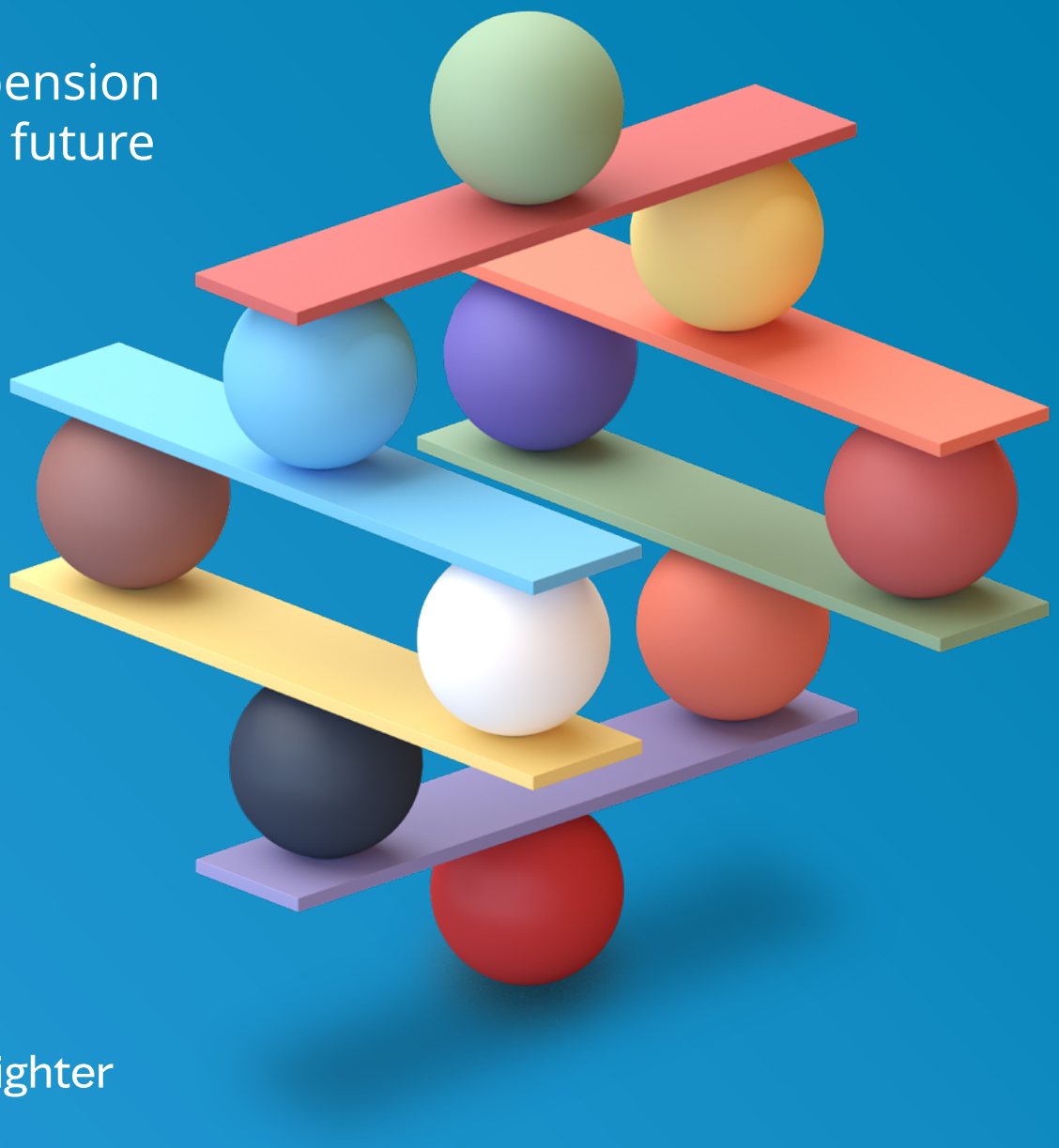
Mercer

Transitioning to a new normal

Refocusing pension plans for the future



welcome to brighter

1 Refocusing on the long term

The state of the market

In March 2020, at the height of the pandemic-induced market turmoil, we published a paper, *COVID-19 — Managing Your Pension Risks*, exploring the immediate impact on core asset classes and what it could mean for pension fund investment strategies.

