THE CHANGING ECOSYSTEM OF DEFINED BENEFIT PENSIONS

VOLUME 4 – SPRING / SUMMER 2024

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Foreword

Our latest research sheds light on the priorities and concerns of Defined Benefit (DB) pension schemes in early 2024. In this fourth edition, we witnessed a greater spread of responses, indicating a wider range of challenges faced by schemes.

Our results also show a growing divergence between the priorities of large and small DB pension schemes, with the latter appearing more focused on improving their funding position than derisking. Conversely, for larger schemes, concerns surrounding the 2022 Gilt Crisis appear relegated to the past, with many showing confidence with their current funding levels and focusing efforts on preparing for endgame.

What particularly stands out in our latest research are the emerging priorities and concerns of pension schemes. Environmental, Social, and Governance (ESG) factors are becoming a greater focus – albeit with limitations. Regulation also stands out as the top concern for schemes that is unlikely to ease anytime soon.

We hope you find the Russell Investments' fourth UK Defined Benefit Markets Insights study insightful, 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

Improving and maintaining funding levels (48%) and **improving ESG** (45%) are the most cited priorities among respondents.

A larger proportion of respondents (when compared to autumn/winter 2023) expect to **increase their allocations to Developed Market Equities** (+11%) **and Emerging Market Equities** (+8%) in the next six months.

Differing priorities between larger and smaller schemes. A third of smaller scheme respondents said derisking was a priority. For comparison, half of larger scheme respondents said it was their priority.

Over half (58%) of respondents plan to increase their focus on **climate change risk** over the next 12 months. Yet, 77% of respondents say they are **unlikely to focus on impact investing**.

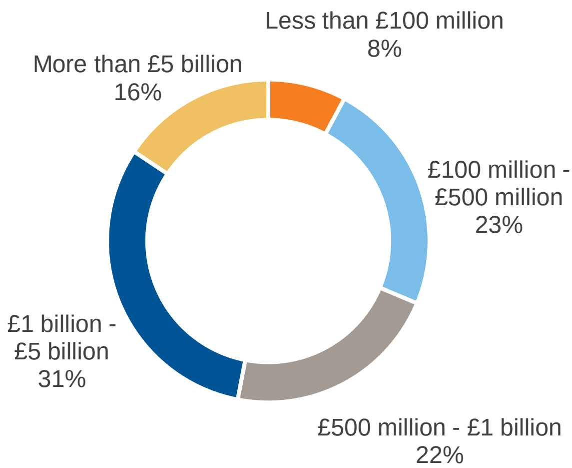
46% of respondents cite **regulation as a key concern** – up 21% from our prior autumn/winter 2023 survey.

Survey methodology

The Russell Investments UK Defined Benefit Market Insights is based on the responses of 115 UK DB schemes between March and April 2024. Those participating in the study are responsible for over £270 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, detailed interviews with a focus group of 10 leading professional and independent trustees were undertaken to assess their views on a range of key topics. Comments from these respondents are included in this report.

We would like to thank those individuals interviewed for their time and insights.



Focus Group of 10 professional trustees: Endgame and regulatory burdens dominate conversations

The focus group shared positive sentiment regarding the state of DB pension schemes over the past two years, with seven of the ten interviewees noting improvements in meeting their long-term objectives. There was a noted decrease to liabilities while maintaining stable contributions, which has likely helped to close any remaining funding gaps for schemes.

Eight trustees showed a growing inclination towards buyout options, with some noting that their smaller schemes are typically looking to remove themselves from sponsors' balance sheets, though consideration was also given to utilising surpluses for the benefit of both sponsors and members.

Several of the interviewees believed there has been a shift in the mindset of the pensions industry regarding future-oriented goals, with schemes looking to more bespoke and customised solutions from advisers, consultants and fiduciary managers, rather than standardised ones.

On ESG, while many of the interviewees recognised its necessity, they also identified the compliance paperwork, reporting and time-cost associated with the Task Force on Climate-related Financial Disclosures (TCFD) and upcoming consultations as costly and burdensome. There was a noted understanding of the importance of ESG considerations among trustee boards, but proactive engagement has varied. In a positive example, one scheme claims to be encouraged by regulatory requirements like the TCFD to prioritise ESG issues, which they say is influencing their selection of buyout providers.

However, a clear message from eight of the ten interviewees was that regulation was a significant concern, particularly in terms of resource management and defining responsibilities between trustees and advisers. They emphasised how trustees are facing significant time constraints, necessitating work beyond scheduled meetings to address evolving industry requirements.

Focus group quotes

"There's been a process of realigning to the new world and understanding what the endgame is, is it much closer than you thought, and are you adjusting investment strategies accordingly? There's probably been quite a lot of derisking and more serious conversations about buyout. What had always seemed like a distant dream might now be within five years or less for the majority of schemes."

Alison Bostock, Zedra, Professional Trustee

"If you think back to when ESG became big in this industry – TCFD, it's only two or three years ago – so for small schemes its only two, three or four trustee meetings. So a lot of the field consultants at small consultancies aren't up to speed on ESG yet."

Bobby Riddaway, Independent Professional Trustee

"The biggest challenge that the industry faces is resourcing. Admin is probably where this is felt most acutely. Insurance companies are competing for people with an admin background and professional trustee firms are a possible avenue for these individuals too. There is a finite pool of good quality admin people."

