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Defined Benefit Pension Schemes

Deloitte Funding Tracker Q2 2017

The Deloitte Scheme Funding Deficit Tracker shows how the deficit of three illustrative schemes with Return Seeking, Lower Risk and Hedging investment strategies have performed since 2014.

How does your scheme compare?

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Q2 2017

Q2 2017 at a glance

Over the second quarter of 2017, long-term interest rates increased by 0.1% p.a. and long-term inflation expectations remained broadly the same. On the asset side equities returned 1.4%, long-dated corporate bond values fell by 0.3% and long-dated government bond values fell by 2.3%.

The Return Seeking strategy performed most strongly with a 0.7% increase in assets, followed by the Hedging Strategy which decreased by 1.1% and then the Lower Risk strategy which decreased by 1.2%.

These compare to a 1.1% decrease in the liabilities of each scheme.

Hedging Strategy

0% Improvement in funding Level over the quarter

Change in assets over the quarter -1.1%

Return Seeking

+1.1% Improvement in funding Level over the quarter

Change in assets over the quarter +0.7%

Lower Risk

-0.1% Improvement in funding Level over the quarter

Change in assets over the quarter -1.2%

Background

Since 2014 we have been following the progress of 3 similar, illustrative, UK Defined Benefits schemes with different investment strategies.

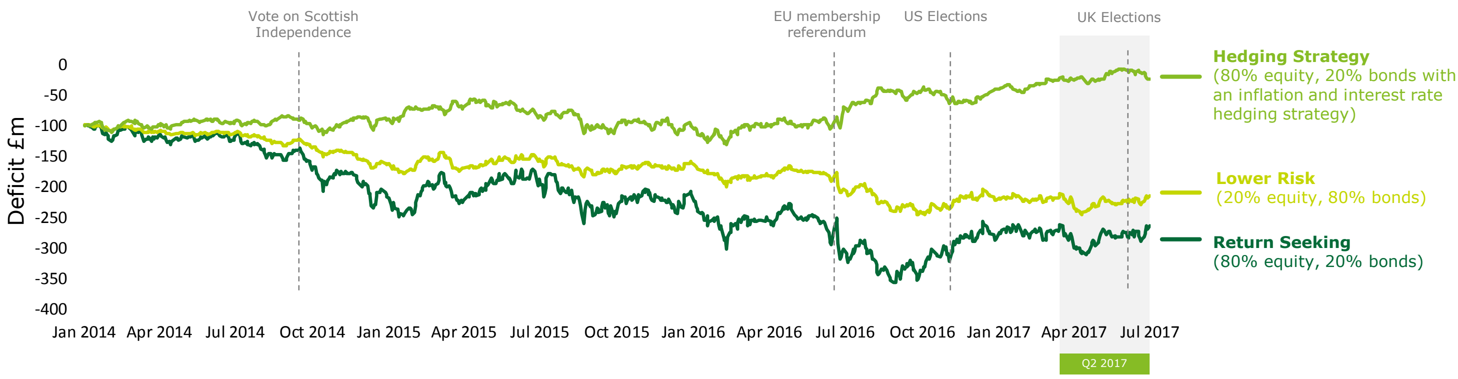
At the start, each scheme had liabilities of £500m and assets of £400m and profiles typical to that of the average UK scheme. To track just the impact of the investment strategies, we have removed impact of the accrual of benefits and the impact of deficit reduction contributions paid by the sponsors.

The "Return Seeking" scheme's investment strategy has an 80% exposure to equities and other return seeking assets and a 20% exposure to government and corporate bonds.

The "Lower Risk" scheme's investment strategy has a 20% exposure to equities and other return seeking assets and an 80% exposure to government and corporate bonds.

The scheme with a "Hedging Strategy" has an 80% exposure to return seeking assets and a 20% exposure to government and corporate bonds, but has a leveraged hedging strategy in place removing the majority of the interest rate and inflation risk.