Now that the global economy is on a more stable footing, with vaccines being rolled out across the world and temporary restrictions being lifted in many places, we felt it was time to revisit this report and give an update on the longer-term outlook for pension funds and their investment portfolios.

Many aspects of our lives have been uprooted or changed by the pandemic, in some cases fundamentally and irreversibly. The rise of remote working, the effects on global travel and the pricing impacts on various asset classes have reshaped the outlook for many areas of investment portfolios.

In addition, inflation expectations have become more uncertain. In recent months, we have experienced a sharp increase in consumer price indices across leading economies. In the UK, the CPIH measure increased sharply from 0.8% in December 2020 to 3.0% in August 2021.[1] In the US, meanwhile, August's CPI-U inflation rate hit 5.3%, while in Europe, the HICP inflation rate has risen to 3.0% in August from -0.3% in December 2020 — with inflation in Germany as high as 3.4%.[2]

In the short term, these elevated levels can be attributed to base effects as economies return to near full capacity compared to the collapse in demand observed a year ago. However, with some supply chains still facing significant challenges, and many governments and central banks having spent huge amounts of money to prop up their economies, the longer-term outlook for inflation is unclear. Traditional models do not help us when trying to make sense of the unprecedented events of the past two years. (For more on inflation, see page 8.)

Equities have enjoyed a strong bull market since the crash in March 2020. The MSCI World Net Return Index has gained 95% in US-dollar terms from the market bottom on March 16, 2020, to August 31, 2021.[3]

Meanwhile, government bond yields, real yields in particular (taking inflation into account), have continued to fall, largely because of accommodative central bank policies, including bond-purchase programs. The UK 10-year gilt yield reached a record low of 0.07% in July 2020,[4] and it was estimated that US$18 trillion in bonds were trading with a negative real yield by December 2020.[5]

[1] UK Office for National Statistics. "CPIH Annual Rate 00: All Items 2015=100," September 15, 2021, available at https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l55o/mm23.

[2] Bureau of Labor Statistics. "Consumer Price Index," available at https://www.bls.gov/cpi/latest-numbers.htm; European Central Bank. "Measuring inflation – the Harmonised Index of Consumer Prices (HICP)," available at https://www.ecb.europa.eu/stats/macroeconomic_and_sectoral/hicp/html/index.en.html.

[3] MSCI. "End of Day Data Regional," available at https://www.msci.com/end-of-day-data-regional.

[4] Milliken D. "UK 10-Year Government Bond Yields Hit All-Time Low," *Reuters*, July 31, 2020, available at https://www.reuters.com/article/britain-bonds-idUSL5N2F25C5.

[5] Mullen C and Ainger J. "World's Negative-Yielding Debt Pile Hits $18 Trillion Record," *Bloomberg*, December 10, 2020, available at https://www.bloomberg.com/news/articles/2020-12-11/world-s-negative-yield-debt-pile-at-18-trillion-for-first-time?sref=Rc78bfqv.

Index	December 31, 2019	December 31, 2020	September 30, 2021
German 10-year government bond yield	-0.19%	-0.58%	-0.22%
Eurozone 25-year inflation swap	1.49%	1.45%	1.98%
MSCI World Equity Net Index, US dollars	6,910	8,008	9,053
iBoxx Euro IG all corporates — spread	1.04%	1.01%	0.97%
USD/EUR exchange rate	1.22	1.22	1.16

2 Passing the test

When we were writing last year's paper, it was difficult to predict what would happen in the short term. We therefore set out three scenarios for the global economy in the wake of the pandemic: a "severe shock," a "moderate shock" and "Q2 recovery." Thankfully, our severe-shock scenario did not occur, and the economic recession was short lived: two months in the US, according to the National Bureau of Economic Research.[6]

The reality was somewhere between our moderate and recovery scenarios. Central banks and governments were broadly supportive and helped to limit corporate failures. However, many companies — particularly in sectors such as travel and hospitality — were affected severely and experienced heavy impacts to their revenues.

