To De-risk or Not Dr-risk – Summary of Talk

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Introduction

This presentation discusses the case for de-risking, including the main barriers. It then discusses how di-risking can be achieved and describes some of the ways in which the investment products have been developed to aid de-risking. Finally, it considers the timing issues associated with de-risking and the potential to re-risk.

The case for de-risking

Most trustees of pension schemes have considered de-risking in one form or another. The case for de-risking is driven by a number of factors including:

- The increasing maturity of schemes
- The closure of schemes to accrual
- The need to generate cash as pension payments and expenses outstrip contributions
- The desire to extinguish liabilities in the form of an annuity buyout

The main reason why trustees appear reluctant to de-risk appear to be cost. De-risking usually involves investing in lower return assets, thus increasing required contributions. However, products have been developed that mean that de-risking can be achieved without necessarily lowering the expected investment returns. Two examples of this include

a) leveraged liability driven investment funds, where for each pound invested you can get approximately three times the level of (real and nominal) interest rate protection that an equivalent bond would give
b) Equity linked bond funds which use derivatives to obtain equity market exposure and then invest in physical bonds

In addition, innovations in the annuity market have led to further options for purchasing annuities, such as deferred premium annuities, whereby the cost of purchasing annuities can be spread over a number of years, whilst fixing the price now.

How to de-risk

The starting point when considering de-risking is to consider the risk that can be tolerated by the pension scheme and the sponsor, by performing an Asset Liability Study, taking into account investment, funding and covenant. Ideally trustees should consider an ultimate goal with the sponsor, such as buyout, or a low risk (self-sufficient) funding position) and then should consider the initial risk being run in the portfolio.

The talk looked at examples whereby risk can be reduced, by looking at more efficient investment portfolios. It also looked at the governance and education requirements around the more efficient portfolios. Whereas in the past it was generally accepted that trustees could run much simpler portfolios if they didn't understand the more complex funds, it is now incumbent on trustees to understand all the options available to them, especially if they are being used widely by other pension schemes.

Also, in terms of annuities, the market is very active and can now be monitored. There is a strong case for considering annuities at the point of a strategy review as it may be affordable to by-pass some of the other solutions such as LDI.

When to De-Risk

Finally the talk then moved on to when to de-risk, in particular once the initial strategy has been set how to de-risk further. It looked at the opportunities that have been missed in the past, when funding was generally much better than today. It then discussed three main forms and the issue of re-risking.:

Triggers – setting market and or funding level triggers (funding level preferred). These can vary in terms of the target set, the frequency of monitoring, the speed of implementation and the discretion applied at the point of a trigger being hit. With the technology now available daily trigger level monitoring is a service available to even the smallest pension schemes.

Mechanical switching – as schemes mature, a static asset allocation becomes more risky. So there is a strong case for schemes to at least de-risk at the pace that the liabilities mature. This can be achieved by setting up a plan to de-risk at various points of time. Or a third solution is to do a step de-risk.

Re-Risking

Re-risking is often thought of as a single question, however it can be separately considered in a number of scenarios.

When doing an investment review there may be a number of valid reasons why the risk budget has increased since the last investment review. This could be due to a stronger covenant, or lower than intended risk being run for some other reason. In this case the trustees may validly adopt a higher level of investment risk – but if the scheme is maturing and/ or closed to accrual as most schemes are, then the future path may be to de-risk, as discussed earlier.

Most de-risking plans set triggers for de-risking if funding improves. But what about if funding worsens? In most cases, this will not be a signal for increasing risk further and most schemes that have plans to consider what happens in this scenario, include a plan to ask for extra contribution rather than to re-risk.

Finally, there may be a belief that financial markets are such that risky assets are cheap compared to matching assets and trustees may want to take advantage of this. This is a very hard thing to call and not something I would recommend that Trustees look to do. The professional investment managers rarely call major asset allocation timing correctly. If Trustees have a benchmark asset allocation, the above scenario would probably lead to risky assets being underweight so trustees could validly re-risk back to their agreed risk position, and re-balance. This is something that a lot of schemes did during the last major fall in equities in 2008.

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