Figure 1. Movement in deficit since 2014



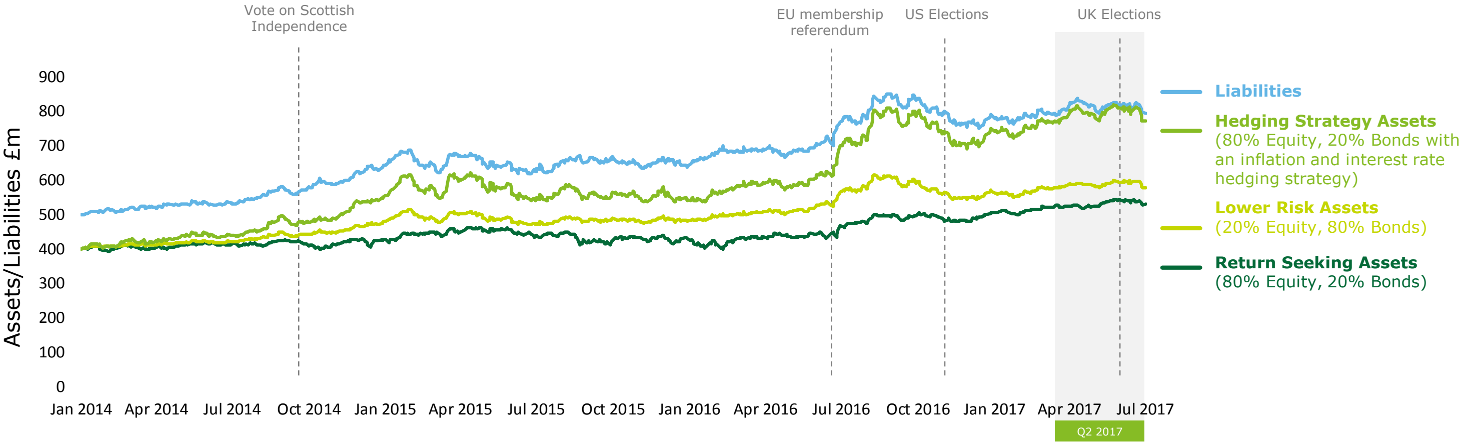
Key Commentary

Over the Q2 2017, the funding level of the scheme with a Return Seeking strategy improved by 1.1% (from 65.0% to 66.1%). This is as a result of modest positive equity returns combined with a reduction to the value of the scheme's liabilities. The scheme's remaining assets (corporate and government bonds) reduced in value offsetting some of the equity returns.

The funding level of the Lower Risk scheme reduced slightly as a result of the net impact of positive equity returns, negative returns on both long-dated corporate bonds and long-dated government bonds, and a reduction in liabilities. At 30 June 2017 the scheme was 72.6% funded (down 0.1% from the start of the quarter). The main difference compared to the Return Seeking strategy was the lower investment returns as a result of the Lower Risk scheme's smaller exposure to equities.

A Hedging Strategy can protect schemes against reductions to interest rates and inflation expectations, it can also reduces the upside potential when interest rates and inflation rise. This was the case over Q2 2017 and the improvement from modest positive equity returns was offset by reductions in value of the interest rate and inflation hedges. The net impact in funding level was to hold the funding level at 97.0%.

Figure 2. Movements in assets and liabilities over the last three years



Market Movements

The key drivers of changes to the schemes' liabilities are changes to long-term interest rates (UK government bond yields) and changes in long-term inflation expectations.

A reduction in interest rates increases the schemes' liabilities and a reduction to inflation expectations reduces the schemes' liabilities.

In Figure 3 we show how long-term interest rates have moved changed and similarly how long-term market implied inflation expectations have changed since 2014.

The key drivers of changes to the schemes' assets are the return on the individual assets classes (as well as the impact of the hedging strategy).

In Figure 4 we show how the key assets classes have performed since 2014.