Many of our clients rightly reduced discretionary spending and postponed projects due to the highly uncertain environment. This hiatus allowed businesses to focus on day-to-day operations and the shift to remote working, reduced hours or lower volumes.

This pause included pension de-risking projects, particularly those that were dependent on capital injections from the sponsor — although overall de-risking volume for the year was still one of the highest levels on record. There were two key reasons for this. First, wider credit spreads in the earlier stages of the pandemic offered an attractive price point for buyouts. And more recently, buoyant equity markets have helped support funding levels for plans with preexisting de-risking programs. Although de-risking projects may have been paused, unprecedented levels of energy were put into environmental, social and governance (ESG) programs, improving the impact of asset pools on sustainability and our climate. (See page 10 for more on ESG.)

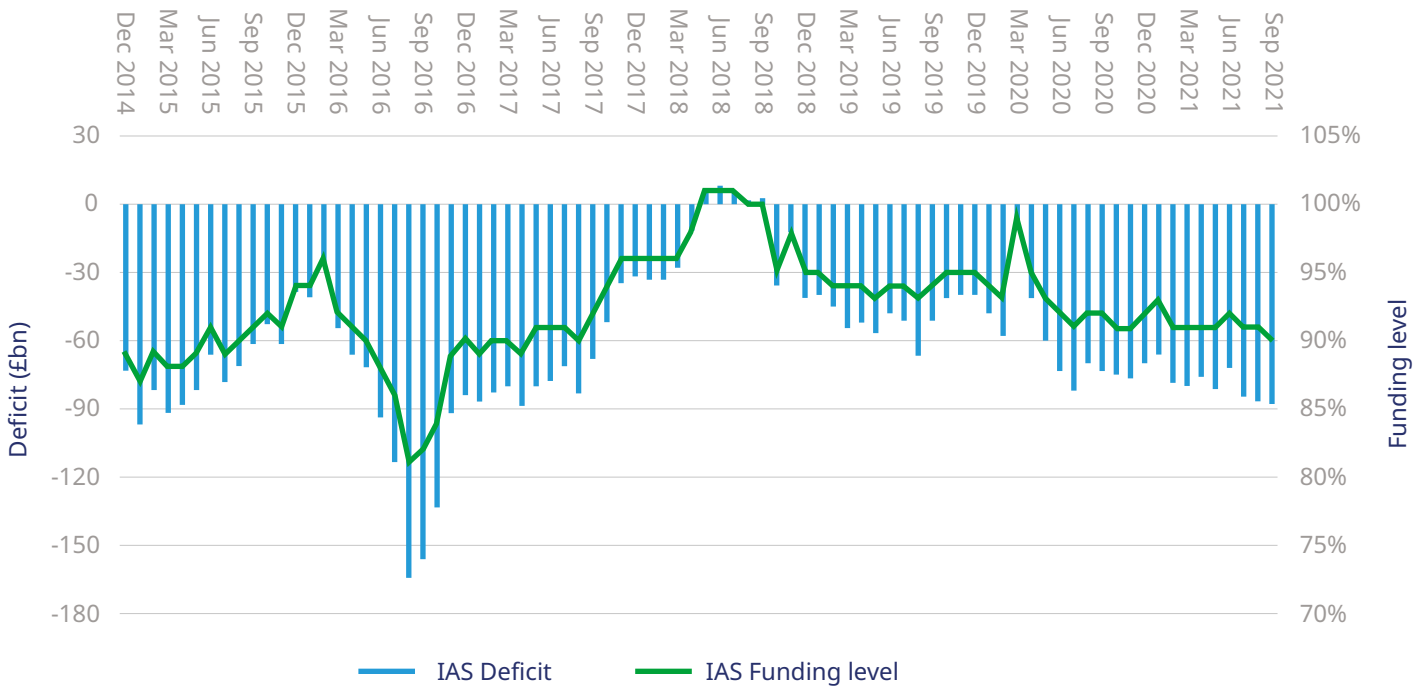
Vaccines injected confidence back into global markets in the second half of 2020. Pension funds that were hedged effectively managed to ride out the worst of the volatility. Data from Mercer's monthly pensions index showed that funding levels for defined benefit (DB) pensions at FTSE 350 companies mostly held steady over the year. In 2021, companies have been reenergized by the reopening of economies and the speed at which most countries have emerged from recession.

