THE CHANGING ECOSYSTEM OF DEFINED BENEFIT PENSIONS

VOLUME 1 – AUTUMN/WINTER 2022

EMBRACE THE POSSIBLE™

Foreword

The UK Defined Benefit (DB) pensions landscape is evolving rapidly, and trustees have a lot of challenges to overcome. Changing market conditions, increased regulatory requirements, and environmental, social and governance (ESG) factors require careful consideration. These challenges, coupled with the recent gilt market volatility, have led many to review their decision-making structures and implementation approaches.

These dynamics have been further complicated by the overarching macro events of 2022. The impact of the Russia-Ukraine war, increasingly fractured geopolitical relationships, supply chain challenges, an energy crisis, spiraling inflation and rising interest rates have left DB schemes in a very different position. Many are now much further along their journey to ‘endgame’, while others find themselves grappling with liquidity concerns and liability risk management challenges.

In what is likely to be a more challenging environment for investors and pension schemes to navigate moving forward, now is an opportune time to assess the health of the UK DB market and the key priorities and concerns facing stakeholders.

We are therefore pleased to present the findings of Russell Investments’ UK Defined Benefit Market Insights study, a new bi-annual series which will survey senior decision-makers to understand their current views and priorities.

We hope you find the insights from our study useful, and we welcome further discussion into the detail of the survey and its conclusions.

Simon Partridge

Head of Fiduciary Management Solutions
spartridge@russellinvestments.com

“The UK Defined Benefit market has clearly been challenged over the last year, with increased uncertainty and market volatility adding to concerns over slowing growth, recession and climate change. Trustees and sponsors are responding to these challenges through changes to their strategic plans and asset allocations, as well as the deployment of outsourced support to strengthen decision-making and governance practices. We expect this trend to continue as schemes seek external expertise to meet their long-term goals.”

Jim Leggate, Head of UK Institutional, Middle East and Africa, Russell Investments

Contents

Key findings

Inflation and central bank policy action are critical issues for pension trustees and sponsors, with **74% of respondents** ranking these as their main concern in the next six months. These concerns ranked higher (13% increase) among respondents following the UK mini-budget, compared to those surveyed beforehand. The majority of respondents also cited significant fears over the prospect of recession and current geopolitical dynamics and their impact.

The UK mini-budget statement has impacted pension schemes’ current priorities: prior to the government announcement, trustees and sponsors were primarily focused on improving funding levels (68%), managing risks (61%) and ESG (43%). Since the statement, the proportion of respondents identifying **de-risking towards endgame as a priority has increased by 20%**. Improvements to funding levels and managing risks fell back by 10% and 5%, respectively, in terms of priority.

More than half of respondents expect to retain their current liability hedge ratios over the next two years, while just over one quarter expect to increase hedging. The proportion of respondents planning to **increase liability hedge ratios has fallen 20%** following the UK government statement, potentially reflecting the expected lower use of leverage going forwards

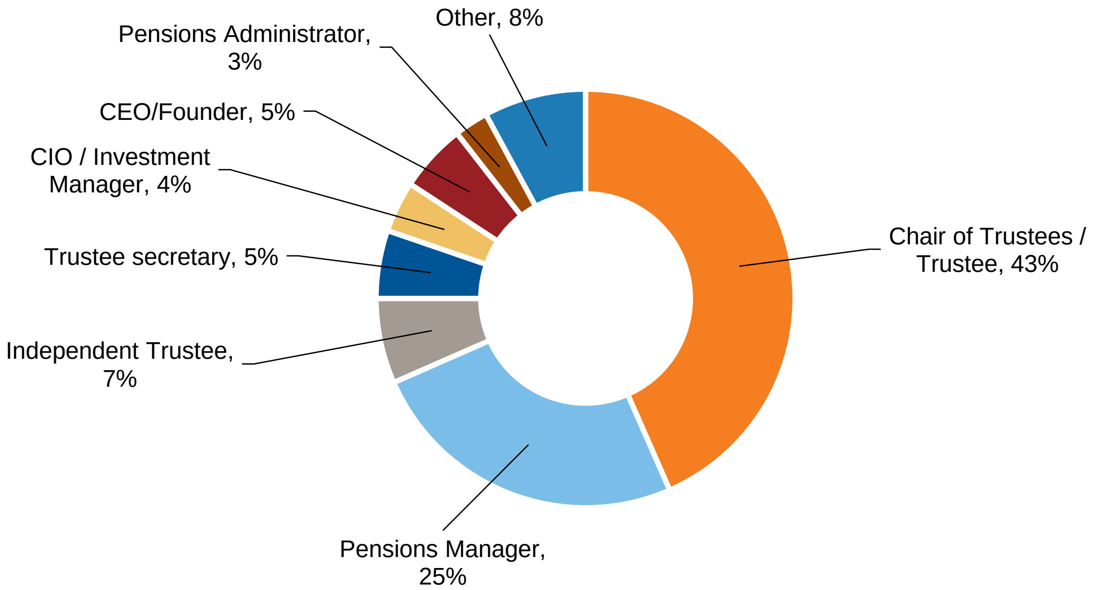
Two-thirds of respondents are likely or very likely to **increase their focus on climate change** over the next twelve months, while over a third have already set a net-zero target of 2050 or earlier.

