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The Search for Growth: Time for Bold Solutions

For decades UK pension schemes have been pushed ever further towards risk aversion. But with millions of UK employees still lacking adequate pension provision and the economy urgently in need of investment, the time has come for bold solutions.

The UK pensions sector has long had a troubled relationship with risk. High-profile crises in individual schemes and periods of market instability have led to an increased regulatory burden and, arguably, an excess of caution among schemes.

Caution has its place in any investment strategy, but at a certain point aversion to risk has the potential to look like defeatism — a loss of confidence in our ability to invest for growth and real returns. When that happens, caution itself becomes the greater risk. I believe we are at just such a moment.

It is time for bold solutions. This does not mean throwing caution to the wind. Rather, it means taking a more sophisticated and confident approach to risk management and embracing innovation.

The Flight from Growth Investments

Years of excessive risk aversion in the UK pensions sector — significantly driven by an understandable but sometimes overly-complex regulatory approach — have left us with a messy patchwork of schemes. A substantial proportion of which are seeking to reduce risk, lock in surpluses and eventually, though a buyout, leave investment activity behind altogether.

The challenge of excess caution can be seen in the current state of defined benefit (DB) schemes, and ironically it is their current strength that could be further undermining their ambition.

The rapid rise in gilt yields in the autumn of 2022 was an existential threat to some schemes, as collateral calls on liability driven investment (LDI) strategies prompted forced selling. But once this had settled down many DB schemes found themselves in a better state than before.

Aon's Global Pension Risk Survey of 204 DB scheme sponsors, trustees and managers carried out in the summer of 2023 found 47 percent saying that their funding position was unchanged after this period and 37 percent saying their funding position had improved. Clearly, this should be seen as a positive, but what also matters is where this buoyant funding is leading the DB sector in the near future.

Our survey found that 39 percent of DB schemes now plan to reduce their equity investments. Meanwhile, the most popular destinations for the capital released from equities are credit, bulk annuities and, perhaps ironically, LDI. The logic appears impeccable. The sustained rise in interest rates and gilt yields has made these solutions more attractive and allows DB schemes to lock in their improved funding positions.

Maria Johannessen is Aon's Head of UK Investment, having joined the firm in June 2022. During her 20-year career Maria has worked at a range of top-tier investment and consultancy businesses. She holds a BA Hons degree in Finance and Economics and an MSc in Financial Engineering.

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The other hugely significant finding from our survey is that, for the first time in the survey's history, more than half (55 percent of DB schemes) said their ultimate objective was a buyout.

On paper this sounds good, locking in current valuations and establishing a clear exit strategy, but it reflects an excessively cautious approach. In the immediate future it represents a withdrawal of capital from investments that would be most effective in supporting economic growth — the precise opposite of the Government's ambition for pension schemes to invest in the UK economy. Looking further ahead, it is far from clear that the insurance industry's capacity and appetite for buyouts would be able to meet the demand these findings indicate is coming down the track.

Equally concerning is that this picture does not solve the wider pensions crisis in the UK. According to the Department for Work and Pensions, a large proportion of the UK population is still not on target to achieve comfortable retirement incomes. As this is largely due to under-saving*, increased contributions from employers and employees must be part of the solution — but so must improving returns from investments.

Bold Solutions Required

The current economic and investment environment, combined with the capital available in many pension schemes, should be a call for greater ambition. This does not necessarily mean a significant increase in risk, but it does mean a fresh focus on what investment professionals are (or should be) most skilled at — sophisticated risk management and innovation.

The consolidation of schemes is one of the solutions that has gained traction among policymakers and schemes, but innovation must go further than this, including, for example, a willingness to unlock DB surpluses to invest in DC or hybrid schemes sponsored by the same company. Meanwhile, DB schemes could improve the resilience of their surpluses by active investment in growth companies and sectors.

To be clear, I am not suggesting a wholesale move to 'risk-on' for all pension schemes. Every scheme is different, not least in their scales and time horizons of their liabilities, and for some a highly cautious investment approach and/or a buyout may be the right solution. But it should not be the default strategy.

The UK pensions sector faces many challenges. But, in the end, we must ask ourselves two simple questions. Should we give up on growth? Should we abandon the pursuit of real risk-adjusted returns?

My answer to both is a resolute 'no'.

Ambitious investment and innovative solutions, combined with advanced risk management is eminently possible and can deliver investment to our economy, superior returns for pension scheme members — and a more secure retirement for all of us.

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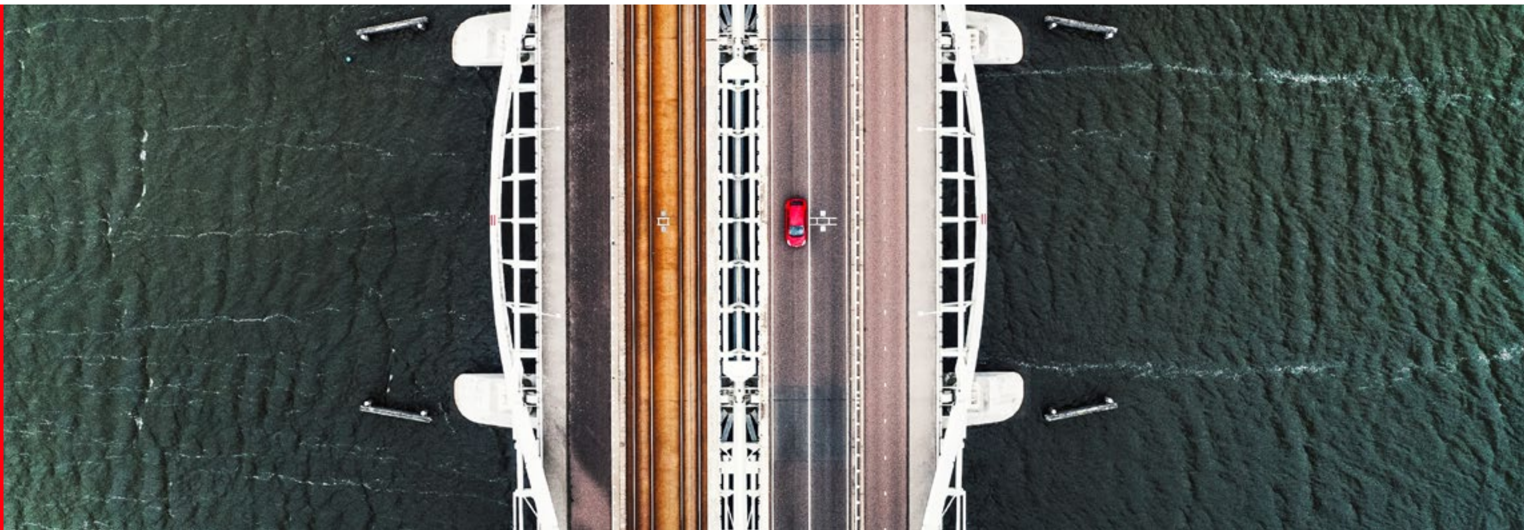
* Analysis of future pension incomes - GOV.UK



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