[6] Cox J. "It's Official: The Covid Recession Lasted Just Two Months, the Shortest in U.S. history," *CNBC*, July 19, 2021, available at https://www.cnbc.com/2021/07/19/its-official-the-covid-recession-lasted-just-two-months-the-shortest-in-us-history.html.

However, while confidence is creeping back into the global economy, COVID-19 variants that are more contagious or more resistant to vaccines are emerging. Countries such as Australia are still imposing localized lockdowns in an effort to contain outbreaks.

The challenge now for companies and pension funds is to take stock of the past 18 months and reassess the suitability of investment strategies. For example, many trustee boards suspended automatic rebalancing of portfolios to avoid buying and selling in a period of extreme volatility— and will now be considering restarting these efforts if they have not already done so.

Figure 1. FTSE 350 retirement plan deficits and funding levels



Source: Mercer. "FTSE 350 Pension Scheme Deficits Increase Slightly in a Volatile Month," October 1, 2021, available at https://www.uk.mercer.com/newsroom/ftse-350-pension-scheme-deficits-increase-slightly-in-a-volatile-month.html.

3 Actions to consider

Most companies are past the worst short-term effects of the pandemic. Immediate funding issues are still at the top of the agenda for DB pension fund sponsors in sectors such as travel and hospitality that continue to be affected by localized lockdowns and staff shortages due to illness or isolation requirements.

Companies that have ridden out the worst of the pandemic are now facing very different issues from those they faced this time last year. Many are facing surges in demand while simultaneously suffering supply constraints. The post-pandemic world has presented many opportunities and challenges — so what does this mean for institutional investors?

Even before the pandemic, investors had a range of issues to confront. In this chapter, we look at those that remain, those that have just arrived and those that have significantly increased in intensity. We also make suggestions about how investors can either start or step up their approaches to tackle these challenges.

Return to growth

Economic growth in most major markets is trending at a rate above where it was projected to be before the pandemic. Productivity has improved for some companies that have been able to leverage efficiencies from remote working. Less time spent commuting has helped staff improve their work-life balance and enabled them to be more productive with time that used to be spent on a train or in a car.

Improvements in remote-working technology have also encouraged more collaboration between teams in different locations. We have experienced this within Mercer. Our teams based in countries around the world have been working together much more effectively in a virtual environment, allowing us to get the best out of our talent.

Many of our clients now have the luxury of being able to spend the money they held back last year to help them ride out the uncertainty. Profits have returned, budgets have been met and pension plan funding, for the most part, has held steady, so corporate leadership can once again look to longer-term strategies.

Social issues

The pandemic has thrown a spotlight on inequality across societies, as women and minorities were often more affected by redundancies or falls in income. The killing of George Floyd in the US elevated the Black Lives Matter movement globally, encouraging action on racial equality and diversity across the financial sector and beyond.

Meanwhile, employee mental health and well-being topped agendas last year as staff faced sudden and significant upheaval to their lives. For investors, consideration of social issues such as gender and racial equality are front of mind more than ever.

At Mercer, we encourage the use of data-driven insights to inform and measure success and strong leadership that can commit to taking action and engaging employees as part of a solution. For more information and insights, see our 2020 report, *Let's Get Real About Equality*.[7]

Climate risk

The most recent report from the Intergovernmental Panel on Climate Change (IPCC), published at the start of August 2020, was unequivocal about the serious threat to life on earth posed by the changing climate.[8] This year has seen unprecedented flooding across central Europe, record heat waves in Canada and Russia, and wildfires raging in Greece, Turkey, the US and Australia, among others.

