July 2019

XPS Investment News

Bringing you the latest investment news, insights and opinion from across the pensions industry

In brief

- Global equity markets rally over June
- Geopolitical risks in the Middle East led to increases in the price of oil and gold over the quarter
- The funding level of a typical pension scheme has stayed relatively flat over the quarter

Key considerations for trustees

- Have you got a longevity risk management plan?

Alan Greenlees
Senior Investment Consultant

Equity markets bounce back

Following a tough May for equity markets they bounced back strongly to rally over June, returning double digits year-to-date.

The US Federal Reserve and European Central Bank decided against cutting interest rates at their respective June meetings, but signalled a willingness to do so should the global outlook not improve. These dovish signals from central banks continue to support growth markets and developed market 10 year government bond yields remain very suppressed. The Monetary Policy Committee also held rates primarily to keep its options open.

Uncertainty remains around the outcome of ongoing US trade disputes although they appear to be in a more favourable position than they were at the start of June. A deal was made with Mexico, putting a halt to Trump's sudden and unexpected threat to impose tariffs on all Mexican imports into the US. Also, the US president and China's President Xi Jinping reached an agreement to resume trade talks. However the outcome remains highly unpredictable.

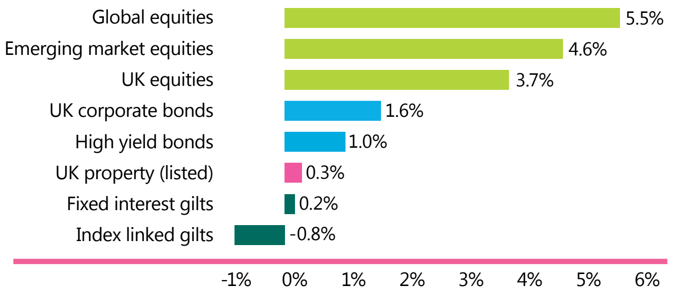
Geopolitical risks in the Middle East stepped up another notch over the month. Iran is being accused of attacks that severely damaged two oil tankers and they also admitted to shooting down an American surveillance drone. This contributed to an increase in the price of Brent Crude oil and also acted as a catalyst in the rally of gold.

Ten candidates have become two in the race to replace Theresa May as Prime Minister. The results of a postal ballot of party members will be announced in the week beginning 22 July. Both candidates are in favour of making changes to the Withdrawal Agreement negotiated by May (although the EU firmly stated when extending the UK's leaving date that there can be no re-opening of the withdrawal agreement).

Large falls in gilt yields over the quarter were matched by strong growth asset performance, meaning that the funding level of a typical pension scheme would have stayed relatively flat over the quarter.

