Are Defined Benefit Schemes prepared for potential economic changes?

Since the global financial crisis central banks have been pursuing experimental monetary policy to stimulate growth and restore liquidity to markets. With interest rates becoming a blunt instrument, many of the world's major central banks have turned to other measures, such as quantitative easing.

These measures have driven yields lower on many asset classes including long-term gilt yields which are the reference rates used to place present values on pension scheme liabilities. The falls in gilt yields has led to a rise in the value placed on pension scheme liabilities which the assets backing these liabilities have struggled to keep pace with. This has been exacerbated as many schemes were unfunded prior to the onset of the global financial crisis and in the majority of cases pension schemes have seen their deficits widen further despite paying in recovery contributions. However, central bank policy has not been the only factor driving down gilt yields with UK gilts becoming a safe-haven asset over these turbulent economic times.

UK defined benefit pension schemes are facing much uncertainty given the current economic environment and long-term gilt yields falling to historic lows. But how are pension schemes positioning their assets and what economic conditions are they preparing for?

Well there are a few underlying strategic assumptions that could be implied by how schemes are positioning their assets. Firstly only a limited number of schemes, and primarily the larger pension schemes, are using an explicit Liability Driven Investment ("LDI") strategy to manage their liability risks. This may be due to the accessibility of LDI to smaller schemes, however given the incredibly low use of LDI strategies it may suggest that pension schemes are preparing for gilt yields to rise. Unfortunately for many schemes this has been a long-standing view and schemes not managing their interest rate risk are likely to have seen their deficits increase. Furthermore, the lack of LDI strategies used implies that schemes are also not hedging their inflation risk, which may be a conscious decision or again due to problems accessing assets whose returns are driven by changes in UK inflation expectations.

Over the past five years defined benefit pension schemes have been extending the number of asset classes invested in with many schemes now making allocations to property and/or "alternative assets". This may in part be driven by concerns over economic growth which is the primary driver of equity and bond returns. Whilst diversifying scheme assets is generally a positive measure, these allocations remain only a small part of total scheme assets leaving schemes heavily relying on equities to provide the investment returns to close their funding deficits.

Whilst investing in equity is no bad thing schemes need to be aware of their potential volatility. With diverging central bank policy, with the UK and US likely to move towards monetary tightening, and fragile economic growth in developed economies pension schemes need to be more vigilant than ever when investing in equity. As schemes are closing and annual benefit payments are increasing the investment time horizon is reducing lowering the ability of schemes to recover from any setbacks.

Ultimately whether pension schemes are prepared for potential economic changes boils down to their governance structure and ability to act. Great strides have been made in pension scheme governance, however there are still improvements to be made. In particular, pension schemes and their advisors should look to discuss possible plans of action to take advantage of opportunities that will improve the likelihood of achieving the scheme's objectives either through improving returns or managing risks. Discussing likely actions prior to an event should put schemes in a better position to act.

Furthermore, scheme governance can be improved by providing scheme decision makers with the right metrics to make informed decisions. Whilst funding positions and funding risks are easily understood metrics and which scheme stakeholders are familiar with, it is not necessarily the best metric to make investment decisions from. For example, metrics that assess the impact various risks have on the time to achieve objectives, may be more appropriate for schemes.

Only time will tell whether pension schemes are taking the right asset allocation decisions, however there is evidence that steps are being made in the right direction to manage risks more effectively and long may this continue.