

THE CHANGING ECOSYSTEM OF DEFINED BENEFIT PENSIONS

VOLUME 3 – AUTUMN/WINTER 2023



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Foreword

In the autumn of 2022, the pensions world was rocked by the UK Government's autumn statement announcement. A huge crisis in the UK gilt market followed. Many schemes were under pressure to adjust their portfolios, resulting in significant selloffs of assets to create sufficient collateral and liquidity to manage the crisis.

Just over twelve months later, pension schemes find themselves in a very different position. Many have seen their endgame prospects improve. Rises in interest rates and yields have had a substantial impact on funding levels. As a result, most schemes are much better placed, with some considering endgame within a much shorter time horizon than envisaged 18 months ago.

While positive, this also leaves pension schemes and their decision-makers with much to reflect on. Important decisions need to be made if they are to navigate new circumstances successfully. It is in this context that we present the findings of Russell Investments' third UK Defined Benefit Markets Insights study, where we survey senior personnel within the pensions world to understand their expectations, priorities and concerns.

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



Simon Partridge

Head of UK Fiduciary Management

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Key findings



Improvements in funding levels resulting from market conditions have resulted in a significant number of schemes accelerating their plans focusing on endgame. **Almost one-third (30%) indicate that they are now working towards endgame within a shorter timeframe.**



This change in timeframes is impacting asset allocation decisions. **Schemes are prioritising increases in liquidity to make portfolios as attractive as possible for insurers so that these schemes can move to buyout.** However, this raises some challenges in how schemes reduce exposure to illiquid assets such as private equity without having to accept discounts.



The capacity of the buyout market is a concern for pension schemes. One-fifth of respondents identify this as a significant risk.



While ESG remains an important consideration for many pension schemes (specifically the issue of climate change), **decision-makers recognise the implications of changing asset allocations. Specifically, the move away from equities and illiquid assets to bonds and cash is impacting schemes' ability to effect long-term tangible ESG action.**

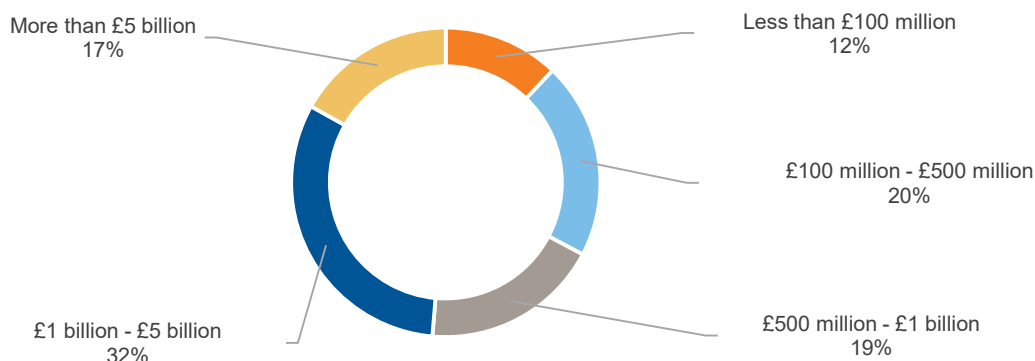


Regulatory volume remains a key challenge for many schemes. Combined with practical operational pressures as schemes seek to position themselves for endgame, some are looking at moving to a sole trustee model to ensure sufficient access to specialist expertise to manage these demands.

Survey methodology

The Russell Investments UK Defined Benefit Market Insights is based on the responses of 107 UK defined benefit schemes between September and October 2023. Those participating in the study are responsible for over £250 billion of assets under management in total. Respondents included scheme CEOs, 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 undertook detailed interviews with a focus group of 12 leading professional and independent trustees to assess their views on a range of key topics. Comments from these respondents are included in this report on an unattributed basis. We would like to thank those individuals interviewed for their time and insights.



Source: Russell Investments, November 2023.

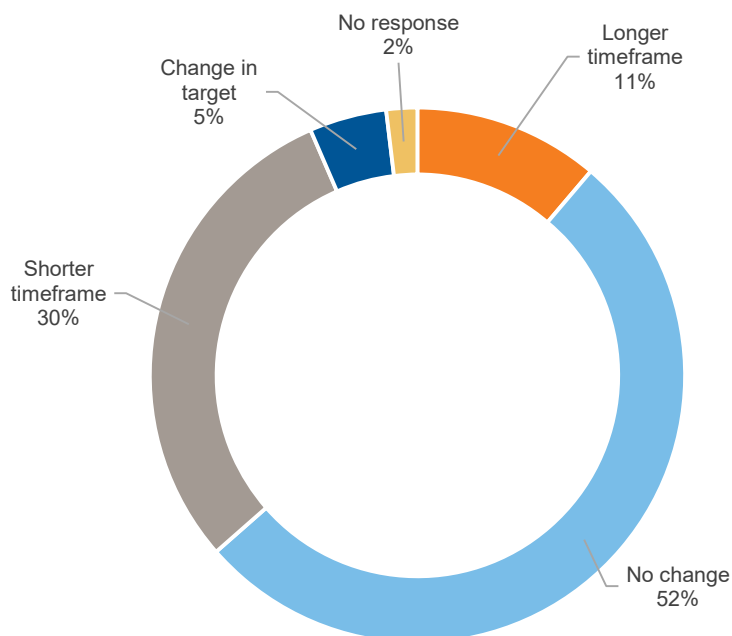
Improved funding levels accelerate focus on derisking and endgame

Despite the challenges arising from the UK government's autumn statement debacle in 2022, in many cases pension schemes find themselves in a much-improved position than might have been anticipated at the start of that year. Funding levels have improved, resulting in some schemes beginning to consider endgame solutions within a much shorter time horizon than previously anticipated.