Of those respondents currently using an outsourced investment provider, the majority identified a **greater depth of expertise, improved reporting and transparency**, and the application of **strong governance structures** as the top three reasons for utilising such support.

Survey methodology

The Russell Investments UK Defined Benefit Market Insights Study is based on the responses of 76 UK defined benefit schemes between August and October 2022, with approximately 40% of responses received before the UK Government’s mini-budget at the end of September. Schemes responding to the study are responsible for in excess of £100 billion of assets under management. Over three-quarters of respondents were responsible for more than £100 million of assets. Respondents included scheme chief executives, CIOs, trustees and pension managers. Responses were collected via an online survey conducted using SurveyMonkey.

Exhibit 1: Breakdown of respondents' roles



Source: Russell Investments, November 2022.

To supplement our insights, Russell Investments also undertook detailed interviews with senior decision-makers at seven leading corporate and local authority pension schemes to assess their views on a range of key topics. We would like to thank those individuals interviewed for their time and insights.

Identifying the concerns of defined benefit pension schemes

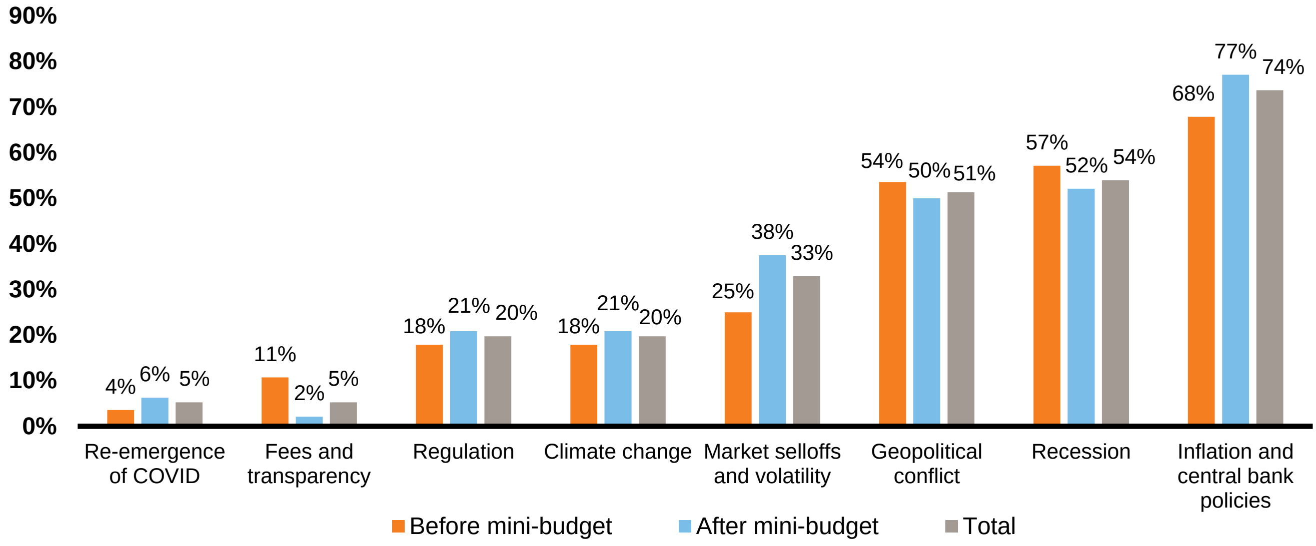
A defining feature of 2022 has been the rapid rise in inflation and central bank efforts to combat this. In the UK, the Bank of England recorded the biggest rate rise in three decades in its November 2022 announcement[1], whilst setting the expectation for further increases to follow. In the US, inflation levels at the time of writing had fallen slightly to reach their lowest level since January but still remain above the Fed's 2% target. Policymakers have given clear indications of their intention to bring inflation under control, expressing concerns that the danger of doing too little likely outweighs the cost of doing too much[2].

"The current economic instability is worrying mainly as the reputation to the UK is being harmed at a time when inward investment globally is being sought. The UK must not become an economic outlier and/or pariah in the name of a false boom!"

Pension Scheme Investment Manager

The challenges faced at an economic level are reflected in the short-term worries of pension schemes, with 74% of respondents identifying inflation and central bank policy as a key concern for the next six months.

Exhibit 2: Respondents' concerns over the next six months (before/after mini-budget of 23 Sept 2022)



Source: Russell Investments, November 2022.

A further concern for DB decision-makers is the potential for geopolitical conflict. Heightened by Russia's invasion of Ukraine, there are increasing questions over key international dynamics, including China's role on the international stage, its relationship with the US and the long-term future of Taiwan. Time will tell as to how these events will progress, with economic and political commentators varying in opinion on the outlook. This increased instability is being felt by DB pension schemes and may well be reflected in their management of assets going forward.