Figure 3. Movement in long-term interest rate and inflation expectations

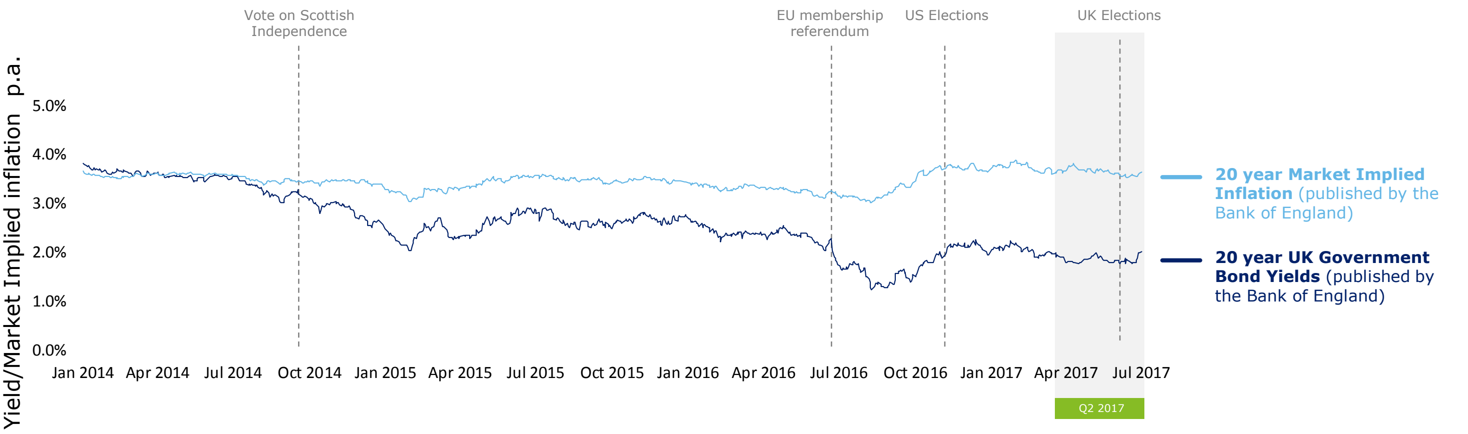
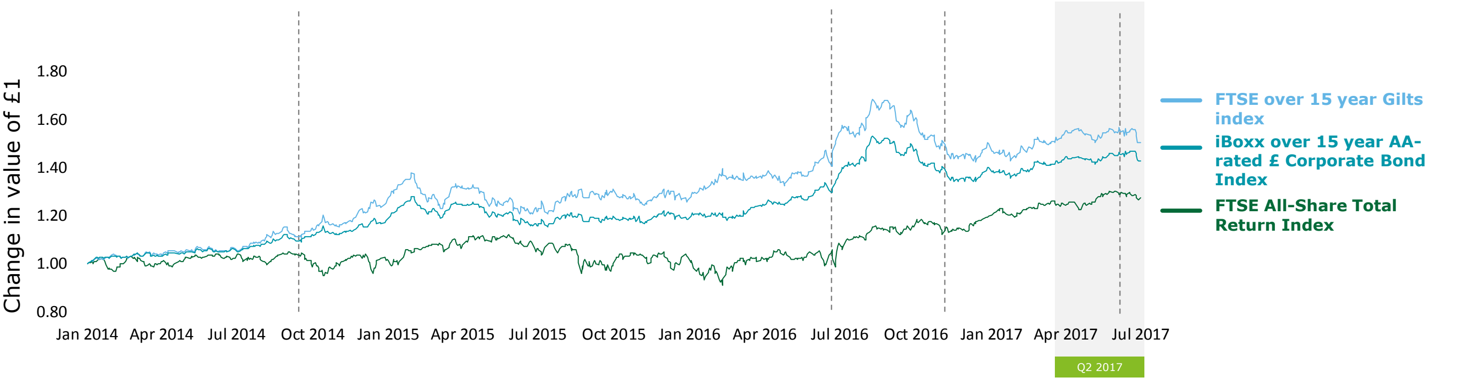


Figure 4. Movements major asset classes



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Quarterly strategy performance

Figure 5 shows how each strategy has performed in each of the last 8 quarters.

For the purpose of this we have rebased the schemes to be 80% funded at the start of each quarter (liabilities of £500m and assets of £400m) and compared how the funding levels have moved.

For example, a +0.2% change would mean the funding level has increased from 80% at the start of the quarter to 80.2% at the end of the quarter.

Figure 5. Change in funding level over the last 8 quarters

Quarter	Return Seeking	Lower Risk	Hedging Strategy
Q2 2017	+1.4%	-0.1%	0.0%
Q1 2017	+0.2%	+1.0%	+1.3%
Q4 2016	+6.9%	+1.2%	-0.3%
Q3 2016	-1.4%	-2.7%	+3.8%
Q2 2016	-2.9%	-0.3%	+5.1%
Q1 2016	-2.9%	-1.0%	+1.9%
Q4 2015	+2.6%	+1.4%	-0.6%
Q3 2015	-7.8%	-2.2%	-2.1%

Volatility of performance

In the charts below we show the distribution of the quarterly changes in funding level.

