THE CHANGING ECOSYSTEM OF DEFINED BENEFIT PENSIONS

VOLUME 2 – SPRING/SUMMER 2023

russellinvestments.com/dbresearch

EMBRACE THE POSSIBLE™

Foreword

We have continued to see significant upheaval within the UK Defined Benefit (DB) pensions market in recent months. The changing landscape, primarily underscored by the continued impact of prolonged inflation and rising interest rates, has given trustees much to think about and in many cases forced decision-makers to confront situations they would not have anticipated even a year ago.

Increasing regulatory requirements, geopolitical concerns and ongoing considerations around environmental, social and governance (ESG) issues also cannot be ignored. We are now in arguably the most dynamic and changeable environment that the UK pensions sector has seen for a generation.

Understanding these dynamics and pressures is critical if decision-makers are to make the right choices in order to meet the needs of scheme members. It is with this in mind that we present the findings of Russell Investments' second UK Defined Benefit Market Insights study, a biannual series surveying senior decision-makers within the pensions world to gauge their expectations, priorities and concerns as they seek to meet the requirements of their stakeholders over the long term.

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

Simon Partridge

Head of UK Fiduciary Management

Contents

Key findings	3
Rising interest rates accelerate focus on de-risking towards endgame	4
A muted fallout from the LDI crisis for larger schemes	7
Inflation remains the number one concern, but with other issues on the horizon	10
Climate change focuses adapt in response to changing pension scheme circumstances	13
Regulation seen as a greater hurdle for schemes without outsourced support	15
Summary	17

Key findings

While improving and maintaining funding levels (60%) remains the most important priority for pension schemes, **there is a marked increase in the importance decision-makers are placing on de-risking towards endgame, rising by 11% in importance** since the previous iteration of this study in Autumn/Winter 2022.

Despite the initial fallout from the UK mini-budget and gilt market sell-off, the long-term impact of these events appears to be somewhat muted. 57% of respondents to this study report that their hedge ratios have remained the same despite gilt market volatility, while 73% expect to keep their current hedge ratio for the next two years.

Inflation and central bank policies (71%) remain the single biggest concern for pensions decision-makers in the next six months, with a slight increase in unease over geopolitical conflict (+7%). However, worries about the prospect of recession have receded notably, with just 28% of respondents identifying this as a concern compared to 54% in Autumn/Winter 2022.

While sustainability and ESG remain a priority for schemes generally, **improved funding levels and an acceleration towards endgame are impacting the extent to which pension schemes are able to focus on climate change,** with 41% unsure or unlikely to increase their focus on this area in the next twelve months.

Excessive regulation is seen as being the biggest challenge for DB schemes currently (49%). It was also cited as a significantly higher challenge for schemes currently not employing outsourced support, potentially reflecting the considerable demands on resource in meeting these requirements.

Survey methodology

The Russell Investments UK Defined Benefit Market Insights is based on the responses of 132 UK defined benefit schemes between March and May 2023. Those participating in the study are responsible for over £300 billion of assets under management in total, with more than half representing schemes with over £1 billion of assets. Respondents included scheme chief executives, CIOs, professional, company- and member-nominated trustees, and pension managers. Responses were collected via an online survey conducted by SurveyMonkey, with support from the Pensions and Lifetime Savings Association (PLSA).

To supplement our insights, Russell Investments also undertook detailed interviews with a focus group of senior decision-makers at 11 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.

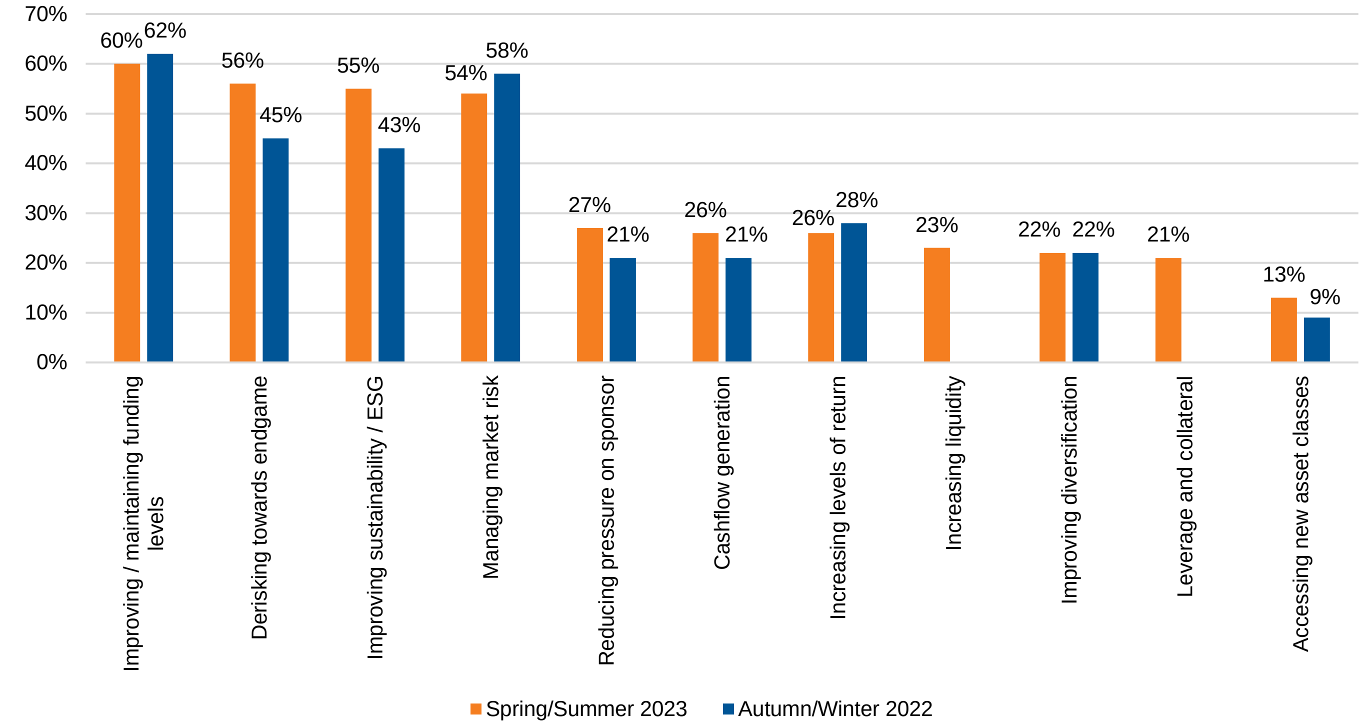
Rising interest rates accelerate focus on de-risking towards endgame

Continuing efforts by central banks to curb inflation, which has remained stubbornly high over the last twelve months, have continued to define the macroeconomic landscape. Policymakers remain committed to this course, with the Bank of England refusing to rule out further rises[1]. At time of writing, UK inflation had fallen to its lowest level for almost twelve months[2], but continues to be significantly above the 2% target set by the Bank of England.

The impact of rising interest rates has been felt strongly by pension schemes. While improving and/or maintaining funding levels remains the key priority for decision-makers, there is a marked increase of 11% in the proportion of respondents identifying de-risking towards endgame as a key focus.

> "We had been looking at time horizons that had stretched several years ahead…. The way the environment has changed has improved the funding position in a way that has potentially shortened that timeframe materially. The material shift has been adjusting our thinking to a rather different timeline and looking together with sponsors as to how we might accelerate the strategy that we already have in place."
>
> *Pension Scheme Chair of Trustees*

Exhibit 1: Current respondent investment priorities[3]



Source: Russell Investments, June 2023.

This increased focus ultimately reflects the substantial improvements that schemes have seen in their funding levels as a result of interest rate rises, with many in a position – considering the near-term prospect of buyout – that they might not have anticipated being in for a number of years.

