XPS Investment

Investment briefing

May 2022

Is your pension scheme better funded than you thought?

Since the start of the year we've witnessed a complex and volatile market environment. The substantial movement in equity markets, credit markets, inflation and interest rates have led to a huge dispersion of impacts on schemes in different situations.

For some, the particular combination of factors have contrived to create a perfect opportunity to take steps to de-risk. In this note we highlight the nature of these developments and schemes most likely to have found themselves in this fortunate position.

Key findings

- **Equity and credit markets have suffered meaningful losses** since the start of the year and inflation has risen.
- **Gilt yields have risen by 1.3%** since their recent trough in December 2021, the sharpest increase since 1994, positively impacting some pension funding levels despite other headwinds.
- Some schemes will have witnessed **funding improvements in the order of 5% to 10%** since the start of the year whilst others a **deterioration of up to 8%.**
- Insurance pricing for full scheme buyouts is currently the **most attractive it has been for a decade.**

Now is the time to check to see if your scheme is better funded than you thought and if there are steps you can take to de-risk.

Long dated gilt yields have been rising at a rate and extent that has not been witnessed in almost 30 years. This presents a significant opportunity for some schemes to de-risk.

Simeon Willis
Chief Investment Officer

Since the start of 2022 we have witnessed a challenging environment for investors:

- **Equities markets down 9%** from the first trading day of 2022 global equity markets started to fall, having spent the prior 21 months resiliently climbing against a backdrop of COVID-challenged economies.
- **Credit has suffered**, with investment grade credit spreads rising by 0.6% since the start of the year, along with notable spread rises in the high yield markets too.
- **Long term inflation expectations rose** in the first quarter but have subsequently declined to only be slightly higher than where they started the year

This would seem to paint a bleak backdrop for the majority of pension scheme funding levels save for one other key development – a striking rise in long dated gilt yields which have been rising at a rate and extent that has not been witnessed since 1994.

The implications for a scheme's funding level is very dependent on their funding position, investment strategy and hedging approach.

The average scheme would have witnessed an estimated improvement of 5% over this period. However schemes with relatively low levels of equity assets and relatively modest levels of hedging will have performed best since the start of the year.

Some schemes will have experienced funding level improvements of 10% or more since the start of the year.

The heat map below shows an estimate of how different schemes will have been impacted by the market movements from 31 December 2021 to 20 May 2022.

Equity allocation (assumes 30% in LDI and remainder in corporate bonds)

LDI hedging level (% liabilities)	0%	10%	20%	30%	40%	50%	60%	70%
100%	2%	0%	-1%	-3%	-4%	-6%	-7%	-9%
90%	4%	2%	1%	-1%	-2%	-4%	-5%	-7%
80%	6%	4%	3%	1%	0%	-2%	-3%	-5%
70%	7%	6%	4%	3%	1%	0%	-2%	-3%
60%	9%	8%	6%	5%	3%	2%	0%	-1%
50%	11%	9%	8%	6%	5%	3%	2%	0%
40%	13%	11%	10%	8%	7%	5%	4%	2%
30%	15%	13%	12%	10%	9%	7%	6%	4%
20%	16%	15%	13%	12%	10%	9%	7%	6%
10%	18%	17%	15%	14%	12%	11%	9%	8%
0%	20%	18%	17%	15%	14%	12%	11%	9%