For example, Figure 6a. shows that for the Return Seeking strategy, in 1 quarter since 2014 the funding level per quarter has been 0% to +2%.

The wider the distribution on the charts the more volatile the strategy is on funding level. The narrower the distribution on the charts the lower the volatility of the strategy is on funding level.

Figure 6a. Frequency of performance for the Return Seeking strategy since January 2014

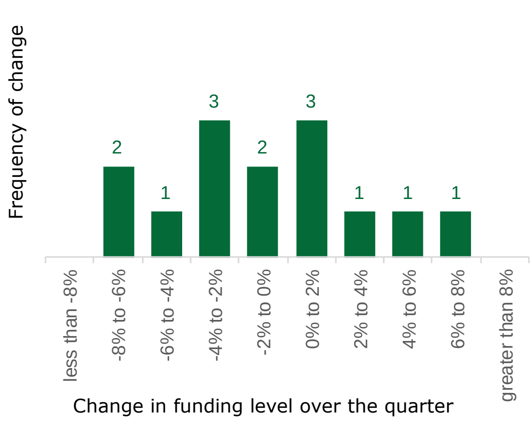


Figure 6b. Frequency of performance for the Lower Risk strategy since January 2014

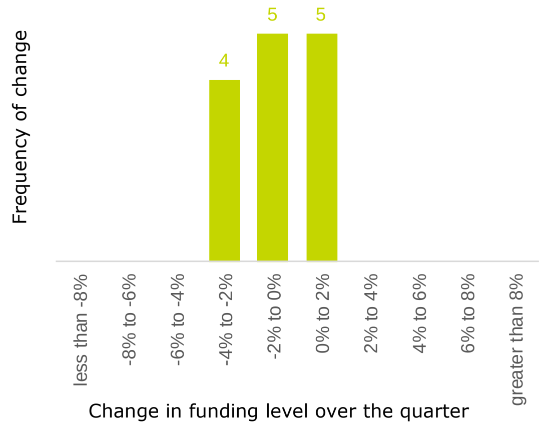
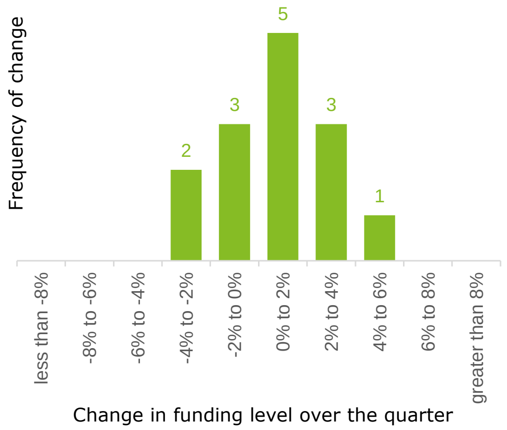


Figure 6c. Frequency of performance for the Hedging Strategy since January 2014



Movements in the funding level have been significantly wider (-7.8% to 6.9%) for the Return Seeking strategy than they have for the Lower Risk strategy (-2.7% to +1.4%).

The Hedging Strategy removes the majority of the interest rate and inflation risk and the residual risk largely relates equity performance.

Since 2014 the Hedging Strategy has been less volatile than the Return Seeking strategy (measured on a quarterly basis), but more volatile than the Lower Risk strategy.

Finding out more

Our three illustrative schemes and funding strategies are unlikely to replicate your scheme's strategy, investment profile (e.g. mix between asset classes, split of active and passive investments, annual management charges or levels of risk in your bond portfolio) and liability profile or your risk appetite, but are designed to show how different strategies have performed over time.

Whilst both recent volatility relative to the liabilities and historic returns can be important factors to consider, we generally advocate a bespoke funding strategy that balances the expected returns, the downside risk of a deficit developing and the ability of the company to fund a deficit.

If you would like to speak to us about how different strategies can impact the funding position of a scheme and differing level risk associated with these please let one of our team below or your usual Deloitte contact.

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