XPS Pensions Group

Pensions briefing

March 2020

COVID-19 and implications for DC Schemes

Background

- COVID-19 is causing significant disruption to everyday lives, investment markets, and potentially pension scheme governance
- DC members and trustees should be warned against any knee-jerk reactions due to market movements
- The risk is that members and trustees may react and make poor, misinformed decisions

Actions

- Consider how you will support members during this turbulent time
- Take action to ensure you can continue to undertake good governance of your scheme
- Consider your investment strategy and how it has fared recently
- Continue to engage with your members and issue clear, helpful communications
- Members who are approaching retirement, or considering it, may need specific guidance

COVID-19 continues to cause havoc in investment markets and our everyday lives. We provide our thoughts on how members of DC schemes have likely been impacted and the actions that trustees should now consider to help their members make good, informed decisions. It is also critical that trustees continue to operate and govern their schemes well.

We highlight below a number of areas that trustees of DC schemes should consider in order to continue meeting their governance requirements and to meet their primary aim; providing financial wellbeing to their members.

Monitor Investment Performance/Consider Strategy

- Schemes need to review strategy at least every 3 years, or if circumstances require.
- Is the Default Strategy still fit for purpose?
- Do self-select investment options remain appropriate?
- Are schemes regularly monitoring DC investment performance?

Member Communications & Engagement

- Additional information will ensure that members take appropriate actions – poor decisions can cause lasting damage.
- Can trustees locate members (especially those no longer in active employment)? Do these need tracing?
- Consider different member cohorts and demographics to maintain good engagement.

Consider Overall Pensions Strategy and Governance

- How will this impact on the ability to pay regular contributions?
- Will this environment prompt more member opt-outs?
- Do employers need guidance on how to meet their obligations?
- Trustees should continue good governance and ensure key decisions can be made, including key person risks.

Retirement Planning for Members

- Members should be encouraged to review their retirement plans.
- Those approaching retirement may need specialised support.
- Member workshops or online retirement tools can provide useful support.
- Encourage members to avoid knee-jerk reactions and to plan appropriately for the future.

Impact on DC Asset Classes

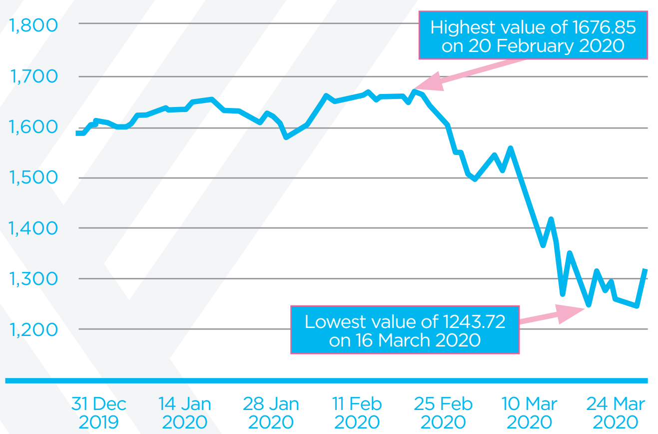
2019 was one of the best performing years on record for investing following 2018, which was one of the worst. Now in the wake of coronavirus, 2020 is shaping up to be a very challenging year for the global economy on a level we haven't seen before. We look into the key asset classes below and how these have likely impacted on members of DC schemes.

Equities

Equity markets have borne the brunt of recent falls and have lost more than 25% of their value from the peak for a sterling investor. The UK has been one of the worst impacted regions, seeing significant falls but global markets have not been far behind. Depreciation of sterling has benefited returns of overseas investments.

The charts below illustrate movements to 24 March but markets continue to remain volatile.

World Equity index - FTSE World Total Return Index (£) From 31 December 2019 to 24 March 2020



Source: Refinitiv Datastream

Members invested in equities will have experienced losses since the start of the year. Equities continue to be the most popular driver for returns in the accumulation phase of DC investment strategies. Members who are typically further away from retirement and have greater exposure to equities will be one of the hardest hit groups. They will now be reliant on their position as long-term investors and grateful for the potential to recoup losses over the coming years, although doing so risks participating in further declines in the near term. Members who now disinvest from equities, in the wake of the market uncertainty, could be 'locking in' those recent losses in exchange for not participating in any further possible declines.

