Invesco

Defined Benefit Pensions Outlook

Invesco Investment Solutions | Q1 2022 | GBP

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This article is for Professional Clients, Financial Advisers, Qualified Investors, Qualified Clients/Sophisticated Investors (as defined in the important information at the end); for Sophisticated or Professional Investors in Australia; Institutional Investors in the United States; for accredited investors as defined under National Instrument 14-106 in Canada; for Qualified Institutional Investors in Japan; for Professional Investors in Hong Kong, for Institutional Investors and/or Accredited Investors in Singapore, for certain specific sovereign wealth funds and/or Qualified Domestic Institutional Investors approved by local regulators only in the People's Republic of China, for certain specific Qualified Institutions and/or Sophisticated Investors only in Taiwan, for Qualified Professional Investors in Korea, for certain specific institutional investors in Brunei, for Qualified Institutional Investors and/or certain specific institutional investors in Thailand, for certain specific institutional investors in Indonesia and for qualified buyers in the Philippines for informational purposes only. It is not intended for and should not be distributed to or relied upon by the public or retail investors.

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1 Introduction

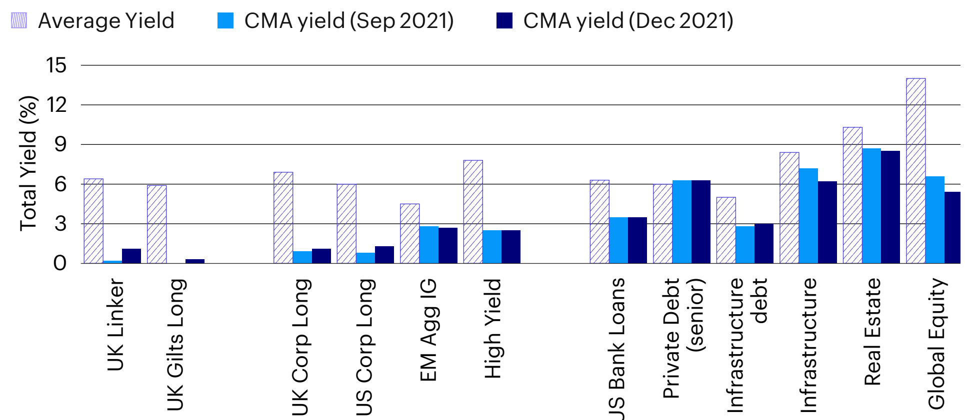
Market Summary

Year-on-year inflation rose from 3.1% to 5.4% over the quarter, although the rise in inflation hedging cost at longer maturities was more muted given its existing elevated level above central bank targets. Yields plunged over the first two months on fears of Omicron and potential future variants, before selling off as inflation concerns dominated. At the time of writing, six 0.25% hikes in US rates are now expected in 2023. Credit spreads widened on the dual concerns of prolonged changes in consumer spending and higher debt servicing costs as interest rates rise. Equity performed strongly in Q4, with MSCI World hedged to GBP gaining 8.2%.

Looking ahead to 2022, we expect year-on-year inflation to peak in the first half of 2022 before falling back but remaining elevated. GDP growth is likely to slow as incomes fail to keep pace with rising rates. Net government bond issuance is expected to rise as QE programmes end, potentially lifting longer-dated rates where there is a lack of structural demand. We reduced our 10y forecast for equities by around 1.3% (to 5.4% for US equities, in USD), in the light of a weaker outlook to earnings growth, together with generally lower price/earnings multiples. Our fixed income return forecasts remained little changed at year end as we already expected some reversion to higher interest rates. We do however expect higher correlations between equity and fixed income over the next 10 years as low fixed income yields may offer less protection against falling risk assets if this coincides with higher inflation risk.

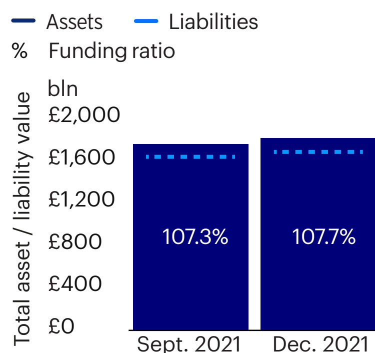
This strengthens the case for alternative assets in our view, in order to benefit not only from risk premia which have not (yet) compressed to the extent seen in public markets, but also to retain the benefit to risk-adjusted returns from diversification which bonds have traditionally provided against equities.

