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A BRIEF GUIDE TO INVESTING FOR SURPLUS RELEASE

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BNY MELLON | INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

MOST DEFINED BENEFIT (DB) SCHEMES ARE NOW IN CONTROL OF ASSETS THAT ARE WELL ABOVE WHAT IS NEEDED TO SECURE BENEFITS. HOW CAN THESE ASSETS BE MANAGED FOR SURPLUS RELEASE OVER TIME?

For 20 years the pensions industry has focused on the de-risking of DB pension schemes. But with the majority of schemes now in surplus[1] (i.e. having more assets than that needed to pay benefits over time), we are seeing the beginnings of a big mindset shift. That shift is to contemplate how a scheme could invest its assets to realise their full potential for the benefits of members, sponsors and society, but importantly without putting member benefit security at risk.

We estimate that many DB schemes could already buy enough contractual assets with cashflows that would more than cover benefits, even under very stressed market scenarios.

We demonstrate how a portfolio of contractual assets could generate a surplus even under a stressed default scenario while preserving member benefit security.

For such a portfolio we favour shorter-dated contractual assets due to a greater weight of issuance enabling greater geographical, issuer and sector diversification.

For those targeting a higher surplus, a small allocation to equities can complement a core contractual portfolio. We demonstrate the potential upside and downsides of a 5% equity allocation to such a portfolio.

A cashflow-based understanding of a scheme's assets versus its liability positions…reveals the comfortable level of certainty that is now on offer.

[1] Source: Occupational defined benefit (DB) landscape in the UK 2023, February 2024, The Pensions Regulator. It reported that 3,620 schemes out of 5,297 are in surplus with funding on a low dependency basis.

CASE STUDY:
HOW A £1BN SCHEME CAN INVEST FOR SURPLUS RELEASE

Let's start by picturing a scheme with £1bn of liabilities that is fully funded on a gilts-flat basis. For such a scheme, we calculate that the actual cost of meeting liabilities will be c.£810m-c.£870m if assets are invested on a gilts plus 1%-1.5% basis.

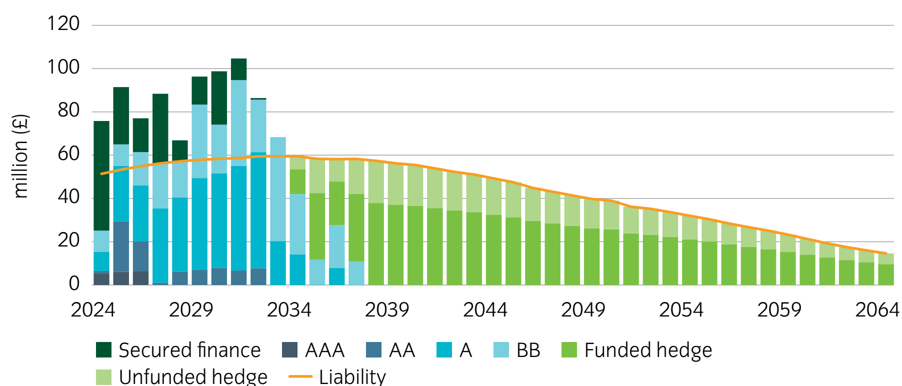
Below we demonstrate two ways of investing for surplus release, while preserving member security: the first seeks to pay out an annual sum to the sponsor and members with a high level of certainty; the second targets higher surplus distributions, but with lower certainty on size and timing.

A CONTRACTUAL ABILITY TO GENERATE SURPLUSES

We believe that the starting point for any DB endgame discussion should be to obtain a cashflow-based understanding of a scheme's assets versus its liability positions. Doing so reveals the comfortable level of certainty that is now on offer, which is too often hidden by the traditional asset-allocation view.

We estimate that many schemes could already buy enough contractual assets, such as high-quality corporate bonds, with cashflows that would more than cover benefits, even under very stressed market scenarios. That is, when you combine the high levels of funding with the contractual returns available in the markets 'today'[2], many schemes are already in a position where they can achieve additional 'contractual surpluses'. Figure 1 (below) shows how our £1bn case study might approach this.

Figure 1: A cashflow-based view[3]



[2] Analysis is as at 31 December 2023.
[3] For illustrative purposes.

This portfolio is designed to:

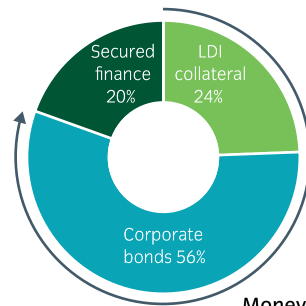
- Hedge increases in the cost of meeting the liabilities – using LDI assets
- Secure the return required to grow additional surpluses – using buy and maintain credit
- Mitigate the need to sell assets prior to their maturity date – contractual maturing asset proceeds are sufficient to meet benefit payments, and credit collateralisation (i.e. the ability to use corporate bonds for collateral purposes) mitigates forced selling for collateral top-ups
- Enable access to a supportable level of illiquidity risk premium – secured finance

Figure 2 shows that by investing in this way, the portfolio would generate a surplus of £116m over 10 years, assuming default rates consistent with historical median levels. Even under a stressed default scenario[4] the contractual surplus available is £94m and the portfolio has collateral headroom of over 10%.