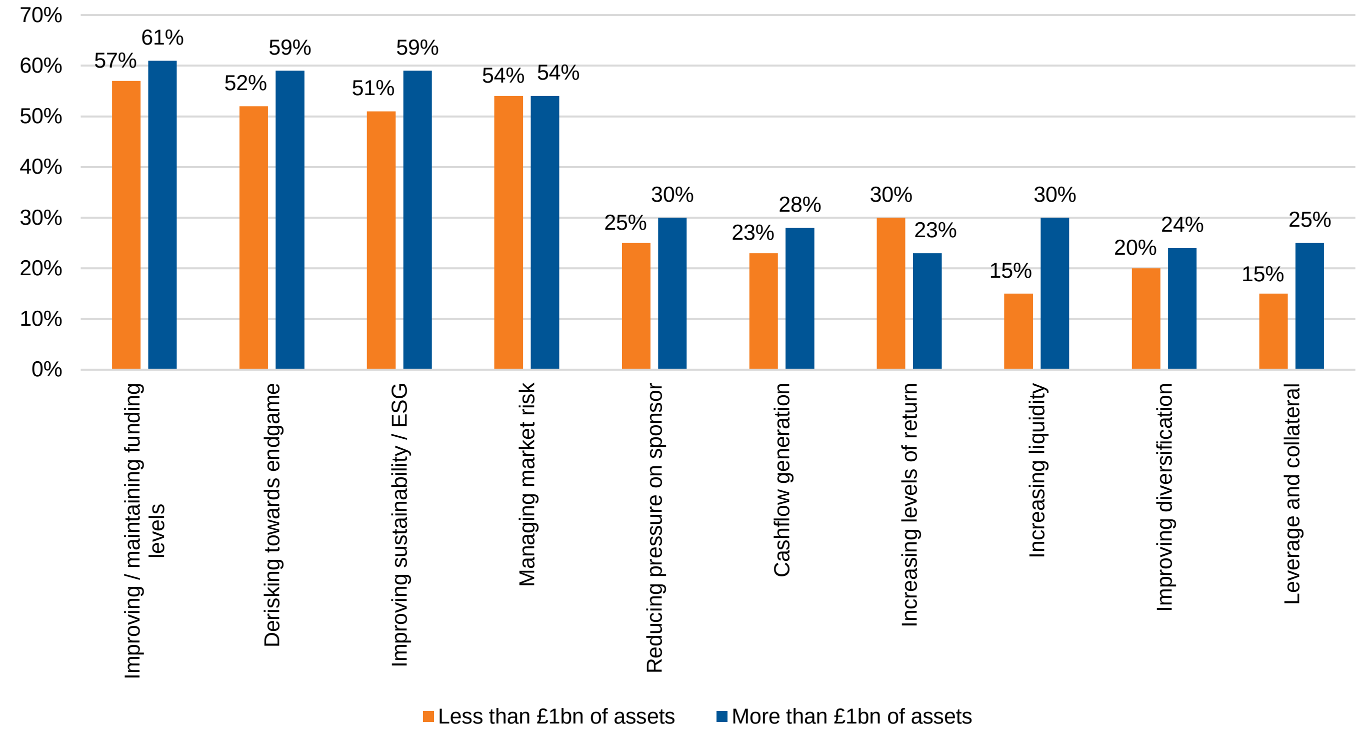
> "It's about alignment of the assets with whatever an insurer is going to want to take. We have some illiquid assets – what can we transfer, what can we sell and when? How do we make sure that the liquid assets are good to go whenever we want to? And how do we deal with collateral in that interim period, making sure we're not forced to sell anything an insurer would want purely to be collateral."
>
> *Head of Pension Investments*

[1] David Milliken and Andy Bruce, Reuters: Bank of England raises rates and Bailey promises to 'stay the course' (https://www.reuters.com/world/uk/bank-england-raises-rates-45-inflation-slow-fall-2023-05-11/), 11 May 2023
[2] BBC NewsUK inflation down to 8.7% but food bills still rising quickly (https://www.bbc.co.uk/news/live/business-65653791), 24 May 2023
[3] 'Leverage and collateral' and 'Increasing liquidity' are new additions to this survey, having not been measured in Autumn/Winter 2022

Reducing pressure on scheme sponsors and the importance of cashflow generation also increased noticeably in importance (by 6% and 5% respectively), while there is also a significant rise among decision-makers to improve sustainability and ESG (a priority for 55% of respondents compared to 43% in Autumn/Winter 2022).

To some degree, priorities do vary depending on the size of the scheme, with larger entities (those with more than £1bn of assets) showing a slightly greater focus on de-risking, improving or maintaining funding levels, improving sustainability and ESG, and, most notably, increasing liquidity. In contrast, smaller schemes show a greater focus, relative to their larger peers, on increasing levels of return.

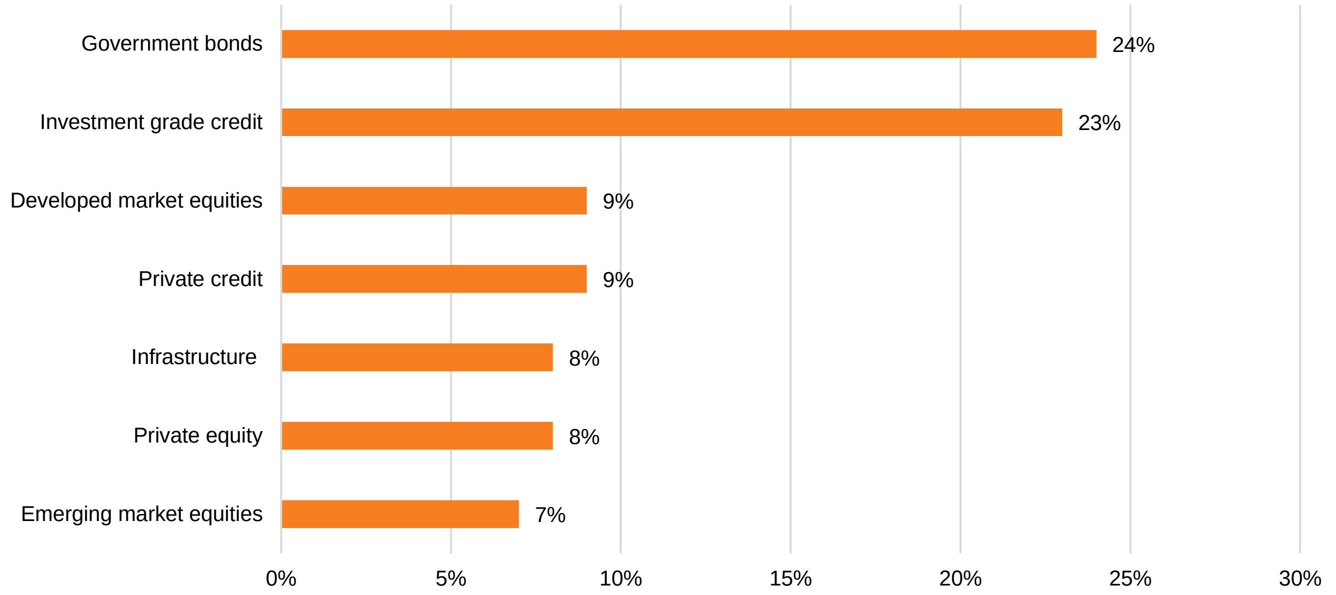
Exhibit 2: Investment priorities by size of pension scheme



Source: Russell Investments, June 2023.