Asset class yield (GBP CMA) compared to historical average yield



Source: Invesco, estimates as of Dec. 31, 2021. Proxies listed in footer on page 2; These estimates are forward-looking, are not guarantees, and they involve risks, uncertainties, and assumptions. These estimates reflect the views of Invesco Investment Solutions, the views of other investment teams at Invesco may differ from those presented here.

Pension Protection Fund (PPF) funding level, change over quarter



Funding edged higher over the quarter, to 108%.

Liabilities and assets both rose around 3% in aggregate, with growth asset returns marginally outpacing the impact of lower bond yields.

However, there is significant dispersion with 41% of schemes remaining in deficit.

This dispersion is likely to have been exacerbated by the sharp rise in interest rates and fall in equity values following year end.

We expect significant de-risking activity in 2022, with the appropriate form depending on each scheme's progress towards its long-term objective.

Source: Pension Protection Fund (PPF S179 basis), Dec. 31, 2021.

Our private asset expected yields are represented by the CMAs of those asset classes in GBP.

2 CDI and the de-risking journey

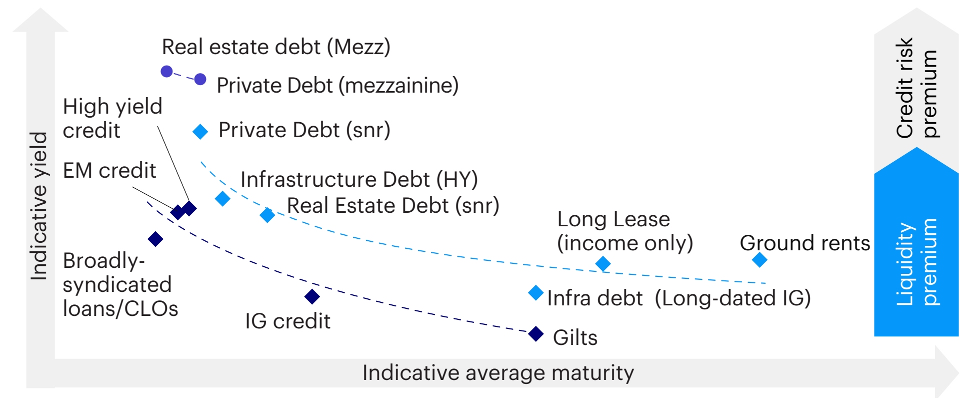
Rather than considering 'growth' and 'matching' assets in isolation, each investment held has a role to play in delivering cashflows when needed to pay pensions while also delivering sufficient yield to pay all liabilities in full. Schemes later in the de-risking journey may build a significant allocation to Buy & Maintain Credit, while schemes further from buyout or self-sufficiency can still de-risk without adversely affecting the liability discount rate. This is achievably by switching into assets offering higher cashflow certainty and lower capital risk, with returns driven from a variety of private market sources.

We refer to this holistic investment approach as "Cashflow Driven Investing".

A well designed strategy will be able to weather short-term volatility as assets don't need to be sold in a hurry, and many clients will adopt a "de-risking plan" to build up this portfolio over time.

The chart below illustrates the breadth of the toolkit which can deliver more de-risking than a traditional approach:

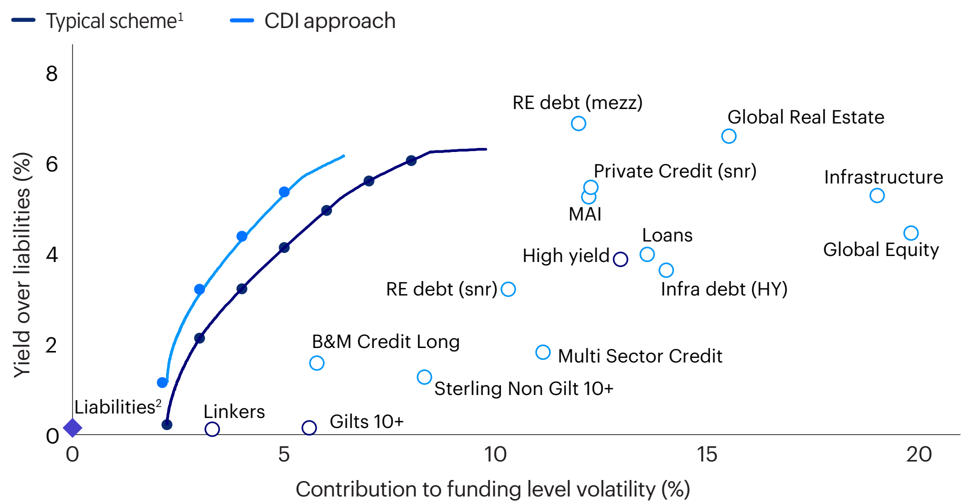
CDI fixed income toolkit



Source: Invesco Investment Solutions, as of Dec. 31, 2021. For illustrative purposes only.

By comparing the investment efficiency that is possible using typical asset classes (for schemes in the PPF 7800 index) and using a full CDI strategy, we show that **the CDI toolkit can reduce risk for a given expected return.**

A CDI approach can improve investment efficiency



Source: Invesco Vision, MSCI, PPF as at Dec. 31, 2021.

Risk measure shows forecast 1-year volatility of return relative to liabilities - this is just one of a range of measures needed to assess risk.

1. **Typical scheme:** PPF Purple Book, as of Dec. 31, 2021.
Proxies are:
UK equity: MSCI UK - Daily;
Global equity: MSCI WORLD ex UK IMI - Daily;
UK Credit: Bloomberg Barclays Sterling Non-Gilts;
Hedge funds: Proxy - Hedge fund US HFRI FoF composite;
Global real estate: Direct real estate CMA income component (unleveraged), based on NCREIF property index;
Private equity: Proxy - Private equity US large buyout (De-smoothed);
UK gilts: Bloomberg Barclays sterling gilts;
UK linkers: ICE BofAML UK inflation-Linked gilt index;
Cash: Currency pound sterling;

2. **Liabilities:** representative cashflow profile with 19y duration and 13y inflation duration valued on a Gilts + 0% discount basis, and assumes a 72% funding level, interest rate hedge ratio and inflation hedge ratio on that basis.

3. **CDI strategy:** Proxies are:
Long-dated buy and maintain credit: Custom cashflows with c13y duration;
EM debt: Bloomberg Barclays EM USD aggregate: Investment Grade;
ABS: Bloomberg Barclays Non-Agency Investment Grade CMBS: Bbb Index;
High yield: Bloomberg Barclays global high yield;
Loans: Credit Suisse Leveraged Loan Index;
Private credit: IVZ proxy: Private credit: IVZ Proxy - US senior corporate (De-smoothed) unlevered;
RE debt: IVZ Proxy - Private credit US senior real estate (De-smoothed) unlevered;
Infra debt (HY): IVZ Proxy - Private credit US infrastructure HY (De-smoothed);
Asset leases: Proxy - Other Credit US aircraft leasing (De-smoothed);
Alternative credit: Proxy - Other credit US venture lending (De-smoothed);
Infrastructure: Proxy - Infrastructure US core (De-smoothed);
Global real estate: Direct real estate CMA income component (unleveraged), based on NCREIF property index.

A CDI approach can reduce solvency uncertainty

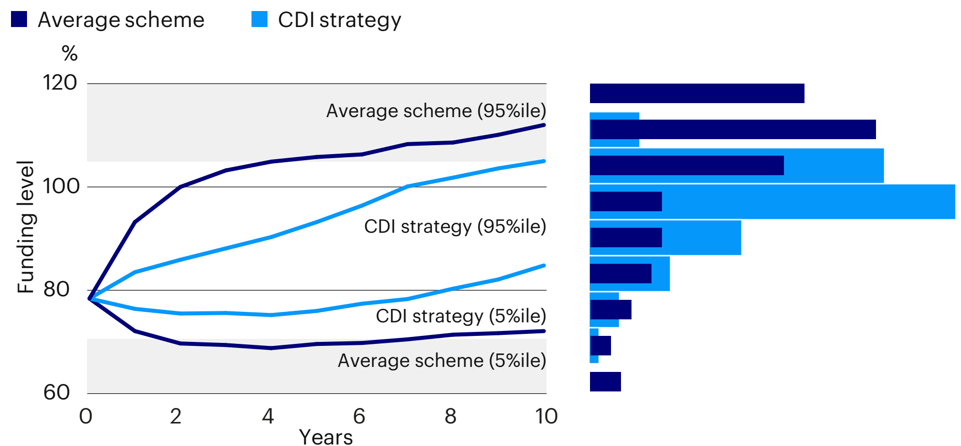
We model two investment strategies: The first models the **average asset allocation** of schemes in the PPF 7800 index[1] and assumes de-risking proceeds as funding levels are hit to reach a low-risk portfolio when fully funded on a low-risk basis[2]. The second models a **CDI asset allocation** holding a diversified mix of fixed income and real assets[3] and following the same trigger-based de-risking approach. We project asset values and deduct liability cashflows as they fall due.