Pavan Bhardwaj, IGG, Professional Trustee

External expertise and operational support drives outsourcing

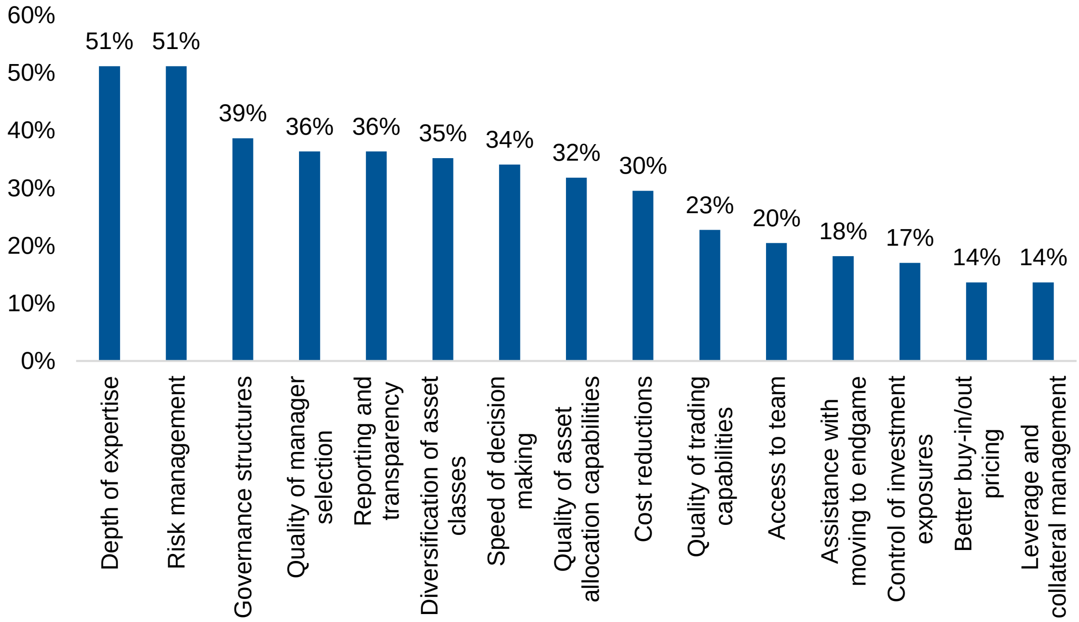
Of the 115 total responses, 83 (72%) indicated they have appointed or are looking to appoint an outsourced provider.

With operational burden and cost being at the forefront of our interviewees' minds, it is no surprise that these factors are also reflected among survey respondents. While depth of expertise and risk management are the main cited reasons for pension schemes appointing an outsourced provider (51%), reporting and transparency (36%) and cost reductions (30%) are also highlighted as significant reasons.

Surprisingly, assistance with moving to endgame is only cited by 18% of respondents, indicating that such an appointment may be taken with more immediate needs in mind. Moreover, the breadth of responses could also indicate a wider range of tasks and challenges which trustees are facing.

For instance, governance (39%) and speed of decision making (34%) were highlighted by a significant portion of respondents as reasons for outsourcing a provider. This echoes some of the feedback received from our qualitative interviews that identified boards as becoming increasingly time-constrained which could be affecting decision-making processes.

Exhibit 1: Reasons for appointing an outsourced provider (what are/were you looking to improve?)



Source: Russell Investments, April 2024.

Focus Group Quotes

"The real challenge is if you have an ambition to go somewhere, how are you going to get there? There are a lot of parts to move and control, a lot of project planning to be done. You can't just drift in this direction."

Graham Jung, Pi Partnership, Professional Trustee

"We are exploring whether there's a better way to do things – are we making decisions in the best way? Within the team, have we got the right skills? Are we as effective and efficient as we could be? These are really the questions that we're asking ourselves."