While the majority (52%) of respondents indicate that their time horizons towards endgame have not changed, almost one-third (30%) suggest they are now operating on a shorter timeframe – in some cases looking at this as an immediate priority. 11% of schemes are now considering a longer timeframe to endgame, suggesting a shift in objective towards a run-off or low-dependence strategy.

Interestingly, only a small proportion have changed their target, as noted in the Focus Group comments to the right. However, no clear pattern has emerged from this small sample: schemes have variously moved to target buyout, low-dependency run-off or pension scheme consolidation.

Exhibit 1: Changes in endgame timeframe



Source: Russell Investments, November 2023.

Focus Group Quotes

“Those that had little or no LDI in place did really well and are looking at being fully funded. Some have accelerated their derisking process by probably 10 or 15 years.”

“Schemes have largely been in two camps. Those that have been well-governed have probably come out of it [LDI] in a more difficult position [due to higher levels of hedging].”

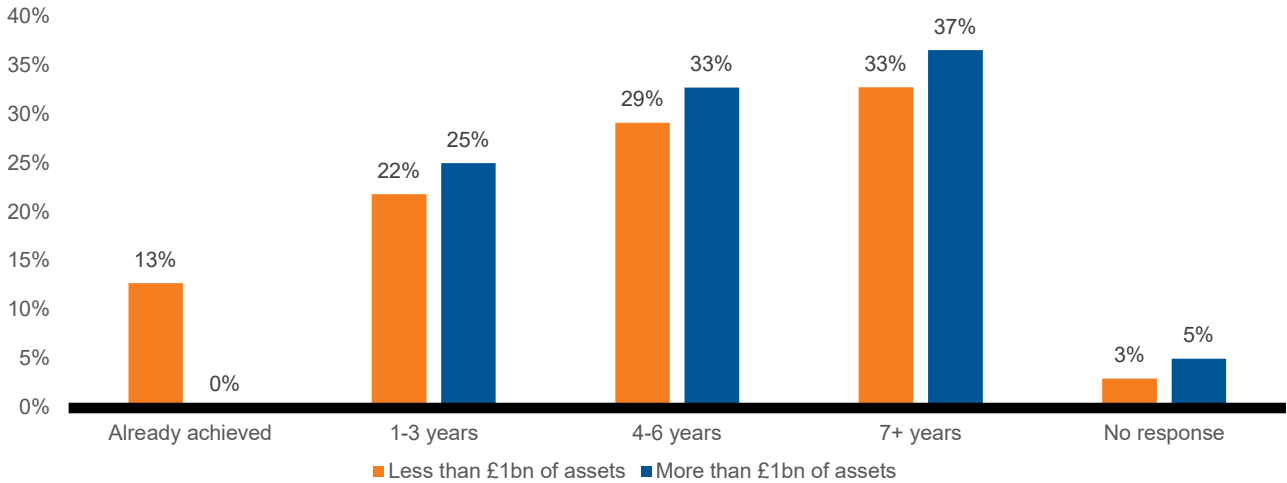
“The majority of schemes have seen an improvement in funding levels and are probably ahead of where they would expect to be. There's probably a bit of irony that the schemes that were quite unhedged have really benefitted.”

“Objectives are still similar, but timeframes have moved. There have been quite a few operational aspects to consider, but so far, it's only timeframes that have changed.”

Looking at endgame time horizons, there are small differences depending on scheme size. The majority of schemes are still at least four years away from their endgame, with over a third looking at timeframes of more than seven years.

However it is interesting to note that nearly a quarter of all schemes expect to reach their endgame objective broadly within the next valuation cycle (1-3 years), while 13% of smaller schemes surveyed have already reached their endgame target.

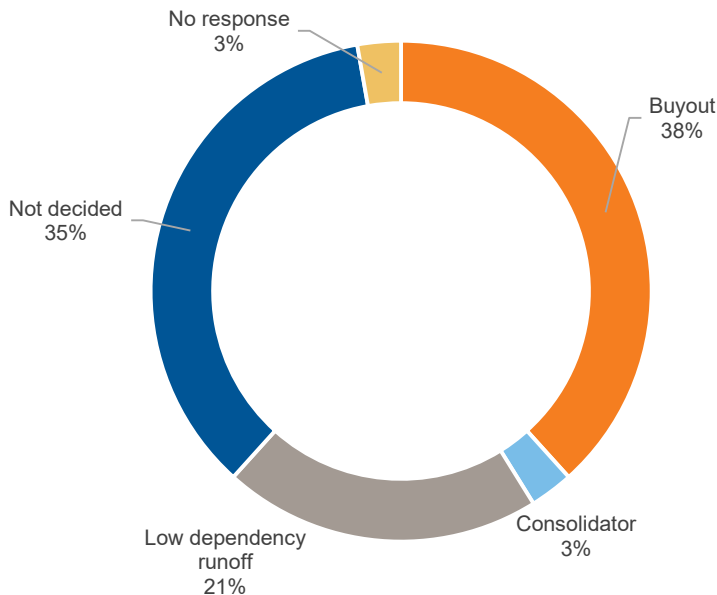
Exhibit 2: Expected timeframe to endgame



Source: Russell Investments, November 2023.