"There is a quadruple whammy hitting schemes at the moment, namely: 1) inflation; 2) rising interest rates; 3) the energy crisis; and 4) the war in Ukraine. This is making the focus on cash flow and liquidity all the more important as pension payment for beneficiaries is the lifeline and most pensions are relatively small in comparison to private pension plans."

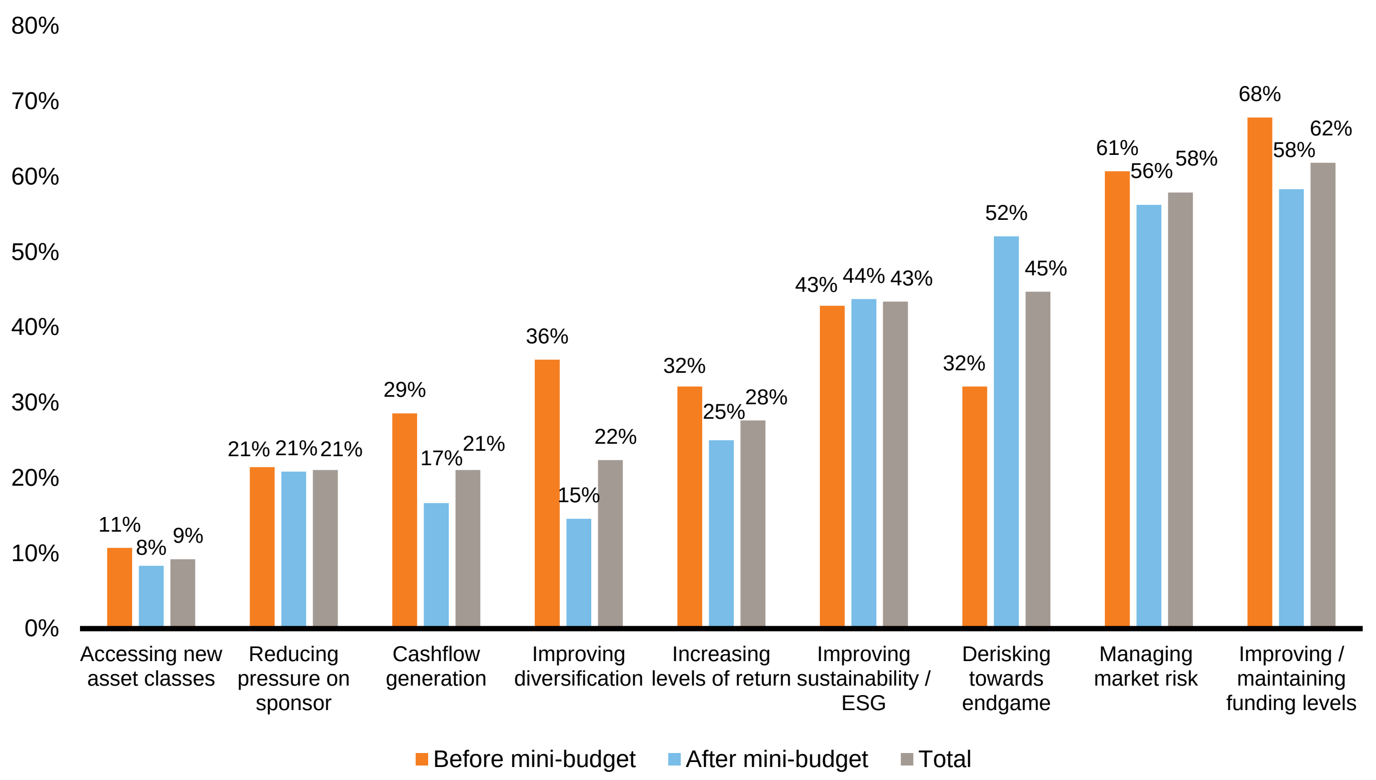
Pension Scheme Investment Manager

Interestingly, a number of themes that could be considered long-term challenges - including climate change, regulation, fees and transparency - appear to be having limited impact on decision-making, suggesting a clear focus on more immediate priorities. Concerns over COVID-19 and a possible new strain are also muted. This appears to be due to pension schemes focusing on other issues and potentially an acceptance that future waves of infection may become common, but more manageable.

[1] Bank of England: Monetary Policy summary and minutes of the Monetary Policy Committee meeting (https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2022/november-2022), 3 November 2022.
[2] Dan Burns and Anne Saphir, Reuters: Fed officials worried more about doing too little on inflation than too much (https://www.reuters.com/markets/us/fed-officials-worried-about-ending-inflation-battle-prematurely-minutes-show-2022-10-12/), 12 October 2022.

Changing priorities of defined benefit pension schemes

Exhibit 3: Respondents' current investment priorities (before/after mini-budget of 23 Sept 2022)



Source: Russell Investments, November 2022.