Andy McKinnell, AML, Professional Trustee

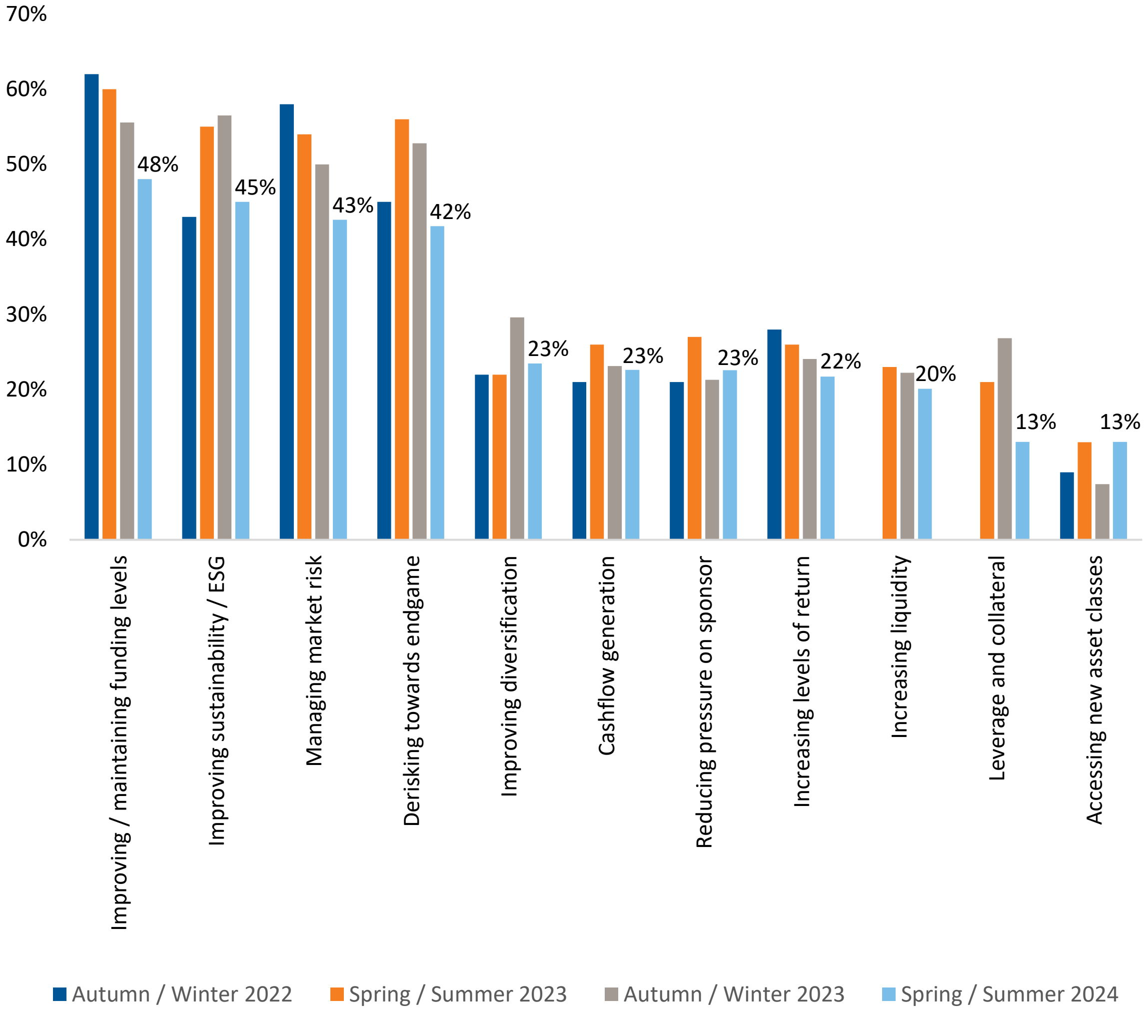
A cooling of industry concerns

When comparing the priorities of pension schemes in spring 2024 with prior survey responses, it's clear that while broadly the same, there has been a steady cooling of concerns that arose from the 2022 Gilt Crisis.

Leverage and collateral continues to fall down the priority list for pension schemes, down from being selected by 27% of respondents in the autumn/winter of 2023 and 21% in spring/summer 2023 to 13% in 2024. This could indicate that schemes in 2024 are more comfortable with their liquidity positioning (and have greater transparency on this following reporting improvements) when compared to prior years.

This is reinforced by drops in priorities in improving/maintaining funding levels (8% less than spring/summer 2023), managing market risk (7% less), and improving diversification (7% less).

Exhibit 2: Current respondent investment priorities



Source: Russell Investments, April 2024.

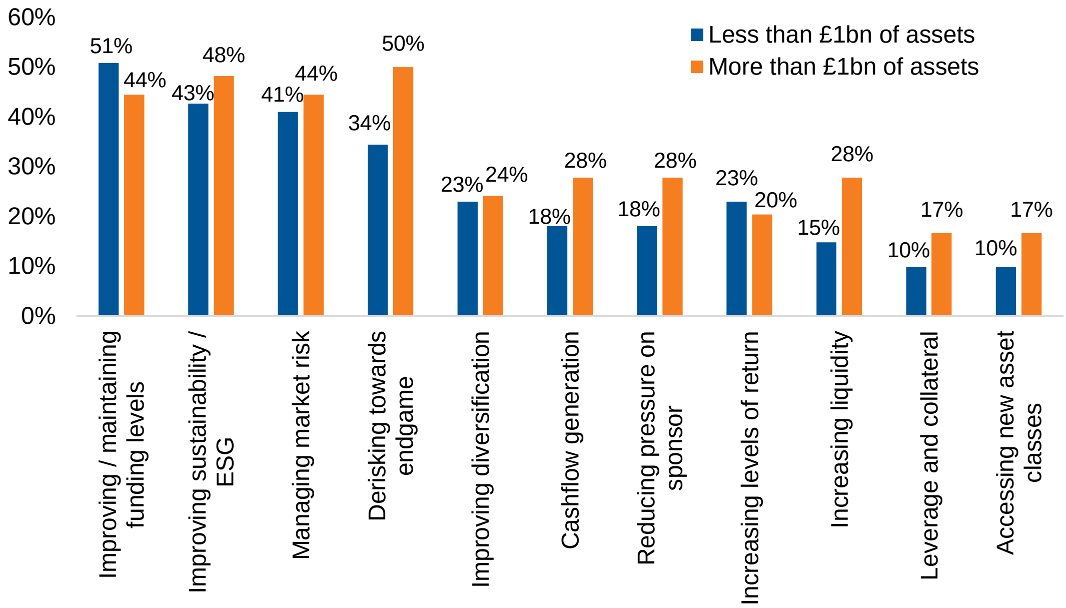
Smaller and larger schemes' priorities diverge

The gradual shift in the priorities of DB schemes is further evidenced in the disparity between different sizes of schemes. Exhibit 3 illustrates that 51% of schemes with less than £1 billion in assets are focused on improving/maintaining funding levels, compared to 44% of those with assets of more than £1 billion.

Conversely, half (50%) of these larger schemes cite derisking towards endgame as a priority, but only a third (34%) of smaller (sub-£1bn) schemes said so. Additionally, nearly twice as many larger schemes registered increasing liquidity as a priority (28%) than smaller schemes (15%).

These differing priorities could be reflecting the varying asset allocations to illiquids. Larger schemes with more illiquid assets would be more likely to highlight increasing liquidity as a priority than smaller schemes (that typically hold a lower allocation to illiquid assets). This would also explain why derisking was a greater priority for larger schemes than smaller ones.

Exhibit 3: Current respondent investment priorities by size of scheme



Source: Russell Investments, April 2024.

Focus Group Quotes

"Smaller schemes where you have maybe a legacy UK business with a relatively large pension scheme but still small in an absolute scale, but large relative to the size of the business, I still think finance directors and CFOs are very keen on getting that risk off the books."

Pavan Bhardwaj, IGG, Professional Trustee

"At the small end, what we're certainly seeing are concerns with ongoing running costs, and the Regulator has also highlighted smaller schemes being disproportionately affected by cost. To continue running on a scheme, if you're small that's quite a big hurdle to get over in terms of ongoing costs, even if you're running it in a really efficient way."