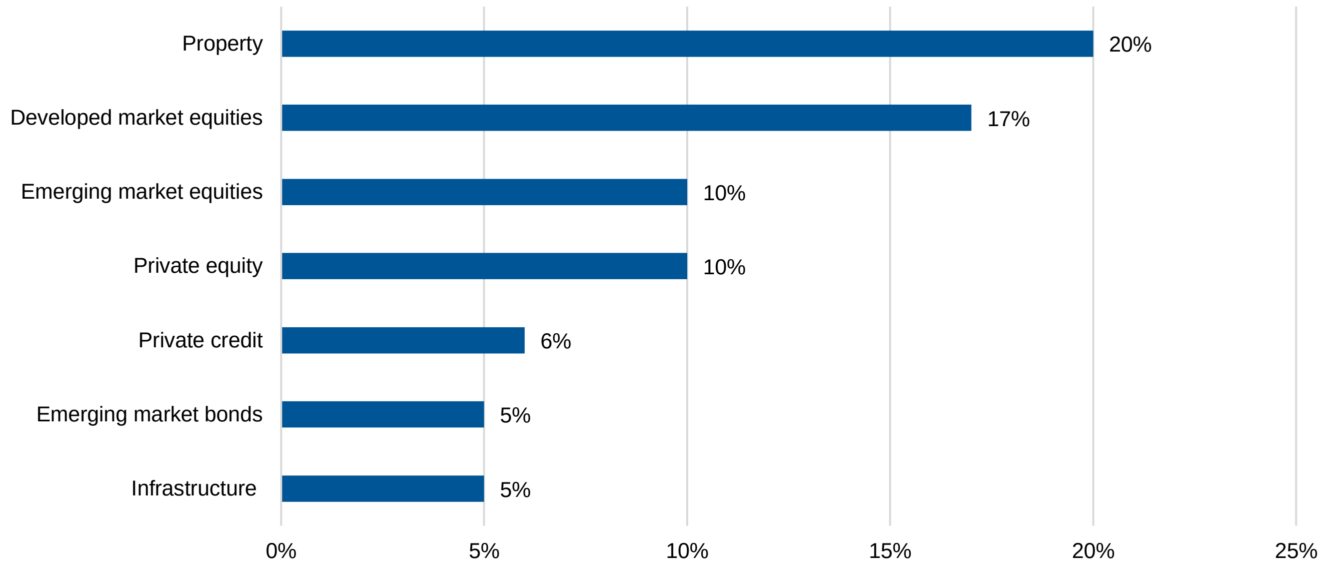
Efforts to de-risk are reflected noticeably in the asset allocation decisions being taken by pension schemes. Similar to the findings from our Autumn/Winter study, respondents are continuing to focus on increasing exposure to fixed income assets, primarily at the expense of equities and illiquid assets, particularly property and private equity. Respondents also noted the importance of getting portfolios 'buyout ready' and adjusting exposures to those that would prove attractive to insurers once the scheme gets to that point.

Exhibit 3: Expected increases to asset allocation exposures in the next six months



Source: Russell Investments, June 2023.

Exhibit 4: Expected decreases to asset allocation exposures in the next six months



Source: Russell Investments, June 2023.

In this respect, however, pension scheme decision-makers have a number of significant considerations to make. These will include the extent to which some exposure to growth assets will need to be maintained in order to meet required return levels and, in particular, the practicalities of reducing exposure to illiquid assets over time given the prospect of peers doing the same, resulting prospective demand and pricing within secondary markets.

> "We've been very put off by the crisis… we don't want to be in the same situation as in September and October where we've got these very nice illiquids but can't do anything with them. We're not considering selling them – we've looked at that – but the secondary market prices are punishing."
>
> *Pensions Investment Manager*

A muted fallout from the LDI crisis for larger schemes

The impact of the UK mini-budget in September 2022 and resulting gilt market sell-off was undoubtedly a moment of extreme concern for many investors. Yet while the immediate ramifications felt sizeable, this has not appeared to convert into the significant long-term impact that might have been expected at the time.

This is not to say that there have not been lessons to learn. Pension schemes have had to reassess their exposures and consider their liquidity and cashflow requirements. Certainly, there are instances where schemes had to move quickly to sell holdings and ensure sufficient headroom to meet their immediate requirements and/or avoid margin call scenarios. Some schemes lost money through forced reductions in liability hedges, possibly happening without their prior knowledge. Even the most robust governance structures will have experienced significant stress. Most, if not all, trustee boards will have reassessed what the right approach is for the future which enables them to respond quickly and efficiently in times of turbulence.

Ultimately though, the long-term impact of the crisis has been much more muted than might have been expected at the time. Our interviews with senior pension scheme decision-makers (including CEOs, CIOs, trustees and investment and pensions managers) found that the majority (64%) felt only a 'limited' or 'very limited' impact of the mini-budget and gilt sell-off. This may be because of their larger size, and the segregated nature of their portfolios which gave them greater control over the recapitalisation process.

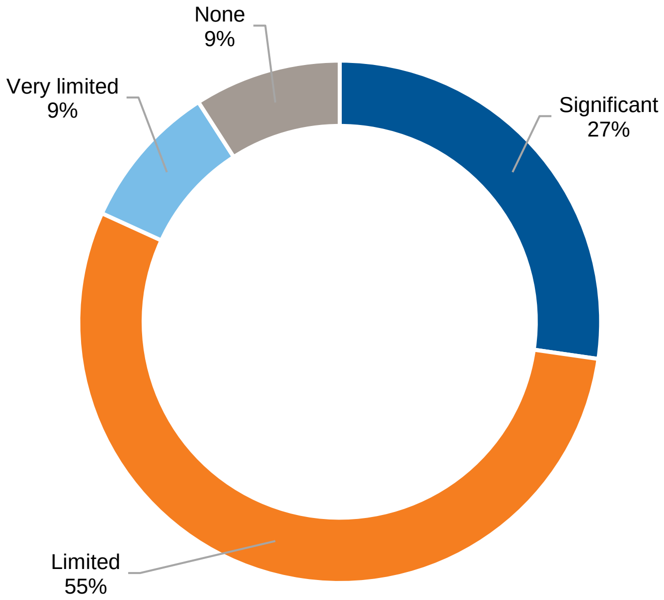
"At the time of the UK mini budget there was some limited requirement for some liquidity to ensure pension commitments were met. Therefore, some liquid equities were sold as were some high-grade Asset Backed Securities but there was a tendency to favour classes that had performed pretty well over the past decade so the impact on the overall scheme was limited."

Pension Scheme Head of Investments

"The mini crisis in the UK is a useful reminder to all about the importance of liquidity and cash flow in paying out benefits. This is something that all smaller companies understand so well – that cashflow is king!"

Pension Scheme CEO

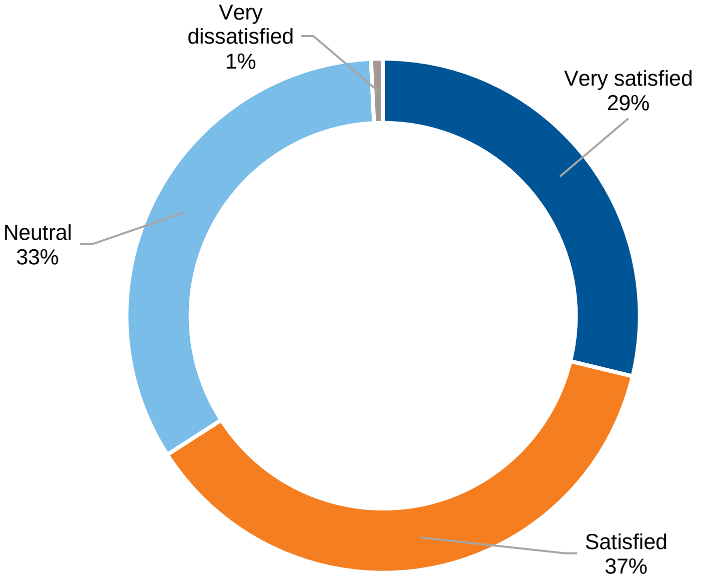
Exhibit 5: Focus Group - Impact of the UK mini-budget and gilt sell-off on pension schemes



Source: Russell Investments, June 2023.