It is essential that pension funds have a robust policy for addressing the very real risks that climate change poses to their portfolios. Regulators in many jurisdictions are introducing stricter rules for investors to report on their climate-change-related risks and exposures. In the UK, for example, the Department for Work and Pensions has recently introduced reporting requirements for large pension funds in line with the recommendations of the Task Force on Climate-related Financial Disclosures.

[7] Mercer. *Let's Get Real About Equality*, 2020, available at https://www.mercer.com/content/dam/mercer/attachments/private/gl-2020-wwt-global-research-report-2020.pdf.

[8] IPCC. *AR6 Climate Change 2021: The Physical Science Basis*, August 9, 2021, available at https://www.ipcc.ch/report/ar6/wg1/.

In the EU, the Sustainable Finance Disclosure Regulation (SFDR) became effective in March 2021. It is expected to dramatically increase the level of attention given to sustainability in investment decision-making, whether from the product or the corporate perspective.

Our Investing in a Time of Climate Change papers, published in 2011, 2015[9] and 2019,[10] set out detailed scenarios for how climate change will affect different asset classes. Regardless of where pension funds and other asset owners are on their journeys, we believe we can help them model the long-term risks to their portfolios, construct effective risk-management strategies, integrate climate change into the heart of investment-governance processes, and help identify appropriate assets that can meet investment needs and contribute to a low-carbon future.

Inflation

As explained on page 1, inflation has spiked in several countries over the past few months as base effects from 2020 unwind, commodity prices recover and economies regain momentum. In its interim economic outlook published in September 2021, the OECD revised its forecast for 2022 consumer price inflation in the G20 by an increase of 0.5%, to 3.9%, while the IMF has warned that central banks will need to be prepared to act quickly should rising inflation expectations become unanchored.[11]

However, there remain several factors that we believe are likely to curtail higher inflation in the long run, including the record amount of consumer debt in Western economies and the continued pace of technological progress. In many European countries, aging demographics, high unemployment rates and high savings rates are likely to dampen demand-driven inflation, even in the face of supportive monetary and fiscal stimulus.

Increased protectionism in global trade may impact inflation from the supply side, and we simply do not know at this point the full economic cost of the journey toward a more sustainable planet, in particular, net-zero emissions. In addition, traditional inflation measures do not include asset price inflation, which has been exceptionally high in recent years, particularly in areas such as property.

Inflation risk is also a significant issue for defined contribution (DC) pension arrangements, as future retirees face the prospect of potentially reduced purchasing power. Indeed, nearly the entire history of DC pension provision has been in a benign inflation environment, in which life-styling and other objectives have been able to target nominal benefit objectives. We would recommend that DC pension providers take the opportunity now to consider the potential impact of inflation on their plans, including the measures that could be taken to assist in protecting future retirees.

Fixed income

During the global financial crisis of 2007–2009, central banks injected extraordinary amounts of money into the bond market through quantitative easing in an effort to reduce the cost of borrowing and to provide liquidity. When the pandemic hit, the Federal Reserve, Bank of England, European Central Bank and others resumed these bond purchases as a way to bolster confidence and try to keep their economies stable through the pandemic.

These purchases have added to what is now a 30-plus-year bull market in bond prices. However, this cannot go on forever, particularly in the face of higher inflation expectations. Although it is impossible to know yet when these policies will be unwound, pension funds must look beyond the bond bull market at where stable, reliable and sustainable income can be generated in the long term.

To some extent, this will depend on individual de-risking strategies and how liquid a pension portfolio needs to be. Many of our larger pension fund clients — and even some smaller funds — have been turning to pooled vehicles to access alternative asset classes that can help them boost expected returns while reducing exposure to capital depreciation.

[9] Mercer. *Investing in a Time of Climate Change*, 2015, available at https://www.mercer.com/content/dam/mercer/attachments/global/investments/mercer-climate-change-report-2015.pdf.

[10] Mercer. *Investing in a Time of Climate Change — The Sequel*, 2019, available at https://www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html.