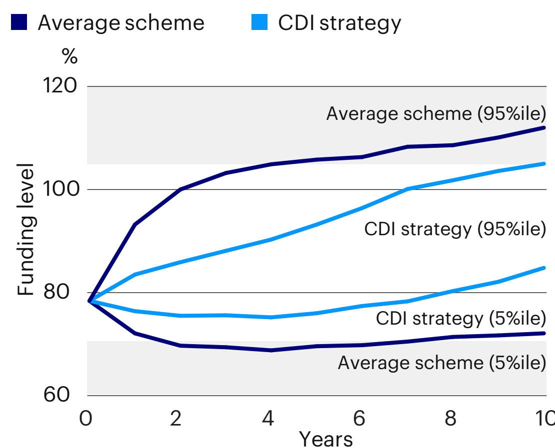
The initial expected return of both strategies is the same. However the CDI strategy exhibits significantly less dispersion of future funding levels as while market volatility affects both strategies similarly in the early years, the CDI strategy delivers more certain cashflows over time, reducing the likelihood of a persistent deficit.

Modestly higher funding levels since last quarter have increased the starting point of the projection, increasing the probability of reaching full funding on a buyout basis within the 10 year period.

Solvency projection

CDI strategy offers lower funding level uncertainty





Source: Invesco, Moodys, as of Dec. 31, 2021. Funding level on a low-risk basis[1]

UK Regulatory update

Climate change disclosures: In December, The Pensions Regulator (TPR) published final guidance for trustees on how their annual climate change reports should meet the requirements of the climate change regulations. Further, the Department for Work and Pensions (DWP) proposed in October that trustees of larger occupational pension schemes should disclose the alignment of their investment portfolio with the goal of limiting the increase in the global average temperature to 1.5°C above pre-industrial levels. The metric would be disclosed in schemes' climate change (TCFD) reports and come into effect from Oct. 1, 2022.

Revised DB Code of Practice delayed: TPR second consultation on the new Code is now expected in late Summer 2022. TPR confirmed the delay just before Christmas. In the meantime, we expect DWP to publish the related draft funding and investment regulations in the Spring.

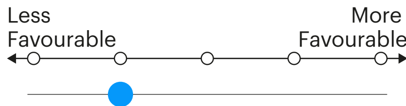
TPR's new Code of Practice also delayed: TPR is updating its Codes of Practice from 15 existing codes into a single, online code. Following significant interest in the public consultation, TPR has confirmed the new code is unlikely to come into effect before the Summer.

DB Superfunds: The first new DB superfund to meet TPR's (interim regime) standards was added to the online list at the end of November.

LIBOR transition: As of Jan. 1, 2022, only legacy use of synthetic 1m, 3m and 6m GBP and JPY LIBOR settings is permitted in all contracts (except cleared derivatives) until the end of 2022. In addition, overnight, 1m, 3m, 6m and 12m USD LIBOR settings will be published until end-June 2023.

3 Global market conditions*

Inflation

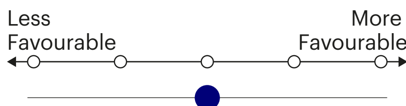


Year-on-year UK CPI rose from 3.1% to 5.4% over the quarter (US CPI: 7.0%, EU CPI 4.7%), driven higher by rising goods prices as consumption has shifted from services towards good during COVID restrictions and a global rise in energy prices. The cost of inflation hedging was already somewhat higher than the BoE's 2% target and has so far remained well-anchored.

While changes to consumer consumption may prove transitory, higher energy prices are likely to persist beyond the current elevated tensions between the EU and Russia (from whom it receives over 40% of its gas), as economies shift away from coal and oil-powered energy generation before renewable sources are able to make up the difference. From an ESG perspective, this may help to accelerate renewable energy capacity.

