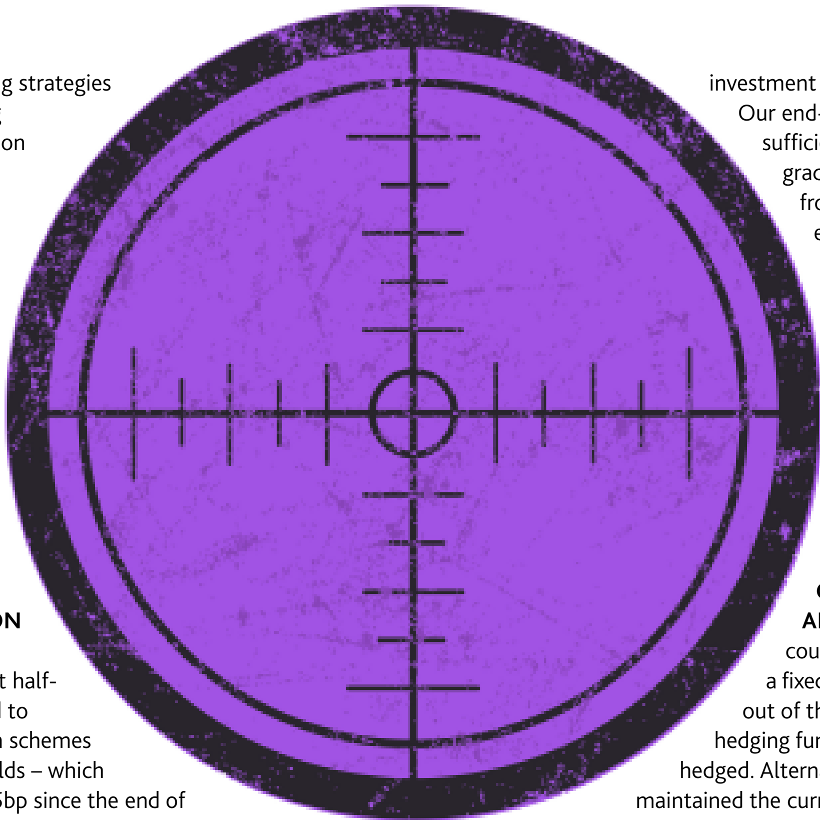
Ready, aim, fire

THE TREASURER TALKS TO ANDREW BIRKETT, GROUP PENSIONS MANAGER OF BABCOCK INTERNATIONAL, AND MATTHEW BALE, CLIENT SOLUTIONS DIRECTOR OF INVESTMENT MANAGER PENSIONSFIRST, ABOUT THE HOW AND WHY OF TRIGGER-BASED PENSION DERISKING.



Trigger-based derisking strategies have been attracting attention from pension schemes seeking to adopt more dynamic investment approaches as a way to manage risk more effectively. But what are the advantages of employing such strategies and what are the barriers to their effective implementation?

Q: IS NOW A GOOD TIME FOR SPONSORS AND TRUSTEES TO BE THINKING ABOUT DERISKING THEIR PENSION SCHEMES?

Matthew Bale: Yes. The past half-year has been relatively kind to defined benefit [DB] pension schemes with steadily rising bond yields – which have increased by around 25bp since the end of 2010 – driving down scheme liabilities and increasing equities having the opposite effect on scheme asset values. Combined, these factors have resulted in increasing funding levels for the majority of pension schemes. Indeed, PensionsFirst research shows that over the last four months the proxy funding deficit of the FTSE 100's DB schemes has been slashed by over £40bn – around 30%. Yet while increasing funding levels are welcome, they could equally well disappear in the coming months if scheme sponsors do not bank the gains by engaging in derisking transactions.

Andrew Birkett: Pension schemes are becoming increasingly aware of the fact that if they do not act to lock in improvements in funding levels, then they risk their deficit widening once more the next time the FTSE takes a hit or bond prices fall. Like many schemes, Babcock has therefore reorientated the traditional approach to pension scheme management – which has long focused on simply maximising asset returns – to try to reduce the risk to funded status through investment strategy and asset allocation. Our end-game is to become self-sufficient over a 20-year period by gradually switching investment from a growth fund – which exists to improve funding levels – to a hedging fund that will reduce the scheme's exposure to interest rate and inflation risk, but crucially only at times when it is appropriate and affordable.

Q: IN PRACTICE, HOW DO YOU PLAN ON ACHIEVING THIS OBJECTIVE?

AB: In terms of execution, we could have opted simply to move a fixed percentage of our investment out of the growth fund and into the hedging fund year on year until fully hedged. Alternatively, we could have maintained the current growth-to-hedging proportions until a 100% funded level was hit, and then derisk at that point. However, the first does not consider individual scheme or market changes, introducing the possibility of the scheme either derisking at unfavourable times or missing opportunities. The latter hands the initiative with respect to risk management over to luck. Our view is that this would be deemed unacceptable for the management of a £2.8bn company, and pension schemes should be treated no differently. We have therefore decided to implement a trigger-based derisking strategy that prepares for periods when the scheme's assets and liabilities, prevailing market conditions and other factors align to create an opportunity to help immunise part of the portfolio with fixed-income assets and derivatives.