Sarah Leslie, ndapt, Professional Trustee

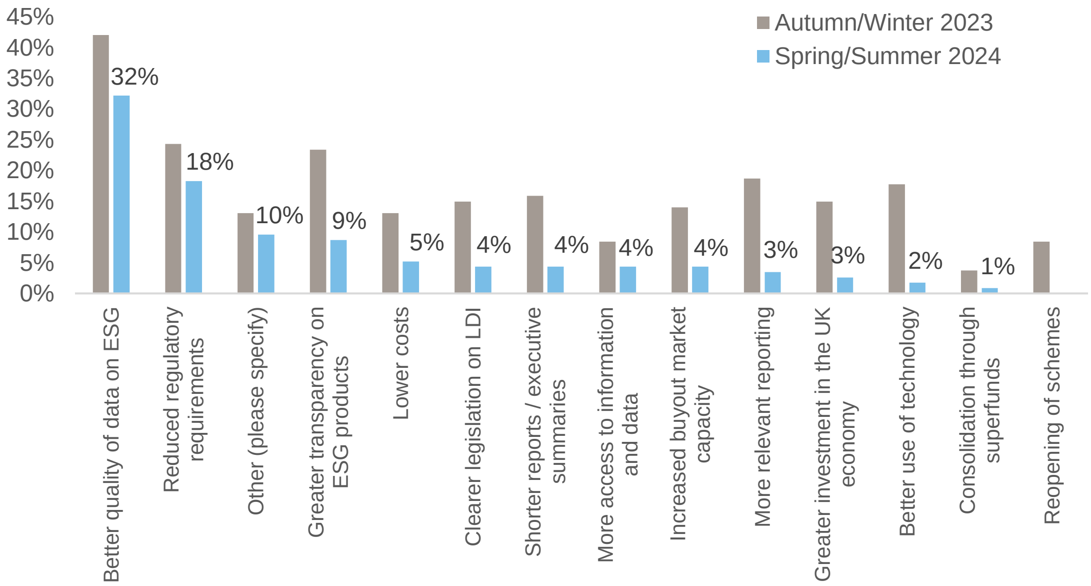
Fatigue with ESG and regulatory reporting

In another sign of shifting focuses, when asked for one change respondents would like to see in the DB market over the next twelve months, ESG and regulatory reporting stood out:

- Better quality of data on ESG, while a decline from the autumn/winter of last year, was selected by 32% of respondents. This echoes the sentiment mentioned among some of the qualitative interviewees that highlighted the importance of stewardship and holding asset managers to account in meeting the scheme's ESG objectives. In this regard, the provision of high quality ESG data will no doubt be essential.
- The call for reduced regulatory requirements (18%) is consistent with prior surveys. However, the reduced emphasis on introducing more relevant reporting (3%) and shorter reports (4%), when compared to the autumn/winter 2023 figures (19%,16%, respectively), suggests that there may be a broader sense of reporting fatigue this time around among trustees.

These views were validated in the focus group interviews where the mounting regulatory requirements were widely cited. One interviewee even acknowledged that the 'goalposts' were often shifting and that everyone would benefit from letting the dust settle around new regulation.

Exhibit 4: What is the one change that you would like to see in the UK DB market in the next twelve months?



Source: Russell Investments, April 2024.

Focus Group Quotes

"The regulator announced that there's a summer of consultations coming. All that governance – to come back to ESG – is going to take the attention of those schemes that haven't taken climate change seriously yet. It's going to nudge that off the agenda if we're not careful."

Bobby Riddaway, Independent Professional Trustee

"The stretching of resource in the industry. Everyone is just so busy all the time. It's very difficult to get things done."

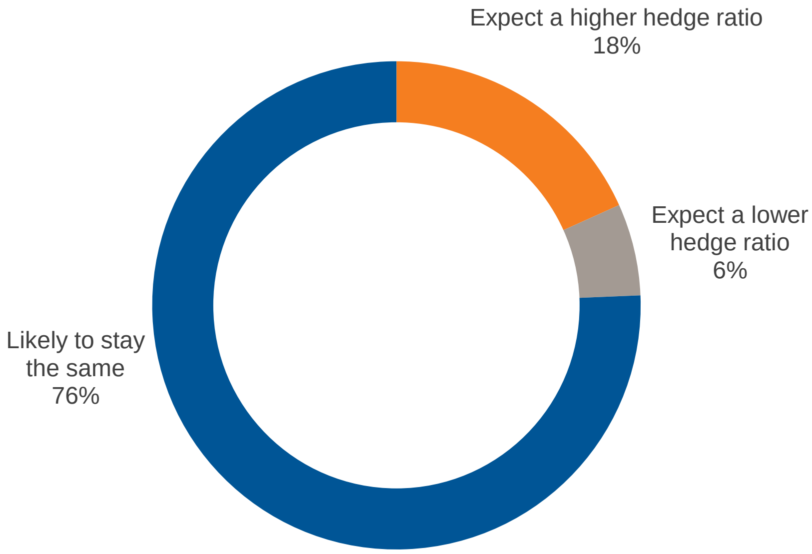
Alison Bostock, Zedra, Professional Trustee

Liability hedging expected to stay the same

Given limited yield movements since last year, it is unsurprising that hedge ratios have remained relatively unchanged, with 76% of respondents stating that their hedge ratios in the next two years are likely to remain the same.

As highlighted in the qualitative interviews, there is a sense that the typical DB scheme is well funded (and now well hedged). This is in part attributed to yields having improved significantly over the last two years, allowing schemes to better hedge their liabilities.

Exhibit 5: Hedge ratio changes expected in next two years



Source: Russell Investments, April 2024.