[11] OECD. *Economic Outlook, Interim Report*, September 21, 2021, available at https://www.oecd-ilibrary.org/economics/oecd-economic-outlook_16097408; IMF. "Transcript of October 2021 World Economic Outlook Press Briefing," available at https://www.imf.org/en/News/Articles/2021/10/13/tr101221-transcript-of-october-2021-world-economic-outlook-press-briefing.

Yields on traditional government and corporate bonds are unlikely to keep falling at the rate they have over the past decade. We believe now is a good time to review fixed income exposures and hedging levels, and to consider whether alternatives such as private debt or infrastructure could be a better match for pension fund liabilities. At Mercer, we offer deep expertise to asset owners seeking to earn additional yield, including pooled vehicle options for smaller investors seeking to participate in alternative investment options normally available only to larger investors.

De-risking

Activity in the buy-in and buyout market was muted in the first three quarters of 2021, but we fully expect this to pick back up in the final quarter of the year as insurers and reinsurers continue to have plenty of capacity to take on new pension clients.

Innovation in the insurance sector has also boosted capacity to take on more complex arrangements and smaller schemes. We would encourage pension funds that are fully funded and exploring their end games to begin planning for an insurance transaction, along with developing an understanding of potential alternatives. At Mercer, we have significant experience in facilitating small and large insurance transactions of varying complexities. We believe we can help employers and trustee boards navigate these deals efficiently to obtain an optimum price and the best deal for pension fund members.

Insurers are offering attractive pricing for insurance transactions that can compensate for the effect of low interest rates, which typically push up the cost of buyouts or buy-ins.

As corporates have become more comfortable putting capital to work, merger and acquisition activity has increased significantly. Companies are exploring growth opportunities and the disposal of noncore businesses, and this means they will be looking to de-risk pension plans linked to these sales or purchases. At Mercer, we have observed this as a factor behind several of the de-risking projects with which we have been involved in the past few quarters.

4 Looking ahead

A key development over the course of the pandemic months has been the rightful elevation of risk managers within organizations to more strategic roles. In Europe, the IORP Directive has sought similar objectives for pension funds through the introduction of the risk function. At Mercer, we believe that although implementing a risk function for smaller plans is not without its challenges, it presents larger plans and their sponsors with an excellent opportunity to reappraise and improve governance arrangements, enhance member communications and integrate leading industry practice around risk management into the operation of the fund.

The recent IPCC climate report has underlined the serious risks posed to our environment and the role asset owners can play in shaping a better future for the planet. Although the pace at which the asset management community is embracing ESG in its culture is encouraging, it is critical that asset owners be proactive in driving change. Pension plans should consider how ESG — particularly climate — is integrated into the investment process and ensure that pension plans are leading rather than lagging within the sponsor's organization. In our view, time spent understanding and responding to developments such as the Sustainable Finance Disclosure Regulation (SFDR) should be used as an opportunity to make meaningful change rather than a compliance exercise.

Low interest rates are likely here to stay, at least for the medium term, propping up liability valuations and lowering annuity rates. Government bonds are likely to remain expensive as central banks continue to support recovering economies. In our view, although schemes with strong covenants may be able to justify lower hedge ratios, other schemes would be wise to be realistic about the prospect of materially higher interest rates in the near term. Schemes and their sponsors could usefully assess the extent to which alternative investments could be used to generate additional yield and lower the overall cost of pension provision.

To the extent that plan funding has improved in recent months, opportunities for affordable de-risking are more likely to present themselves. To be able to take advantage of pricing opportunities such as those that arose in March and April 2020, preparedness is key, which means having clean, transaction-ready member records and benefit specifications. Plans should have a clear understanding of what and when they might transact, how the investments can be prepared, what risks might be retained and what contractual documentation is likely to involve.

DC plans and their sponsors should take a deep look at inflation risk. Corporates should pay special attention to this risk since their DC-DB balance has shifted dramatically in recent years, and, historically, they have not needed to think paternalistically about DC benefits. This is particularly relevant in markets like the Netherlands, where a wholesale change in pensions provision is expected. Regardless of the market, inflation poses a risk to purchasing power and warrants consideration and, if appropriate, investment response.

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