In spite of the accelerated endgame time horizon, many schemes are still to finalise their plans and thinking. While buyout is the most popular choice for schemes, over one-third (35%) are still to decide on their ultimate endgame objective.

Exhibit 3: Endgame objective



Focus Group Quotes

“It’s been drummed into everybody that the gold standard is going into the insurance market. Are there structural risks that are created by having everybody in the same type of approach?”

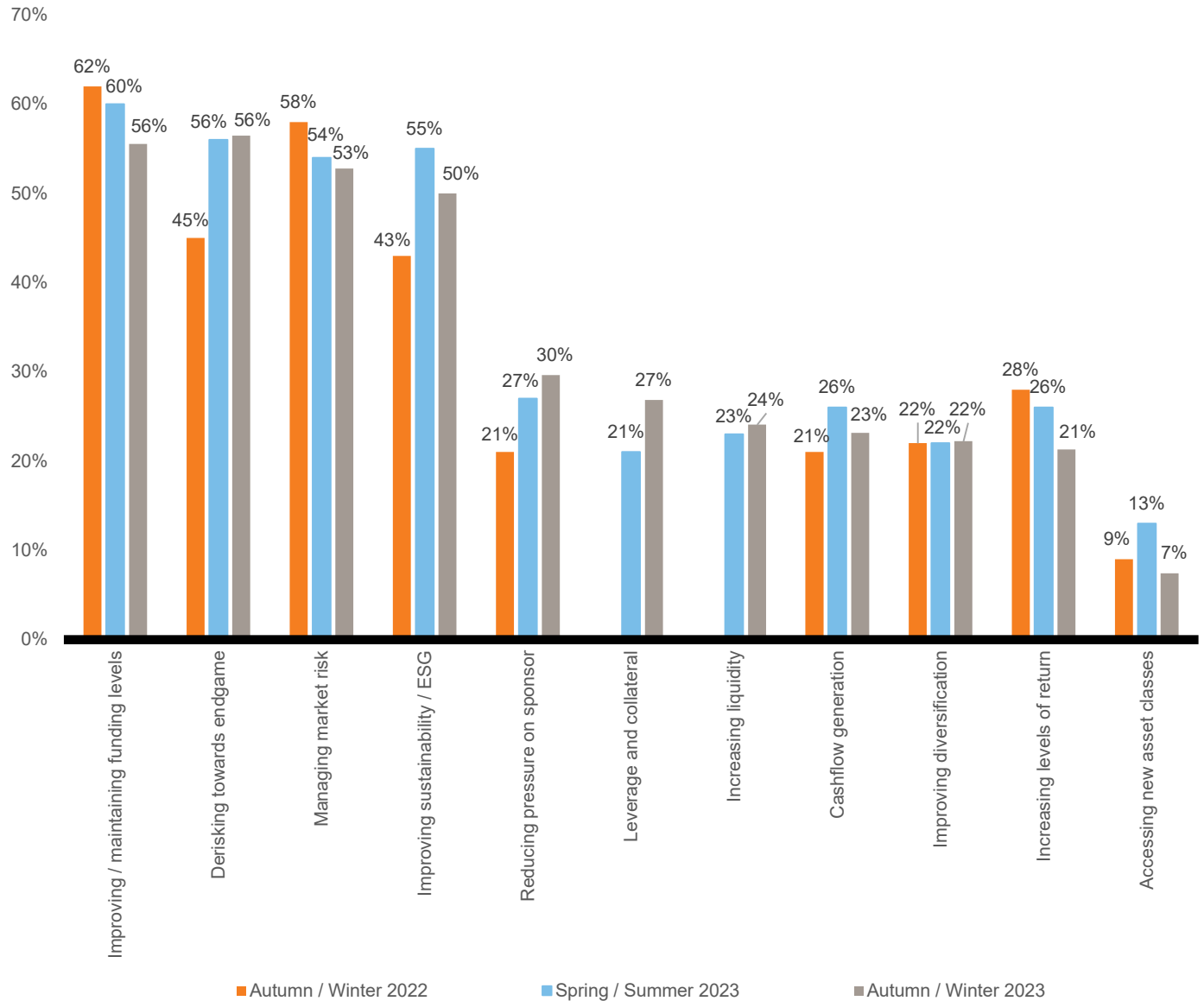
“I would advocate that all trustees take a pause and look at whether (going into the insurance market) is actually the best thing for the scheme members.”

Source: Russell Investments, November 2023.

The improved circumstances of pension schemes are reflected in their shifting priorities. Improving and maintaining funding levels (56%) and derisking towards endgame (also 56%) remain the primary focus for decision-makers. Of almost equal importance is managing market risk (53%) and improving sustainability (50%).

Reducing pressure on sponsors (30%) is increasing in priority as is leverage and collateral (27%), while accessing new asset classes (7%) is seen as low priority by almost all respondents, reflecting the leap forward in funding positions and focus on derisking.