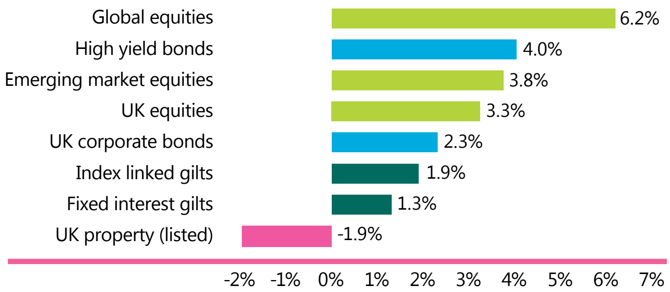
Click to watch
Alan's Market Overview

1 month to 30 June 2019

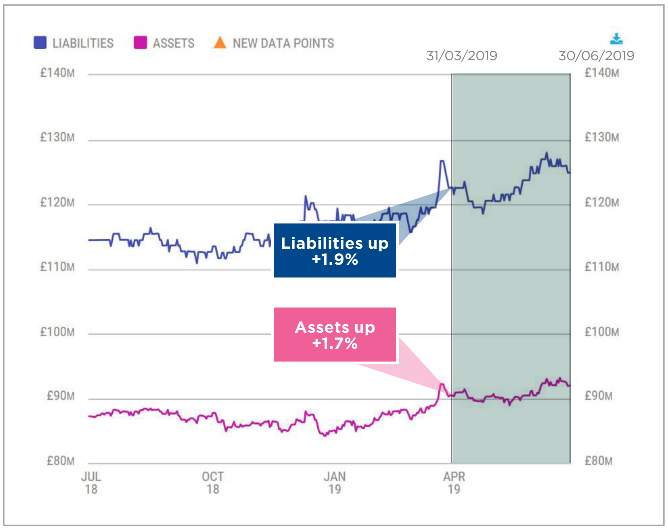


Source: Refinitiv

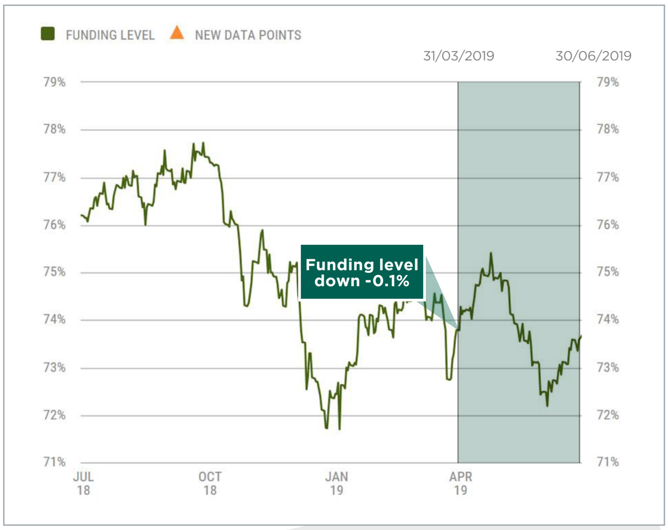
3 months to 30 June 2019



Source: Refinitiv



Source: XPS Radar



Source: XPS Radar

The typical scheme used has an assumed asset allocation of 27% equities, 34% corporate bonds, 11.6% multi-asset, 4.8% property and 25% in liability driven investment (LDI) with the LDI overlay providing a 50% hedge on inflation and interest rates. This example scheme was 80% funded in 2015.

XPS Investment Asset Class Views

Asset class	Favourable	Neutral	Unfavourable	Movement
Developed equities			●	
Emerging market equities		●		
Investment grade corporate bonds (UK)		●		
High yield bonds (global)			●	
Property (UK)			●	
Private markets		●		
Equity option strategies		●		
Pensioner buy-in		●		↓

Longevity special:
Finding a home for longevity risk

Longevity risk has historically been seen as an inherent part of running a pension scheme. But innovation in the market has changed this and getting a grip on longevity risk is no longer the preserve of large sophisticated schemes.

In this note we highlight how longevity risk can be managed within the same framework as investment decision making, much like Liability Driven Investment. When done well, this can lead to lower risk and a smoother path to the long term funding target.

What is longevity risk?

Longevity risk is the risk that pension scheme members live longer than expected.

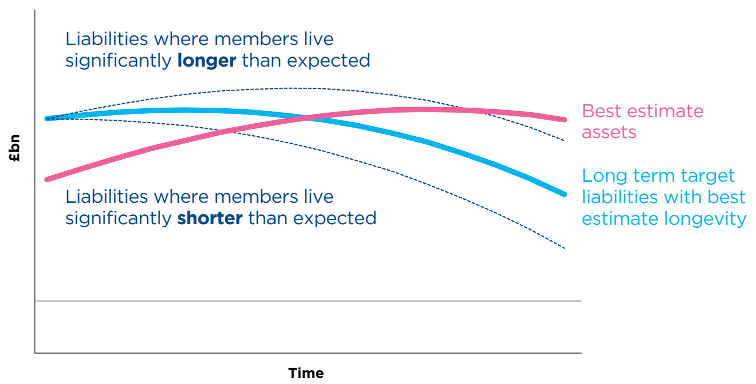
Pure longevity risk is a combination of three elements:

