BlueBay
Asset Management

D for diversification: Enhancing pension portfolios with alternatives

DB and DC pension schemes might differ vastly in structure, but both are facing challenges that ultimately result in a need for greater diversification – a key watchword for the whole industry.

We believe alternative sources of fixed income can play an important role in the composition of both structures of pension portfolio.

PUBLISHED
April 2019

READ TIME
5 mins

AUTHOR
BlueBay Asset Management

Defined benefit (DB)	Defined contribution (DC)
The world today	
The DB universe has seen a significant shift in portfolio composition. Back in 2003, DB pensions held 68% of their portfolios in equities, 31% in bonds and 1% in what was classed as 'other' by consultants Mercer. By 2018, a shift away from volatile equity markets saw investors holding 50% of the average DB portfolio in bonds, with equities and 'other' comprising an equal split between the remainder.	The DC market – the now standard option for newly enrolling retirement savers – has grown rapidly in recent years. Between January 2003 and June 2018, some 98% of the 9.8 million employees that were enrolled into pension schemes joined DC arrangements, bringing the DC pool size to a cool 13.1 million active members, according to data from Cerulli Associates – dwarfing the 7 million DB scheme members recorded in 2017.

RBC Global Asset Management

Defined benefit (DB)	Defined contribution (DC)
Investment problem	
This change in composition has resulted in an allocation issue, as increasing weightings to traditional fixed income allocations – typically 'plain vanilla' government debt – increases the correlation concentration within a portfolio while failing to match liabilities as the global economy remains in a low rates environment. DB pension investors require something different from the norm to best utilise their increased fixed income allocation buckets. Optimal portfolios need fixed income assets that have low correlations to existing holdings and that can provide a secure income stream even in tough market conditions.	UK DC pension savers are predicted to have amassed a pool worth approximately USD1.14 trillion by 2021 and are likely to look for investment options outside of what is currently available to deploy this capital into. At present, most DC platforms largely offer passive investment solutions, in the form of a default option. But as DC investors can often take control of their own allocations, they are more likely to take on greater levels of risk than DB investors.
An alternative solution	
This is where the huge range of alternative fixed income instruments comes into focus, with allocation options ranging from the more familiar commercial real estate options, through infrastructure debt to less standardised selections, such as structured credit and local and hard currency exposures in emerging markets. While investment-grade credit and government bonds still account for a large proportion of institutional portfolios, fixed income managers have been able to introduce trustees to a world of investments away from traditional sovereigns and listed companies. Additionally, different types of credit have become available as global banks – crippled by the financial crisis and ensuing regulation – have fled bond and loan markets in order to satisfy new regulatory capital requirements. As a result, there is now a vast spectrum of alternatives available, catering to all investment needs and risk-tolerances. This spectrum has expanded to include private debt, which offers its own diversification angle. Private debt securities are not issued onto the main bond market. Instead, individual fund managers directly acquire the debt of a company. In private debt, the likelihood of two managers owning the same security is low. This is good for pension funds' correlation scores as the source of return is different to the rest of a portfolio. With the investment universe continuing to expand and investors needs' changing to become less cyclical and more income orientated, fund managers need to remain at trustees' sides to accompany them down this alternative road.	In the fixed income universe, we are seeing DC investors looking for more interesting return stories than those offered by traditional government bond products, which is where alternative strategies come into the picture. Options like multi-asset credit, which spreads risk across sectors, instruments and duration, could be a more suitable pick for savers than volatile equity markets. By giving up some of the upside offered by equities, these funds aim to reduce potential downside and produce a regular income for savers at any point in their retirement journey. Another change that we see as re-shaping the DC market is the shifting view of retirement – at what age you take it and for how long you need to fund yourself. Some workers may decide to go part-time and keep contributing and investing, while others may prefer to sit back and relax. Thanks to the government's pensions freedom initiative, savers no longer have to accept an annuity, and as the market adapts to this development, options to invest through retirement in a range of securities that provide a regular income, while protecting capital, will likely become available. A testing point for alternatives in the DC market is the charge cap, set by the regulator to ensure savers do not pay over the odds for investments in default DC options. But while the charge cap exists in the UK, there are plenty of options on offer, particularly liquid alternatives, which use a range of instruments to mirror more expensive strategies, and some areas of credit. We believe there is a huge market just waiting to gain a critical mass of more alternative assets in DC pension schemes. The challenge for managers is to create innovation and attractive investment options and to work with trustee-led schemes, platforms and collective DC arrangements to educate savers about their choices.