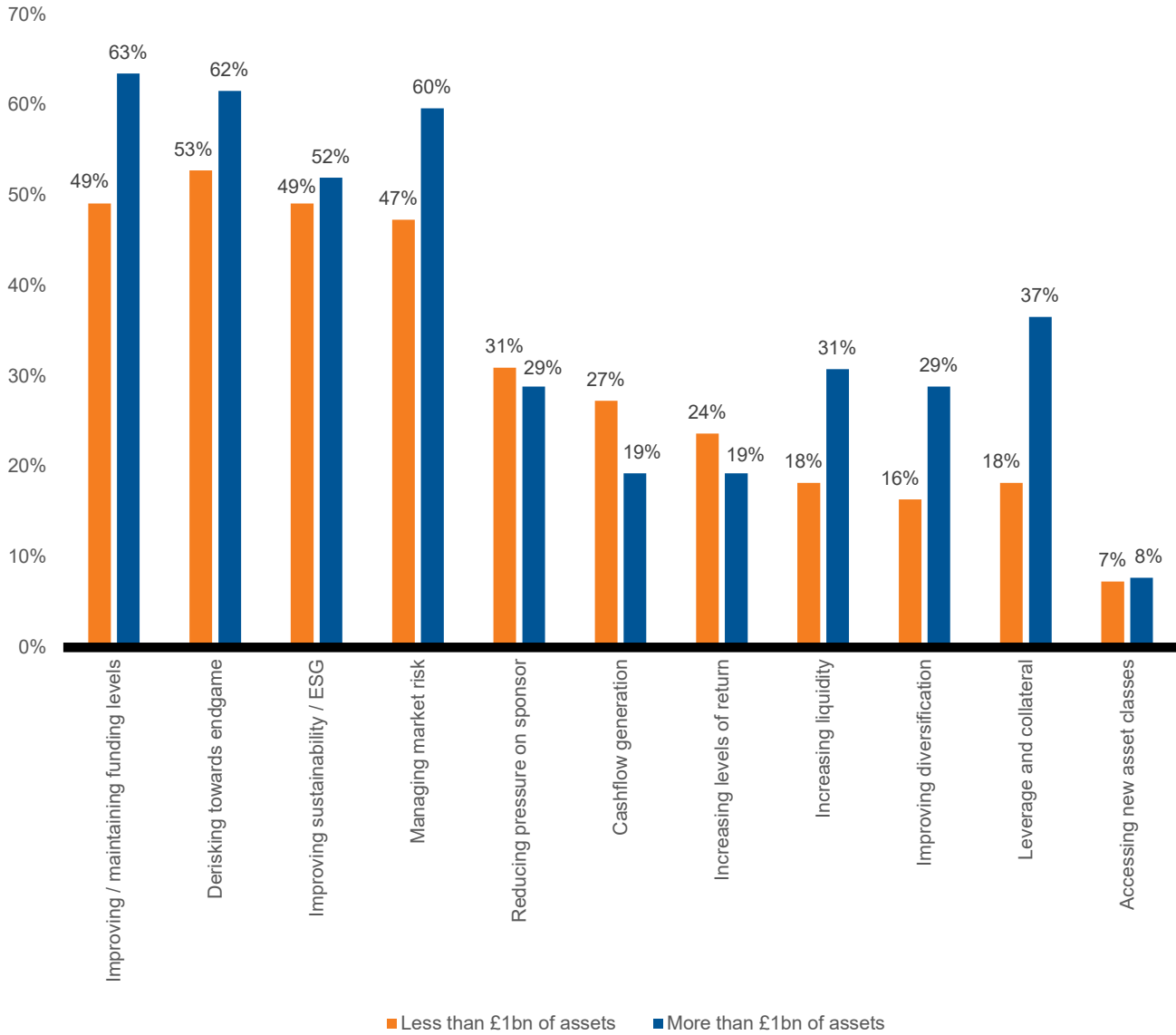
Exhibit 5: Current respondent investment priorities



Source: Russell Investments, November 2023.

Further trends arise when priorities are assessed based on the size of scheme. In addition to the same key priorities noted above, larger entities (those with more than £1 billion of assets) are more focused on leverage and collateral, increasing liquidity and improving diversification than their smaller peers.

Exhibit 6: Current respondent investment priorities by size of scheme

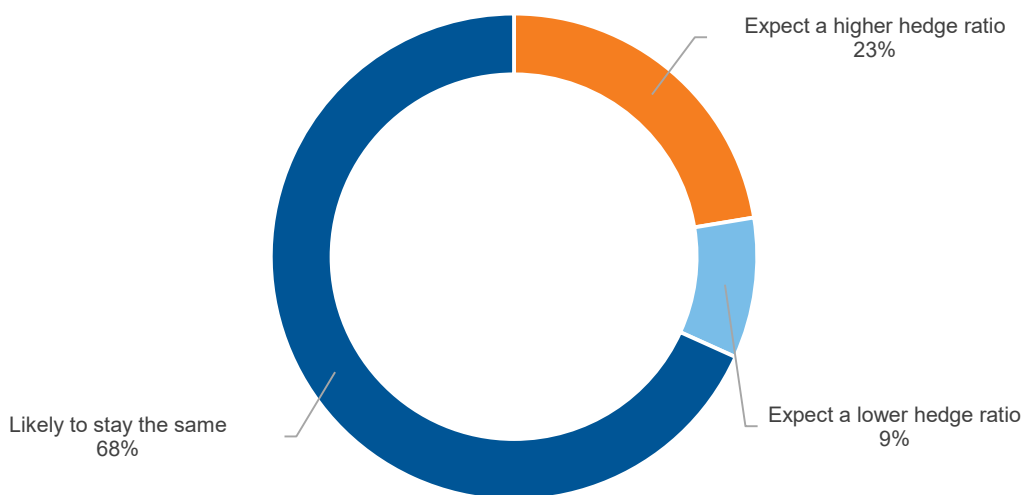


Source: Russell Investments, November 2023.