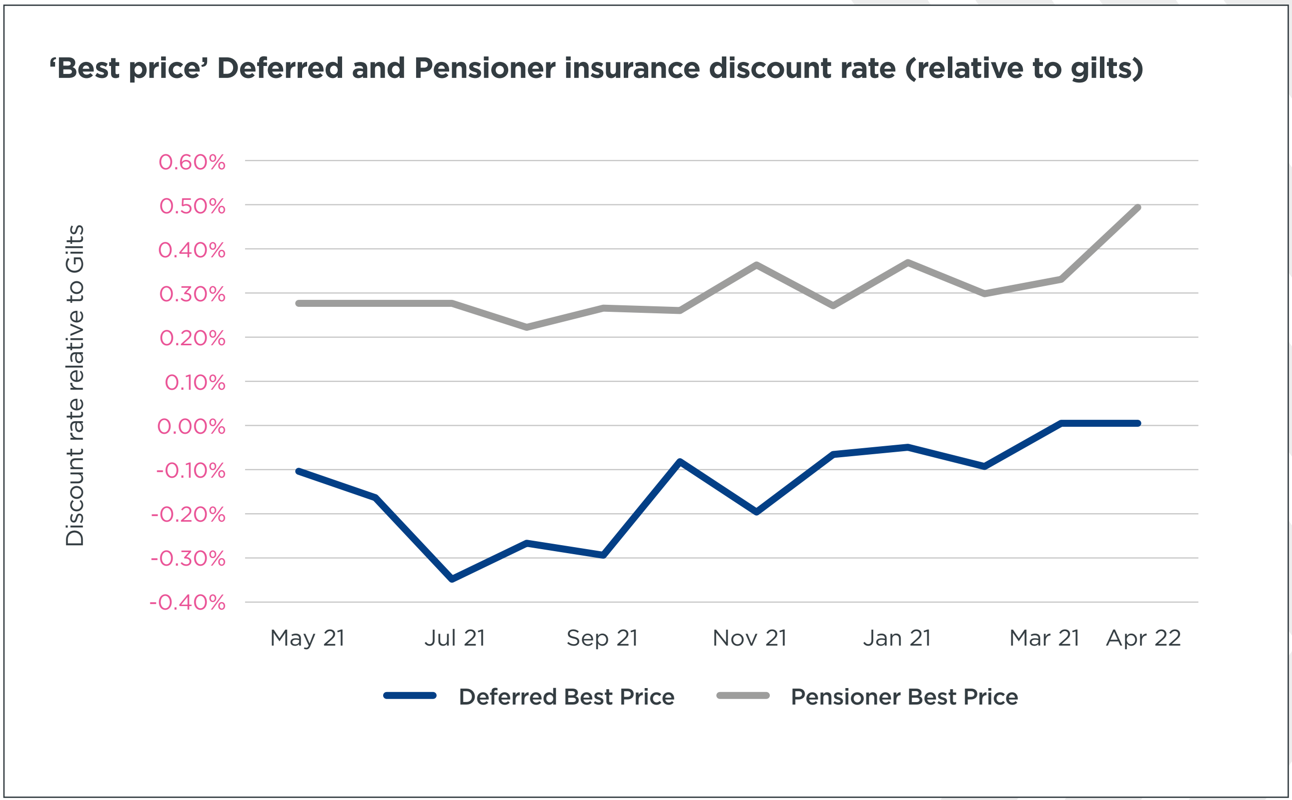
Source: XPS calculations. The analysis assumes that 30% is invested in cash or gilt assets, and the remaining assets are invested in a mix of either global equities or all stocks corporate bonds with interest rate and inflation hedging applied to the given % of liabilities proportionally across all liabilities. The assumed starting funding position was 91% on a Gilts + 0.5% basis, sourced from XPS UK:DB estimated funding position of aggregate UK pension schemes. Please note this analysis is for guidance only and some illustrated portfolios will be difficult to achieve in practice.

An opportunity within the insurance market

Rising gilt yields and credit spreads are both components in insurance market pricing. The rise of both has positively impacted insurer pricing for bulk annuity transactions. But that's not the full story as these improvements have further been compounded by the following:

- Insurers' reporting a good pipeline of illiquid and long duration assets – a key driver in pricing non-pensioner liabilities
- Improvements in reinsurance pricing
- Competition in the market, after a relatively slow start to 2022

The chart below illustrates XPS's estimates of best buy-in pricing for pensioner and deferred members.



Source: XPS estimates based ongoing interaction with insurance market

Insurance pricing has improved meaningfully for both pensioner and deferred liabilities.

For some schemes, the "stars have aligned" with buyout funding positions improving significantly. Indeed, lots of schemes at the start of the year were working through a 5 year journey plan to buyout which has now turned into a 1 or 2 year plan.

However, as always, it's important for these schemes to be well prepared before approaching the insurers as they will need to be attractive and stand out to insurers in what could be a very busy market.

Actions trustees can take

- **Review your latest funding position** (e.g. using XPS's RADAR tool)
- **Consider:**
  - if there is scope to increase your liability hedging to take advantage of pricing;
  - if being ahead of your journey plan creates scope to reduce the exposure to risky assets whilst staying on track for your long term target;
  - if there is a role for buy-in or buy-out in your long term strategy and check current insurer pricing, and if appropriate look for ways to position you scheme to be 'transaction ready' in time.

Past experience tells us that opportunities to de-risk don't last forever.

If you would like to discuss what this could mean for your scheme in more detail please contact **Simeon Willis, Stephen Purves** or your usual XPS contact.

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