MB: To help capture these market opportunities, we have witnessed a number of schemes beginning to explore the greater delegation of asset allocation changes with the help of predefined triggers for action. However, while the benefits of this approach ring true with scheme sponsors and trustees alike, a lack of knowledge about how best to implement such a strategy can often stall or completely halt progress.

Q: EXPLAIN IN MORE DETAIL HOW TRIGGER-BASED DERISKING STRATEGIES WORK. WHAT TRIGGERS CAN SCHEMES USE TO PROMPT CHANGES IN ASSET ALLOCATIONS?

MB: Using funding-level triggers ties derisking closely to the funding level, ensuring that growth assets remain when they are needed to make up the deficit but are reduced at higher funding levels, when seeking upside is less of a concern than reducing risk. At PensionsFirst, we believe that funding-level triggers are the most effective way of implementing a trigger strategy. However, it is also possible to state the triggers in terms of market indicators, such as a yield on a bond.

It is also important to consider how trigger-based derisking strategies interact with funding plans. Whenever a trigger point is reached, and derisking takes place, the scheme's technical provisions may be impacted, therefore establishing a new funding plan – or flight path – for the scheme.

AB: We have adopted two sets of automatic trigger mechanisms. The first of these monitors funding levels and prompts derisking, moving the scheme to a new flight path each time the funding level increases by 5%. And within our hedging portfolio we have a second set of market-based triggers that aim to reduce interest rate and inflation risk gradually as opportunities arise over time.

> "WHILE INCREASING FUNDING LEVELS ARE WELCOME, THEY COULD EQUALLY WELL DISAPPEAR IN THE COMING MONTHS IF SCHEME SPONSORS DO NOT BANK THE GAINS BY ENGAGING IN DERISKING TRANSACTIONS."

Q: WHAT ARE THE KEY ADVANTAGES FOR PENSION SCHEMES OF ADOPTING A TRIGGER-BASED STRATEGY?

AB: Our derisking flight path allows us to reduce investment risk over time, with the aim of partially locking in gains in the funding level. In practice, this allows us to reduce the scheme's exposure to riskier growth assets as the funding level improves and to reduce liability risks by investing in assets that match the interest rate and inflation exposure in the liabilities.

MB: Although market shifts are unpredictable, a strategy like the one adopted by Babcock enables schemes to bank gains and reduce risk when it is most affordable. The importance of doing this should not be underestimated. To put this in context, with FTSE 100 sponsors paying around £12bn a year in cash to fund pension deficits, the recent improvement in deficits of £40bn represents over three years of deficit funding. Banking this gain therefore could cut years off a recovery plan for a pension scheme.

Q: WHAT ARE THE BARRIERS TO IMPLEMENTING SUCH A STRATEGY?

AB: We found that the key hurdle to executing a funding-level trigger strategy was accessing accurate valuations of our pension assets and liabilities on a timely basis. Indeed, industry-wide, DB pension analysis has long been based on information rolled forward from a formal actuarial valuation – a process that is generally only carried out on a triennial basis.

MB: Certainly, relying on triennial formal actuarial valuations – or roll-forwards from these valuations – is a hindrance to the execution of funding level-driven approaches. By the time the actuarial valuations are complete, changes to the situation of individual members within the plan, as well as changes in investment portfolio valuations and in economic conditions, only too often render the figures obsolete. And roll-forwards of these valuations, which by their very nature are merely approximations, introduce inaccuracy into the process.

Our research shows that if pension schemes don't have daily, real-time and accurate information on their pension liabilities they can lose much of the value derived from implementing a trigger-based derisking strategy. In effect, they are adding unrewarded funding-level risk relative to best-in-class implementation. The scale of this risk depends on the inaccuracy of approximate valuations, but our research suggests that for a £1bn scheme this can be equivalent to investing 3-4% of the scheme assets in equities rather than bonds, without the compensatory £1m a year in expected return.

AB: I would suggest that scheme governance is also an issue. In the past, Babcock's four main pension schemes – which in turn are governed by four separate trustee boards – used to work independently, with four separate investment advisers on four separate investment strategies. This governance framework created huge inefficiencies and therefore hampered effective decision-making.

Given that the concept of trigger-based strategies centres on improving the speed of actions to capture opportunities it was clearly a barrier. A key focus for us therefore was working with the trustees so that they bought into the notion of working with one team of investment advisers and a newly formed investment sub-committee on a single trigger-based strategy, which would benefit all of the schemes.

Inevitably, however, this necessitated some delegation away from the trustee board to the investment sub-committee. For the trustees to become confident in this delegation of responsibility, it was clear to us that any information underpinning the strategy would need to be accurate and available in a timely fashion and there would need to be a robust and appropriate process in place to implement changes.

Q: WHAT ARE THE SOLUTIONS TO THESE PROBLEMS?

AB: Technological advancements can overcome many of these hurdles mentioned and help provide a stable and robust foundation on which to build a dynamic trigger-based strategy. Indeed, PFaroe – the business intelligence platform provided to us by PensionsFirst – now enables us to view accurate liability and funding-level information on a daily basis. This technology allows our investment sub-committee to react quickly and effectively to derisk the scheme at favourable times, and further provides confidence to the trustees that they will do so in line with their intentions. With the technology and governance infrastructure in place, we are confident that we are now in a stronger position to react as soon as opportunity knocks.