Pension schemes' priorities appear to have shifted in response to the UK government's mini-budget statement. The impact of the Truss government's plans were widely felt[3], with sterling falling to record lows versus the US dollar and a huge sell off in UK gilts, forcing unprecedented Bank of England intervention.

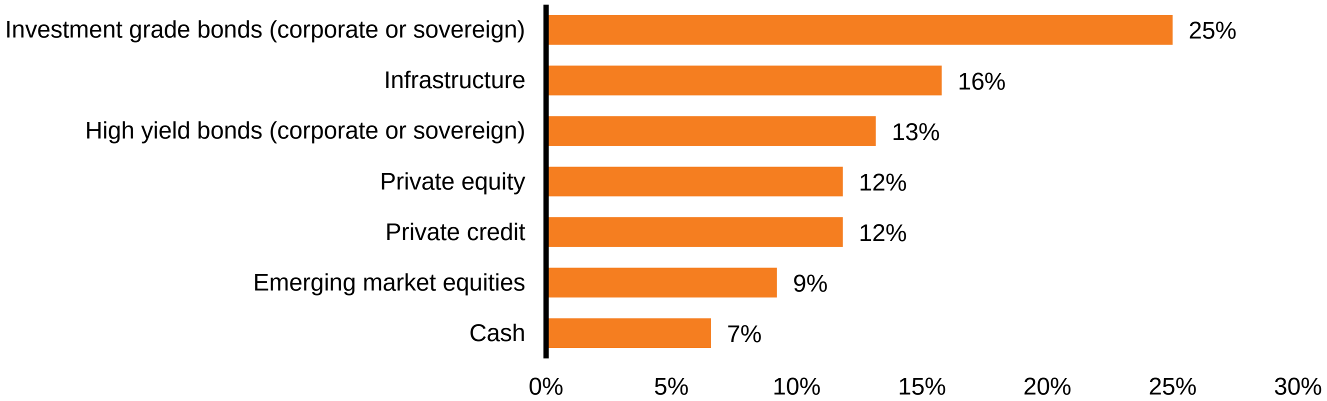
The upheaval of recent months has been reflected in changes in pension schemes' priorities, with responses following the mini-budget indicating a much greater focus among DB pension schemes in de-risking towards 'endgame'. The proportion of respondents identifying this as a priority increased by 20% following the UK government statement while other key priorities such as managing risk and improving funding levels fell back by 5% and 10% respectively.

Rising interest rates and actions taken by central banks – in this case the Bank of England – have been a critical consideration for trustees and sponsors throughout 2022. Rapid increases have caused significant improvements in funding levels, moving schemes to think about 'endgame' planning much sooner than they might have expected.

> "The endgame strategy is such that previous strategic planning reports need to be ripped up!"
>
> *Pension Scheme CEO*

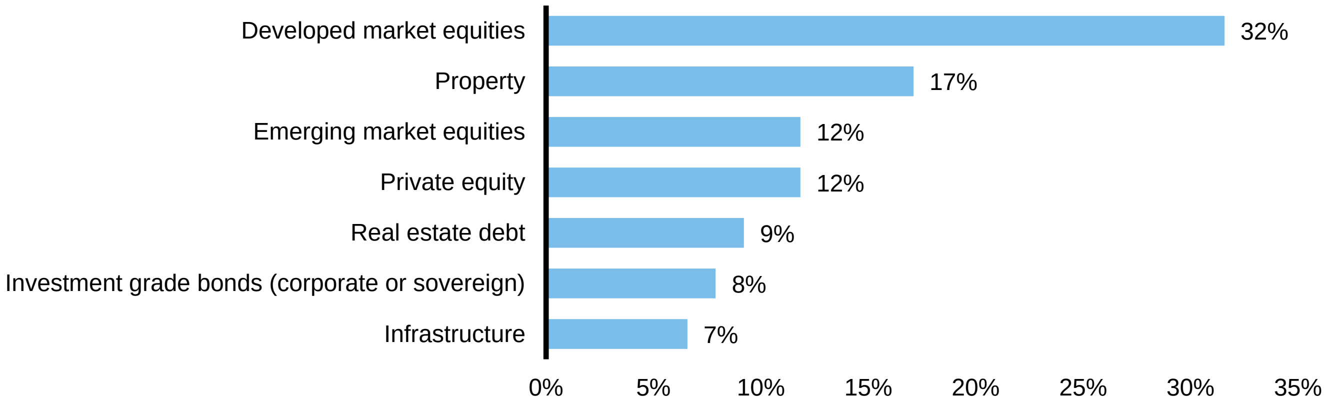
[3] Keith Fray, Carolina Vargas, Kevin Wilson, Charlotte Middlehurst, Sam Joiner, The Financial Times, How the markets broke 'Trussonomics' (https://www.ft.com/content/156682c1-1fb9-42d1-aac3-de531e266d68), 22 October 2022.

Exhibit 4: Expected increased asset allocation exposure over the next 12 months



Source: Russell Investments, November 2022.