Liability hedging expected to stay at current levels or increase

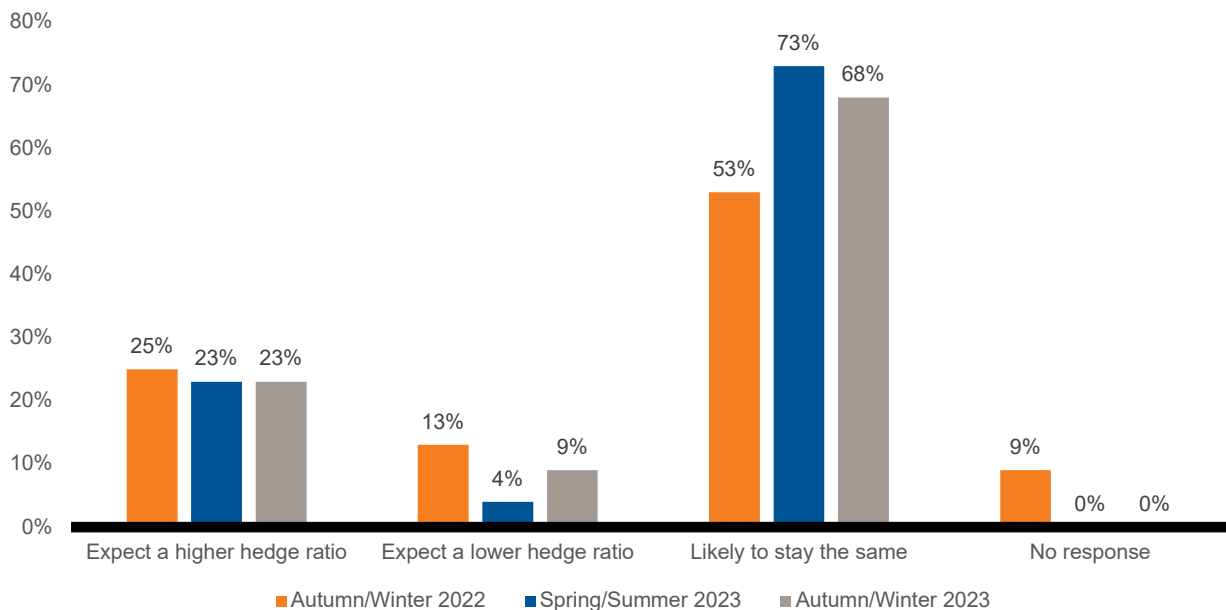
As noted by one respondent: *“I think the first step is trying to continue to manage the risk and not lose the gains that have been achieved.”* This can be seen in schemes’ future plans when it comes to anticipated changes in liability hedge ratios. The majority (68%) of respondents expect their hedge ratio to remain the same, while almost one-quarter (23%) expect to have a higher hedge ratio over the next two years. Just 9% of respondents expect it to be lower. The priorities of pension schemes therefore appear clear, with a definite focus on protecting the improved positions that many have found themselves in.

Exhibit 7: Expected changes in hedge ratio in next two years



Source: Russell Investments, November 2023.

Exhibit 8: Expected changes in hedge ratio in next two years



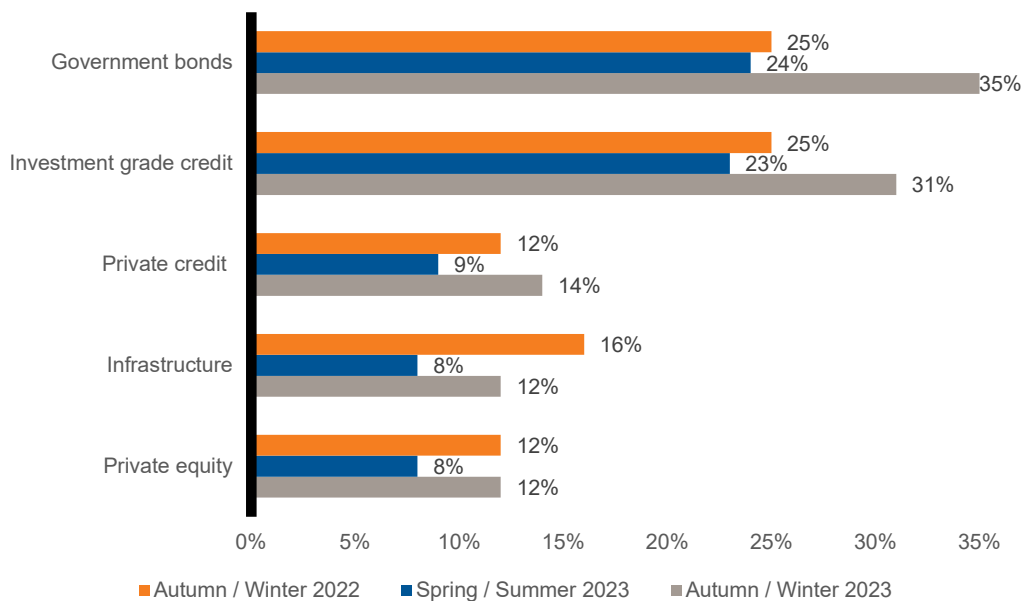
Source: Russell Investments, November 2023.

Challenges arise as schemes seek to address portfolio liquidity

The acceleration of many schemes' journeys towards endgame is reflected in asset allocations. Planned increases and decreases in exposures illustrate a focus on reducing risk and improving liquidity.

This is reflected in a significant acceleration in allocations to fixed income assets. Appetite for both government bonds and investment grade credit have increased substantially as schemes seek to derisk.