Key aspect of longevity risk	Explanation	Schemes particularly affected
1. Base risk	Risk arising from the characteristics of a scheme's membership not being precisely reflected in the actuarial assumptions	Smaller sized and immature schemes
2. Trend risk	Uncertainty associated with predicting future improvements in life expectancy across the population	All scheme sizes particularly immature schemes
3. Idiosyncratic risk	The risk your scheme experiences lower than expected deaths purely due to randomness and small sample size	Smaller sized schemes or those with concentration of liabilities in a few members
There is a fourth risk which is not directly related to actual longevity but is closely connected as it relates to how predictions change over time:		
4. Measurement risk	Changes to forward looking longevity assumptions in light of new actuarial techniques and information	All schemes are impacted but schemes that update their assumptions triennially may see a bigger impact compared to annual updates

Bringing longevity risk into the frame

Trustees are familiar with the concept of setting a risk budget for their scheme and looking to diversify sources of return within their investment portfolio. Is it possible for pension schemes to apply this rationale to managing longevity risk?

Journey plan projection with different longevity scenarios



Members living longer than expected can materially increase the length of a journey plan. The graph opposite illustrates how the uncertainty around how long members will live significantly impacts the time taken to achieve its target.

Over the last 20 years the life expectancy for an average person in the UK has increased from 77 to 81 years old. However, this is very much a story of two halves and from 2012 onwards the observed rates of improvement have significantly slowed.

The effect of this is that as updates to longevity forecasts are released a typical pension scheme's funding level will have improved.

Longevity risk is normally measured over the lifetime of a scheme (e.g. a lifetime Value at Risk), compared to other risks which are often measured over one or three years. It is therefore more difficult to draw comparisons between longevity risk and other risks such as investment, interest rate or inflation.

What is the true cost of hedging longevity?

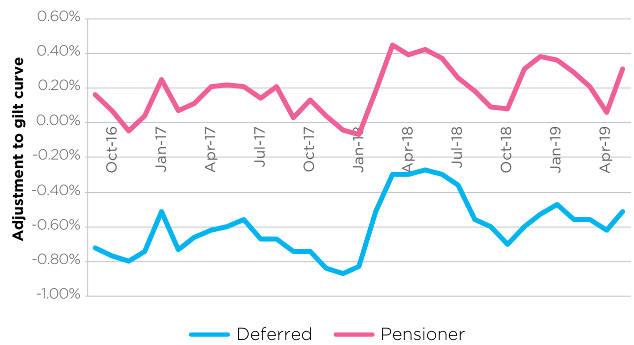
Longevity risk is unusual because it isn't a rewarded risk in the traditional sense but there can often be a cost to remove it. For example when the risk is hedged with a longevity swap a more conservative life expectancy assumption typically increases the expected benefit cashflows by between 5% and 8%. This cost means longevity risk can often be considered as being rewarded for the purpose of decision making – i.e. you don't incur the cost if you retain the risk.

However, this doesn't in itself undermine the case for removing or hedging some or all of your longevity risk. This is the same principle as is employed in an efficient investment strategy which will seek to diversify return drivers rather than put all of the eggs in one basket. To complicate matters further, some ways of managing longevity risk do not involve cost at all. For example some member option-based approaches implicitly reduce longevity risk whilst improving a scheme's funding level.

When using buy-in, longevity is one of several factors in the pricing. The buy-in pricing chart opposite shows the implied expected return relative to gilts of investing in buy-in which can fluctuate considerably over time. Buy-in pricing of pensioners often provides a return well above gilts, as is the case currently.

Therefore we need to break down the different sources of longevity risk in a scheme, understand the costs of removing them and weigh this up against the risk reduction this can offer.

Implied return from a buy-in (over gilts)