Exhibit 5: Expected decreased asset allocation exposure over the next 12 months



Source: Russell Investments, November 2022.

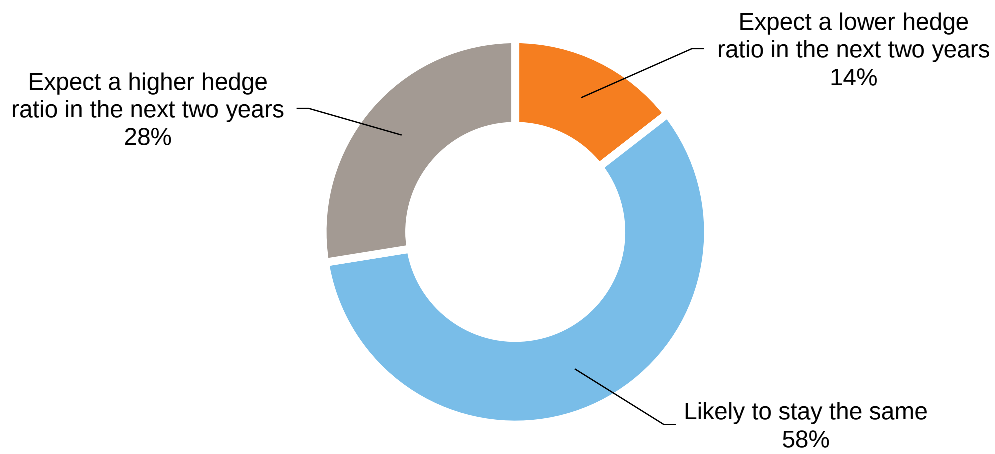
> "A comprehensive return seeking asset allocation that is well diversified is what is required, and this certainly includes illiquid private markets… Infrastructure, property, alternatives and full global diversification as well as a levelling up agenda is key."
>
> *Pension Scheme Investment Manager*

This is now being reflected in asset allocation decisions of respondents, with moves away from developed (32%) and emerging market equities (12%), as well as property (17%) exposure. Investment grade (25%) and high yield credit (13%) appear to be beneficiaries of this trend, as do infrastructure (16%) and private credit (12%), reflecting broad de-risking away from equity and the perceived attractiveness of the risk/return opportunities available in these asset classes.

Defined benefit hedge ratios expected to remain the same

Despite the challenges that pension schemes have faced in recent times, there appears to be little appetite to adjust liability hedge ratios in the current climate. The average hedge ratio of our respondents was around 75-80% of assets, and more than half of those surveyed expect to retain their current hedge levels over the next two years.

Exhibit 6: Current expected changes to hedge ratios in the next two years



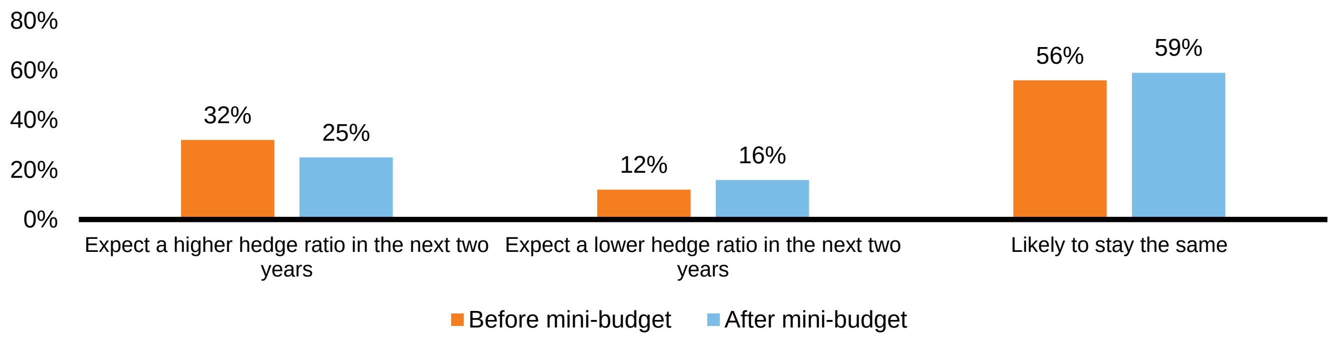
Source: Russell Investments, November 2022.

Whilst there was significant short-term distress in the gilt market caused by the UK mini-budget in September, and subsequent questions raised over the effectiveness of liability-driven investment (LDI) strategies, it appears this has had little or no impact on pension schemes' hedging intentions. Indeed, there appears to be a stronger intention amongst schemes to maintain their current course. However, this is not to say that questions over hedging approaches are not being asked, with several respondents expecting this to be assessed at an industry level in the aftermath of the mini-budget crisis. Some schemes that have been forced to reduce their hedges to maintain expected return levels may also feel the need to evaluate their approach.

