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Is this time really that different?

Pensions Education | May 2020

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In highly volatile markets there is always the temptation to be seen to be doing something, rather than just sitting on your hands, taking a step back and weighing up your options. However, given the short- to medium-term future is so uncertain, most defined benefit (DB) scheme trustees appear to be undertaking nothing more than a phased and limited rebalancing of their portfolios towards the strategic benchmark, while most defined contribution (DC) scheme trustees are reviewing how resilient the default fund and its associated retirement glidepath has been over the past few months. But what else could trustees be doing in re-evaluating their investment choices?

In my 13 years as a DB and DC scheme trustee, and having experienced a considerable number of financial market setbacks during my working life – seven in fact, going back to 1987 – perhaps unsurprisingly my observation has been that each market drawdown has resulted from a different catalyst and has been met with equally varying fiscal, monetary and regulatory policy responses from governments, central banks and regulators – some coordinated, some not. This crisis is no different in that respect, although it is of course unlike everything else that has gone before it – perhaps excepting the flu/pneumonia pandemic of 1918/19. But despite having likely similar peak mortality rates as we are experiencing today, and following a more muted second wave in 1919, this didn't culminate in a significant market setback. In fact, in both 1918 and 1919 the equity market delivered double-digit returns.

Avoiding action bias

Against the backdrop of today's highly volatile markets there is always the temptation to be seen to be doing something, rather than just sitting on your hands and riding it out. This is known as action bias and stems from our hunter-gather days when taking decisive action in the face of uncertainty was almost always the right thing to do. If it

looked like a sabre tooth tiger was coming towards you, you didn't take time out to figure whether your intuition was correct, you took immediate action for self-preservation.

However today, given the absence of sabre tooth tigers, invariably it is better to stand back and be more analytical about your options. This is what behavioural economists would term avoiding your quick-fire System 1 way of thinking by adopting your more thoughtful System 2. Incidentally, women think in a System 2 way more often than men. This came through strongly during the global financial crisis (GFC) of 2008/09.

Markets and trustee actions

Given that the short- to medium-term future is so uncertain, two things are evident: that calculating both forward-looking risk premia (ie, the prospective return from risk assets over and above that for government bonds), and appraising each risk asset's relative attractiveness, is proving a difficult if not impossible task.

After all, to do both one needs to consider three plausible scenarios. Are we heading for: a V-shaped, quick bounce back in markets (indeed, after a big setback, markets can recover quickly); a more protracted U-shaped recovery (on average, markets take a couple of years to bounce back after a severe setback, although this has varied widely throughout history); or a very protracted L-shaped recovery (that is, a 1930s-style depression when investors had to wait 34 years to break even in nominal terms)?

This analysis isn't helped by US equities which have experienced a significant bounce back in recent weeks, appearing to price in a V-shaped recovery, while corporate bonds price in a U-shaped. Thankfully, there doesn't appear to be any pricing in of an L-shaped outlook, at least at the moment.

Therefore, most DB schemes appear to be undertaking nothing more than a cautious, phased and limited rebalancing of their portfolios back towards, rather than moving directly to, the strategic benchmark. Basically, if an asset class has taken a significant hit but you still believe in it, it makes sense to buy more of that asset at this lower price, albeit in a cautious manner given the uncertain outlook. That said, some DB schemes are focusing on the seemingly more obvious investment opportunities that have arisen, such as wider investment grade credit spreads which, despite recovering some lost ground, are still implying significantly higher default rates than are likely to materialise – just as they did, albeit to a lesser degree, in 2008/09.

Also, those real assets, or secure income assets, with a secure covenant, a defined and explicitly inflation-linked long-term income stream, strong environmental, social and governance credentials, whose returns are typically less sensitive to the macroeconomic environment and corporate cash flows than equity or credit returns, are increasingly finding their way on to trustee radars – especially those with dry powder to deploy and an appetite for illiquidity premia.

However, for a considerable number of DB schemes the bigger concern is assessing and keeping a beady eye on the strength of the sponsor covenant, particularly the sponsor's free cash flow and credit rating, and how to respond to sponsor requests for suspending deficit reduction contributions. Of course, both have major implications for how much long-run rewarded investment risk the trustees should run, and the extent to which long-run unrewarded risks (such as interest rate and inflation risk) should be hedged. For fear of stating the obvious, a renewed focus on trustee governance and integrated risk management is key.

For those DB schemes with a weak sponsor, or whose position is weakening, the idea of running more investment risk to achieve the journey plan, in a highly volatile, risk-off environment, probably isn't an option, especially for those who haven't hedged rates and

inflation to any great degree, and those who in retrospect have relied too heavily on the equity risk premium to reduce the deficit.

For others, there will likely be a quid pro quo if investment is expected to do more of the heavy lifting, such as the provision of a stronger guarantee or perhaps externalising the covenant via bank letters of credit and/or insurance surety bonds.

For DC scheme trustees, revisiting the default fund, its composition (ie, whether it is capturing a sufficiently diverse range of return drivers and risk premia), and the retirement glidepath and assessing how resilient each has been over the past couple of months, while rebalancing the underlying funds back to their agreed weightings, must be at the top of their agendas. Again, this comes back to good governance and risk management.

The value of selective active management

Of course, no one ever said being a trustee was easy. Or for that matter being an active asset manager or investment consultant – both of whom really do earn their fees in environments such as this.

Indeed, this is exactly when skilful active managers, used selectively, prove their worth. I emphasise the words skilful and selective. Active management doesn't work in all environments and it is only those skilled active managers, adhering to their chosen investment style in a market that favours that style, who act to limit losses and make the most of opportunities during market dislocations and episodes of fundamental regime change – those characterised by periods of high volatility and highly dispersed stock returns. Take the GFC and its immediate aftermath when active management came into its own: while in the first half of 2009, 70% of active equity managers in the US (that most price-efficient of markets) outperformed the S&P 500 gross of fees[1], this outperformance wasn't evenly distributed. Skill and manager style saw a distinct dichotomy in the ranking of these returns. Certainly something to ponder.

Good governance and good risk management is key

In conclusion, there are five actions trustees should continually monitor and reflect in their investment beliefs in the name of good governance and good risk management. These are to consider whether:

1. The scheme's assets are adequately diversified by return drivers and risk premia
2. There continues to be periodic rebalancing to the strategic benchmark
3. For DB schemes, long-run unrewarded interest rate and inflation risk has been adequately mitigated
4. The most is being made of manager skill and capturing illiquidity premia
5. Enough thought is being given to the identification and mitigation of extreme risks.

The last of these actions is crucially important, not least because the unexpected, by definition, tends to surface when you least expect it to. Scenario testing for a whole raft of known unknowns possibly lurking on the horizon – deflation, stagflation, trade wars, pandemics – and how these might be mitigated really is time well spent, but often neglected when the good times lull you into a false sense of security. This is what behavioural economists call the curse of induction.

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[1] Empirical Research Partners, 8 October 2009

Again, for fear of stating the obvious, good governance and good risk management should, more so than ever, be at the top of trustee agendas if member security is to remain front and centre of all that trustees do. The past 13 years have taught me that much at least.

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