

## FTSE350 PENSIONS

# The Covid-19 investment shock

As UK defined benefit (DB) pension schemes mature, planning ahead becomes increasingly important. This is particularly true in relation to scheme investment strategies, where having a clear plan in place for current and future strategies is paramount.

However, as the last year has proven, even the best laid plans are subject to trials and tribulations. As the Covid-19 pandemic has brought a huge amount of volatility to financial markets, historic investment strategy decisions have been thoroughly tested, and the current uncertain economic outlook makes decision-making even more challenging.

In this investment-focused analysis of FTSE350 companies with DB pension obligations, we assess how schemes' investment strategies have resulted in a divergence in funding levels over recent months and what the disruption caused by Covid-19 will mean for future investment strategy decisions.

## Market turmoil

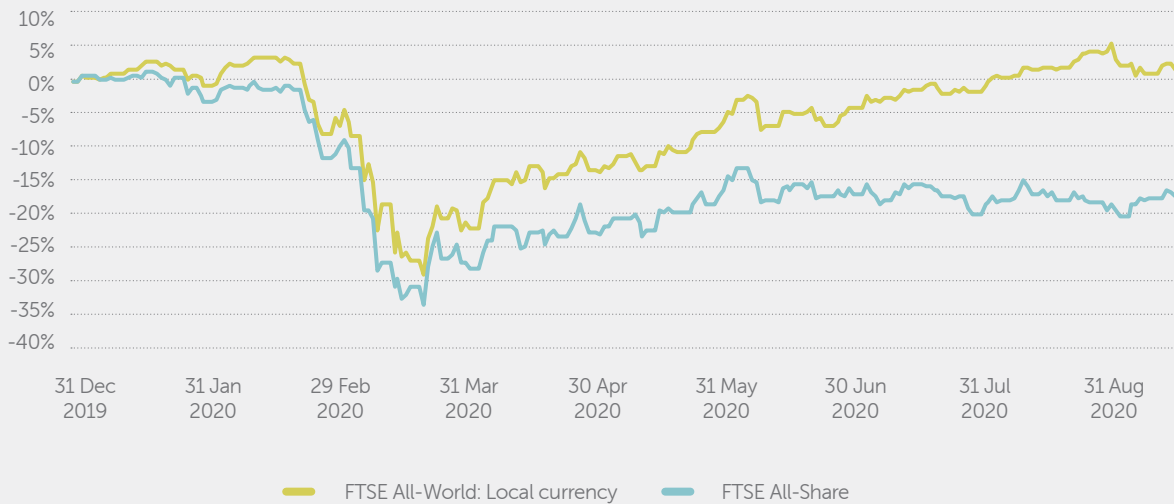
Markets started the year strongly with global equities rising 4% to their peak in mid-February. Shortly after, however, the pandemic began to spread across the world and markets quickly took fright. By mid-March, global equity markets had fallen 33% peak-to-trough due to the strict lockdowns imposed in the developed economies.

Over the period since March, central bank and government intervention and the easing of lockdowns led to the start of a market recovery. While global equity markets are back above levels seen before the virus, this has been driven by US equity markets, in particular large technology stocks, with most other regions still showing negative returns over 2020.



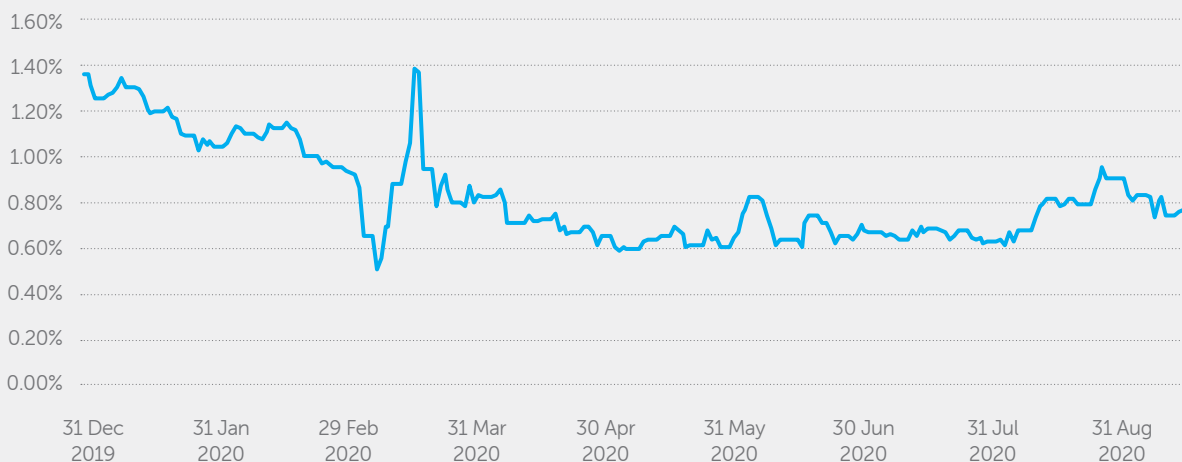
The chart below shows the performance of UK and global equity markets since the start of the year.