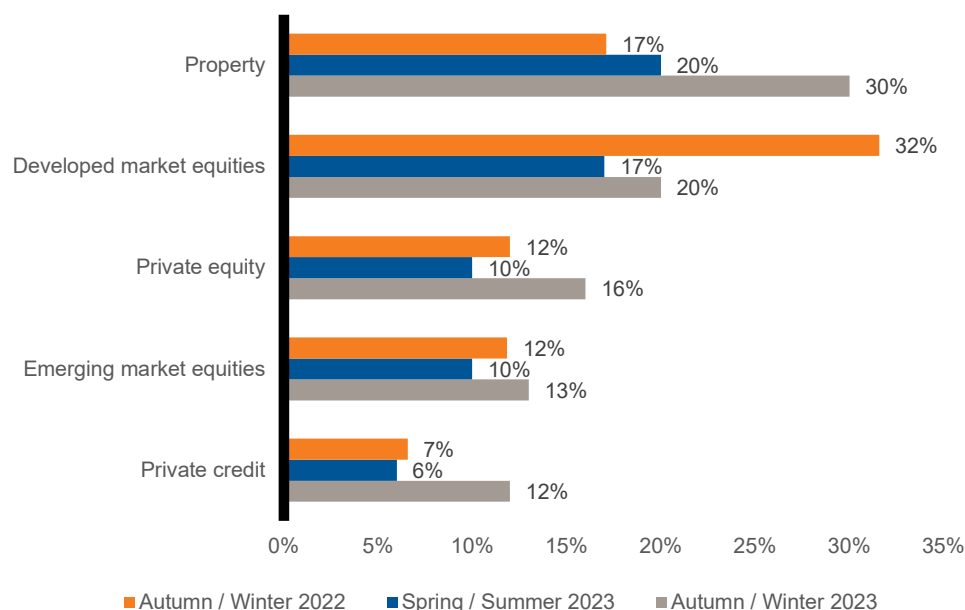
Exhibit 9: Expected increases to asset allocation exposures in the next six months



Source: Russell Investments, November 2023.

Most notably negatively impacted are exposures to property and listed market equities. There is a marked increase in scheme plans to reduce allocations to property compared to previous UK defined benefit market studies.

Exhibit 10: Expected decreases to asset allocation exposures in the next six months



Source: Russell Investments, November 2023.

Focus Group Quotes

“Generally, people are looking for the best way to get out [of illiquids] and decide when the best time is to do so. There are issues like property funds being gated and durations to consider. Some schemes are questioning whether to go to the secondary market now and take a discount.”

“Some schemes are taking more of a piecemeal approach rather than putting all their eggs in one basket; going to the secondary market and taking a 20% haircut straightaway.”

Appetite towards other parts of the private markets space remains mixed, with some schemes indicating plans to increase allocations whilst others intend to reduce their exposure. Typically, the desire to reduce these allocations comes from larger schemes, with those with more than £1 billion of assets showing greater appetite to reduce private equity (19%) and private credit (14%) exposures. This potentially indicates some differences in the maturity of these schemes, with larger entities being better funded and therefore better placed to consider endgame options sooner.

Pension schemes are, however, beginning to experience some challenges. Respondents note a concerted effort by many schemes to reduce their exposure to illiquid assets in order make themselves more attractive propositions for insurers and increase their ability to move to buyout. As one respondent noted: *"I think the smaller [schemes] are [recognising that] insurers just want cash. So, it's about being liquid but also moving in a similar way to insurer [pricing]."*

The number of schemes seeking to take such action raises questions about the capacity within the secondary market for private assets. One independent trustee interviewed for this study went as far as to suggest that *"There's not really a secondary market for a lot of these closed end illiquid assets"*. Some schemes may therefore be in the unenviable position of having to accept significant discounts on the price of their assets to move to endgame within their desired timeframe.