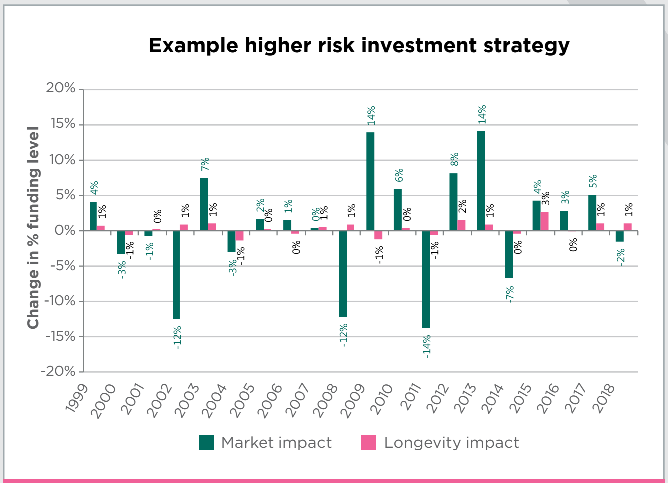


Longevity risk in context

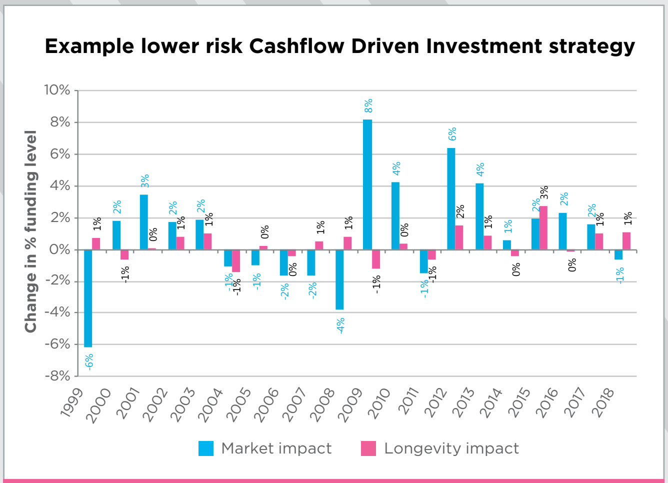
To build a full picture, longevity risk should be considered both in isolation and at an overall level to capture the dilution with other uncorrelated risks.

We have used historic scenario analysis to look at how the scheme's funding level would have been affected by market factors (including investment returns, interest rate and inflation) and compared alongside the impact longevity assumptions would have had on the funding level in each of the last 20 years.

The charts below illustrate the difference between the magnitude of longevity risk on two schemes, with higher and lower risk investment strategies:



In all years the market related impact exceeds the longevity impact by some margin. Average ratio of longevity impact to market impact 13%.



In several years the market related impact is overshadowed by the longevity movements. Average ratio of longevity impact to market impact 30%.

The impact of longevity is relatively more significant the lower the return target of the investment strategy. As most schemes are on a journey of de-risking, over time longevity risk will inevitably become progressively more material to overall risk.

The toolkit

There are a range of approaches that can be used to control and moderate the longevity risk a scheme is exposed to including:

Approach	Impact on longevity risk
Pension increase exchange	Removes longevity risk on future pension increases
Flexible retirement option	Members retiring early are offered flexible pensions which can often be front end loaded
Transfer value exercise	Longevity risk is completely removed for members who transfer
Partial buy-in	Longevity risk is removed for insured benefits
Longevity swap	Longevity risk is removed for benefits covered by swap
Consolidator	Longevity risk is completely removed

Further you can reduce the base and trend risks through using the latest approaches, such as member profiling, to better estimate your membership's characteristics. The more we understand about your scheme's membership the better we can reflect how long your members are living and how this may change in the future.

In summary

Historically pension schemes have seen managing longevity risk as being a matter of black and white, but the reality is more shades of grey.

An approach that seeks to start from the best estimate of your membership combined with a granular assessment of the different groups within the membership, taken in the context of the wider strategy, could unlock the means to better control future funding of your scheme.

To discuss any of the issues covered in this edition, please get in touch with Alan Greenlees or Simeon Willis:

Alan Greenlees
Senior Investment Consultant

t 0113 284 8048

e alan.greenlees@xpsgroup.com

Simeon Willis
Chief Investment Officer

t 0118 313 0700

e simeon.willis@xpsgroup.com

Alternatively, please speak to your usual XPS contact.

Events

Meeting TPR's requirements for Journey Planning and Long Term Funding Targets

9 July **Leeds**

DataRocks! Managing Data – A Practical Approach for Trustees, Employers and Pension Scheme Administrators

18 July **London**

Trustee Training: Funding, Covenant and Integrated Risk Management

24 Sep **London**

Trustee Training: Understanding LDI

17 Oct **London**

Annual Pensions Conference

3 Oct **London** 14 Nov **Leeds**

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