Hewitt

SPOTLIGHT

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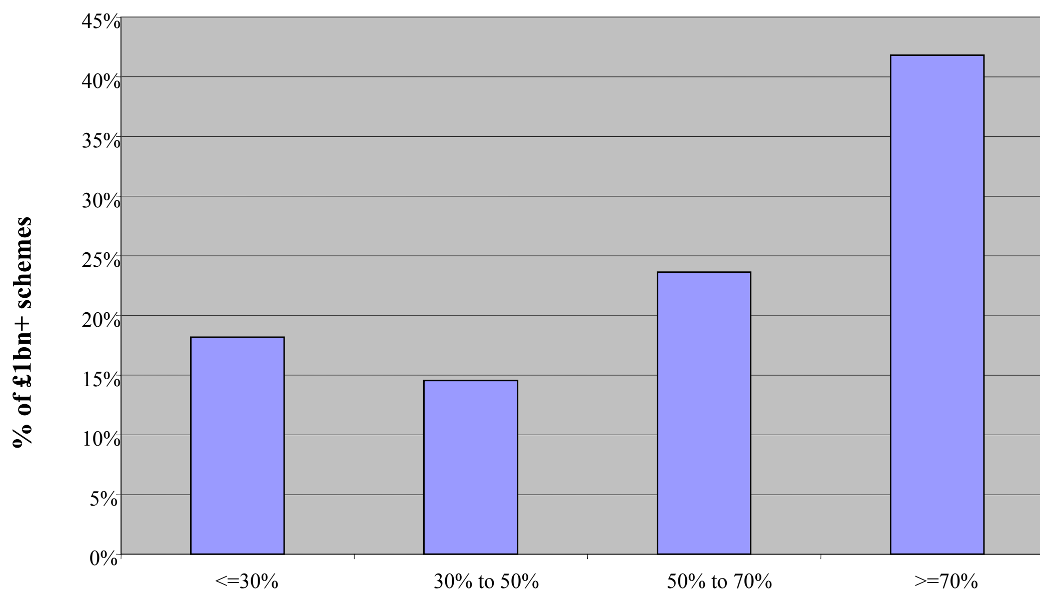
Issue 65: Asset and liability de-risking by £1 billion + schemes

Hewitt advises over 50 clients that have pension fund assets greater than £1bn. Our recent survey considered a wide range of aspects of these "mega schemes" – and here we look at what we found.

In the second of this two part series on this survey we look at the asset and liability de-risking techniques being used by these schemes. For more information on the full range of risk management techniques please see Spotlight Issue 63.

On examining investment strategies and the level to which schemes of this size have sought to de-risk assets, we see that an emphasis on investment return has remained. 40% of schemes surveyed still have 70% or more of their assets in return seeking assets such as equities. Furthermore, about a third of schemes surveyed are including a greater allowance for equity out-performance in their recovery plan than in their technical provisions.

Proportion of £1bn+ schemes invested in equities



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Much has been written about pension schemes selling equities and buying bonds. This has been driven by a heightened need for some schemes to manage more effectively shorter term risks relative to liabilities. However, what this research shows is that many trustees of the largest schemes are still relying on future equity returns as an integral element of their schemes' recovery plans.

In reality, any optimal asset allocation mix should be based on many individual factors, including the scheme's maturity, the trustees' risk and return requirements and their overarching investment beliefs . Critically, an assessment of the financial health of the sponsor, or covenant, is also a key factor. Both covenant strength and maturity of the scheme can vary substantially and our survey showed that maturity levels (liability of current pensioners and dependants as a proportion of total liabilities) within these large schemes is in fact in a wide range - 5% to 85%. This influences investment time horizons and, therefore, the appetite for risk.

Although schemes in this sample with a high equity content are aiming to achieve a high return on assets over the longer term, they should still be concerned about short term volatility and consider appropriate measures to mitigate risk. Typically, this is done by diversifying return-seeking assets and hedging unrewarded risk, while actively monitoring the sponsoring company's ability to meet shortfalls in the event of financial downturns.

Two-thirds of schemes surveyed have partially de-risked liabilities by traditional routes such as closing to new entrants, moving accrual to a career average scheme or even closing to future accrual. A handful of schemes surveyed are looking at, or implementing more innovative solutions to de-risk the liabilities such as sharing the longevity risk with the members.

Potentially the ultimate end of the pension scheme life cycle is to transfer the risk by buying out liabilities. However, schemes of this size have access to the resources to implement sophisticated risk management strategies themselves and, as a result, are likely to put in place bespoke structured solutions rather than undertake simple buy outs. Very few of those schemes surveyed are currently contemplating buy out, even on a partial basis.

There was more information on the survey in Spotlight issue no 64. Please note we are not releasing the full results of this survey for reasons of client confidentiality, but if you are interested in a specific area and what it might mean for your scheme please contact your usual Hewitt consultant or on pension issues Lynda Whitney (e-mail lynda.whitney@hewitt.com or phone +44 (0) 1372 733617) or on investment issues John Belgrove (e-mail john.belgrove@hewitt.com or phone +44 (0) 20 7939 4277)

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