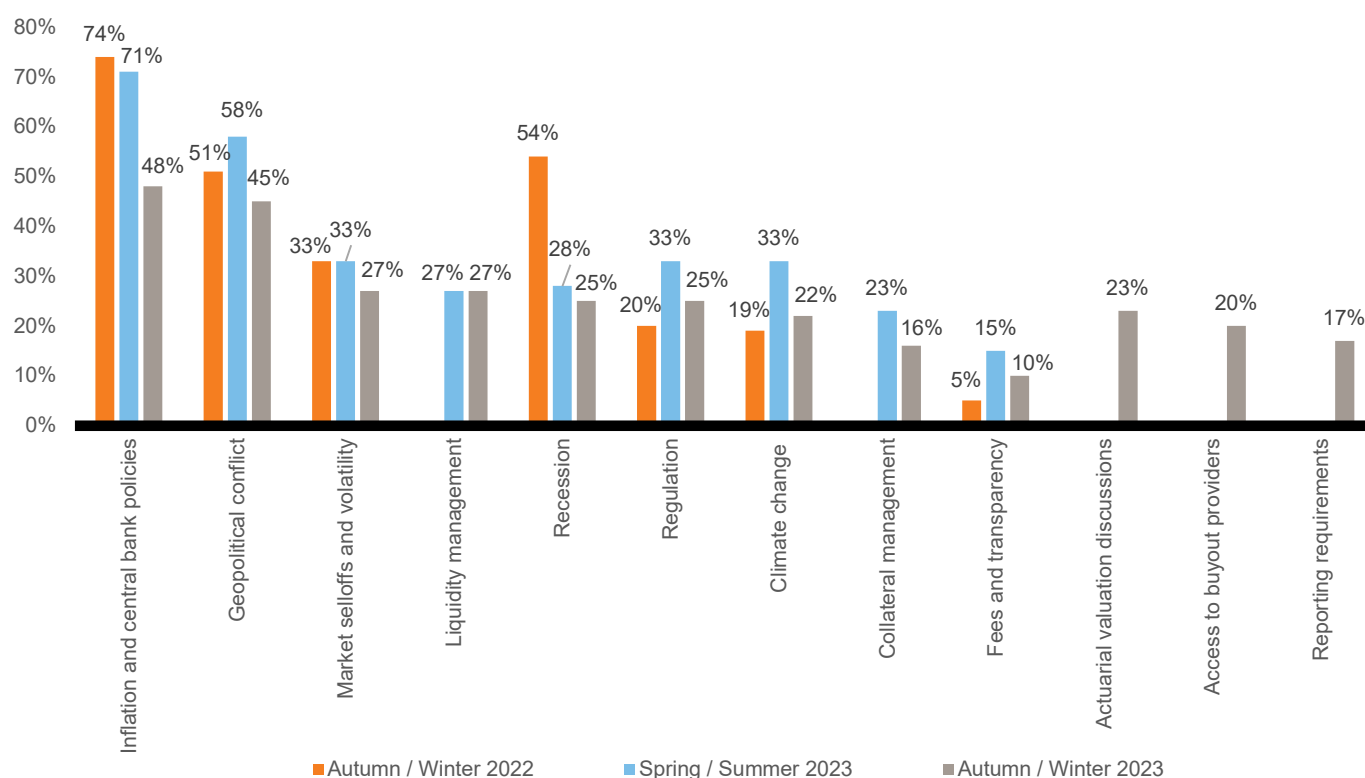
This feedback aligns with Russell Investments' experience over the past 12 months where a number of clients have looked to dispose of their private market assets. Despite the challenges faced by some investors we managed to negotiate sales at only minimum (if any) discounts to Net Asset Value.

Fears over inflation reduce but schemes question insurance market capacity

Concerns over inflation and central bank action have reduced markedly in the last six months. Respondents appear to have greater confidence that efforts to reduce inflation are beginning to have an impact (a consideration borne out by October 2023 figures which recorded the lowest inflation levels in two years). Similar sentiments can also be seen with respect to the possibility of recession, indicating greater optimism for either a 'soft' landing or possibly even complete avoidance of a recessionary scenario.

We do note that figures indicating diminishing concerns over geopolitical conflict do not incorporate the recent conflict in Gaza, with this study largely completed before the tragic events of recent weeks. Whether this impacts asset owners' thinking in the long-term remains to be seen. However, at this stage the market reaction to events in the Middle East has been muted. To that end, reducing concerns over potential geopolitical conflict can largely be attributed to the stalemate between Russia and Ukraine in Eastern Europe and less pronounced worries over the influence of China on the world stage.

Exhibit 11: Key concerns for pension schemes in the next six months



Source: Russell Investments, November 2023. Note we added the last three options for the first time in this year's survey.

However, unease is beginning to arise elsewhere, with decision-makers identifying the demands of reporting requirements and actuarial valuations as sources for potential concern.

A further area of consideration for pension scheme decision-makers is the ability of the insurance market to meet the significant and growing demands for buyout solutions. The shortening of endgame time horizons raises questions about the capacity of insurers and what pension schemes need to do to make themselves attractive to buyout providers.

Respondents to interviews for this study, in addition to highlighting issues around asset allocation and liquidity, noted the critical importance of governance meeting requirements such as GMP equalisation, and data cleansing. The consensus among respondents is that insurers will become increasingly selective and will only accept schemes that have addressed all these issues and are considered the best prospects.

Focus Group Quotes

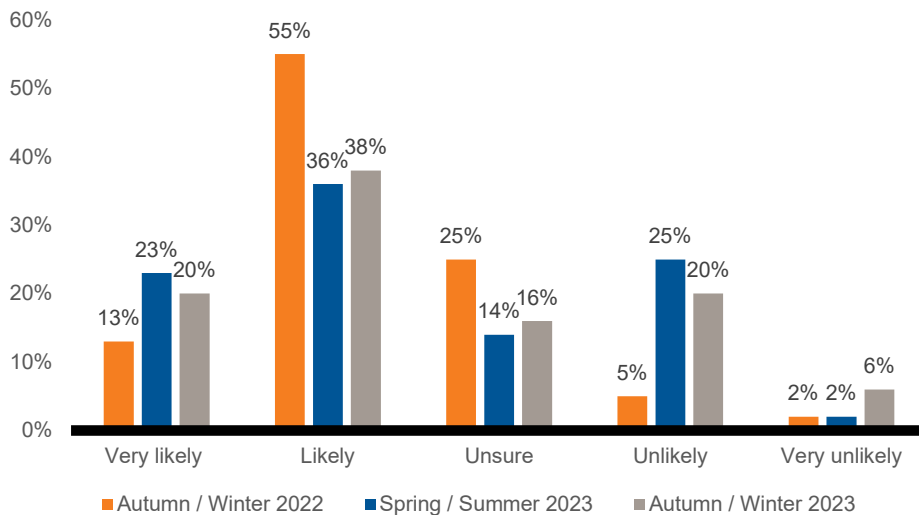
"We see two barriers. One is general capacity in the insurance market. The other is getting the schemes, the data, the liabilities etc. into a position that an insurer would be willing to work with."

"Insurers now can be incredibly picky and can pick and choose who they want to partner with to go through the buy-in exercise leading to buyout."