"Short-term, everyone will be looking at LDI very closely and there may even be a Regulatory Review. Also, there will be differentiation amongst Fiduciary Managers – which did well, which didn't and how was the client hand holding during this unprecedented period…"

Pension Scheme CEO

Exhibit 7: Expected changes to hedge ratios in the next two years (before/after mini-budget of Sept 2022)

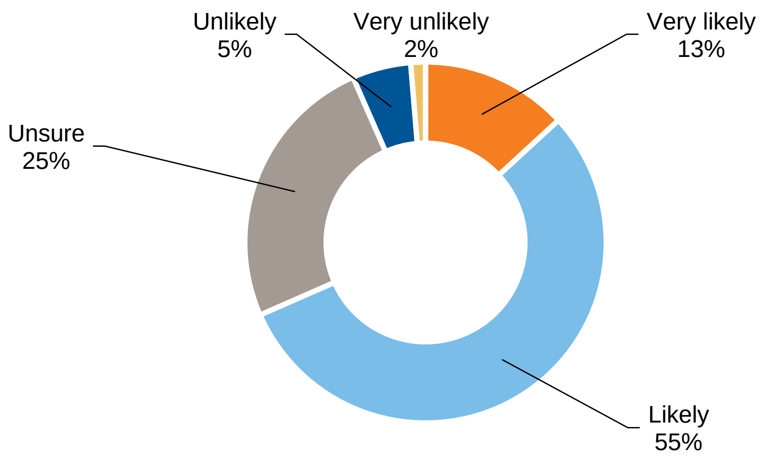


Source: Russell Investments, November 2022.

An increased focus on climate change

Climate change has long been a major focus for institutional investors, becoming synonymous with the investing lexicon and increasingly driving ESG-related debates. This shows no sign of changing and, indeed, is likely to increase further as investors recognise the importance of tackling a critical issue to global society. Over two-thirds (68%) of DB schemes surveyed indicated that they were either 'likely' or 'very likely' to increase their focus on climate change related issues in the next twelve months.

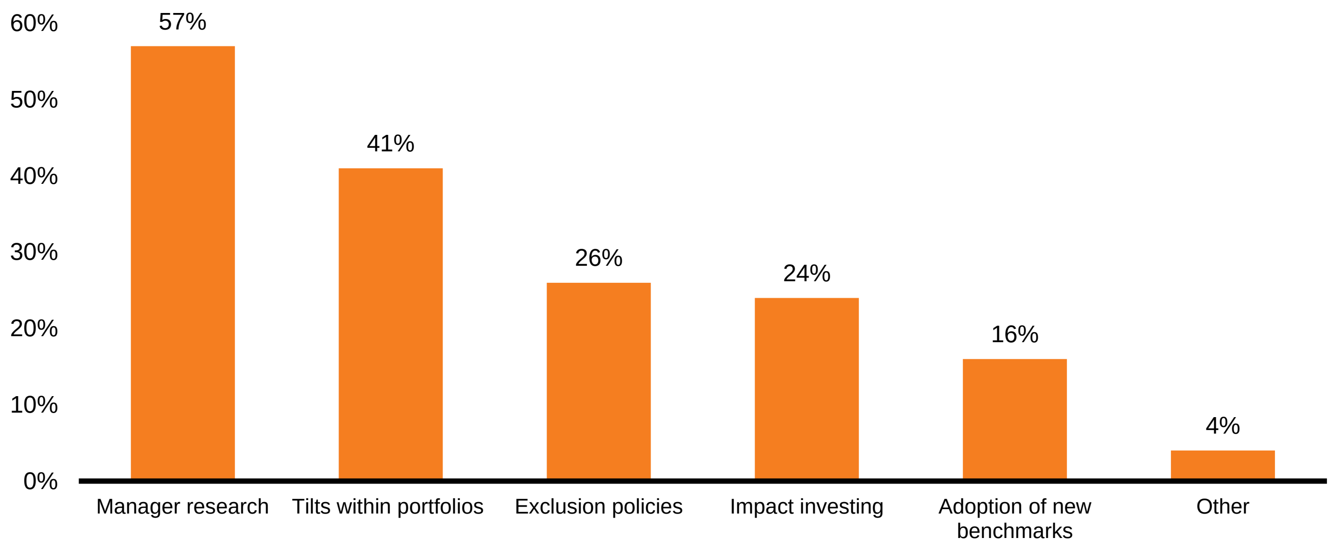
Exhibit 8: Expected focus on climate change in the next 12 months



Source: Russell Investments, November 2022.