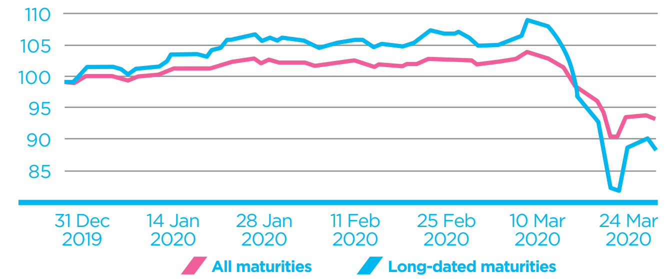
Strategies that are well diversified and not confined to equity markets will have fared better in 2020, although are still expected to have experienced losses nonetheless.

Corporate and Government Bonds

Bond markets tend to have an inverse relationship with equity markets and are typically viewed as safe haven assets. Against the backdrop of equity market turmoil, the value of bonds did initially increase, but their value has fluctuated wildly since then. UK Government bonds have outperformed corporate bonds since the start of the year.

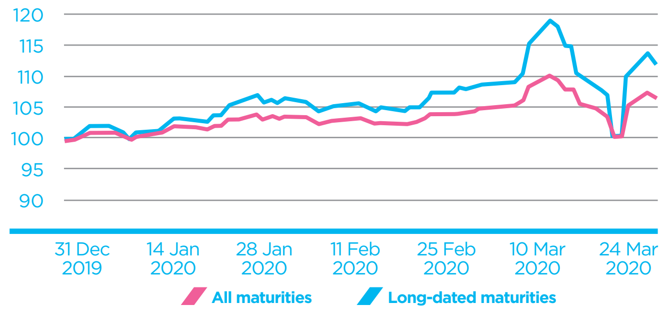
Performance of the various bond markets is best illustrated via the charts below.

Sterling Corporate Bond Index – Rebased to 100



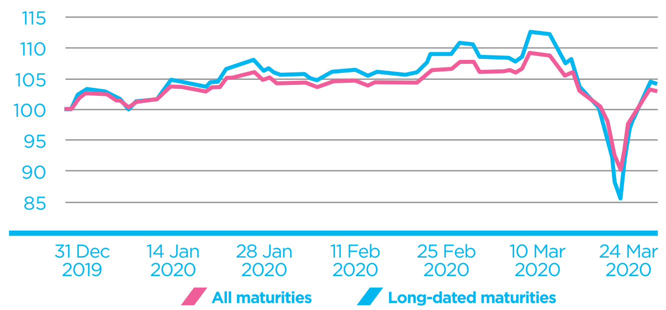
Source: Refinitiv Datastream

UK Fixed Interest Gilt Index – Rebased to 100



Source: Refinitiv Datastream

UK Index Linked Gilt Index – Rebased to 100



Source: Refinitiv Datastream

> **Equity markets have historically taken between 2 and 3 years to reach the bottom of the market and then a further 3 years to recover after significant shocks. However, there are no guarantees. Members invested in equity strategies may wish to consider such timescales and how it may impact on their retirement plans.**
>
> **Alan Greenlees** – Senior Investment Consultant

The developments in the bond markets will have consequences for members of DC schemes:-

- The greater resilience of bond values will be seen as good news for members whose pension pots are dominated by such 'low-risk' assets. Default strategies generally incorporate some level of age-dependent de-risking, so members closer to their target retirement age will typically fall into this group.
- Some members will already be drawing their pension in retirement, through the use of flexible drawdown strategies. Again, we would anticipate that such members will be heavily invested in bond assets, which can be used to provide regular income to members. The volatility in asset values may have direct impact on those using these assets to withdraw regular income.
- With government bond yields at low levels, the price of annuities (which are purchased with an insurance company and provide a regular income stream in retirement) has increased in recent years. Members who are now looking to purchase an annuity as part of their retirement plans will now receive lower levels of future income in exchange for their pension pot.

Property

The substantial economic uncertainty has placed constraints on the robustness of the independent valuation of non-listed market assets such as property. This has led to regulatory limitations on trading of some property funds given the reliance they place on the underlying valuations to price the funds correctly.

This means members may be unable to invest or withdraw monies from these funds.