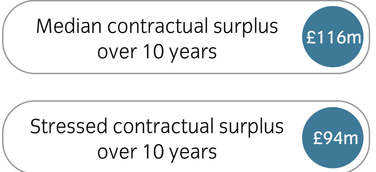
The primary remaining risk is longevity, and one use of the contractual surplus could be to reserve against increases in member life expectancy.

Figure 2: Case study of a cashflow-focused portfolio[5]

Asset allocation



	Allocation	Spread (over gilts)
LDI collateral	24%	0.0%
AAA	2%	0.2%
AA	6%	0.6%
A	27%	1.3%
BBB	21%	2.0%
Secured finance	20%	6.1%
Total	**100%**	**2.0%**



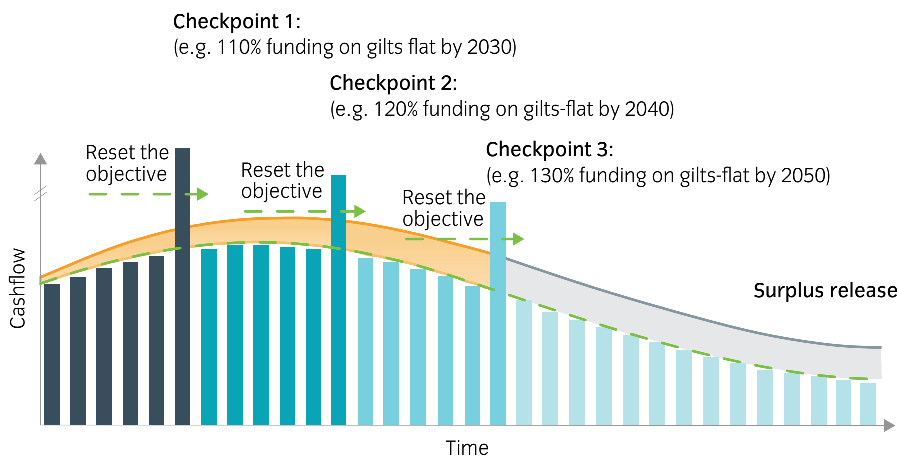
[4] We assume the 80th percentile default experience, applied independently to bonds of every individual credit rating and maturity.
[5] Source: Insight. Spreads as at 31 December 2023. For illustrative purposes only.

COUPLING EFFICIENCY AND INVESTMENT FLEXIBILITY

We believe that surplus investing should be easy to implement, be founded on a clear articulation of objectives and leave scope for stakeholders to react to changing market environments and scheme circumstances.

From a theoretical perspective this led us to the concept of checkpoints as outlined in Figure 3, which enable quantification of the scope for surplus generation and release over a pre-agreed initial timescale. Investment timeframes would subsequently be extended subject to a continued desire for surplus release.

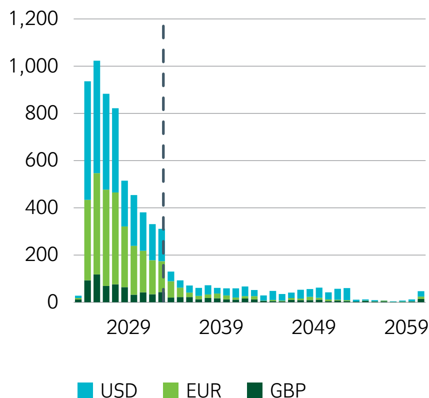
Figure 3: 10-year surplus checkpoints[6]

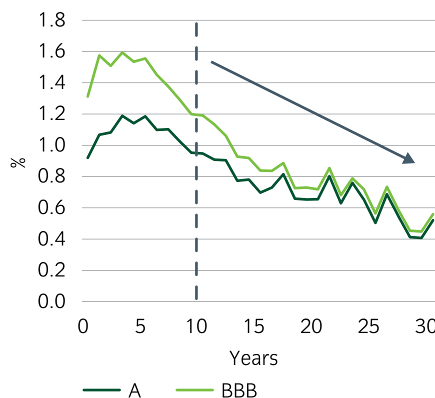


From an investment standpoint, the focus on shorter-dated contractual assets complements the market environment and has many attractive features including:

- Access to the weight of debt issuance enabling greater geographical, issuer and sector diversification – Figure 4 left hand chart
- Scope to secure higher returns on a default-adjusted basis – Figure 4 right hand chart

Figure 4: Maximising the ‘best’ part of the credit universe[7]