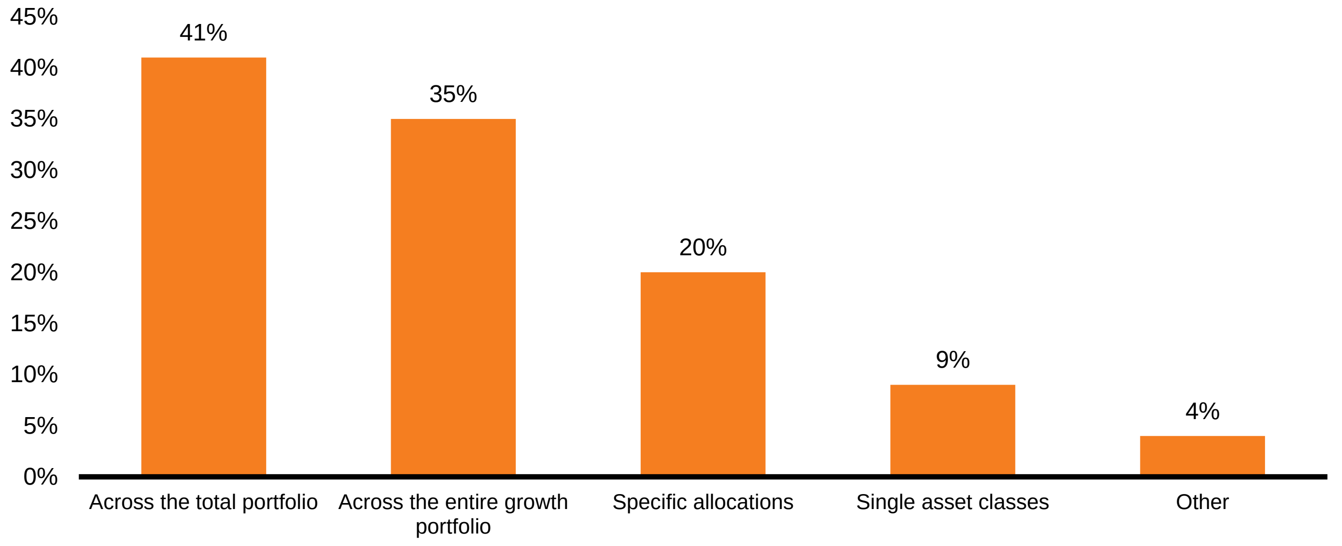
This includes the use of scenario analysis to consider climate change risks and discussion of climate change policy with the advisors and managers that schemes employ. Incorporating climate change criteria into manager research and selection appears to be the most popular approach by DB pension schemes, with only a limited number employing explicit exclusion policies or applying tilts within their portfolios to meet their climate change goals. Our research also indicates that where sustainability is being incorporated, it is being done across portfolios as a whole rather than via specific allocations.

Exhibit 9: Respondents' means of incorporating sustainability into portfolios



Source: Russell Investments, November 2022.

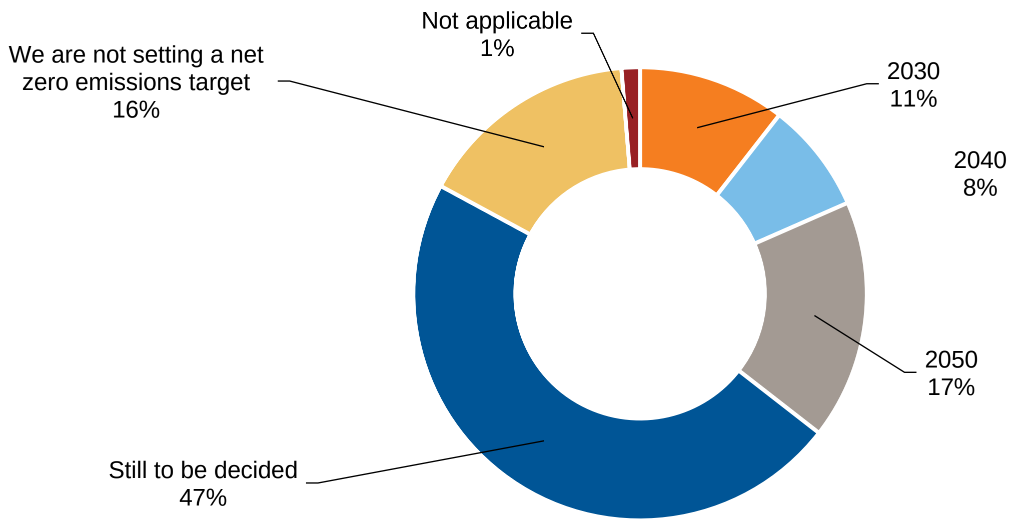
Exhibit 10: Respondents' application of sustainability into portfolios



Source: Russell Investments, November 2022.

Further evidence of the importance of climate change to DB pension schemes can be seen in the setting of net zero targets, with 36% of respondents having already set a target of 2050 or earlier, 47% are in the process of considering their approach while only 16% have decided not to set any target.

