, as well as the fact that a proportion of plans still have reasonably significant unhedged exposures.

Though plans have, in general, already come a long way in increasing hedge ratios, we should also look at how they plan to further increase hedge ratios in the future. Most plans (58%) expect hedging to increase by virtue of future de-risking out of growth assets. A substantial number (38%) of plans also expect to increase hedging opportunistically, when bond yields increase to a level that makes bond prices more attractive. The use of time-based triggers and specified-yield triggers is 6% and 3%, respectively. A time-based or yield trigger-based approach gives the greatest certainty of increasing the hedge ratio over time.

Figure 16. Methods for increasing liability hedging (%)



Note: The figures do not add to 100% since some plans are using more than one method for increasing their liability hedging ratio.

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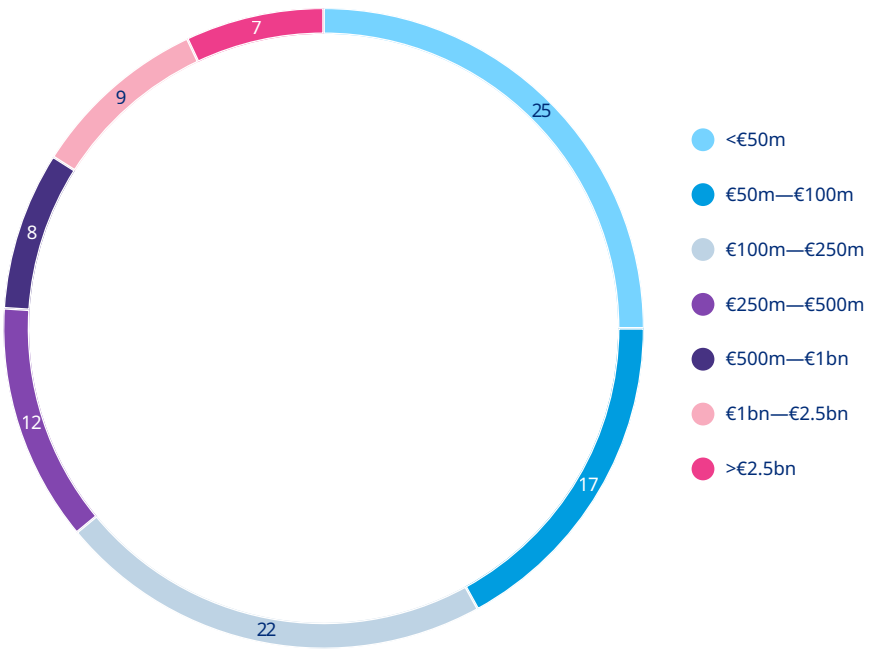
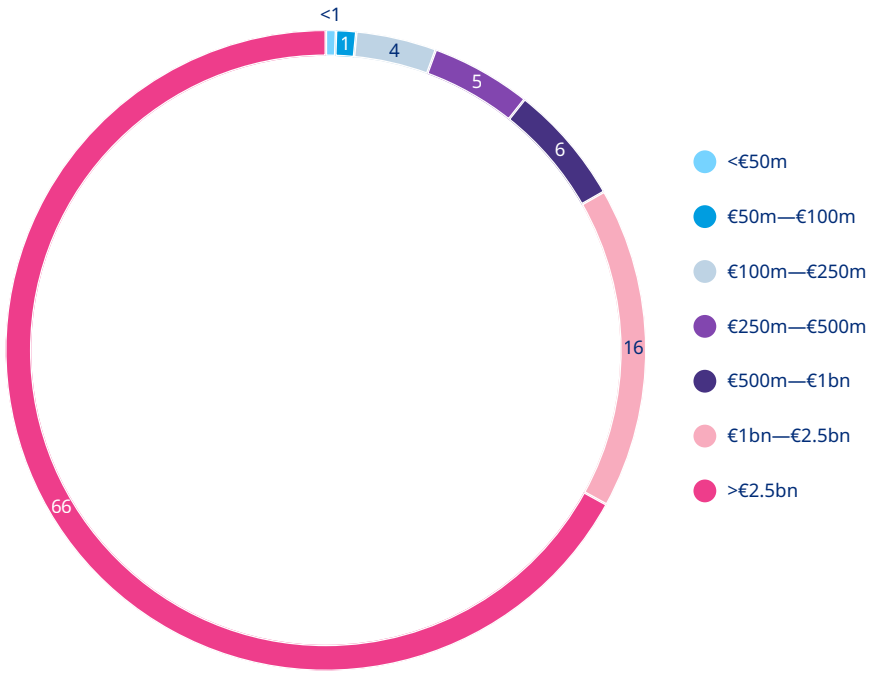
Appendix: Survey participants

Figure 17. Split of total survey participants by plan size (UK) (%)



Just over 40% of the participants (by number) represent plans with assets under €100 million, whereas around 15% had over €1 billion of assets.

Figure 18. Split of total survey assets by plan size (UK) (%)



Although smaller in number, these larger plans dominate the overall assets under review.

Some year-on-year turnover among survey participants is inevitable, but most of the plans have remained part of the survey over time, allowing us to identify asset-allocation trends based on robust core data.

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