Looking ahead, UK CPI is expected to peak in April before fall back to average around 4% over 2022, with GDP only marginally higher (4.4%). Inflationary pressure is greater in the US and is expected to average around 5% over 2022.

Interest rates



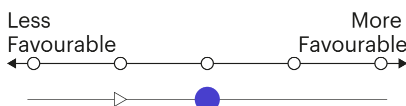
Gilt yields plunged over the first two months of the quarter to a low of 0.9%, on fears of the emerging Omicron variant (and potential future variants). Inflation concerns grew into year end, repricing yields higher, with 20y gilts ending at 1.2%. The result was the first year of negative returns for gilts since 2013 (and for EU sovereigns, 2006).

These inflation concerns grew substantially into the new year as a combination of forecasts for persistently higher energy prices, low unemployment and rising consumption as those households with savings accumulated during COVID-19 lockdowns are able to spend them. At the time of writing we now expect six 0.25% rate hikes in the US and quantitative easing programmes are expected to rapidly come to an end and begin to be gradually unwound.

However, while the speed of repositioning has been breathtaking, much of the move has brought forward hikes which were already priced in for 2023 and beyond, with longer term yields rising much more modestly (20y forward 10y yield rose +25bps in the first 6 weeks of 2022), and these yields are now back to 2019 levels.

Looking forward, with governments still running deficits and QE programmes ending, net government bond supply is expected to balloon in the coming years which could cause the sell-off to continue at longer maturities. We therefore expect gradual and probably limited QE unwinds as net supply will need to be carefully managed to avoid knock-on implications on sovereign debt (particularly in some peripheral Eurozone countries), and future COVID variants cannot be ruled out.

Credit risk premium

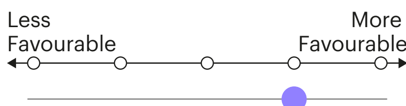


Corporate bond spreads widened somewhat in Q4 (Sterling: +12bps) reflecting expectations of tighter monetary policy (increasing corporate borrowing costs). Pension scheme demand remained a strong driver of technical support and this has helped eliminate what had been a persistent "sterling credit market premium" over US and Euro credit. Sterling IG spreads ended the quarter at 113bps over gilts. IG credit returned 1.37% over gilts over 2021. Nevertheless, we continued to see upward ratings migration.

In the UK, spreads continued to widen into 2022 after the Bank of England's surprise announcement that it intends to unwind its Corporate Bond Purchase Scheme by the end of 2023. This could result in some outflows from the sector which may widen Sterling spreads further; as a result we currently see more value in non-Sterling credit. However, we believe any such flows will be short-lived as companies enter the year with very robust fundamental credit profiles. In terms of valuations, spreads remain somewhat low relative to recent history reflecting that financial conditions are therefore likely to continue to support IG corporate spreads over the coming years.

Taken together, we believe the current risk-reward balance favours a more cautious stance on credit, but attractive entry levels may present themselves in the coming months where long-term investors are looking to de-risk into investment grade credit.

Illiquidity premium



The excess return available from private assets compared to public markets remains high. The combination of record levels of private equity powder, a robust M&A environment, and a continued post-2008 retrenchment from middle-market lending by banks means the supply/demand balance continues to favour direct lenders.

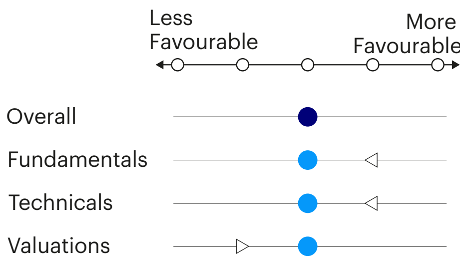
As a result, we believe that investors able to take liquidity risk are likely to be rewarded.

"More Favourable" indicates we are more likely to allocate new capital, whereas "Less Favourable" indicates we are inclined to be more selective and tactical in how we allocate new capital.

*These views reflect the views of Invesco Investment Solutions, the views of other investment teams at Invesco may differ from those presented here

Public debt

Gilts / LDI



Government bonds provide a large and liquid source of interest rate and inflation exposure to match residual liability sensitivity not provided by other assets. Exposure is typically leveraged to improve investment efficiency.