Exhibit 11: Respondents' targets to reach net zero



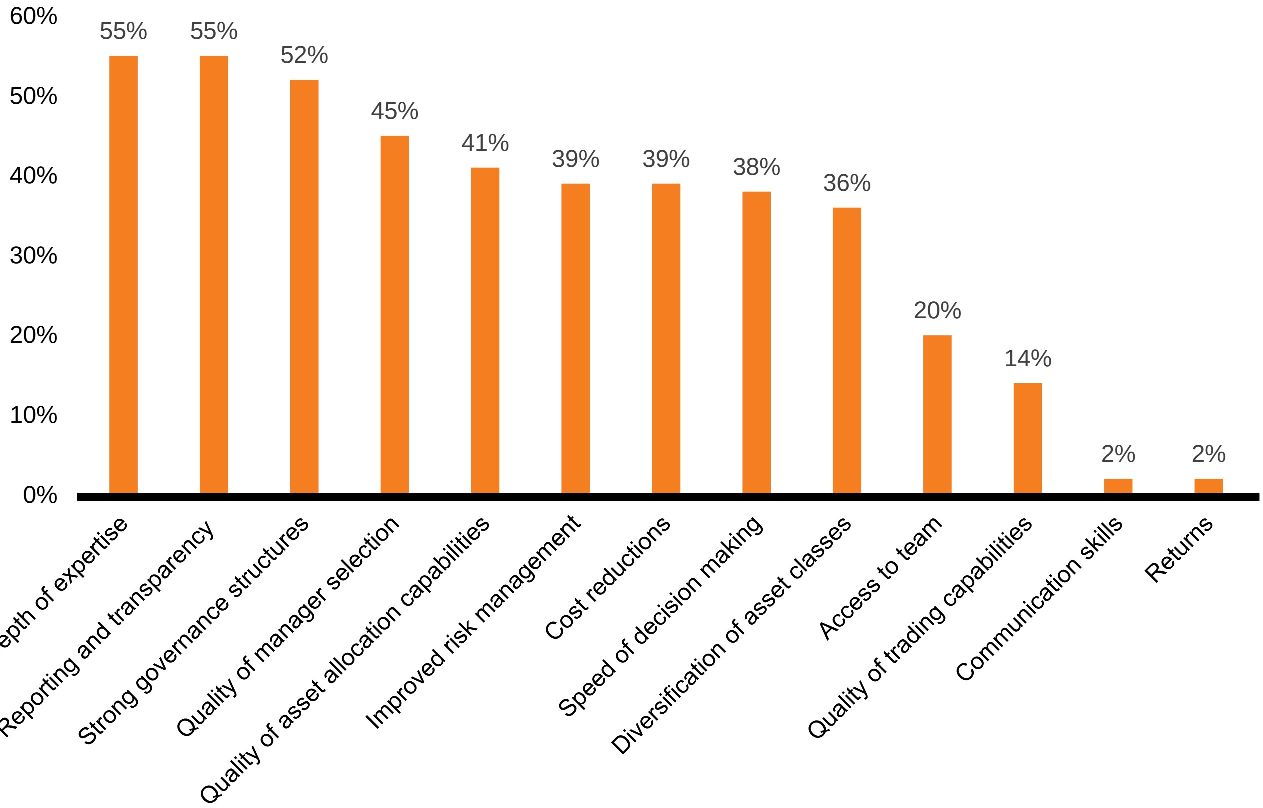
Source: Russell Investments, November 2022.

Utilising outsourced support

The trend towards DB schemes utilising the support of outsourced providers is well-established, with various independent studies showing growth in both the number of tenders and volume of assets managed by outsourced providers[4].

55% of respondents to our study identified the desire to access a greater depth of expertise as a reason for employing an outsourced investment support. In addition, respondents also value the structure that fiduciary management and OCIO services provide – in terms of greater governance and improved reporting and transparency. This indicates a clear preference towards improving decision-making and accountability.

Exhibit 12: Respondents' reasons for employing an outsourced investment provider



Source: Russell Investments, November 2022.

An important consideration in the use of outsourced providers, aligned to the need for improved governance structures, is the regulatory demands that schemes face. Respondents, particularly those responsible for smaller sized schemes, noted the challenges posed by this, the extent to which regulation volume was becoming a concern and what this meant in the context of ensuring that good governance structures are in place. This potentially indicates further growth in the use of fiduciary management and outsourced support, which we will continue to monitor in our 2023 UK DB market studies.

> "Regulation, regulation and yet more regulation is a major concern, the analogy of a 'sledgehammer to crack a nut comes to mind'. It is counter-productive and expensive for a small scheme."
>
> *Independent Trustee*

[4] IC Select: Fiduciary Management Market Survey https://www.ic-select.co.uk/media/attachments/2022/09/08/ics-fm-survey-report-2022-final.pdf), September 2022.

Summary

A number of clear and immediate challenges face the UK defined benefit pensions market in the coming months, spurred on by continuing high levels of inflation which is proving longer lasting than many commentators predicted at the beginning of this year. Paradoxically, however, rising interest rates – being used by central banks to combat inflationary threats – have left schemes in a different and potentially better funding position than they might have expected, encouraging many to consider de-risking towards the ‘endgame’ at a more rapid pace.

Time will tell as to the durability of this environment. However, it is clear that pension schemes will have to consider all aspects of their investments – including objectives, strategy and governance frameworks – very carefully in the short to medium-term if they are to continue on the trajectory to meet their long-term goals.

FOR MORE INFORMATION

Visit russellinvestments.com/dbresearch.