

Adapting to a changing investment world

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Seven key considerations following recent Covid-19 regulatory guidance



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On 15 January 2020, China and the US signed a breakthrough “Phase One” deal to halt their long-running trade war and ease one of the largest geopolitical risks facing global financial markets. At that point most asset classes looked set to continue to rise until ... well, we all know what happened. The Covid-19 pandemic swept the world, we’re in the midst of another global financial crisis and the relationship between both countries has strained again. How quickly things can change. Four months on and many defined benefit (DB) pension schemes have experienced collapsed funding levels due to plummeting gilt yields and investment markets

Every crisis brings change, and with change comes opportunity. On 27 March, the Pensions Regulator (TPR) responded to the crisis by publishing its Covid-19 guidance to trustees, and public service scheme representatives, in relation to funding and investments. The guidance highlights some good practice ideas in relation to managing investment risks and taking advantage of opportunities from market dislocations.

This note summarises the key investment aspects of TPR’s guidance and explains what it could mean for UK DB pension schemes.

Covid-19 investment-related guidance

Most DB pension schemes have been de-risking in recent years so falls in funding levels may not have been as bad as expected. But, for some schemes, particularly those with low levels of hedging (of their assets or liabilities) and significant allocations to ‘risk’ assets, those falls will have been very significant. Market uncertainty will continue for some time as the effects of Covid-19, and central government policy responses, feed through and measures to gradually ease lockdown start to materialise.

DB pension schemes generally have long-term investment horizons and many trustees and employers will have the ability to trade through the current challenging market conditions. However, there are some significant short-term risks for all schemes, and medium to long-term risks for schemes where the employer’s longer-term prospects will be challenged.

TPR’s 12 recommendations to trustees in relation to investments can be summarised under the following five areas. Trustees should:

1. Review their scheme’s cash inflows and outflows, how they might vary, and how they expect pension obligations to be met over the short to medium term. They should allow for issues such as additional ‘cash strain’ arising from increased member movement, potential reduction in or suspension of deficit repayment contributions (DRCs), lower levels of investment income and investment ‘cash calls’.
2. Review and manage specific risks which may now exist within their portfolios or within their sponsoring employer’s business, e.g. concentrations of risk and/or exposures to deteriorating sectors/credits.
3. Review any previously agreed investment and risk management decisions due to be implemented in the future. This is to ensure they remain appropriate, efficient and do not introduce risks or crystallise losses.
4. Review their investment governance structures and delegations to ensure they can continue to function and make decisions in the event of trustee incapacity or absence.
5. Assess, following the recent performance of their scheme, whether they should make any changes to their investment and risk management governance framework, for example rebalancing requirements.

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Trustees should also be mindful of the opportunities that may have arisen from recent market dislocations. They should consider, with their advisers, how they might evolve their investment strategies or arrangements at an appropriate time. Some of these opportunities may involve:

- Value-enhancing investment opportunities
- Value preservation activities, for example through proactive management of deteriorating risks, or
- Risk transfer opportunities, where funding levels permit, through buy-in or buy-out activities.

While there is no specific asset class commentary in the recent Covid-19 guidance, it is reasonably clear that trustees should consider their cash-flow needs, any potential portfolio re-balancing changes and take advantage of investment opportunities from market dislocations.

Implied impact on demand for strategies and solutions

Hopefully trustees, employers and their advisers have integrated risk management frameworks in place that are flexible enough to cope with the impact of this severe economic downturn due to Covid-19. Schemes will be affected to a larger or lesser extent depending on their circumstances, and some may face significant challenges.

In our view, TPR's investment-related guidance for trustees will affect investment strategies in the following seven key ways:

- **Increased importance of implementing cash-flow driven investment (CDI) strategies.** These strategies offer many value-enhancing and value-preserving benefits to schemes facing additional 'cash strains'. These benefits include enhanced security of returns, income generated to meet current or additional cashflow needs, and potentially reduced funding level volatility.
- **Rising demand for liquid cash-flow / income-oriented strategies and solutions.** Trustees need to stress-test their incoming and out-going cash-flows to assess how this might have changed under recent market conditions. To meet any shortfalls in income, they could potentially take advantage of opportunities from market dislocations in secured finance, high yield credit, multi-asset credit and investment grade credit managed on a buy and maintain basis.

- **Increased focus on liquidity within fixed income markets.** Trustees and representatives of public sector schemes can take advantage of some outstanding opportunities emerging from periods of illiquidity in credit markets. But this needs to be weighed up against the severity and duration of this economic downturn.
- **Opportunities to review short-dated liquidity portfolios.** It would be helpful to review portfolios positions that are used to service changes in cash-flow requirements including collateral calls and pension payments. This review could result in value-enhancing opportunities – such as taking a modest amount of additional risk and investing in shorter dated credits.
- **Journey plans need to be reviewed.** De-risking plans enable trustees to demonstrate a plan for investment risks to decrease over time as funding levels, or investment opportunities, improve and there is less visibility of the strength of the employer covenant. End-game targets might also need to be reviewed. Any value-preserving de-risking activity should include pursuing low-risk income-generating strategies, for example CDI and LDI solutions.
- **ESG will become more prominent.** ESG companies have shown better risk-adjusted returns during the recent downturn. DB schemes that invest in strategies with an integrated ESG approach, geared towards enhancing returns and reducing risks, are more likely to outperform over the long term.
- **Improved dynamism in managing portfolios.** Trustees should review, and improve where appropriate, their current investment and risk governance arrangements. This will help investment and risk management decisions to be made quicker and more effectively. Options include forming an additional sub-committee that meets and expedites decisions regularly, appointing a fiduciary manager and speaking more frequently with their in-house investment teams and external asset managers.

There is no one-size-fits-all in relation to the above points. However, these changes can be meaningful for schemes, will require careful consideration and, in time, action, for many.

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