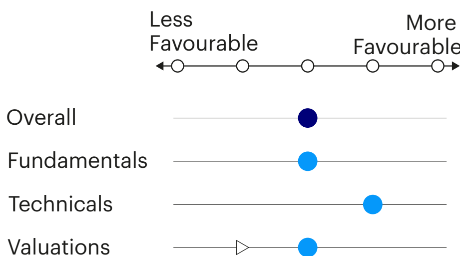
The cost of inflation hedging was already somewhat higher than the BoE's 2% target and has so far remained well-anchored (5y Gilt Breakeven rose 0.2% to 4.1% over the quarter, 20y ended the quarter unchanged at 3.7%).

With linkers remaining priced for inflation to overshoot the Bank of England's target by 1.5% every year for the next 20 years, the risk of persistent inflation is already well priced. If priced correctly, more pension components will be capped, reducing the sensitivity of liabilities to inflation. In this environment, many schemes will find that returns, not more linkers, are required. We therefore continue to seek cheaper ways to protect against inflation risk such as via real assets (covered below).

With yields now back to 2019 levels, the result is stronger funding levels particularly for those schemes with more interest rate hedging to complete.

Looking forward, with governments still running deficits and QE programmes ending, net government bond supply is expected to balloon in the coming years. This provides an opportunity for pension schemes to accelerate hedging programmes at a cheaper entry point, although we caution against large market timing decisions as the extent and impact of this increase in net supply is uncertain and potentially limited as central banks look carefully manage the programme, particularly if future COVID variants emerge.

Investment grade (IG) credit



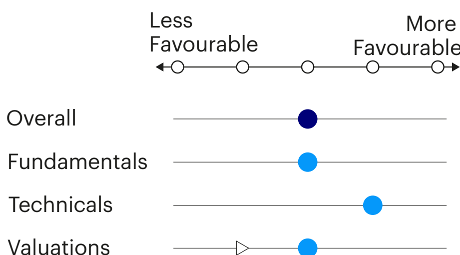
High quality bonds are a key source of duration and credit risk premia. Assets managed on a "buy and maintain" basis benefit from the yield enhancement from lower turnover and holding bonds to maturity.

Corporate bond spreads widened somewhat in Q4 (Sterling: +12bps) reflecting expectations of tighter monetary policy (increasing borrowing costs). Pension scheme demand remained a strong driver of technical support and this has helped eliminate what had been a persistent "Sterling credit market premium" over US and Euro credit. Sterling IG spreads ended the quarter at 113bps over gilts. IG credit returned 1.37% over gilts over 2021. Nevertheless, we continued to see upward ratings migration.

In terms of valuations, spreads remain somewhat low relative to recent history reflecting that financial conditions are therefore likely to continue to support IG corporate spreads over the coming years. Nevertheless, we see pockets of value in areas such as logistics, corporate hybrids and subordinated financials. One emerging risk for buy and hold investors is a rise in leveraged buyouts of undervalued assets from cash-rich private equity sponsors, which could lead to some bond cashflows needing to be replaced.

Taken together, we believe the current risk-reward balance favours a more cautious stance on credit, but attractive entry levels may present themselves in the coming months where long-term investors are looking to de-risk into investment grade credit.

Emerging market IG (hard currency)

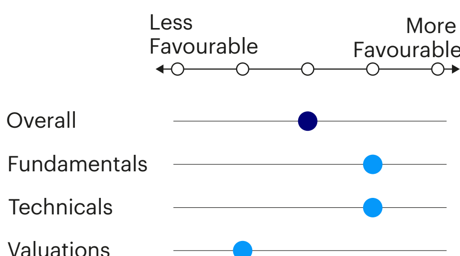


EM credit has offered a premium to developed economies for investors with strong credit research coverage. Hard currency (USD) debt is less exposed to EM currency and emerging market interest rate fluctuations relative to liabilities.

Emerging market bonds face a headwind from the global rise in inflation as EM central banks, almost without exception, are expected to hike rates and as US rates rise. This drives our neutral view on the asset class. China may be the exception given the desire to maintain economic stability with accommodative monetary policy.

Flows into EM funds were above average last year and we expect this to continue given the yield differential between EM and DM bonds.

