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INVESTMENT MANAGERS

Investment viewpoint

Opportunity and recovery: potential next steps for DB pension plans

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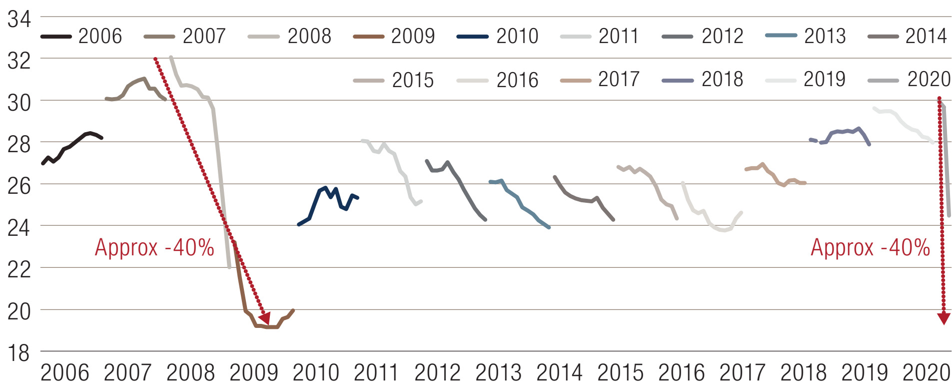
2020 – the year when the world came to a stop…literally

The fight to stop the virus has meant that many countries around the world have implemented "lockdowns." Travel has all but stopped and many businesses have low to no revenues coming in. The chart below shows the downward revision in earnings seen in previous years across Europe.

EUROPEAN EQUITY MARKETS: RAPID DOWNWARD REVISIONS IN EARNINGS



Source: LOIM, Bloomberg as at 27 March 2020.

At the time of writing, Europe had seen a large drop in earnings that could rise to a lot higher if we see a contraction as big as 2008-2009. Negative earning revisions have been experienced in many markets around the world. Needless to say, investment markets have taken a big hit.

However, lately we have also seen signs of Covid-19 infection curves flattening in some countries and market sentiment has shown some signs of improvement. Government intervention via fiscal and monetary policies has also helped. For example, the UK government has pledged to support many workers by paying a proportion of their income. This will help reduce the likelihood of a complete system collapse. There has been some recovery in markets but not enough to reverse the falls.

Turning back to the virus front, as infection rates show signs of flattening (especially in Europe), lockdown exit strategies will be contemplated. Here, the experience of Asia remains key and the incidence of another round of infections in Japan, Hong Kong and Singapore show that binary lifting of lockdown would be problematic. We are envisaging a sequential lifting of shutdown protocols. As such, we think any social and economic activity, which still requires close physical proximity would struggle to fully come back online in the near future.

Overall, we remain bearish than consensus on Q2 growth forecasts for most countries. There is a chance that we continue seeing more falls before things get better.

In this short note, we discuss some investment-related implications and ideas for funded Defined Benefits (DB) pension schemes.

The story so far

Many pension schemes will have been hit: Pension schemes have been de-risking over the past few years. The shift from return generating assets to the matching portfolio will have reduced the impact of the current negative market environment. The biggest source of negative returns is anticipated to be equities and a reducing allocation to equities will have meant a lower impact. Similarly, an increasing allocation to the matching portfolio and in particular, government bonds (via Liability Driven Investment (LDI) strategies) will have helped protect against the rise in funding liability values due to fall in yields.[1] The matching portfolio is likely to have had some form of a hit – falls in credit will have reduced some of the protection from the LDI portfolio.

However, not all pension schemes will have de-risked materially. The funding ratio[1] for many schemes will therefore have reduced a lot. In some cases, a lot more than what would be palatable.

Maturity profile does not wait for markets to recover: This time it is different. Since 2008 most pension schemes have closed to new entrants and many to future accrual, therefore shortening their timeframes. The shorter timeframe and older maturity profile does create challenges such as a lower timeframe to recover from market shocks and a rising pension payroll resulting in an increased rate at which the asset pot is shrinking.

