“Better safe than sorry”

Downside Protection For Defined Benefit Pension Schemes

Most people would rather not lose money. Studies of human behaviour have repeatedly shown that we treat the prospect of losing £100 as a bigger deal than the prospect of gaining £100. In the ordinary course of life, at least when the amounts involved are small, this is irrational. However, in many cases, taking a more cautious stance and avoiding unnecessary risk can be entirely sensible, such as when trustees are making investment decisions for a Defined Benefit (DB) pension scheme. If assets perform particularly well, it may be that the liabilities can be bought out sooner, or the sponsor can cut their contributions – but, as far as the members are concerned, they are still just receiving what they have been promised (benefit improvements being an increasingly rare phenomenon). On the other hand, if assets lose a large part of their value, this can spark a downward spiral that ends in financial pain for both the sponsor and members.

With DB pension investments, it can be argued that avoiding the downside matters more than chasing the upside. In the current volatile environment, when a bigger fall in markets would hardly come as a surprise, being safe rather than sorry makes a lot of sense. This explains why more and more trustees are considering how to use some of their potential investment upside to protect the downside. Below, we explore some key downside protection strategies.

Diversifying portfolios further

The most obvious starting point is to spread assets across a wider range of investments. This could, for example, mean looking beyond traditional asset classes such as equities and bonds, or appointing investment managers that adopt different approaches to finding the best investment opportunities. Diversifying in this way can reduce some of the negative impact on portfolios when the main markets suffer a collective shock.

Given the obvious benefits, why have some schemes been slow to adopt this decades-old economic principle? The often-cited obstacles have to do with governance (“We only want to invest in things we understand well.”) and cost (“We do not want to pay to access areas that require more legwork.”). However, with more and more observable evidence of the risk management benefits (for example, the emerging performance figures of some of the most sophisticated funds in the world, alongside those of the fiduciary managers), the trend towards greater diversification has shown signs of accelerating in recent years.

Assets that do well in times of stress

Another way to shield a fund from a fall in global markets is to invest in assets that are expected to perform well in a downside scenario. Throughout history, investors have put their faith in 'safe haven' assets in times of uncertainty (for example, cash or precious metals). A 21st century pension scheme may do likewise by holding US government bonds – arguably the most liquid and secure assets in the world. The investment can be structured in such a way that only a small proportion of a scheme's physical assets (as little as 2-3%, say) are tied up, which nonetheless provides the right exposure to achieve the desired level of protection.

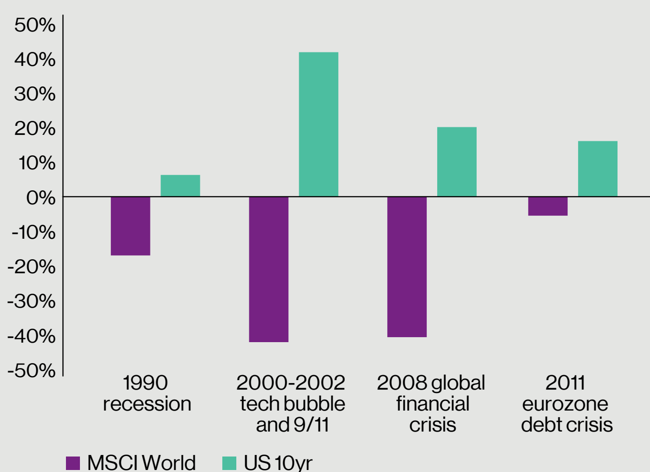
Limiting equity losses

A more direct approach to managing downside outcomes is to use specialist financial instruments, such as equity options. One can think of this as buying insurance against a market downturn. If and when the insured event happens, the pay-off can offset some (or all) of the losses suffered. Setting this up comes with a cost (effectively an insurance premium), and the strategy often involves forgoing some of the upside, for example the excess return above a particular high level.

Having a flexible portfolio

Alongside the more direct protection strategies above, trustees can also aim to manage a flexible portfolio, capable of reacting quickly to significant movements in markets. Being nimble does not only mean getting out of risky areas or protecting the downside when conditions worsen, but also taking advantage of opportunities that emerge when parts of the market bounce back after a downturn. Rather than hoarding cash in case attractive opportunities emerge, schemes should hold sufficient liquidity so that they are able to make meaningful changes in direction at short notice. Having a robust process for making timely decisions and implementing trades is essential if trustees want to capture opportunities ahead of slower moving investors.

Figure 1. **Return comparison between global equities and US government bonds during stress periods**



Source: Bloomberg

Who is doing this?

Our preferred downside risk management strategy is implemented in such a way that the overall return under normal market conditions is largely unchanged. It does, however, sometimes mean sacrificing part of the gains to be had when markets perform really well. An increasing number of schemes have accepted this trade-off recently (typically very large schemes, as well as our fiduciary clients who use some or all of the techniques above). We think that many more schemes can benefit from adopting similar protection strategies at this time.

If we are wrong and markets continue to race ahead, then having paid for insurance that turns out not to be needed is an outcome that most would be delighted to accept.

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wtw-HP-2019-0169d

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