This is also reflected in the attitudes felt by asset owners towards their liability driven investment (LDI) provision. Of those respondents that provided details of their LDI exposure (three-quarters of this study), , a majority (66%) expressed satisfaction with their LDI providers. We note, by way of context that of these respondents, almost half (45%) held exposure via a segregated LDI mandate. On this evidence, concerns over a significant crisis with respect to LDI have not come to pass.

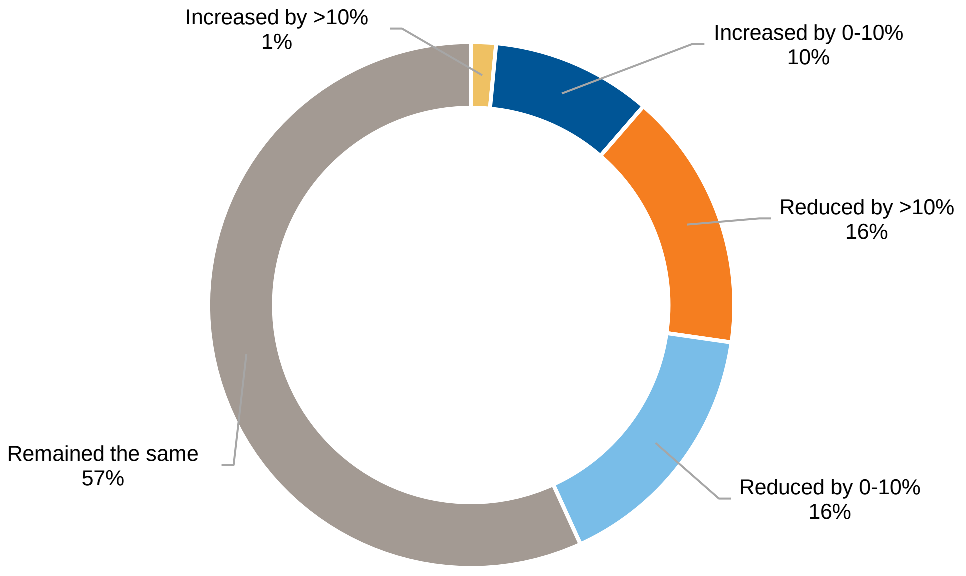
Exhibit 6: Respondent satisfaction towards LDI providers



Source: Russell Investments, June 2023.

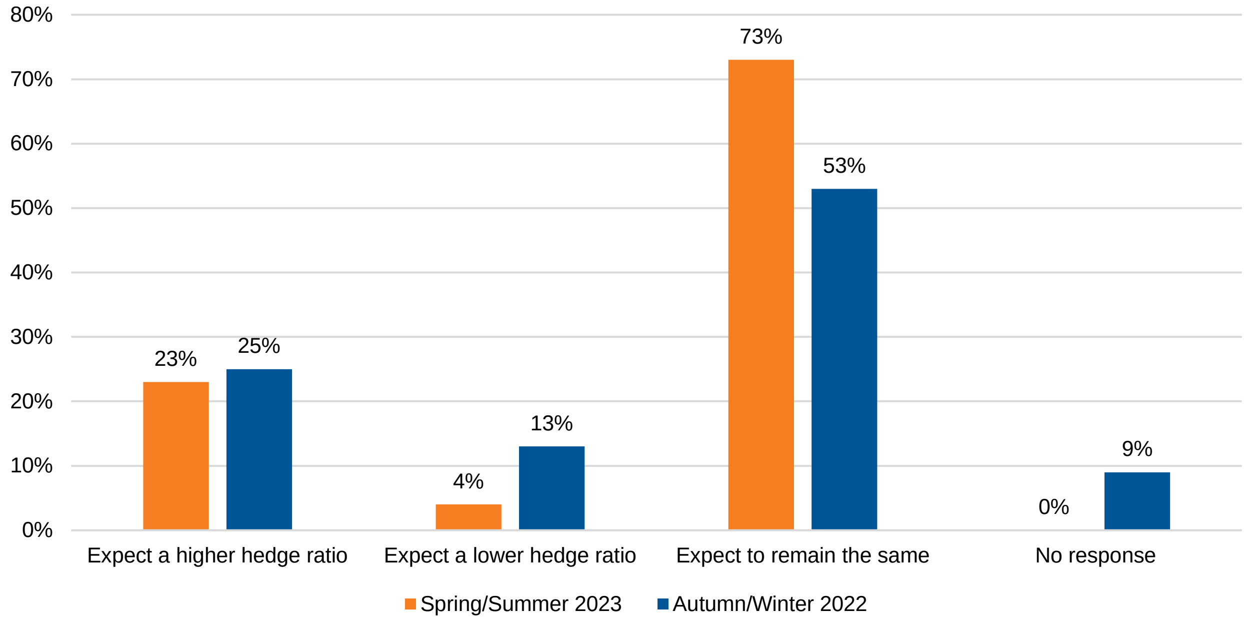
The mini-budget and gilt sell-off also appears to have had limited impact in how pension schemes managed their hedging provisions at the time, as well as their plans moving forward, with 57% of respondents not making any change in their hedge ratios in response to the mini-budget fallout, and almost three-quarters expecting current hedge ratios to remain the same for the next two years.

Exhibit 7: Respondent changes in hedge ratios in response to gilt market volatility



Source: Russell Investments, June 2023.

Exhibit 8: Expected changes in hedge ratios in the next two years



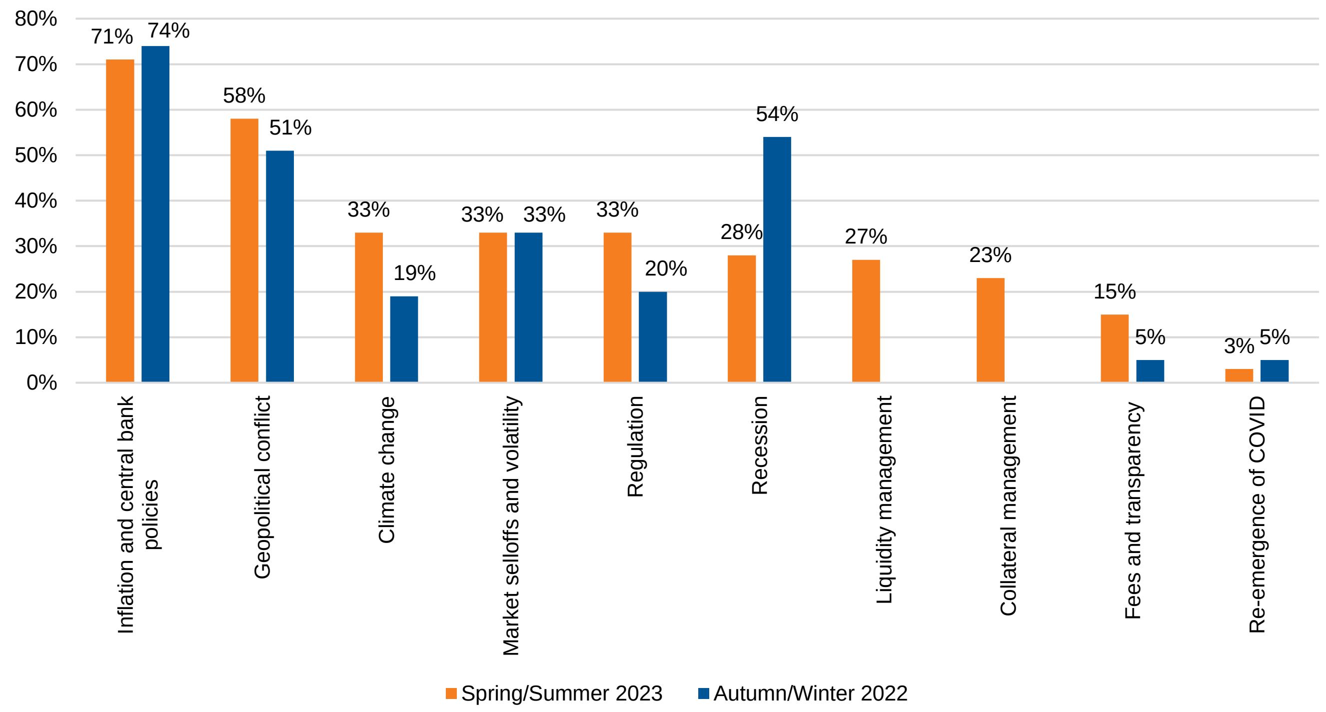
Source: Russell Investments, June 2023.