#### UK AND GLOBAL EQUITY MARKET CHANGES



The market disruption was not confined to equity markets. In an attempt to stimulate economic activity, central banks responded quickly by cutting interest rates. By mid-March the US Fed and the Bank of England had both cut rates to just above zero. Against this backdrop, gilt yields continued their downward march over the year, causing further strain on DB pension schemes' funding levels. The chart below shows the change in the 20-year gilt yield since the start of the year. Overall, long-dated gilt yields have fallen by around 0.65%. After allowing for changes in inflation expectations, scheme liabilities are expected to have increased by around 10% in this short timeframe.

#### 20-YEAR NOMINAL GILT YIELD CHANGES DURING 2020



## Funding level divergence

The events of the past year have put substantial pressure on the funding levels of most schemes. Despite the resurgence of equity markets, most schemes are now likely to be in a worse position than at the start of the year. [Our second analysis in this series](#) found that, on average, Covid-19 had pushed back the FTSE350 DB endgame by around 18 months over the first half of the year.

However, underneath this headline statistic, there has been a considerable divergence in experience for individual schemes, with the underlying investment strategy clearly differentiating how schemes have fared since the start of the year.

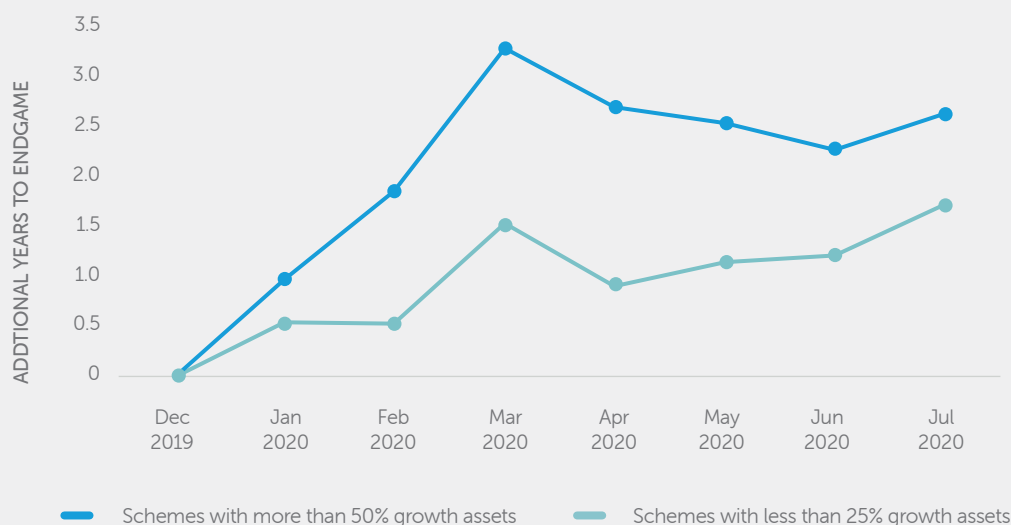
Across the range of FTSE350 DB schemes, those who were further along their endgame journey plans with de-risked, well-hedged strategies and reasonably short time horizons to buyout, were significantly less impacted by the market volatility than those who remain more than ten years from their endgame and with higher levels of investment risk. The chart below demonstrates how the endgame timeframes have been affected for two different categories of FTSE350 schemes since the start of the year.

The chart illustrates the large risk exposure for schemes with a high allocation to growth assets, as well as the benefits of hedging in the current environment.

The average time to buyout has increased by an additional year for schemes with 50% or more of their assets allocated to growth, compared to those with 25% or less in growth assets. The result of this has been a widening in the spread of DB scheme funding levels and a divergence in the resulting timeframe to buyout.

This highlights the importance of having a clear understanding of the risks inherent in the DB scheme investment and funding strategies. Companies and trustees should be assessing their scheme's performance over recent months to ensure that the volatility experienced is consistent with their objectives and appetite for risk. They should also ensure that the employer covenant can justify the level of investment risk being taken, particularly given the post-lockdown challenges facing UK businesses.

### IMPACT OF COVID-19 ON ENDGAME TIMEFRAMES BASED ON INVESTMENT STRATEGY



## The investment return challenge

For schemes no longer on track to reach their endgame within the desired timescales, there are various options available. To get back on track, the following actions can be taken:

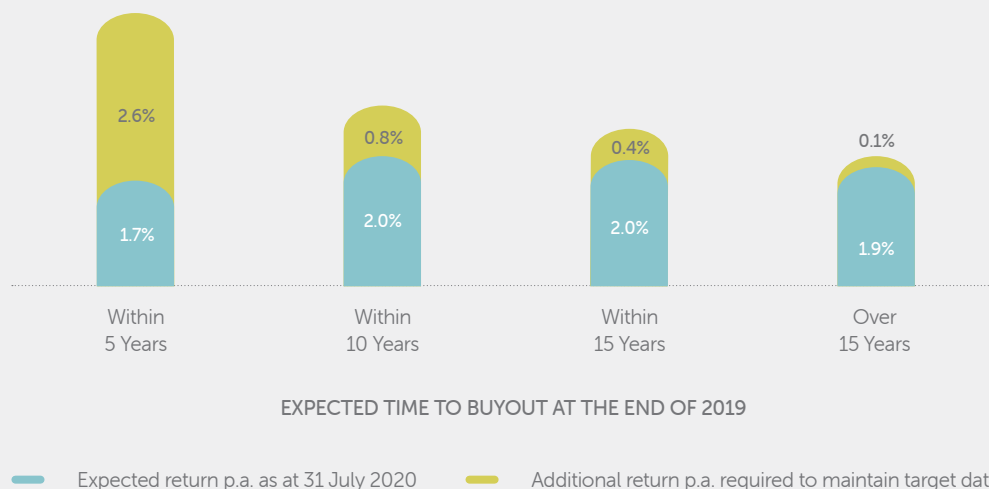
- An increased level of contributions from the company could be agreed
- Alternative ways to settle liabilities could be explored (for example, through liability management exercises)
- The expected return in the investment strategy could be increased
- A combination of the above could be considered

If these actions are not practicable, an extended time to endgame is the likely outcome, unless financial markets move back in a favourable direction. In the analysis that follows, we consider the additional investment returns that would be required for FTSE350 DB schemes to get their endgame plans back on track.

The current average expected return of the FTSE350 DB schemes is 2.0% p.a. based on our best-estimate expected returns, but the average required return to reach the endgame timeframes expected in December 2019 is 3.4% p.a.<sup>1</sup> This means that on average the FTSE350 DB schemes would need to achieve an additional annual return of 1.4% p.a. above current expectations to reach the endgame in line with expectations at the start of the year.

The chart below shows the current best-estimate returns expected from the FTSE350 DB pension schemes investment portfolios, split based on the endgame timeframes anticipated at the start of the year. To illustrate the impact of Covid-19, we have calculated the additional investment returns that these schemes now require to maintain the same endgame timeframes expected at 31 December 2019.

### ADDITIONAL RETURNS REQUIRED AS AT 31 JULY 2020 TO MAINTAIN EXPECTED BUYOUT DATE FROM THE END OF 2019



<sup>1</sup> The endgame is assumed to be buyout for the purposes of this analysis.

While some DB schemes that are further away from their endgames will have been impacted to a greater extent by the recent turmoil (as they are generally exposed to a higher level of investment risk), the longer timeframe provides greater scope to get back on track through investment returns alone. However, even for schemes aiming to buyout within 10-15 years, additional required returns of 0.4% p.a. will still require a material level of re-risking (broadly equivalent to moving 15% of their investment portfolio from investment grade corporate bonds to equities).

At the other end of the spectrum, DB schemes targeting buyout within five years have a limited time period over which to recover losses through additional investment returns.

Given the current volatility in markets and the outlook for most asset classes, it is unrealistic for schemes aiming to buyout in the next five years to assume that investment returns will get them back on track.

For schemes with a shorter endgame timeframe, company contributions are the only real solution to getting the journey plan back on track. In the current environment, however, this will be a tough sell for many businesses.

Our analysis suggests that contribution rates would need to increase by around 50% for the proportion of FTSE350 schemes able to buyout within ten years to get their endgame plan back on track.

Of course, increasing the expected investment return is not without risk and any changes to a scheme's investment strategy should be made with a clear understanding of the implications. The outlook for the global economy and financial markets continues to appear extremely uncertain, but there will be options available for some schemes to improve expected investment returns without materially increasing the overall strategy risk. For example, this could be achieved by reducing risk in parts of the portfolio to offset increases in other areas or by diversifying into different asset classes and strategies.

The recent market turmoil has also created potential opportunities to capture value in some pockets of the market, which companies and trustees should be actively exploring.





## Re-assessing your investment strategy

The economic impact of the pandemic has affected all DB schemes. While we have seen equity markets rebound somewhat since March, gilt yields still languish at record lows. This means most schemes will have experienced some level of setback to their long-term funding plan.

Companies and trustees should understand how events have impacted their scheme and the implications for the journey to the scheme's endgame. In some cases a new plan will be needed, others will need to adapt existing strategies. It is clear that schemes with higher equity allocations and lower hedging levels will have been blown further off course from their endgame plan. Those schemes in the earlier stages of their journey still have time to navigate back, but

need to be considering how best to allocate their risk budget and make the most of current market opportunities to do this.

Having a suitable monitoring framework in place has never been more important. Staying aware of how a scheme is progressing against both short-term funding objectives but also longer-term funding targets is vital for schemes to be able to take advantage of market volatility and to understand which investment opportunities might be suitable.



Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

✉ [info@barnett-waddingham.co.uk](mailto:info@barnett-waddingham.co.uk)

☎ 0333 11 11 222

[www.barnett-waddingham.co.uk](http://www.barnett-waddingham.co.uk)

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office. Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at 2 London Wall Place, London, EC2Y 5AU. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority. BW SIPP LLP is authorised and regulated by the Financial Conduct Authority. Barnett Waddingham Actuaries and Consultants Limited is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.