

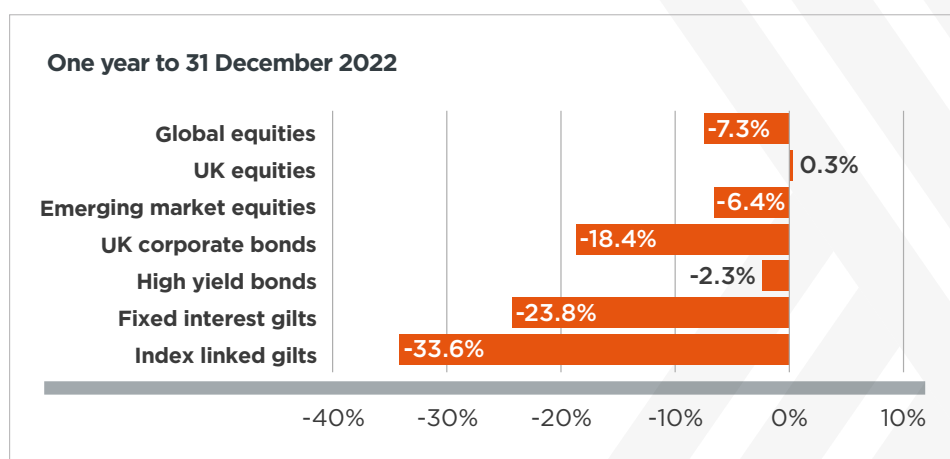
Outlook for DC Pension Schemes

► In brief

- Most DC schemes will have seen negative returns from on their investments over 2022, with strategies closer to retirement likely to be the worse affected, although those targeting annuity purchase will have seen the cost of buying an annuity falling too.
- Now is a good time to reassess the investment strategies covering those who are approaching or close to retirement, to see if 2022 has highlighted any areas for change.
- Trustees will need to start considering their approach to investing in illiquid assets as upcoming regulations mean that their Statement of Investment Principles will need to disclose and explain allocations.
- Sustainability and consideration of ESG risks and opportunities should continue to be high on trustees' agendas through 2023.

2022 brought an abrupt end to steady growth in DC pots as war, high inflation, weakening economic growth and higher interest rates put pressures on growth assets.

Most major asset classes rallied later in the year as equities reacted positively to falling inflation in the US and UK shares rebounded in the aftermath of the mini-budget. However, despite this, many DC schemes will have seen negative returns at all points in their strategy over 2022 as few asset classes provided positive returns over the year.



Not all members were affected equally

Surging inflation in 2022 led central banks to raise rates to levels not seen in over a decade which had an associated knock-on impact on gilt yields. Long term gilt yields (20 years) ended the year having risen almost 3% to 4.2%, with highs of almost 5% at the start of the fourth quarter.



In turbulent conditions, trustees need to have confidence in, or reassess, their long-term investment strategy.

Mark Searle
Head of DC Investment



Lifestyling issues – worse investment performance for those closer to retirement

Most DC schemes tend to use lifestyle investment strategies which look to balance return generation when a member is further from retirement with risk mitigation as members approach retirement. This later stage typically relies on using gilts and higher-grade corporate bonds as lower risk assets to help preserve capital value or match annuity prices depending on how the scheme's members are likely to take their benefits in retirement. Events in the gilts and bonds markets led to many strategies experiencing worse investment performance for members near to retirement rather than those earlier in their savings journeys. Additional communications to members on market performance and strategy design may help reassure and inform members.



Illiquidity

Illiquid assets are those which cannot easily or quickly be exchanged for cash. Their appeal in a DC context is:

- diversification from equities;
- earning an 'illiquidity premium';
- the potential for inflation linkage; and
- potential alignment with Environmental, Social and Governance (ESG) policies.

These types of assets are used widely in other DC markets (e.g. in the Australian super funds) and the UK government has supported the development of a new vehicle, the Long Term Asset Fund (or LTAF), to help facilitate investment by DC schemes.

Draft regulation, due later this year states that from 1 October 2023 (and by 1 October 2024 at the latest), trustees will need to include in their Default Statement of Investment Principles their policy in relation to investment in illiquid assets. This will likely need to include an explanation on why illiquid assets are held and an explanation of the types of illiquid assets used, or an explanation of why the investment strategy does not include illiquid assets and whether there are any plans to include them in the future.

The rapid sell-off in gilts following the mini-budget last year caused significant liquidity issues for Defined Benefit schemes invested in leveraged Liability Driven Investments. However, it was the combination of leverage, often mild illiquidity (i.e. weekly dealt) and the pace / magnitude of changes in the gilt market that caused the issue. Illiquidity itself was not the sole driver. We should therefore approach illiquidity with an open mind in DC through 2023 but of course be mindful of the risk as well as the reward.

Sustainability

Trustees have a fiduciary duty to act in the interests of members, and it's clear that consideration of financially material sustainability issues, including climate change, is an important aspect of investment risk management. Furthermore, there are a growing number of strategies available which give DC investors access to upside opportunities associated with the transition to a low carbon economy (including using some of the illiquid solutions described above). In the context of the typical long term DC member population, it's also increasingly discussed that fiduciary duty may extend to consideration of long term real world outcomes – ensuring that the planet is in a fit state for members to retire. Combining this with the projected growth of the DC workplace universe means that we think sustainability and consideration of ESG should remain high on trustees' agendas.

In November 2022 delegates from across the world met in Sharm el-Sheik, Egypt at COP 27 which culminated in a new agreement to help the poorest nations deal with the effects of climate change. The recommendations made at COP27 will be important in determining how financial resources will be mobilised moving forwards and new investment opportunities will arise as countries and businesses respond.

Moreover, guidance published by the DWP in June 2022 updates reporting requirements on stewardship within both Implementation Statements (IS) and Statement of Investment Principles (SIPs). The guidance is split into non-statutory guidance applicable to SIPs and statutory guidance applicable to ISs. The statutory guidance is effective for ISs being drafted for scheme year ends on or after 1 October 2022.

DWP guidance – in a nutshell

The DWP guidance strengthens its position on engagement by investors in pooled funds.

It explains that **trustees cannot simply state in the SIP that they delegate engagement** with issuers of debt and equity to their investment managers. They need to also – for example – **explain in the SIP how they will monitor and engage** with the investment managers about relevant matters.

It goes on to say that trustees have several options to be actively engaged and advocate their policies, even when invested in pooled funds.

Trustees will therefore need to modify their reporting on engagement activity and we suggest that changes to the SIP are required as well.

Sustainability and stewardship should therefore continue to be high on trustees' agendas for 2023.



Action is needed this year to update both your Statement of Investment Principles and Implementation Statements to cover both illiquid assets and an increased focus on engagement.

Potential actions for trustees

The key investment actions we are highlighting for trustees to consider in 2023 are listed below.

- 1 Understand your scheme's recent performance to help establish member experience – particularly for those approaching retirement.**
- 2 Reassess investment strategies for members who are approaching or close to retirement to see if 2022 has highlighted any areas for change.**
- 3 Receive training and develop a policy on illiquid assets and update your Statement of Investment Principles accordingly.**
- 4 Use our Responsible Investment Framework to establish your desired approach to managing ESG risks, undertake further ESG training as needed and consider the use of sustainable funds to enhance your approach.**
- 5 Understand the new reporting requirements coming into effect from 1 October 2023.**
- 6 Review your scheme communication materials to improve information and education for members.**

To discuss any of the issues covered in this edition, please get in touch with Mark Searle.



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