Inflation remains the number one concern, but with other issues on the horizon

Inflation has been the single most dominant issue in global financial markets over the last twelve months, significantly impacting a broad range of audiences from governments and central banks to individual consumers affected by the challenges of meeting rising costs. Despite initial hopes to the contrary, it is a situation that has proved more prolonged than many forecasters predicted when inflation started rising in early 2022. While central banks have adopted relatively aggressive policies to counter inflation, there appears little immediate prospect of sustained falls back to more accepted levels. It is therefore not much of a surprise that inflation continues to dominate pension schemes' thinking, ranking as the number one concern among decision-makers in the next six months.

> "Because of the events last year, I think the landscape of the DB pension scheme has dramatically changed. Everyone who was not in the de-risking phase will have been through the de-risking phase…. DB portfolios will look increasingly similar to each other. That would create a concentration of where assets go."
>
> *Pensions Investment Manager*

Exhibit 9: Key concerns in the next six months[4]



Source: Russell Investments, June 2023.

More notable though are changes in the level of concern towards other areas. Fears of recession appear to be receding, potentially reflecting some acceptance of this, but also a reduction in concerns over a 'hard landing'. Conversely, worries over issues around regulation and climate change have increased markedly, while geopolitical conflict concerns (China and the Western world, as well as ongoing concerns relating to the Russia-Ukraine conflict) have grown in prominence.

[4] Liquidity management' and 'Collateral management' are new additions to this survey, having not been measured in Autumn/Winter 2022

There are, of course, some variations in levels of concern depending on the size of scheme (and resulting resources individual organisations can apply to tackle these issues). Concerns over climate change are notably higher among larger pension schemes (those with more than £1bn of assets), likely reflecting that these schemes now have to report under the TCFD framework. This analysis may have highlighted areas for greater attention and action.

In contrast, smaller schemes have significantly more worries around fees and transparency, with one quarter identifying this as a concern in the next six months, compared to just 9% of large scheme respondents.

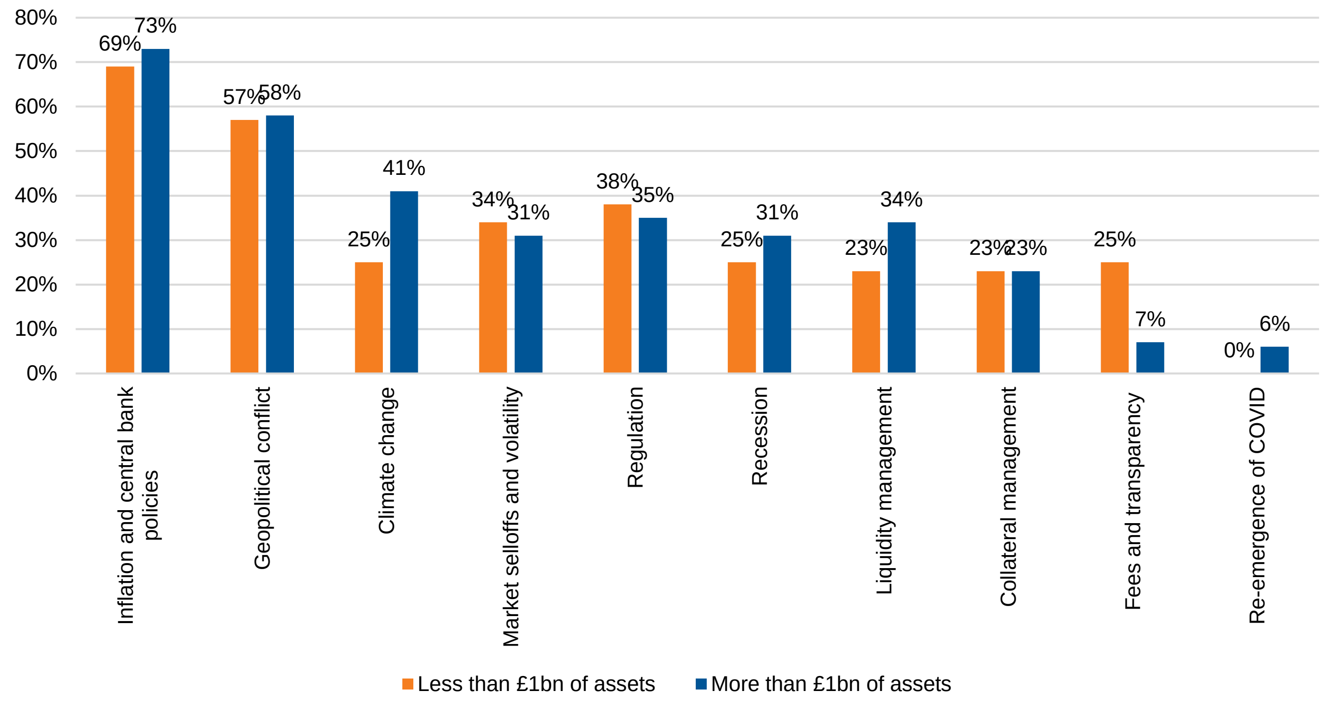
"The issue really is the level of engagement at the regulatory and parliamentary basis. The number of initiatives that just keep washing over us… it's really quite difficult as many pension schemes just don't have huge amounts of internal resources to run stuff and all it take is two or three huge, overarching projects – you know, GMP equalisation has to be done, and it's clearly the right thing to do, but when you combine that with pensions dashboard… you combine that with a couple of optional extras – then we are suffering from a bit of resource stretch."

Pension Scheme CEO

"One thing I would want across the market would be just a bit of breathing space for that to slow down – so no more consultations in the next twelve months on reporting requirements on SIPPs, on implementation statements and all that sort of thing."