Changing priorities and action on ESG

ESG remains an important consideration for schemes, with half of respondents (see Exhibit 5) continuing to identify this as a priority. Climate change continues to dominate thinking; most respondents (58% total) indicate they are 'likely' or 'very likely' to increase their focus here in the next twelve months. That said, over a quarter still view it as unlikely or very unlikely they will focus on climate change – perhaps because they have already looked at this, it's not a priority for them or because their timeframes mean their main focus is elsewhere.

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



Focus Group Quotes

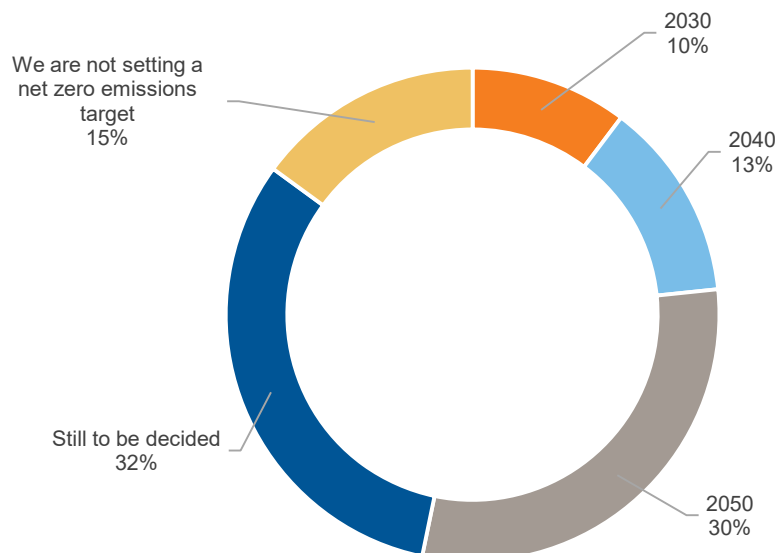
"I think [ESG] is just as important for the growth element, but there's slightly less time spent on it. There's no time to do it in the fixed income space."

"Whilst there might be grandiose ideas of ESG, you might only be holding an asset for 12 or 18 months. Therefore, there's a question as to how impactful you could be in terms of voting and other engagement over quite a short time horizon."

Source: Russell Investments, November 2023.

In our previous surveys, nearly half of respondents had yet to decide on their net zero targets. This has decreased this time around to less than a third, but the proportion who have decided not to set a target has increased to 15% from 8% earlier this year. Those who have set a net zero target increasingly aim for 2050 (30% vs. 21% previously).

Exhibit 13: Pension scheme net zero targets



Source: Russell Investments, November 2023.

A notable challenge identified by pension schemes is how to practically approach ESG issues amidst the acceleration towards endgame. The move away from assets like equities, which are typically considered to be more suitable for ESG-related action, in favour of fixed income, has created limitations to what schemes feel they can achieve from an ESG standpoint. These accelerated timelines also mean that schemes are likely to hold assets for a shorter period, thereby potentially limiting the extent to which they can have any sort of long-term meaningful impact.

Focus Group: Regulatory pressures and operational considerations prompt new approaches to governance

While improvements in funding levels and endgame timelines are positive, schemes recognise these also bring challenges.

Most notable among these pressures are the ones on scheme governance models. This includes endgame preparation, with the need to make asset allocations and operational structures attractive to insurers, as well as cater for regulation and dwindling resources.

The issue of regulatory pressures was emphasised by a focus group of independent trustees interviewed for this study. 58% of respondents expressed frustration with excessive regulation, highlighting the need for pragmatism in legislation given the demands being placed on schemes. Schemes at the smaller end of the spectrum were seen as being particularly affected.

Respondents also noted challenges in retaining experienced resources to manage the various operational requirements schemes face. Difficulties are emerging in attracting and keeping talent given the demands on trustees' time. The limited attraction of working within the defined benefit market as schemes close and career options become more limited was also cited.

In line with recent trends to outsource investment management to a fiduciary manager, several interviewees highlighted movements to sole trustee models, where sponsors delegate responsibility for pension scheme governance to a professional trustee. There is a general expectation that this model will become more prevalent in the UK pensions market, as both schemes and sponsors seek to improve efficiencies and enhance governance structures to meet the demands arising from the proximity to endgame.

Focus Group Quotes

"We're seeing more schemes move to a sole trustee model. In part this has been triggered by events like the gilts crisis. Trustees that had to sign documents in the middle of the night just feel it isn't worth it!"

"One of the issues on the agenda that's very frustrating, and I'm sure all trustees will share, is regulation. You have to look at the DB funding code and think 'are we really still doing this?'"

"A bit more legal pragmatism is needed on things like GMP equalisation. There is a need to be cognisant of the cost burden for small schemes."

Summary

Broadly speaking, UK defined benefit pension schemes report material funding improvements over the last 12-18 months. Better than anticipated positions are leading many schemes to consider endgame scenarios as a realistic near-term objective.

As a result, pension schemes are focused on protecting their improved positions as they begin (or accelerate) preparations for endgame – which, for the time being at least, is still to target a buyout.

While positive, these significant changes to the pensions landscape are bringing new issues for schemes and their advisers. The need to reduce portfolio risk, improve liquidity, enhance governance activities, and address the necessary regulatory requirements to appeal to prospective insurers, pose notable challenges that schemes need to address.

The defined benefit space will need to evolve to reflect this new environment. Pension schemes will have to consider all their activities in totality – investment, operational, and governance – if they are to build on the progress over the past year and meet their long-term objectives.

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