2023: THE YEAR OF REFLECTIVE CALIBRATION

EDITIONS

January 2023

Independent Governance Group

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WHAT WILL PENSION TRUSTEES BE CONTENDING WITH IN 2023?

KEY TAKEAWAYS

In an environment of high volatility with an upside of improved funding levels, we expect 2023 to focus on:

- re-evaluating where a scheme is along its journey plan;
- improvements in investment governance;
- a review of risk profiles and how leverage plays a part in modern investment portfolios;
- a rebuild of trust between all stakeholders though transparency; and
- a focus on delivering on sustainability promises.

Extraordinary events presented significant challenges for investors in 2022. Aggressive interest rate rises and other inflationary drivers, coupled with a political landscape that was challenging to navigate, presented trustees with one of the most volatile years in recent history.

Schemes may find themselves in a tug-of-war contest between:

- evaluating what happened and the fallout from the LDI crisis; and
- extraordinary jumps in funding levels with average funding levels on a buy-out basis improving by around 15% and end game targets being brought forward by five years.

Quite rightly, trustees need to take stock of where to go next and decide if the historical golden standard of buy-out is achievable or desirable.

We consider here the six key themes that we see trustees, schemes, advisers and, to an extent, asset managers needing to grapple with in 2023.

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REVIEW OF END GAME

The recent market movements have placed schemes in better positions than where they anticipated to be, with some estimates suggesting that target timeframes have been brought forward by up to five years. Historically, trustees have sought to move towards a buy-out structure and we have seen an increase in activity in the sector, so much so that capacity (both capital and staff) has become stretched.

This excitement could be misplaced, with some schemes not being able to exercise on the improved pricing quoted by insurance companies. Therefore, schemes will need to stabilise their pricing advantage while simultaneously seeking to manage the transitional aspect of risk transfers.

We see that this quandary may require trustees to re-evaluate what they are seeking to achieve and, no doubt, sponsors will be asking the same questions too.

The new code details what low target or low dependency portfolios are expected to resemble and we expect strategic reviews to be a significant driver of trustee time over the first half of 2023.

UTILISING LEVERAGE

Much has been made over the collateral calls that trustees had to contend with to meet ongoing collateral requirements. This was exacerbated by fund exit terms and areas which traditionally make up the 'liquidity waterfall' being particularly poor. We continue to believe that leverage has a place in portfolio management. The crisis illustrated just how dependent advice has been driven by risk models. We see 2023 move towards a more scenario-based approach to risk measurements and evaluations.

No doubt 2023 will see deleveraging within portfolios, particularly for schemes that invest though pooled offerings. As we write, we see investment managers executing special de-leveraging events to recapitalise such funds. This will lead to portfolio reviews for trustees to maintain flight plans through targeting higher yielding returns outside of LDI.

Elsewhere, the liquidity crisis is highly likely to resurrect alternative collateral structures with renewed consideration of the adjustments to existing arrangements such as extension of derivative collateral pools or the use of more innovate structured products. However, this will promote a need for trustees to actively upskill to evaluate their merits.

INVESTMENT GOVERNANCE

The LDI crisis brought into focus the disjointed approach many pension schemes have operated, with separate asset managers, complex fund structures, and inconsistent data across all stakeholders.

We expect 2023 will see, to varying extents, an increased interest in the expanding array of outsourcing options, such as Superfunds, revised forms of fiduciary management and outsourced-CIO services, to take care of investment functions. Any decision to move to such structures will be dependent on exit costs and the ability to do so. This is likely to be supported by the growth in use of a sole trustee or master trust approach to provide a governance oversight that is fit for modern pension portfolio management.

WHAT WE CONSIDERED THE STABLE APPROACH IN THE PAST MIGHT NOT WORK SO WELL IN THE FUTURE. TRUSTEES, LIKE ALL INVESTORS, MUST RECONSIDER THEIR INVESTMENT BELIEFS AND RISK APPETITE LEVELS.

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REVIEW OF END GAME

The LDI crisis was fuelled in part due to a misunderstanding of schemes' liquidity positions, whether this was the limitation of asset pricing, the value of schemes' liabilities or the aggregate hedging position.

This lack of transparency has, to a certain degree, led to a deterioration of trust and accountability within the marketplace. We believe 2023 will see a greater focus on transparency of information, with a:

- greater demand for funding level updates understanding the position of a scheme's assets versus its liabilities;
- a requirement for an understanding of asset portfolio compositions and where liquidity can be obtained; and,
- a potential move towards more regulatory disclosure, similar to what we saw in 2018 with the European Central Bank pension disclosure requirements.

As a greater number of schemes enter a low-risk self-sufficiency state, there will be a further reduction in managing active risk and an increased reliance on accurate risk monitoring, such as cashflow management and market risk hedging.

The Pensions Regulator ("TPR") has increasingly highlighted the discrepancy of scheme management and governance. Recent reports by TPR have illustrated that most trustees and sponsors have identified this as an area that will result in lower and ineffective returns for members if it is not addressed and we are certainly seeing examples of this across our client portfolio.

SUSTAINING SUSTAINABILITY

With the initial phase of the pension scheme TCFD disclosure behind us, phase 2 schemes are starting to compile and release their sustainability credentials. With organisations across the spectrum – from trustees to the directors of the companies which schemes invest in – having made public declarations as to their de-carbonisation journey. Trustees are going to have to consider how to actively ensure they can demonstrate their engagement and adherence to a future net zero position, given the significant warnings of future progress towards such goals being derailed.

The key to the implementation of this journey will be for fund managers, advisers and trustees to work collaboratively to create innovative solutions in this space which not only target the zero-carbon journey, but simultaneously respect schemes' ultimate objective of acting in members' interests.

FUND MANAGERS, ADVISERS AND TRUSTEES WILL HAVE TO WORK COLLABORATIVELY TO CREATE INNOVATIVE SOLUTIONS TO SUPPORT SCHEMES' SUSTAINABILITY GOALS.

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