Head of Pensions Investment

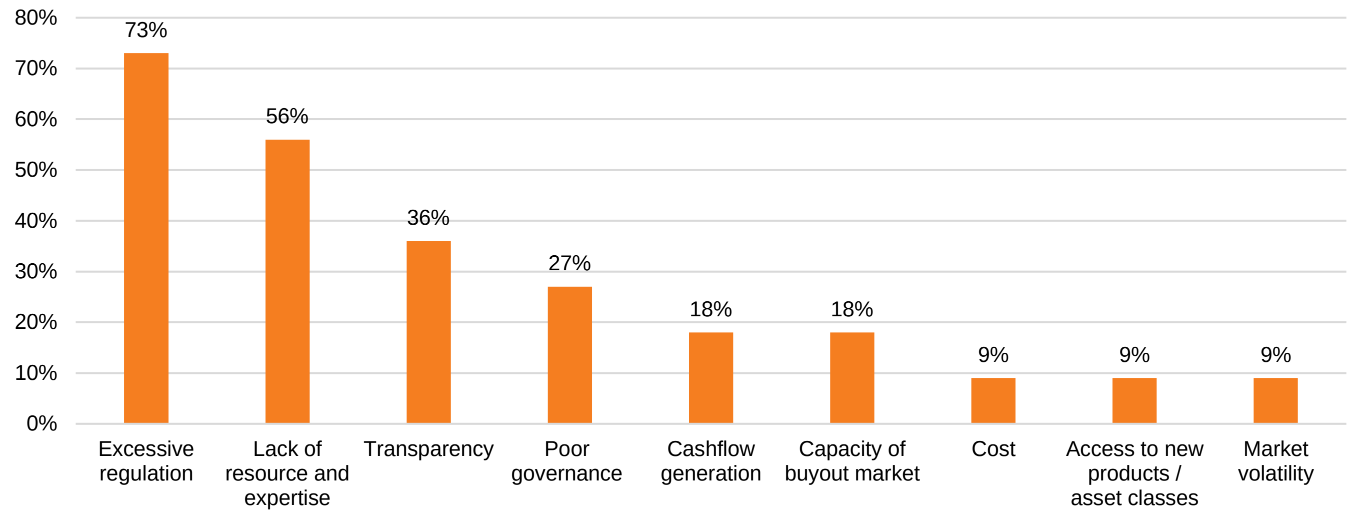
Exhibit 10: Key concerns in the next six months by size of scheme



Source: Russell Investments, June 2023.

The growth in concern over regulation is particularly notable, with senior decision-makers within our focus group raising a number of frustrations. These include the volume of regulation that pension schemes currently have to face, the lack of consistency between regulators and governments, and the challenges of resourcing to meet such requirements. These concerns are exacerbated by the maturity of the DB market making it harder for in-house teams to attract and retain talent. The desire for some 'breathing room' for trustees and pensions managers should not be underestimated.

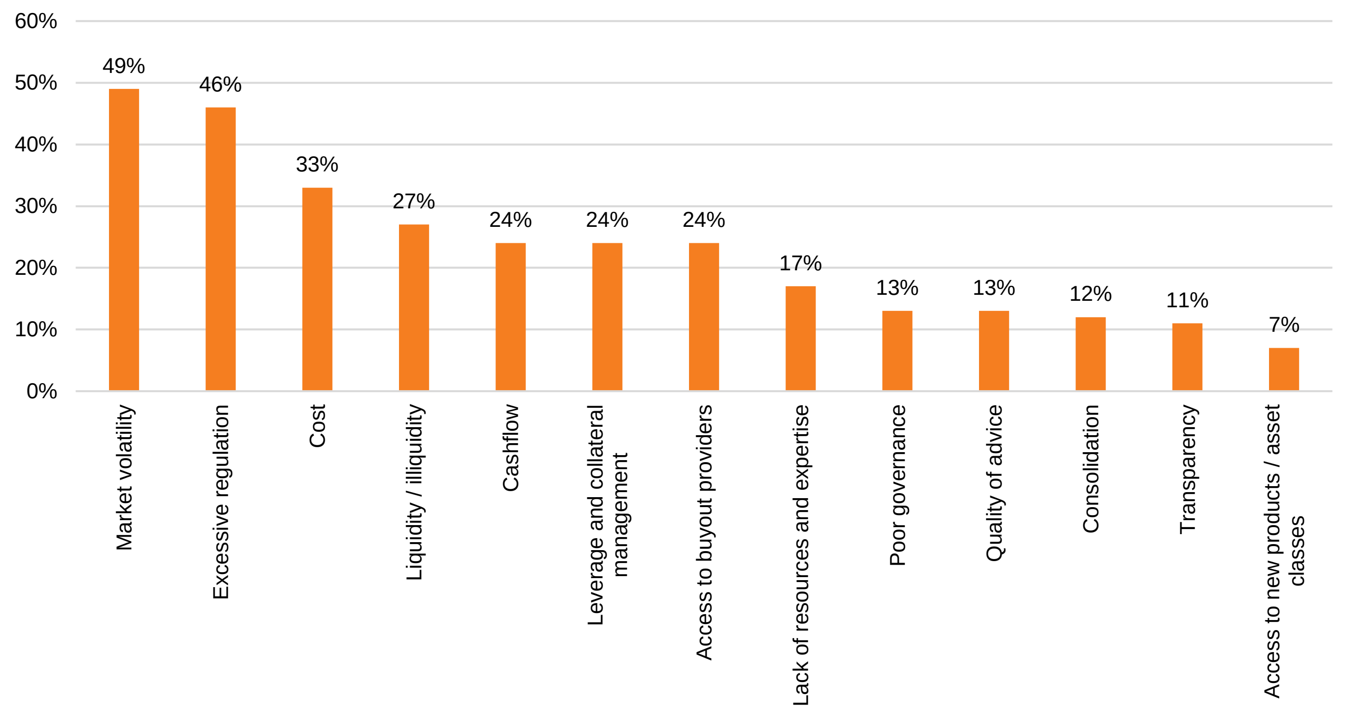
Exhibit 11: Focus Group - Key concerns in the next six months



Source: Russell Investments, June 2023.

Looking forward – across our whole respondent universe, regulation is having a clear impact on pension scheme thinking. Almost half of respondents (49%) identify excessive regulation as a key challenge facing UK DB pension schemes, with issues around transparency (48%), cost (33%) and consolidation (27%) also highlighted as key issues pension schemes will need to manage and potentially overcome.

Exhibit 12: Biggest challenges facing UK DB pension schemes today



Source: Russell Investments, June 2023.

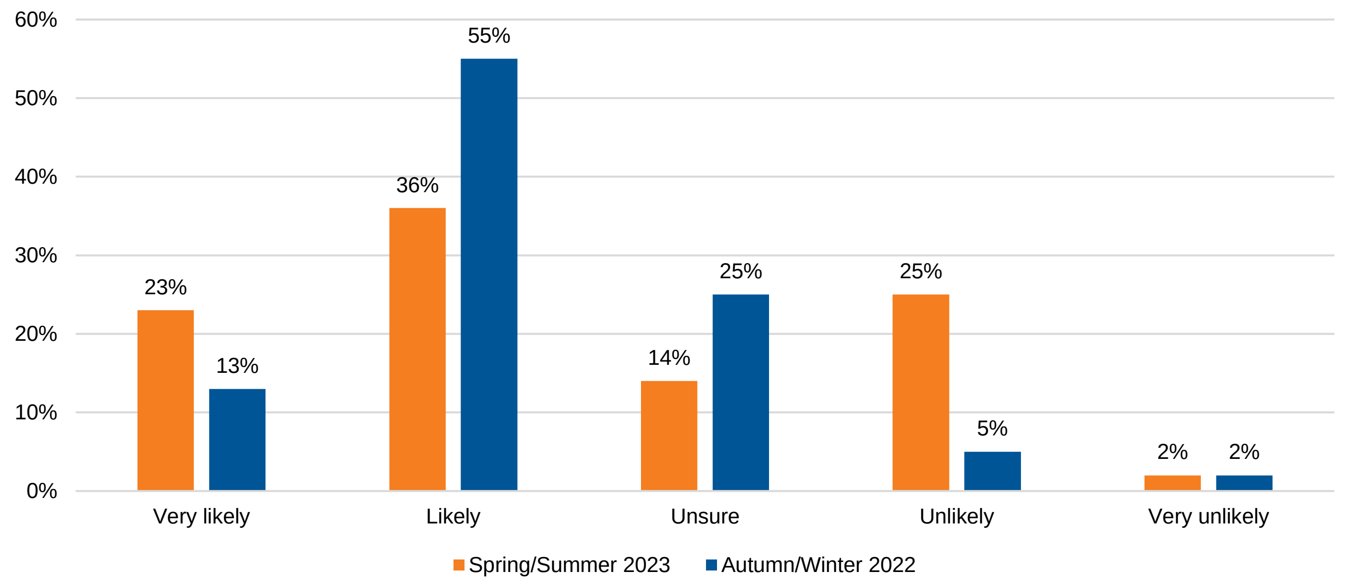
Climate change focuses adapt in response to changing pension scheme circumstances

As noted in Exhibit 1, improving sustainability and ESG remains an important priority for pension schemes.