Focus Group Quotes

"Schemes have decreased in size because, as yields go up, the value of liabilities goes down. Cash contributions coming into those schemes over the same period have remained the same. As a result, contributions as a proportion of the deficit are much higher, and so are working harder to close the gap."

Pavan Bhardwaj, IGG, Professional Trustee

Reallocations to developed and emerging market equities

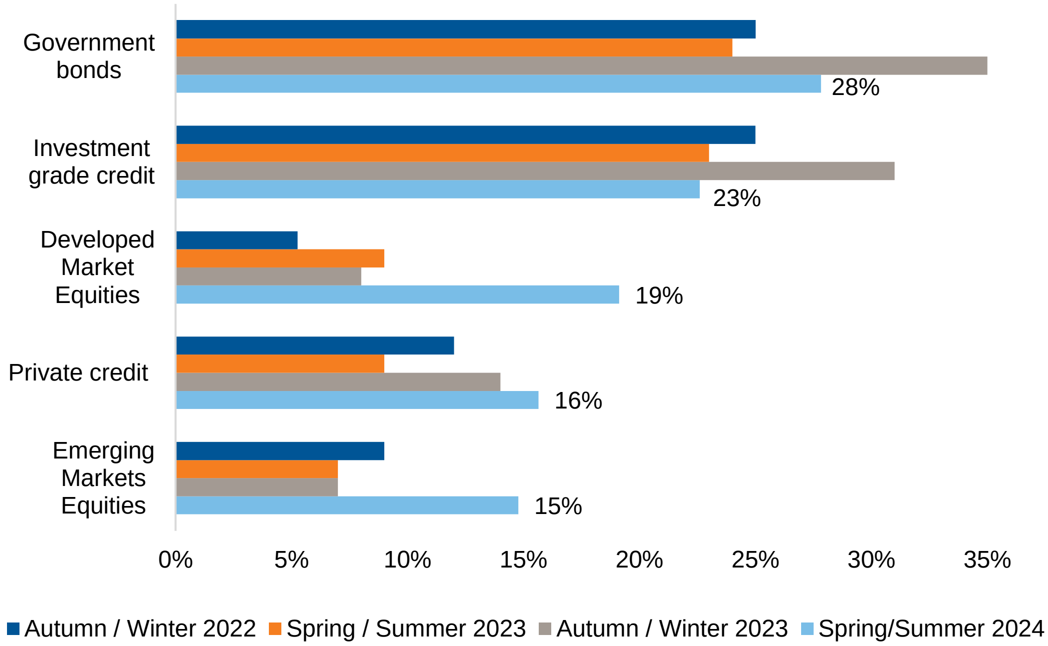
In our third volume of DB research, released last year, we noted an acceleration of schemes allocating their portfolios to safer assets, such as Government bonds and Investment Grade credit. However, in this latest survey, there appears to be a small but growing appetite to “re-risk” into growth assets including Developed Market (DM) and Emerging Markets (EM) equities.

19% of respondents said they expected to increase their asset allocation exposures to DM equities over the next six months, in contrast to only 8% in Autumn/Winter 2023. Similarly for EM, the proportion expecting to increase their allocations rose to 15% this year, up from 7% last year.

This could indicate that there is a greater risk appetite from schemes, potentially due to their stronger funding positions or optimism around the economy and central bank rate cuts (as of April 2024).

Moreover, results show a continuation of the increased appetite for private credit, reflecting a growing interest in the segment. This could be due to the contraction in traditional bank lending as well as the attractive yields that would benefit cashflow generation. This is also consistent with Exhibit 2, where schemes registered a growing interest in accessing new asset classes (12% in Spring 2024, up from 7% in Autumn/Winter 2023).

Exhibit 6: Schemes expected to increase asset allocation exposures in the next six months

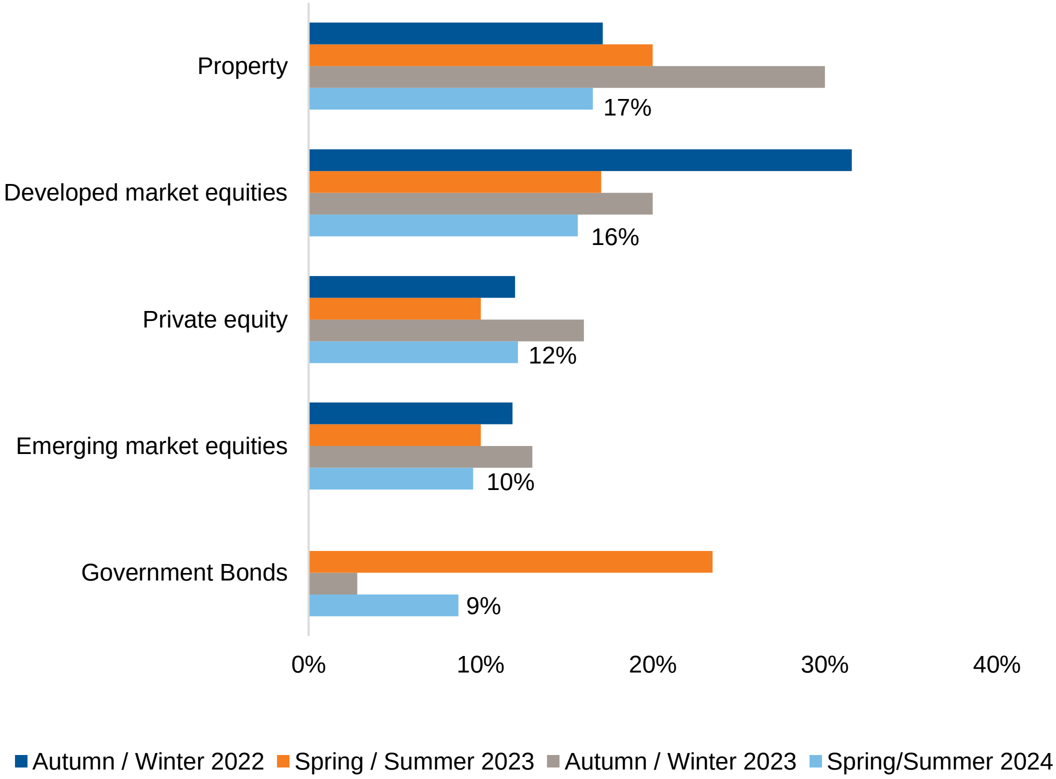


Source: Russell Investments, April 2024.

