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To De-Risk or Re-Risk, That Is The Question

By Ashish Kapur *Wed, Sep 26, 2012*

Pension fund managers across the Pond are feeling boxed-in. The author, European head of institutional solutions at SEI, feels their pain in an essay that first appeared in IPE.com.

With UK Gilt yields hovering around a 319-year low, Dutch bond yields at 500-year lows and US Treasuries offering negative returns across all maturity spectrums, it is unsurprising that trustees of pension schemes are questioning whether fixed income (or bond) assets are overvalued.

Furthermore, UK pension schemes looking to de-risk have an additional conundrum whether they should move their assets from equities yielding 3.7% (FTSE All-Share Dividend Yield as at 31 August) to Gilts yielding 2% (15-year Gilt yield as at 31 August). After adjusting for inflation, these Gilts are also yielding negative returns. This makes Gilts less of a risk-free asset and more of a return-free asset.

So how should a UK pension scheme allocate its assets in such an environment? Should they be de-risking or not? The rest of this article sets out some options for pension schemes to consider. The action for pension schemes will depend on their individual situation such as the funding level and strength of the sponsor.

Whilst in the short term both Gilt yields and equity markets can go lower, safe-haven bonds such as Gilts and US Treasuries are over-priced by most long-term measures. If a pension scheme’s funding level and risk budget permits, it could look to allocate its portfolio towards return-enhancing assets by increasing allocation to equity assets. The relative valuation of these assets means investing in assets that back dividend growth or have high spreads could deliver excess return for pension schemes able to handle the short-term risk. Once governments in the developed world have managed to muddle through the recession and there is some resolution to the euro-zone crisis, equities should deliver significant outperformance relative to bonds.

In the meantime, higher equity allocation could lead to higher volatility of funding level. It is also worth noting that a number of pension schemes over last two years have been considering high-yield bonds as an alternative to Gilts to obtain a higher return. This has created a huge demand in the market over this period. However, this is beginning to taper off, as shown by the volume of trading in European high-yield debt market in the last few quarters.

Yields on high-yield debt have declined towards 7% within the BofA Merrill Lynch US High Yield Master II Constrained index, a level that historically has acted as a floor. In addition, 39% of high-yield debt within the index now trades above its call price. In May 2011, this figure reached 44% just prior to a pronounced decline in prices, possibly suggesting prices are likely to begin to fall soon.

For schemes that wish to de-risk and reduce the volatility of their funding level, they need to first evaluate whether they can afford to do so. For some pension schemes, paying the current market price to hold greater bond investments may be worthwhile to obtain greater certainty of outcomes relative to their liability. If the strategic rationale allows, then pension schemes should not get distracted by the current investment environment. However, the current investment markets also offer opportunities to improve the existing interest rate and inflation hedges without increasing allocation to fixed income assets. This may include slowing the move towards long-duration bonds by investing in shorter-duration bonds or taking advantage of low break-even inflation to switch nominal bond holdings into inflation-linked bond holdings.

Other options available for pension schemes concerned about rising interest rates and losing the absolute value of their bond investment could be to transfer some of their fixed income investment into an unconstrained or absolute return mandate. An unconstrained approach offers a superior ability to navigate interest rate and credit cycles and, as a result, may offer better protection in rising interest rate and spread-widening environments than a long-only fund.

Similar to unconstrained bonds is the greater use of alternative asset classes to obtain inflation and interest rate exposure whilst outperforming government bonds. These alternative assets include timber/forestry, infrastructure (with low private equity correlation) or even solar PV panels for those schemes looking for some added environmental benefits.

Determining the appropriate course for your pension scheme – be it de-risking or re-risking – rests on a number of factors including your funding level and risk appetite. But fundamental to any such process is a governance structure with the agility to react to rapidly changing market environments. This is where trustees who are faced with resource constraints may benefit from working with an investment professional such as a fiduciary manager that is able to identify and implement investment decisions quickly.