

corporate briefing



Are employers sufficiently engaged in the pension scheme investment process?

Summary

Current legislation gives trustees final control over investment strategy; but, given appropriate reassurance (in the form of covenant strength and/or contingent funding), many trustees are very open to sponsor input. Indeed, finance managers have much to add to the trustee investment process, perhaps raising the governance budget to a level that allows them to access some of the more complex investment solutions.

Employer involvement can also remind the trustees of the dynamic nature of the asset allocation decision and, within the confines of the covenant strength, who foots the ultimate bill for pension provision. Asset analysis and resulting strategic decisions need regular review.

The issue

The cost of providing pension benefits is met from existing assets, future contributions and investment returns on both.

Maximising the investment returns within acceptable risk constraints is therefore key to minimising future contribution requirements. Yet, too often we see employers taking no, or a minimal, part in the debate over investment strategy – perhaps taking the view that since legislation gives the trustees control over the Statement of Investment Principles, they have no role.

The risk for the employer then, is that the trustees adopt an investment strategy at odds with the employer's needs. The strategy might be unduly cautious, and therefore increase long-term cost, or it may not match liabilities adequately and lead to volatility of cost and/or accounting disclosures. Left to their own devices, some trustees simply fail to carry out appropriate analysis, or review their investment strategy infrequently, when the circumstances of the scheme and the economic environment may be subject to considerable change.

Deciding investment strategy

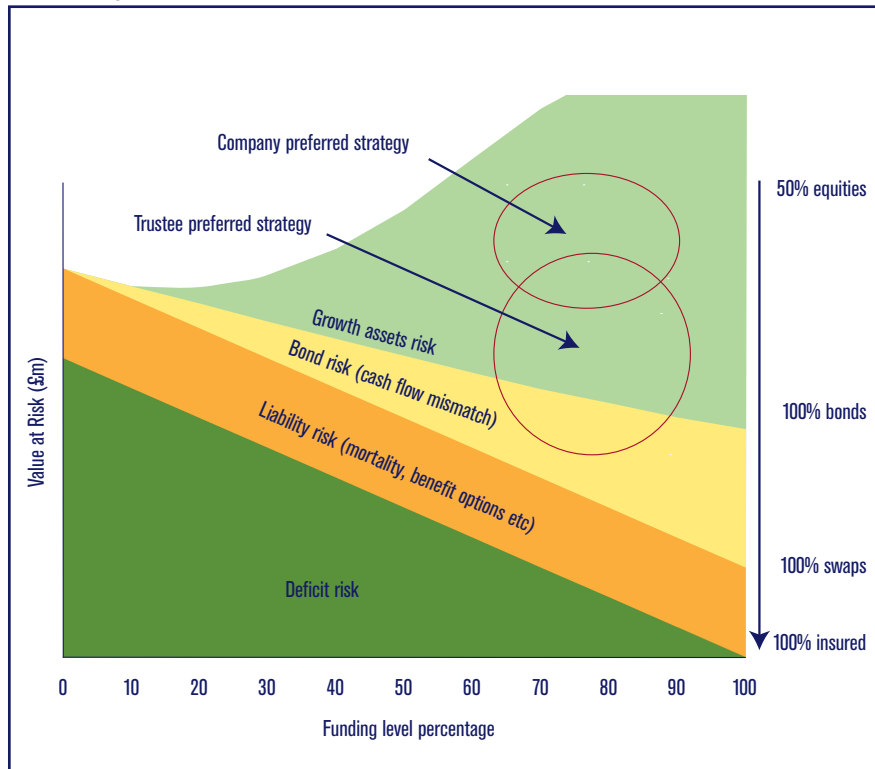
Ultimately, the advice to any investor can be summarised as:

- be clear on the degree of risk you are willing to bear
- do not take unrewarded risk (equally do not automatically remove risk if the reduction in reward is disproportionate)
- diversify.

Within the first category, many trustees will commission stochastic modelling of investment returns and risks to inform their high level asset allocation. This is likely to produce a range of strategies that could meet their benefit security objectives. Equally, however, there will be a range of allocations that meet employer objectives around volatility of contribution cash flows and accounting disclosures. Overlaying these can help determine a 'sweet spot' that best meets all parties' objectives (see Figure 1).



Figure 1 | Overlap between employer and trustees' range of acceptable strategies



Moreover, the trustees' proposals should be reviewed by the company. We have seen examples of trustees adopting a slavish desire for liability matching bonds and swaps. However, these fail to target equity risk, legislative risk or mortality risk. In addition, there may be deficits and inflation/interest rate risks on liabilities not 'swapped', as well as the risk of changes in the shape of the sterling real yield curve. Again, corporate input to the debate can help determine a more efficient approach.

If the trustees have not already commissioned such analysis, the employer can take the initiative and drive the project. Asset liability models have evolved over recent years into affordable and powerful tools; it is hard to justify any investment strategy that is developed without some quantitative analysis of relative risks and returns.

This mutually acceptable allocation will, however, move over time as the scheme becomes more mature, or in response to favourable or adverse investment experience (either to lock in gains, or to redefine the risk/reward trade-off), and as a consequence of changing trustee and employer attitudes to risk (for example as the sponsor covenant strength changes). Both company and trustees need to monitor changes in the circumstances of the scheme and in the investment options available to them.

Access to new asset classes

Minimising risk

Many schemes carry an unrewarded interest rate/inflation risk because their bond portfolio produces different/insufficient cash flows from those projected for the pension liabilities. The widely quoted acronym LDI (Liability Driven Investment) refers to an investment strategy that seeks to minimise this mismatch. Overlaying the bond portfolio with a programme of derivatives can remove much of the risk at relatively low cost, provided the scheme governance budget can stretch that far; experienced treasury managers on the investment sub-committee can facilitate this. Indeed, with the swaps real yield curve often above that for index-linked gilts at most points along the term structure, there is potential for improved returns here as well as better matching.