Looking at Exhibit 7, the prospect of decreasing allocations across different asset classes is more evenly split when compared to prior years. This could indicate that increased liability hedging has already taken place, with schemes being interested in fine-tuning their portfolios rather than undertaking any substantial shifts.

Schemes are continuing to seek to offload their holdings in property, although the lower proportion of schemes looking at this reduction could indicate a less urgent need for liquidity. Several interviewees acknowledged their desire to reduce exposure to illiquids but were cognisant of avoiding a 'fire sale' unless there was a real urgency to offload the assets.

Exhibit 7: Schemes expected to decrease asset allocation exposures in the next six months



Source: Russell Investments, April 2024.

Focus Group Quotes

"What we're not doing [with respect to illiquids exposure] is rushing sales to take the 20%+ haircuts that were out there last year. We didn't want to play that game."

Natalie Winterfrost, Law Debenture, Professional Trustee

"The typical DB scheme is now relatively well funded. Yields have moved significantly higher over the last 18-24 months, and most schemes hedge up to the value of their assets, which means they are underhedged against buyout. Many schemes have seen some improvement against their long-term objectives."

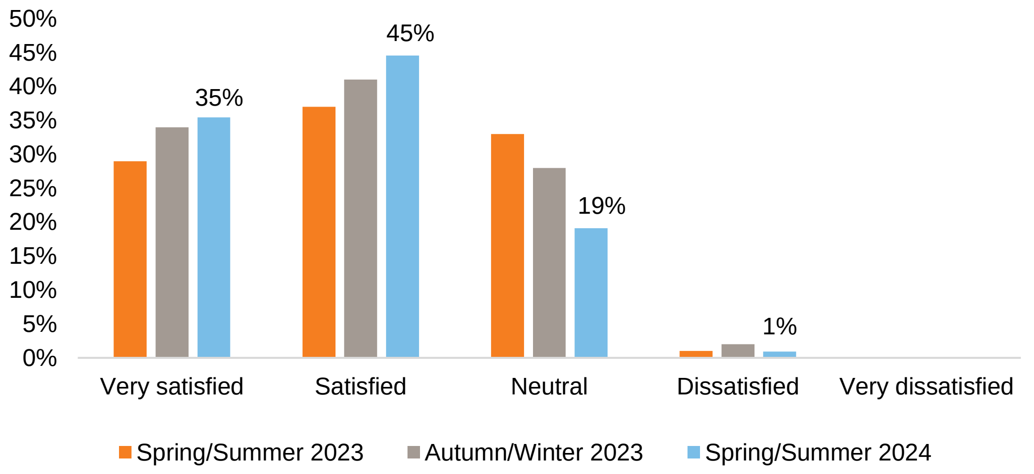
Pavan Bhardwaj, IGG, Professional Trustee

Growing satisfaction with asset managers

Liability Driven Investing (LDI) managers

When quizzed on how satisfied schemes were with their LDI provider, the results show a gradual improvement. Over the past year, the rate of respondents who were satisfied or very satisfied with their provider rose from 66% in spring/summer 2023, to 80% in spring/summer 2024. LDI continues to be an important risk management foundation for schemes and their risk management, and it is reassuring that very few stakeholders are dissatisfied with the efforts of their provider(s).

Exhibit 8: How satisfied are you with your LDI provider?

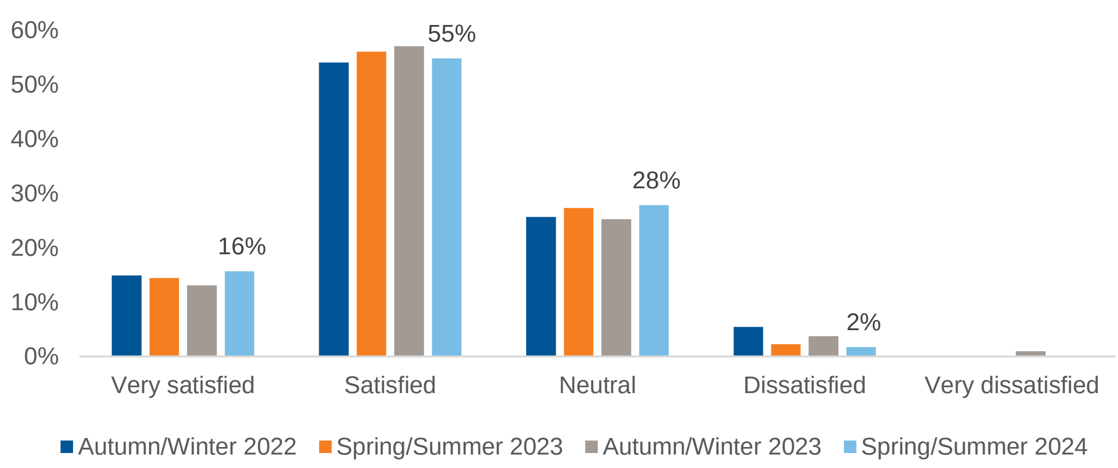


Source: Russell Investments, April 2024.