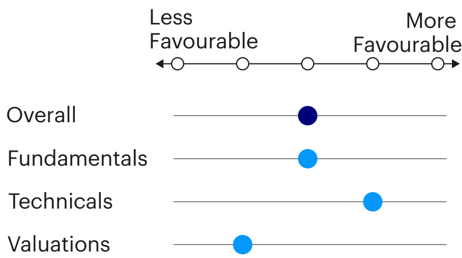
Global asset backed securities (ABS) IG



Asset-backed securities provide a large and diverse universe with the security of an underlying pool of assets, across mortgages, corporate loans, student loans, auto loans and others.

Fundamentals in most ABS sectors continue to provide positive tailwinds for credit conditions, as improved employment conditions and ongoing recovery from COVID-19 allow firms to weather the waning of fiscal stimulus and unemployment benefits. While AAA ABS valuations remain tight, we believe select lower-rated senior ABS are modestly attractive relative to corporate bonds.

Global high yield (HY)

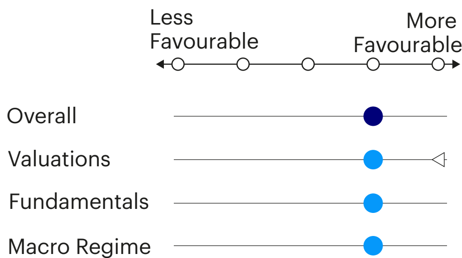


The HY debt market provides a key source of high income potential for clients with higher return targets, either as a small allocation within buy and maintain mandates or within a multi-sector approach.

Robust US economic growth, helped by a recovering global economy, has led to steadily improving HY credit fundamentals and rapidly declining default rates. Strong credit research is therefore key to identify companies more likely to benefit from rating upgrades.

Private debt

Senior secured loans (broadly syndicated)

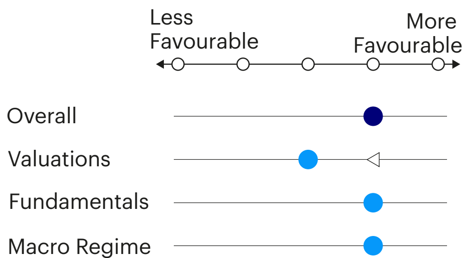


Senior secured loans have delivered a stable level of income through the market cycle, with similar returns and lower volatility than HY bonds.

Although supply-chain issues and now inflation remain a concern, macro surveys are starting to report a decrease in supply times. Early evidence in 2022 is that companies have broadly managed to defend margins in the latest wave of COVID, and balance sheet and cashflow metrics across the market are healthy. Default activity is muted and looks likely to stay that way in the near term.

We expect strong demand from investors concerned about the impact of inflation eroding the value of bonds, and this is stimulating the formation of CLOs to meet demand. Taken together, our outlook for loans relative to other more liquid fixed income is strongly positive.

Private debt (directly originated)

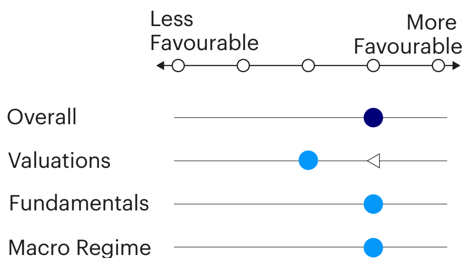


Yields in senior direct lending are derived to a greater extent from illiquidity / direct origination premia rather than credit risk, due to the strong level of covenants. This can provide investors access to attractive yields from relatively conservative assets with inherent downside mitigation.

Direct lending proved to be resilient in 2021 and yields have remained stable despite the rapidly changing economic restrictions and associated uncertainty of outlook.

As we look out to 2022, deal activity has accelerated and all components of our alternatives framework remain signaling "attractive," in our view. Record private equity dry powder should support mergers and acquisitions, increasing the demand for direct lending within the finance package. However, supply chain constraints and a mismatch of skills and demand in the labour market continue to challenge business operating models, creating short-term headwinds for the affordability of debt repayment in some cases.

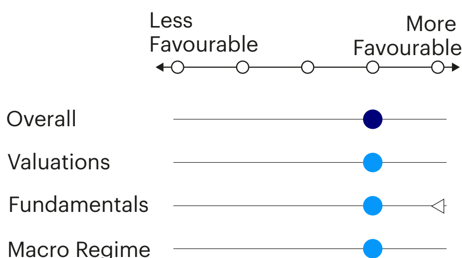
Private debt (distressed)



Distressed investing involves purchasing or restructuring debt from companies in or close to default. Lack of traditional funding sources together with the complexity of working a company out of distress provides opportunity for significant returns for the experienced distressed manager. Level and timing of cashflows are uncertain.

