Too much of a good thing?

Is too much choice killing pension scheme decision-making?

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In 2013, the majority of UK pension schemes find themselves with a deficit hole to fill. Most UK pension scheme trustees and corporate sponsors are relying on investment returns and favourable market conditions to help them do this. But when is the right time to consolidate increases in the assets or falls in the liabilities? How do you do this? Focusing on a ‘set menu’ of key factors can help trustees avoid ‘à la carte’ indecision.

Introduction

Flight paths[1] can help capture those times when the markets reward us. Improvements in funding levels can be monitored and acted upon in a timely manner through pre-specified de-risking mechanisms. Having such a trigger-based framework in place allows changes to be made to a scheme quickly and confidently.

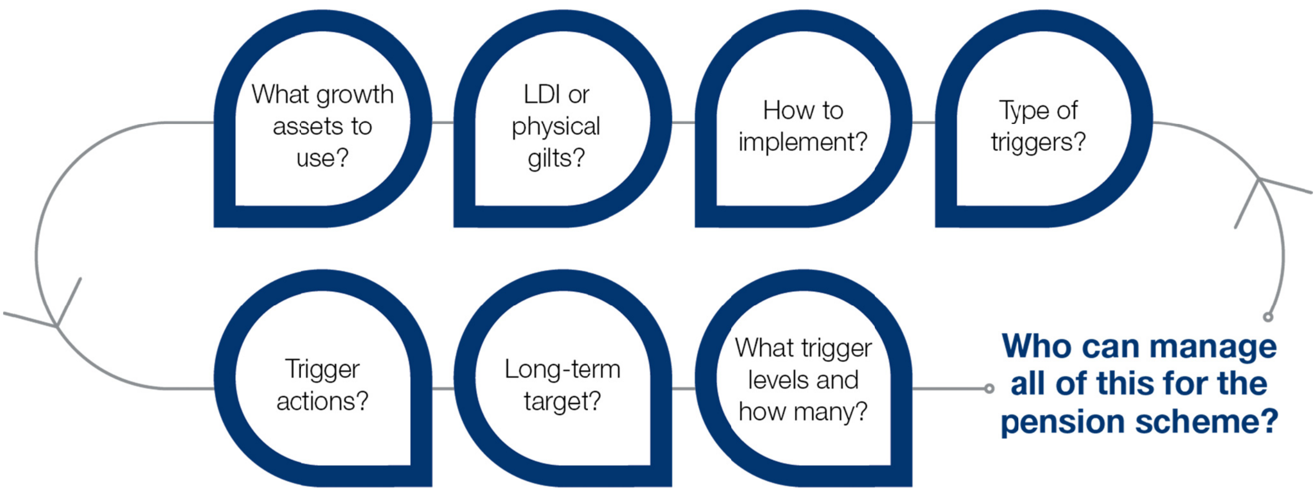
So why haven’t more pension schemes embraced these types of solutions? In a recent survey[2], less than 50% of UK pension schemes had a flight path in place in 2012, although the majority intended to do so at some point in the future. Costs, difficulty and lack of necessary governance were all cited as reasons why they hadn’t implemented a flight path to date.

Such de-risking frameworks may not be perfect, but intuitively, having a de-risking plan in place must be more effective than having no plan at all.

The benefits of simplicity

Consider a typical pension scheme looking to design a flight path. These flexible and robust solutions are designed to fit with the pension scheme’s own governance and belief system. However, the bespoke nature of this strategy means that a lot of decisions will need to be made by the trustees.

The De-Risking Decision Mill



Given all these decisions, is it any wonder more pension schemes do not have a robust risk reduction plan in place? This is especially true when considering smaller pension schemes where it can be even more difficult to find the governance or cash budget to make all of those decisions. However do you have to make all of those decisions? What if you just had to focus on the really important ones? We explore this idea below.

Set Menu

Now think of visiting a high quality restaurant. The waiter hands you the à la carte menu; a long inventory of wonderful delicacies with exotic ingredients, tempting side dishes, added extras; bread and sparkling water, alongside a wine list with hundreds of wines to choose from. Sound familiar? All very tempting to the excited and hungry diner. Sounds a bit expensive though… and what will be left uneaten that wasn't really needed, yet still has to be paid for?

Now consider the same restaurant, but this time you have a menu showing a selection of equally delectable dishes hand picked by the chef himself - usually at a lower price than the à la carte version. This is the Set Menu. The aim of the Set Menu is to offer the customer the advantages of a less complex menu (which benefits the kitchen) by providing a 'best in class' good value menu (which benefits the customer).

Now instead of 'customer' think 'pension scheme trustee'. And instead of 'restaurant' think 'fund manager'. Can the Set Menu principle be applied to flight paths?

What is really important in a de-risking plan?

À la carte flight paths can be time intensive and costly to set up and run. We have refined the different flight path decisions into a set of good value 'principles' – concentrating on the decisions which have the most value or benefit to the pension scheme. This helps us to build the 'Flight Path Set Menu':

FLIGHT PATH SET MENU

Starter

Design

A flight path focussed on your long term objective e.g. to be 100% funded on a low risk basis.

Served with:

Triggers and automatic de-risking actions

Targeting the most important measure of success – the funding level. Growth asset risk and liability risk are by far the largest investment risks for pension schemes. Look to reduce these risks first.

Main

Growth

Using a diversified mix of assets to generate your required return. Select these yourself or delegate to a diversified growth asset manager.

Served with:

Low risk assets and liability matching

Something simple to de-risk from growth assets. Ideally something that can be used as the backing asset for liability matching. Pooled liability matching funds can be used to increase flexibility and retain more assets in the growth allocation if needed, whilst still allowing the match to be tailored to the scheme.

Dessert

A governance medley

Managers: Asset allocation (investment strategy) drives approximately 85%[3] or more of returns. Focus on getting this right first, before spending your time and governance budget on numerous manager selections.

Advisers: Can provide independent oversight and assistance, especially in the design process.

Sponsor: Get them involved. The most effective de-risking plans are a coalition between the sponsor and the scheme trustees.

Is there such a thing as a Flight Path Set Menu?

Yes. There are fund managers who can provide all of the core elements in a flight path (funding level triggers, range of growth strategies and tailored liability matching solution) for clients of any size. In terms of implementation, pooled fund solutions are available in most investment areas. And the provider can offer a comprehensive review process and detailed reporting so you can see where you are on your flight path.

Napoleon Bonaparte supposedly once said "Nothing is more difficult, and therefore more precious, than to be able to decide". Using the Set Menu principle can help pension scheme trustees focus on the most important of the difficult de-risking decisions. This can help them design a focused, tailored and good value flight path that works for their particular governance and cost budget.

If you would like to discuss any of the topics discussed in this paper, please contact a member of the UK Strategic Solutions team www.schroders.com/ukstrategicsolutions

Important information

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[1] Flight paths are tailored asset allocation frameworks used to de-risk pension schemes' assets over time. Triggers (for example based on funding level improvements) are used to implement a change to the asset allocation. This might mean reducing the allocation to return generating or growth type assets. Alongside this, Liability Driven Investment (LDI) solutions are used to reduce the impact of liability risk. These frameworks are sometimes referred to as de-risking plans, flight plans or journey plans.
[2] Schroders independent survey in November 2012 of over 200 UK pension scheme managers, trustees and independent consultants.
[3] The Importance of Asset Allocation, Roger G. Ibbotson, Financial Analysts Journal, Number 2 2010
Determinants of Portfolio Performance (1986)
Determinants of Portfolio Performance II: An Update, Gary P. Brinson (1991)