Growth asset managers

In alignment with previous surveys, c.70% of schemes continue to be satisfied or very satisfied with their growth assets' investment performance. Even following a difficult 2022 for growth assets, stakeholders are comfortable that their managers are looking after their assets in line with their objectives.

Exhibit 9: How satisfied are you with your current growth asset investment performance?



Source: Russell Investments, April 2024.

Schemes showing greater confidence in outlook

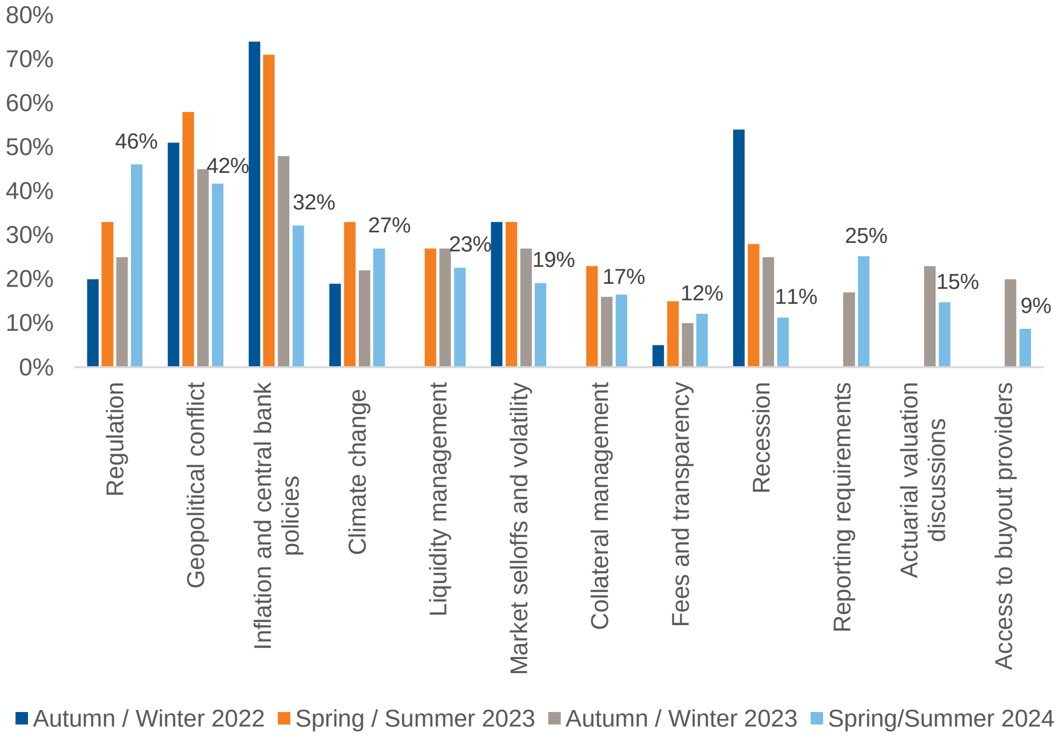
The theme of rising scheme confidence continues to be reflected in their key concerns for the next six months. In April 2024, the number of respondents that saw inflation and interest rates as a key concern dropped significantly over the past year, falling from 71% in spring/summer 2023, to only 32% of respondents in spring/summer 2024.

Similarly, only 11% of respondents saw a recession as a key concern in early 2024, less than half of the 25% who thought so in the autumn/winter of last year. Market selloffs and volatility also saw a significant decrease, falling from 27% last year to 19% this year.

Access to buyout providers also saw a significant drop as a cited concern among respondents, with only 9% selecting it a key concern for pension schemes in the next six months, versus 20% in autumn/winter 2023. This could reflect the increased willingness for insurers to quote for new business of all sizes, as well as the new entrants to the market in recent months (with more expected to join later this year).

Unsurprisingly, regulation rears its head again as a cause for concern for schemes, which saw a 21% increase in being selected by respondents when compared to autumn/winter 2023. This is echoed by concerns surrounding reporting requirements which rose to being selected by 25% of respondents, up from 17% in autumn/winter 2023.

Exhibit 10: Key concerns for pension schemes in the next six months



Source: Russell Investments, April 2024. Note we added the last three options for the first time in the Autumn/ Winter 2023 survey.

Focus Group Quotes

"Geopolitical risks are discussed a lot, but not with a clear idea about what one could do about it. Those sorts of risks, while we want to do something about them and think about them, the cost of offsetting those risks probably isn't really worth it given the probability of those risks."

Natalie Winterfrost, Law Debenture, Professional Trustee

Climate change risk focus preferred over impact

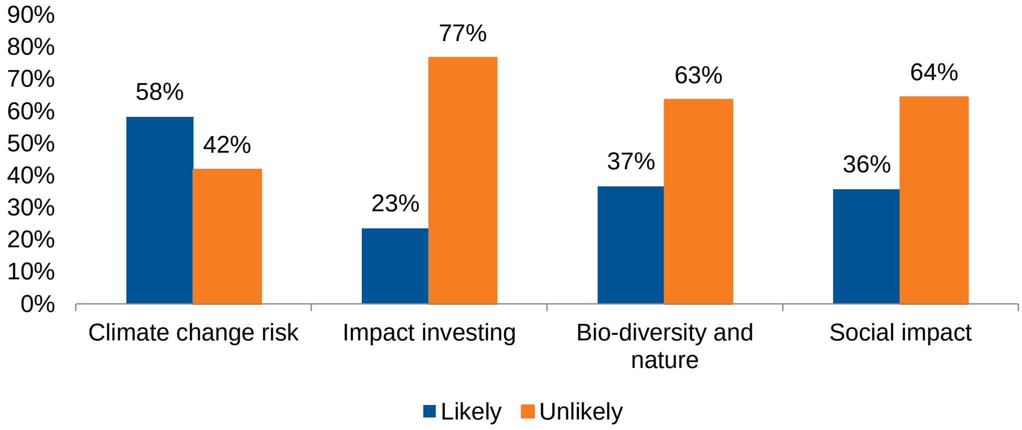
Our research shows that while ESG is still a major focus for DB schemes, there are clear limitations in its implementation. In Exhibit 11, over half of respondents (58%) say they are likely to increase their focus on climate change risk over the next twelve months.