Distressed debt is currently yielding above-average spread over high yield bonds and is supported by similar dynamics to senior and second lien debt covered above, leading to our positive outlook. The swift return to a "low and stable" regime, which has historically supported high returns from private debt vintages, completes our strong outlook for this asset class.

Real estate debt

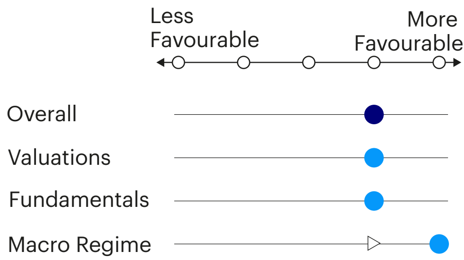


Real estate debt is a source of high and stable income with asset-backed protection. It can be attractive to pension funds and insurers seeking to deploy long-term capital without recourse to syndicated or securitised bank lending.

Senior lending has remained highly resilient. Loan-to-value ratios have remained stable and debt coverage has been rising. Post-2008, more lenders insisted on fixed rate loans or similar protection against a rise in floating interest rates. This has been waning in recent years and could impact affordability if short-term interest rates rise further than the market is pricing. However, as the significant stimulus measures particularly in the US and Eurozone feed through in inflation, this lifts the value of real estate collateral, improving loan to value for lenders. The effect of this can be particularly significant for longer-term leases. We expect some increase in loan defaults for more junior tranches and less prime assets, as borrowers' business plans are delayed, lease space is rationalized and pressure grows to source new lending partners when refinancing. However, this could provide opportunity for fresh lending at attractive rates.

Alternatives

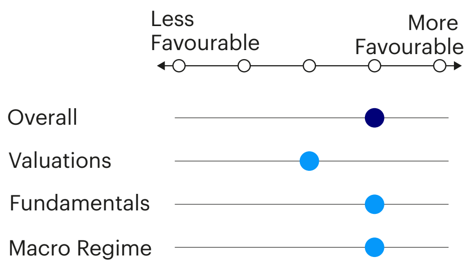
Real estate



Real estate is by far the largest alternative asset class offering long-term, broadly inflation-linked income, as rent and land value tend to rise with inflation. Global diversification can improve risk-adjusted returns. Properties let on longer lease reduce exposure to capital values which can be volatile, but this can reduce the liquidity of the portfolio.

Real assets are enjoying strong demand into 2022, both as economic activity rebounds and as investors seek assets with inflation-linked returns without the very low yields associated with government bonds. While valuations in prime sectors remain well above 2020 lows, spreads to government bonds remains in normal range and debt coverage is high. Fundamentals are sounder in real estate than infrastructure (see below). As a result we view real estate as attractive overall.

Infrastructure



In most global cities there has been an underinvestment in infrastructure, which has put significant strain on the existing assets and provides opportunities for long-term capital, often with inflation-linked income.

Infrastructure markets showed further strong momentum into 2022. Passenger transportation including unregulated toll roads and airports continue to face a headwind due to remote working and travel restrictions. However, the asset class continues to grow, evidenced by the trend for infrastructure funds taking publicly listed assets private. The largest such example to date, IFM's purchase of Sydney Airport, was confirmed early in 2022. While global travel and transport assets have seen a valuation shock, demand is expected to recover, leading to selective investment opportunities at discounts to historic valuations.

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Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Invesco Investment Solutions develops CMAs that provide long-term estimates for the behavior of major asset classes globally. The team is dedicated to designing outcome-oriented, multi-asset portfolios that meet the specific goals of investors. The assumptions, which are based on 5- and 10-year investment time horizons, are intended to guide these strategic asset class allocations. For each selected asset class, we develop assumptions for estimated return, estimated standard deviation of return (volatility), and estimated correlation with other asset classes. This information is not intended as a recommendation to invest in a specific asset class or strategy, or as a promise of future performance. Estimated returns are subject to uncertainty and error, and can be conditional on economic scenarios. In the event a particular scenario comes to pass, actual returns could be significantly higher or lower than these estimates.

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