Are all pension schemes long-term investors today? A long time ago, pension schemes arguably had the luxury of long recovery plans and allowing for aggressive return targets in their liability valuation. However, times have changed and regulations around funding are a lot more stringent today.

Many pension schemes will now be closely monitoring their covenant. Older maturity profiles also reduce the time to recover from investment shocks. And triennial valuations combined with funding negotiations will not disappear. There may be some reprieve from regulators in terms of flexibility in such negotiations but overall, not all pension schemes will be able to take no action and wait for markets to recover.

Not everyone has the luxury of increasing contributions and/or recovery plans: There are many ways to get back to the flight path to full funding. Some of the common approaches are:

- Seek to increase deficit contributions
- Increase recovery periods
- Ask for additional security
- Increase reliance on investment returns (e.g. increase return potential or take greater credit for returns in the valuation basis)

However, this is easily said than done. Not every scheme will have the option of asking for more contributions and/or security. Some schemes will not want to increase recovery periods as the visibility of the sponsor covenant may not be there (especially after allowing for the impact of the current environment).

For many, reliance on investments will be key.

Liquidity has jumped up even higher on the agenda: Liquidity needs of many pension schemes is likely to be a lot higher. This could be due to not having enough liquidity coming through to pay pensions (for example, the scheme is cashflow negative or if the sponsor contributions are deferred), wanting to rebalance the asset allocation, etc. The choice relating to which assets to sell has been reducing as many liquid assets are not as liquid as they may have been perceived and allocations to illiquid assets has been increasing. As the return target reduces (given the de-risking), redemption and trading charges that were previously a small proportion of the total return become even more important.

Investments will remain key – but what can be done?

The reliance on investment returns will therefore remain and in some cases increase. However, it is important to bear in mind that the current market conditions could get worse before improving. Hence, a balance needs to be struck around ensuing a robust risk management framework is in place and enhancing return generating strategies, where appropriate. It is also very difficult (if not impossible) to call the bottom of the market and hence, waiting to make a change may mean that good opportunities are lost. This is one of the lessons learnt from the 2008/9 global financial crisis.

Some pension schemes may prefer to take no action where a view has been taken that markets will revert to their previous levels within a reasonable timeframes. Taking no action should be an active decision and one that requires a strong conviction.

Some pension schemes with strong conviction are looking to make tactical changes.

Another possible way forward could be to take advantage of opportunities and/or to be positioned for a market recovery in a risk aware manner. The ideas set out in the next section primarily relate to this area.

Source of capital for any change should also be carefully considered. Pension schemes in many jurisdiction now have options beyond needing to sell assets to raise such capital – one example is using leverage within the LDI portfolio to raise cash where possible. Such ideas are beyond the scope of this note.

[1] This refers to discount rates that are linked to government bond yields. We note that accounting linked discount rates linked to corporate bond yields will have actually shown a fall in liability values.

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Potential ideas

At a time like this, it becomes crucial to balance the need for return whilst reducing the potential for further downside risk. Our preference would therefore be to embrace:

- Opportunistic ideas
- Strategies that have asymmetric profiles: greater chance of upside with lower downside risk to take advantage of any market reversal
- Focus on dealing with the left tail (downside risk scenarios)

Some of our ideas for investors are set out below:[2]

i. Opportunistic

Making cash funds work harder: Cash plus capabilities

Pension schemes with excess cash could consider using cash plus funds (especially at the current time). Cash funds have traditionally taken the form of:

- cash (targeting returns around Libor)
- and cash plus (targeting Libor + c50bps).