This said, pension schemes' ability or desire to focus as extensively on these as they might have done in the past is open to question. While the majority (59%) of respondents expect to increase their focus on climate change in the next twelve months, a quarter feel that such an increased focus is unlikely and a further 14% are unsure of the importance that climate change will play in their plans and activities.

> "The time horizon does change things as what we are interested in is the impact on our portfolio over a relatively small number of years. That means that our focus on other issues is diminished by that."
>
> *Pension Scheme Chair of Trustees*
>
> "It is a bit of a challenge as they [the schemes] are so de-risked that we're not going to be making investments in green infrastructure [for example] as that's completely out of line with the long-term plan."
>
> *Head of Pensions Investment*
>
> "Up until a couple of years ago, we saw ESG as an exercise in financial risk management… and then the TCFD initiative came by. Originally I saw that really as being just another governance and reporting exercise that we would go through. There was some hesitance about it, some frustration that yet again it's UK pensions that get to plough that furrow first. But as we got into the project, it just got more interesting – when you start to scratch below the surface, look at your carbon exposures, you get some data from managers… you do start to think 'let's look for opportunities to integrate some of this more thoroughly into our investment portfolios.'"
>
> *Pension Scheme Trustee*

Exhibit 13: Expected focus on climate change in the next twelve months

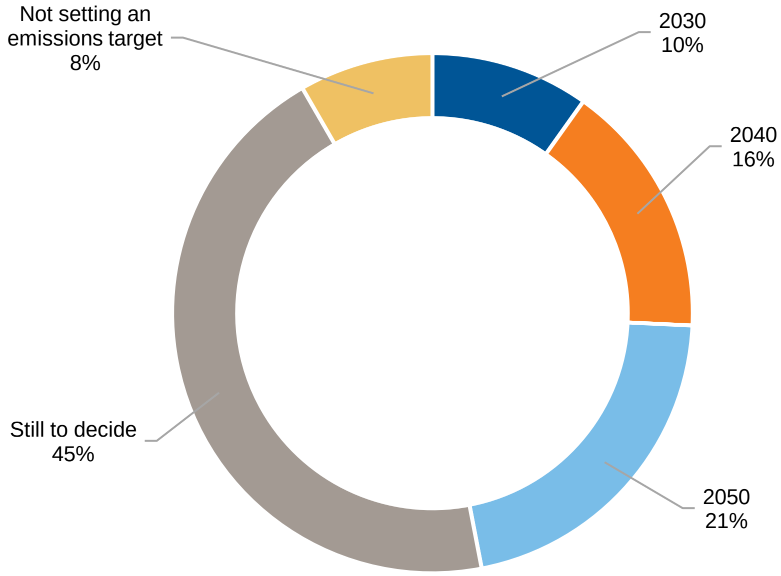


Source: Russell Investments, June 2023.

ESG considerations are where the impact of rising interest rates and the resulting improvements in funding levels is being most noticeably felt. The acceleration of schemes' journeys towards a prospective 'endgame' and the resulting need to de-risk to position themselves for potential buyout has inevitably impacted their ability to allocate to certain assets – such as renewable infrastructure – that would play a tangible role in efforts to combat climate change.

As things stand, the long-term impact of this remains to be seen. Pension schemes clearly remain committed to acting on climate change as much as is feasible, as indicated by thinking and planning around net-zero targets, with slight improvements recorded in numbers setting a specific target compared to our previous study in Autumn/Winter 2022. It is evident, however, that pension schemes will have to consider these issues carefully moving forward, reflecting the reduced flexibility they face on sustainability and ESG issues as a result of funding level improvements.

Exhibit 14: Current net-zero emissions targets



Source: Russell Investments, June 2023.

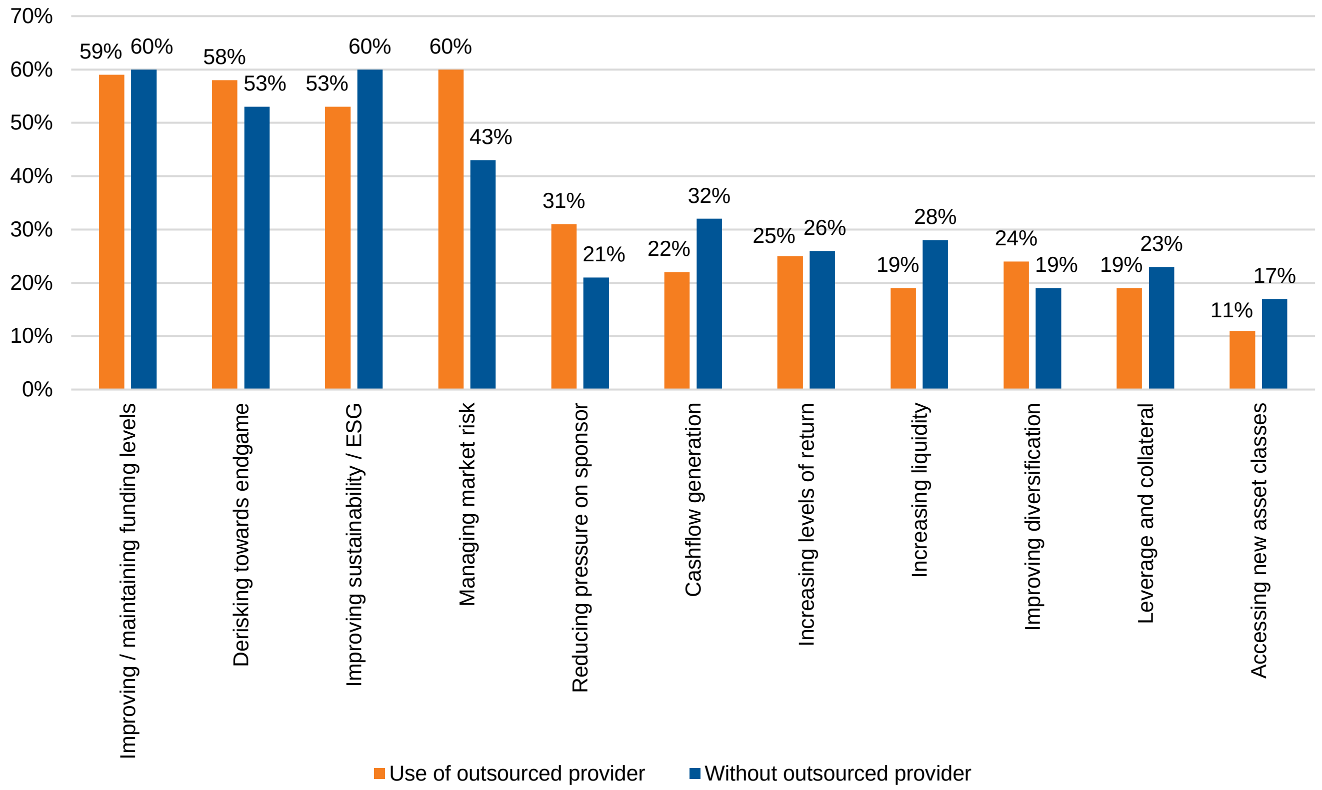
Regulation seen as a greater hurdle for schemes without outsourced support

Almost two-thirds of respondents (64%) to our latest study employ some form of outsourced support to assist in the management of their scheme's activities, with the depth of expertise brought by such providers remaining the key reason for utilising such support.