Yet 77% of respondents say they are unlikely to focus on impact investing, with bio-diversity and nature (63%) and social impact (64%) showing similar responses. This highlights that while schemes want to factor climate change risk management into their portfolios, they are wary of incorporating ESG further.

This is not particularly surprising. With endgame on many scheme decision makers' minds, the prospect of investing in long-term illiquid assets, or those with potential high risk/return outcomes, is something that may conflict with their endgame timeframes. Additionally, while the Taskforce for Nature-related Financial Disclosures (TNFD) legislation is expected to require larger schemes to report against these requirements in the near term, there is currently no legislative requirement for reporting on biodiversity and social metrics, meaning schemes are more likely to prioritise other ESG factors.

Among the focus group interviewees, we also saw a split in responses. Five of the ten said ESG was either an important or a very important focus for them, while the other five considered it to either be an unchanged focus or less of one. We have included a selection of quotes below.

Exhibit 11: How likely are you to increase your focus over the next twelve months to the following?



Source: Russell Investments, April 2024.

Focus Group Quotes

"On the whole, everyone wants to feel good about what they're doing [with respect to ESG], but if it costs more money to go into a fund - if you have two funds the same, one is more ESG focused but costs more - it's quite a challenge to say we should go to the ESG focused one."

Melanie Cusack, Zedra, Professional Trustee

"The industry needs to make sure it provides the solutions for small schemes. The bigger schemes have done a lot more work but even they have been distracted by the TCFD reporting rather than actually getting the money into where it needs to be which is in impact investments, climate solutions, biodiversity solutions etc."

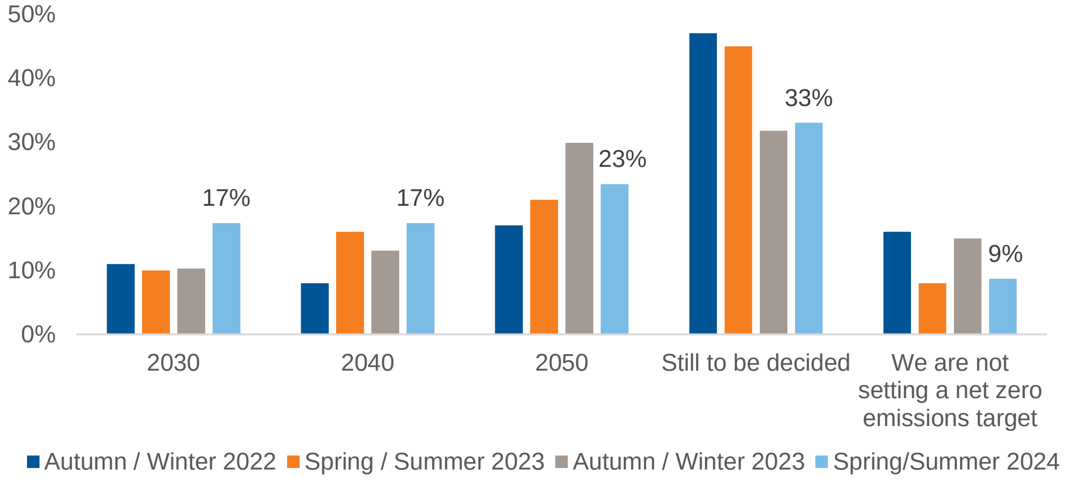
Bobby Riddaway, Independent Professional Trustee

When comparing results to prior surveys, there appears to be a gradual ramping up of the ambition of schemes with regards to net zero targets. While only 10% of schemes in autumn/winter 2023 had a net zero 2030 target, this has since risen to 17%. Similarly, the number of schemes that aim to be net zero by 2040 rose over the same period, from 13% to 17%.

On the flip side, there are also fewer schemes targeting less ambitious net zero goals. The number of schemes targeting 2050 fell from 30% in autumn/winter 2023, to 23% this year. On top of that only 9% of respondents said they aren't planning on setting a net zero target at all, down from 15% last year.

When combined with the results from Exhibit 11, the growing ambition around net zero targets does indicate there is a growing appetite for sustainable investment solutions. While there is hesitancy on how to include these solutions in pension scheme portfolios, it is an opportunity for asset managers to continue to innovate in an important and growing sector.

Exhibit 12: Pension scheme net zero targets



Source: Russell Investments, April 2024.

Summary

Our latest research indicates that UK DB pension schemes have continued to consolidate their funding improvements post the 2022 Gilt Crisis. Their cooling concerns regarding derisking and filling funding gaps, in spite of continued geopolitical uncertainty, indicates they have made significant strides in adjusting to the new market landscape.

However, where concerns two years ago may have been more focused on their scheme's resilience, today regulatory pressure is getting more attention. While not a new trend, the regulation and reporting burden on pension schemes appears to be shifting from being significant, to a genuine barrier of progress (especially for smaller schemes).

ESG is an issue that is gradually rising up the agenda for schemes but is also an area in need of solutions. While the appetite is there, the enablement of better data quality and transparency is lacking. From an investment perspective, there seems to be a ceiling in how far schemes would like to incorporate sustainability into their portfolios, but their growing net-zero ambitions suggest that this is a trend that could eventually change if the right solutions are provided.

As the defined benefit space continues to evolve, we look forward to gauging future industry trends and how pension schemes respond accordingly.

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