Towards the end of March 2020, names traditionally held in the former (cash funds targeting Libor) are now able to add paper at 30 to 70bps above Libor. In addition, the investment choice for cash plus funds means that such plus funds can push yields out to 50-100bps above Libor whilst maintaining their low risk profile

Manager choice in the current environment will be key. Larger cash funds are increasingly having a significant cash drag due to a "liquidity subsidy." Many such funds have to hold huge amounts of liquidity to be prepared for big synchronized outflows creating a large cash drag. You may have read about the rescue (liquidity injection) required for the large Goldman Sachs and Dreyfus money market funds in the US. Our smaller size enables us to maximize the capital that is put to work and we believe being outside the herd is advantageous at the current time.

ii. Opportunistic and strategic

Embracing and enhancing credit

Investment grade credit and high yield debt have both fallen over the past few weeks and we are beginning to see some reversal. However, credit spreads remain at very attractive levels. Pension schemes looking to move into credit now have an opportunity to do so at very attractive levels, in our view. Global investment grade names were trading with credit spreads above 300bps towards the end of March 2020.

Many pension schemes will already have some credit exposure and will have experienced some falls. Selling such credit may lock into losses. However, there are higher yielding opportunities in crossover credit and Asian investment grade credit that investors may want to look into to help boost return as a relative trade against traditional global credit funds (and such positions can also be held at a strategic level).

Our crossover strategy, which combines c70% investment grade (IG) names with c30% names in non-IG that are expected to move to IG (referred to as rising stars and fallen angels), was showing credit spreads above 550 bps towards the end of March 2020.[3]

Asian investment grade (IG) names in particular are trading at even more attractive levels compared to traditional global IG names. Our Asian IG strategy implemented in hard currency USD was locking in credit spreads of c350-400 (c50-100bps higher than global IG spreads) in March 2020 with established and strong multi-national company names in the portfolio.[3] This strategy is particularly popular in Europe given the attractive yield, the strong IG rating and the USD hard currency exposure.

iii. Asymmetric profiles

Asymmetric profiles refer to strategies that have a higher return potential on the way up and a lower negative return potential on the way down. We believe such a framework is particularly relevant for pension schemes who have shorter time horizons. The key will be to be positioned for a recovery whilst ensuring that there is some protection from further falls.

For example, global equities went up c+20% in 2019 and c-20% in the first quarter of 2020. The 2019 gain has pretty much been wiped out this year. The ideal would be for strategies to lock into some of such previous earned gains.

Two ideas are mentioned below that enable pension schemes to target equity-like returns to capture any rebound with an element of downside protection. This is based on our view that, similar to after the 2008/9 crisis, equity markets will recover but there is a risk that the position may get a bit worse before improving.

1. Reducing risk in existing equity and/or existing diversified growth funds by moving into a diversified growth funds with drawdown risk protection

[2] The ideas discussed are 'liquid' in nature. Other illiquid strategy ideas can also be considered – but these are outside the scope of this note.

[3] Source: LOIM, Bloomberg, 30 March 2020. Yields, holdings and/or allocations are subject to change and can vary over time. Past performance is not a guarantee of future results.

Diversified growth funds (DGF) have traditionally offered pension schemes equity like returns at half the risk. The diversification inherent in such funds can be very useful to help simplify governance requirements.

Over the past few weeks, markets have been a sea of red. However, amidst the turmoil, bonds have tended to move in the opposite direction to equities – indeed this has happened on average about 2 days out of 3 this year at the time of writing. This negative correlation is the bedrock of multi-asset portfolios and it has helped. But not enough. Bond yields are already very low and the magnitude of further falls in yield has not been enough to cushion against the fall of return-generating assets such as equities and credit. Indeed, many DGFs have experienced falls of over 10% within the last few weeks – a lot lower than equities but nonetheless not a welcome story.

Like other multi-asset funds, our diversified growth fund was helped by this diversification. But we had to also rely on our explicit downside protection components to help reduce our total fall to c3-4%[4] compared to the 5 to 15% fall range that many DGFs have experienced. This drawdown management is a key feature that is really useful for cashflow negative schemes as it helps create the required asymmetry.