Of course, there is no 'free lunch' as the pension scheme has traded one set of risks for another, for example, the commitment to deliver LIBOR returns, which is not necessarily simple, but is another opportunity for corporate experience to help.

Maximising return

Increasingly, sophisticated asset classes are becoming more prevalent and being adopted by pension schemes in the search for enhanced returns – private equity, hedge funds and infrastructure funds. All of these may be daunting prospects for lay trustees, but might be more familiar to treasury and finance managers.

Company input to the trustees' investment process and governance can therefore support the use of more complex asset classes, which can contribute to higher returns or reduced risk. With risk reduction high on the agenda for many schemes, this should extend to mortality hedging, and/or purchase of bulk annuities.

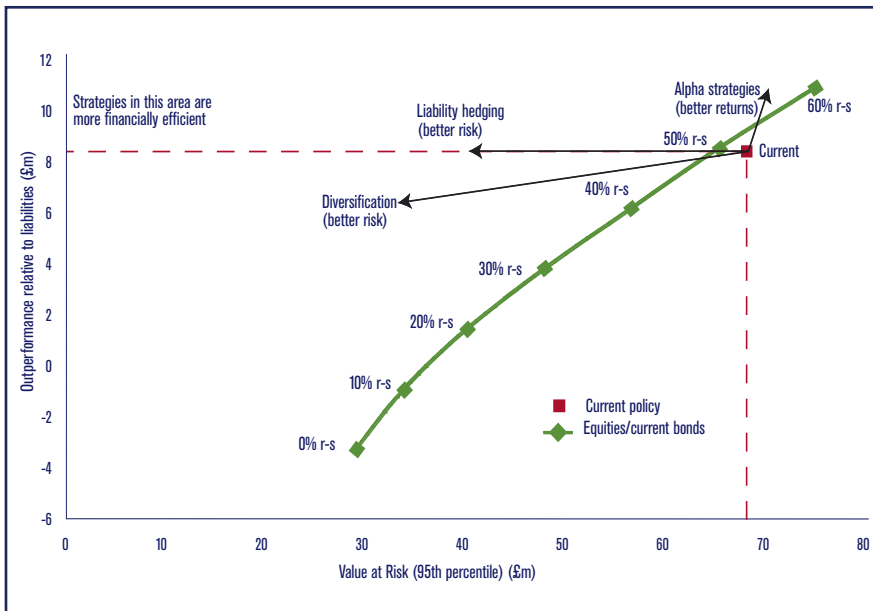
Another benefit from corporate involvement is that it may free up governance for the trustees to pay more attention to the search for 'alpha' – the additional return from appointing active managers who can add value.

Case study A

The trustees of a substantial pension scheme were concerned about medium to long-term prospects for the sponsoring employer (a manufacturing company), and adopted what they believed to be a low risk strategy, with a large proportion of assets in index-linked gilts. The company became concerned that this was an expensive and inefficient use of funds, and commissioned its own asset-liability study.

Using the results of this, they were able to show the trustees that their strategy carried apparent risk reduction too far, and the high level of gilts meant loss of potential returns dwarfed any risk reduction. Instead they found that a modest increase in return-seeking assets, and the use of corporate bonds and swaps would increase the expected returns as well as reducing the annual investment risk (VaR).

Figure 2 | Opportunities to improve financial efficiency – better returns or lower risk



The value of additional governance budget is illustrated in Figure 2. While the strategic risk/reward trade-off can be changed by moving up or down the green curve, there are opportunities to add further value if the governance budget supports the use of alpha strategies (active management), liability hedging (derivatives) or diversification into other asset classes (for example private equity).

Case study B

Following the retirement of two experienced trustees from a large (over £1 billion) pension scheme, the member-nominated replacements were wary of investing outside of pooled equity and bond funds. The company suggested establishing an investment committee, and contributed two experienced finance staff. This gave the trustees the confidence to adopt the advice of their investment adviser to appoint specialist active managers to run part of the equity portfolio.

What about conflict of interests?

In general, although not always the case, we see trustees adopting a lower risk investment strategy than the employer might choose independently. With active debate, the employer may be able to offer some form of contingent funding (or suitably strong covenant) that allows the trustees to adopt a higher risk/higher return strategy, knowing that the employer has effectively underwritten the additional risk.

The trustees' powers over investments cannot be fettered, but we have seen cases where the employer makes available some form of guarantee that the trustees can access provided they adopt a suitably defined investment strategy. This then becomes an important consideration for the trustees, and may enable them to adopt a strategy with a higher risk/reward trade-off than might otherwise be acceptable. Adoption of a modest increase in return-seeking assets can benefit both trustees and employer – and ultimately the scheme members.

Process/structure

Ideally, employer input should be given in a collaborative manner. Employers should raise with their pension scheme trustees whether an investment sub-committee could include employer representatives – there is no requirement for such a sub-committee to be made up exclusively of trustees.

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If the trustees are carrying out any investment modelling, either following an actuarial valuation or as part of that process, the employer should offer to participate in the process, perhaps with an offer to fund a more extensive programme of analysis than might otherwise be used.

Conclusion

Investment strategy is a key factor in the cost of maintaining a pension scheme (as well as affecting volatility of accounting disclosures). The trustees' primary responsibility is benefit security, whereas the employer will have other concerns related to shareholder returns – including cost efficiency, balance sheet variability, contribution holidays and trapped surplus. For many companies, the size of pension scheme liabilities means that employers need to take a proactive role in this process.

Further information

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