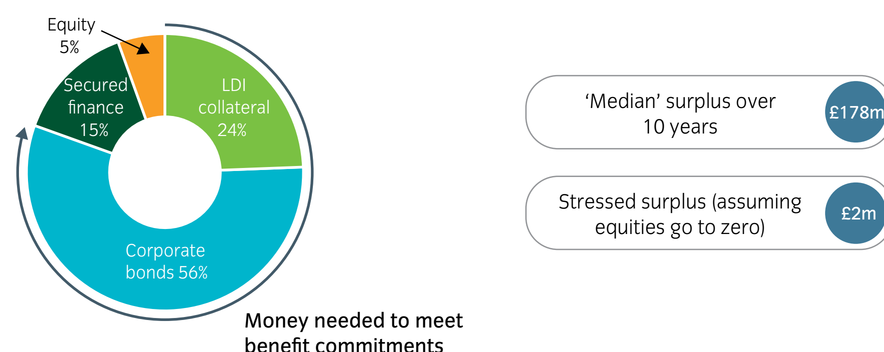
[6] For illustration purposes only.
[7] Source: Insight and Bloomberg as at 31 December 2023. Credit spreads by maturity is net of median historical default losses based on Moody’s data assuming a 40% recovery rate.

DESIRE TO TARGET HIGHER UPSIDE?

For schemes targeting higher surplus distributions, growth-asset exposures can complement a core contractual portfolio. Member benefits remain secured by the contractual assets and the growth assets provide scope for upside beyond available contractual returns.

Figure 5 shows the £1bn pension scheme we previously considered, where median historical equity market returns[8] deliver a surplus of £178m and the strategy would generate a surplus of £2m even if the value of equities falls to zero.

Figure 5: Can we really afford to re-risk?[9]



CONCLUSION

A cashflow perspective for an investment strategy creates scope to invest for surplus release, while preserving member benefit security.

Surplus generation can deliver significant benefits to members, sponsors, and society alike and is straightforward to implement with a core maturing contractual investment approach.

With liability risks, collateral risks, cashflow risks and asset risks addressed what risks are preventing stakeholders from benefiting from a highly successful UK DB pension system?

The focus of the last 20 years has been to achieve the strong level of funding that is currently widespread across the DB industry. We therefore ask, is it not time to benefit from the fruits of that labour?

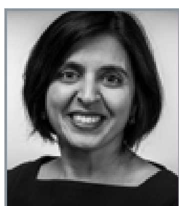
[8] Assessment of 10-year returns based on the S&P 500 index from 1937.
[9] Source: Insight as at 31 December 2023. Projected surplus is defined as the expected future surplus allowing for 80th percentile of corporate bond defaults, 80th percentile of credit spreads for reinvestment and forced-selling risk and the corresponding equity scenario over a 10-year time-horizon. Equity returns of -6.5% and +7.5% pa relative to cash represent the worst and median 10-year historical returns of the S&P 500 index since 1937. For illustrative purposes only.

CONTRIBUTORS

Ren Lin
Head of Client Strategy, Insight Investment

Ren joined Insight in December 2010 and is Head of Client Strategy in the Client Solutions Group. Ren's primary focus is on the development of outcome-focused investment solutions using both derivative and physical instruments to improve the certainty of attaining future funding outcomes for our clients. Prior to Insight, Ren spent five years at Towers Watson as an investment consultant, providing advice to pension funds on investment strategy, with a particular focus on liability hedging. Ren graduated with a double degree in Applied Finance and Actuarial Science from Macquarie University, Australia. He is a Fellow of the Institute of Actuaries, Australia and a Fellow of the Institute and Faculty of Actuaries in the UK. Ren holds his Series 3 license and is an Associated Person with the National Futures Association.

Reena Thakkar
Client Director, Insight Investment



Reena joined the Client Relationship Management Team as a Client Director in January 2023. She is responsible for servicing large, segregated clients investing in a range of asset classes. Prior to joining Insight, Reena spent seven years at Momentum Investment Solutions & Consulting as a lead advisor to large UK defined-benefit clients, advising on all aspects of investment strategy, asset allocation and mandate design. Prior to Momentum, Reena spent nine years at Mercer in a similar role, where she also held a number of management responsibilities. Prior to Mercer, she spent eight years at Willis Towers Watson, working as a consultant in the UK and the US, across a broad range of employee benefits. In all the roles she has held, Reena has been responsible for managing client relationships and junior associates. Reena graduated from Oxford University with a MEng in Engineering, Economics and Management. She is also a Fellow of the Institute and Faculty of Actuaries.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, and exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

Liability-driven investment

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Institutional Business Development
businessdevelopment@insightinvestment.com

European Business Development
europe@insightinvestment.com

Consultant Relationship Management
consultantrelations@insightinvestment.com

company/insight-investment

www.insightinvestment.com

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