Pension schemes can consider replacing equities, other DGFs without drawdown protection and/or other similar return potential investments in their return-seeking portfolio to invest with a DGF that allows for downside protection. Two key versions of our DGF would be relevant here: our flagship DGF with drawdown protection targeting cash + 3-5% (with a volatility expectation of around a third of equities) or invest in our growth DGF targeting cash + 6-8% (with a volatility expectation of around half of equities).[5]

2. Taking advantage of a low cost option via convertible bonds

A convertible bond is a corporate bond (with a coupon and a fixed maturity date) similar to the typical investment made by pension schemes in credit. The differentiation factor is that the convertible bond also has an in-built option that allows the holder to participate in extra returns if the equity of the issuing company goes above a certain price. There is traditionally a cost to such options but a market opportunity has arisen.

Investors who want to participate in a future market equity rally without investing directly in equities now have a choice of investing in convertible bonds or investing directly in derivatives linked to equities (for example call options). Call options typically require a greater governance requirement and traditionally have had good liquidity to tenors of 1-2 years.

Convertible bonds provide investors with a bond yield, a bond floor and an equity upside via an embedded (3-5 year) call option. The bond floor has kicked in this year protecting convertible bond investors compared to equity investors (converts have fallen by around or less than a third of the drop seen in the equities market demonstrating their attractive asymmetric feature).

Yields in convertible bonds as at March 2020 were at levels last seen during the 2008 crisis. More interestingly, the equity option in the contract is currently being offered at almost zero-additional cost. Again, this has not been seen since 2008/2009.

Investors can lock into two benefits in addition to the high credit spread:

a. The equity upside optionality is typically for 3 to 5 years (in line with the maturity of the convertible bond). Hence, there is plenty of time for equity markets to recover and this "free" optionality to kick in. This is a key difference compared to investing directly in shorter dated call options which requires having a strong view that equities will more than recover within the next year or so.

b. Convertible bonds are traditionally issued by healthcare and technology sectors (as well as industrials and consumer cyclicals). Many companies in these sectors are expected to do reasonably well during and after this crisis. This is also a key differentiator compared to investing in a global credit fund which can have a lot more exposure to some of the most leveraged and at-risk sectors as energy and financials.

Pension schemes could sell equities to de-risk whilst maintaining some equity upside by investing in convertible bonds. Or where the risk budget allows it, schemes could sell traditional low risk IG credit and invest in IG rated convertible bonds. The risk profile within convertible bonds can also be tailored to fit a pension scheme's risk-return appetite.

iv. Focus on downside risk management

Ensuring ever increasing risks such as climate change are fully integrated

We have seen some good outperformance from many strategies that embrace sustainability as a financial signal. Sustainability is not only ESG. Neither is it only about making the world a better place. It is perhaps no surprise that

[4] Past performance is not a guarantee of future results.
[5] Breedt at al. (2019). Figures 4 and 5 on page 38.

companies that have made sustainability-led commitments and shown a strong long term focus have in many cases had a lower impact. Large long-term commitments to transition to a net zero carbon economy demonstrate a strong and clear business model. Similarly, companies with a long-term plan and less reliance on leverage also tend to benefit during such crisis. Sustainability also brings opportunities in new technology, with an ever-increasing demand. Companies with such competitive advantages are expected to become future leaders (and some already are).

Ensuring that ever increasing risks such as climate change are managed is expected to help enhance the risk-return consideration (either via ensuring that the risk of existing portfolios to such aspects is reduced or via making a specific investment by selling traditional global equity funds and investing in sustainability led active funds).

Conclusion

Will it be a prolonged recession, a quick V-shaped recovery or some other letter in the alphabet? Tough to say although we do have a central view that we are happy to share.

Knee-jerk reactions should be avoided. Many pension schemes are very busy grappling with ensuring that normal service in areas such as payroll, new retirements, and transfer values is maintained. However, investment-related actions at this juncture are more important than ever. There are a few points for pension schemes to consider that we believe can truly help to manoeuvre through such challenging times.

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