There are some notable differences, however, between those employing outsourced support and those without – both in terms of investment priorities and what are perceived to be the key challenges facing individual schemes and the wider UK DB market moving forward.

From an investment priority perspective, improving sustainability and ESG, cashflow generation and increasing liquidity are seen as higher priorities for schemes without outsourced support, relative to their peers that employ fiduciary management or outsourced CIO services. Non-outsourcing schemes also appear more willing to explore opportunities to access new asset classes.

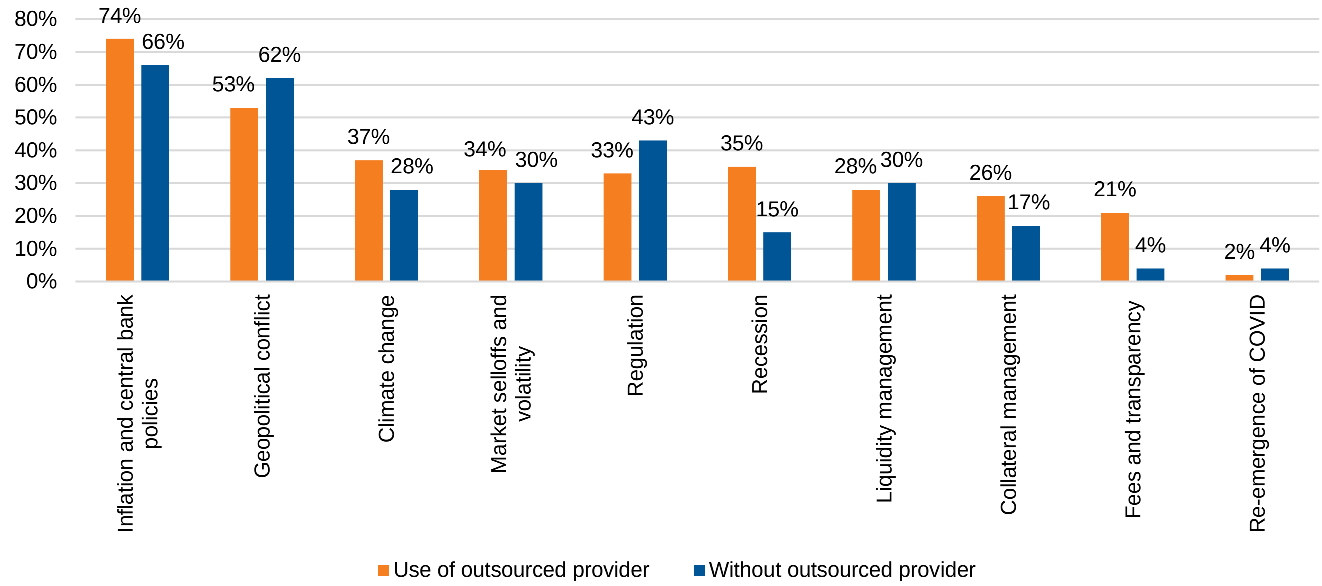
Exhibit 15: Investment priorities by use of outsourced provider



Source: Russell Investments, June 2023.

Differences between schemes who have and haven't employed outsourced support become evident when each group's concerns in the next six months are considered. Inflation and central bank policy remains the biggest concern for both groups (74% and 66% respectively), closely followed by Geopolitical conflict (53% and 62%). Schemes which have outsourced aspects of their investment arrangements are then more concerned about climate change and recession than their non-outsourcing peers. Regulation, liquidity management and market volatility are bigger worries for those schemes which haven't outsourced, suggesting trustee time is focused more on governance aspects and implementation rather than strategic decision-making

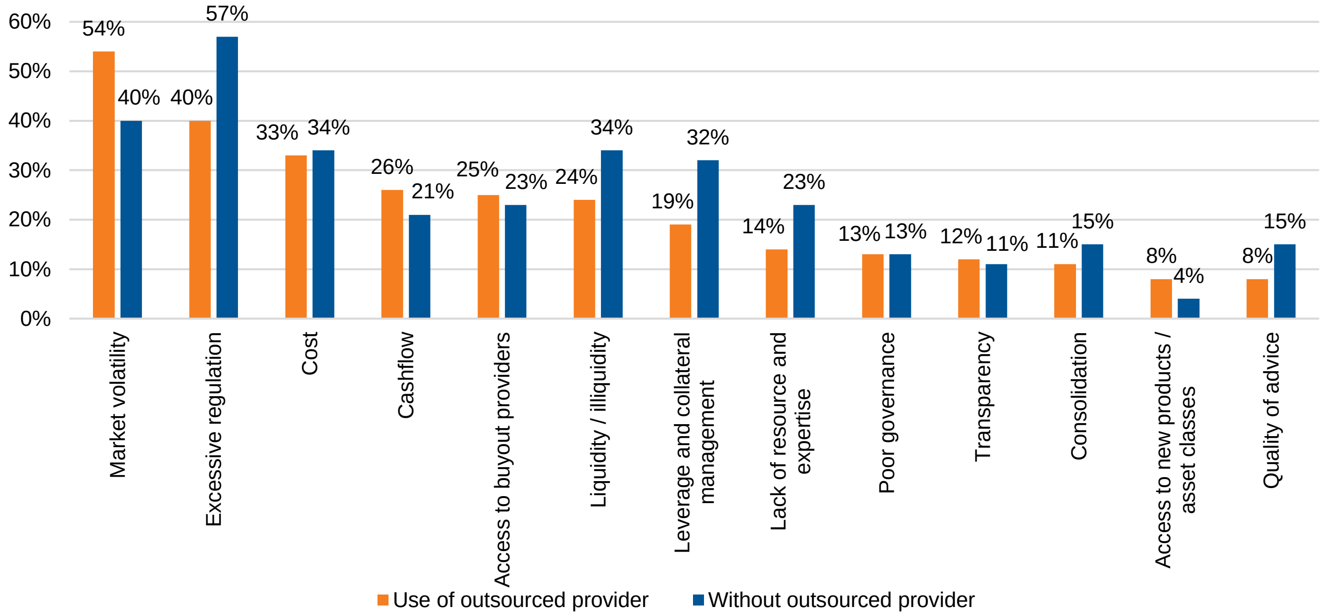
Exhibit 16: Biggest concerns in the next six months for schemes by use of outsourced provider



Source: Russell Investments, June 2023.

These concerns are also reflected when these different groups assess the prospects for the UK DB market more broadly. By some distance, non-outsourcing schemes see excessive regulation as the biggest challenge facing UK DB schemes, potentially reflecting the significant resource needed to deal with such requirements. In contrast, those schemes employing outsourced support see market volatility as a much greater challenge for the wider market, with regulation a less important consideration, perhaps in light of the greater governance support that outsourcing provisions can offer.

Exhibit 17: Key challenges for the UK DB market without outsourced provider support



Source: Russell Investments, June 2023.

Summary

There can be little doubt that the UK defined benefit pensions market has evolved rapidly in recent months, with the effect of rising interest rates being materially felt by many schemes that are now much further along their funding journey than might have been anticipated. As one trustee responding to this study notes: “We had been looking at time horizons that had stretched several years ahead…. The way the environment has changed has improved the funding position in a way that has potentially shortened that timeframe materially.”

It is perhaps too early to assess the long-term effects of this trend, not least if we begin to see a reduction in inflation and a corresponding lowering of interest rates. To that end, however, considerable work will still be needed by pension schemes to protect the improved and advantageous positions they find themselves in.

The unpredictability of this environment is also evident in other areas, with continuing concerns over market volatility, regulation and, to some extent, recession and economic growth continuing to be prevalent. Pension schemes will therefore have to consider investments – at both a strategic and tactical level – very carefully over the coming months if they are to maintain a trajectory to meet their long-term goals.

FOR MORE INFORMATION

Visit russellinvestments.com/dbresearch.