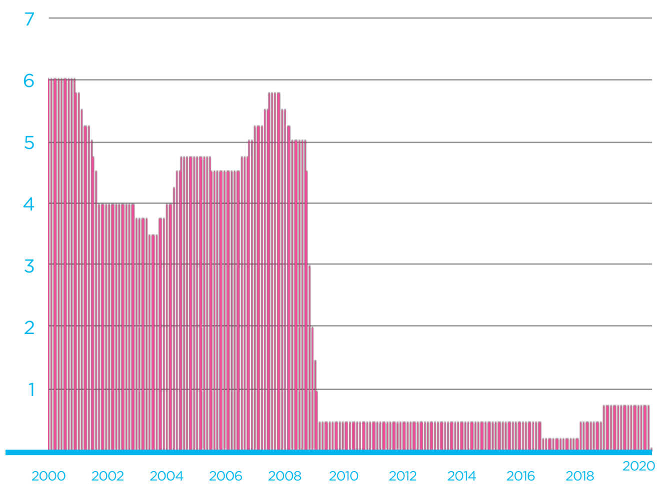
This will be particularly disruptive for any members with investments in these funds who are considering transferring or retiring. Members affected by this will need very specific guidance on how to proceed. Considerations include:

- Clear communications to members who will be impacted by these restrictions.
- Informing members that existing units will need to be held until any restrictions are lifted.
- Should future contributions otherwise earmarked for restricted property funds be invested in cash or other growth assets?

Cash

The cut in the Bank of England bank rate to 0.1% on 19 March saw it reach an all-time record low.

Bank of England Base Rate (%)
From 31 March 2000 to 31 March 2020



Source: Bank of England

Many cash funds will now be delivering very modest level of returns for members. The effect of low returns is compounded after you take into account investment manager fees. Members may well be faced with the prospect of negative net returns. Furthermore, against the current rate of inflation, then cash funds will be delivering meagre long-term returns for investors.

Cash tends not to be a mainstream investment choice for members, except in times of real volatility (where members who have made their own investment choices may elect to move into cash and protect their pot value) and for those in the default arrangement who are moving towards retirement and targeting 25% tax-free cash as part of their retirement benefits.

> We recommend that trustees of DC schemes continue to provide clear and helpful support to their members during this volatile time. Good governance, an appropriate investment strategy and maintaining ongoing operations remain key. XPS can support you with all of these aspects.

Chris Barnes – Senior Consultant

Trustee Actions

It is likely that members will be concerned about how their pension pots have fared. We expect that this will be more relevant for those who are approaching their target retirement age and are therefore well into their retirement planning.

For many members, the temptation will be to amend their investment strategy and revisit their retirement plans in the wake of these developments. The risk of members making reactive changes is that this could further compound the issue and may not be in their best interest or aligned to their risk preferences. Trustees (and on some matters, employers) may wish to consider the following actions.

1 Consider ongoing strategy and governance

At this time, it is imperative that oversight and governance continue (or even increase). Therefore, we would encourage contingencies for trustee meetings (e.g. hold these via telephone or video) and assess key person risks (e.g. trustees, advisors). Review 'Business Continuity Planning' including administration and check employer teams can continue to submit contributions. Also, business as usual must continue e.g. statutory deadlines such as accounts, Chair Statements and Value for Money assessments. Employers may now wish to consider their contribution strategies.

XPS can assist in reviewing operations and implementing change swiftly as required. Also, we can assist employers review their contribution strategies, or trustees where contribution change has been proposed by the employer.

2 Consider Investment Strategy & Member Choices

DC schemes are reminded to review their investment strategy at least every 3 years, or earlier than that if there are significant developments (including large changes in market conditions) that may impact a scheme. Trustees should now consider if the underlying asset allocation and exposure to different markets remain suitable. Trustees could also consider stress tests on asset classes and specified scenario analysis to test the robustness of the strategy and how members would be affected.

We can help you review the investment strategy and consider the ongoing suitability of the assets held. This will include assessing the robustness of the Default strategy. This can give you (and your members) comfort that the strategy is well placed for the future.

3 Member Communications

These volatile market conditions can cause panic among members and trustees may wish to consider if additional communications or newsletters should be issued to avoid poor decision making. Before doing so, trustees should consider the nature of these communications and what the key messages are for members to ensure that they are targeted and as helpful as possible.

We can help you to review and reinvigorate your member engagement strategy, helping you give your members the tools they need to make important pensions decisions.

4 Continue to Monitor Investment Performance

Trustees are required to monitor investment performance as part of their ongoing responsibility for good governance. This includes reviewing individual fund performance, updates from investment managers and how performance compares to respective targets.

We can help you regularly monitor the investment performance of your strategy and include value-add insights which you may wish to address.

5 Member Retirement Planning and Contribution Rates

In the wake of market movements, members are encouraged to review their retirement plans and if these are sufficient to meet any retirement income targets that they have. Trustees may wish to support their members with further information on retirement planning and the options available to them.

We can help you provide retirement planning support to your members. This will enable your members to make well-informed decisions, which are bespoke to them and provide greater financial wellbeing in their retirement.

> It's times like these where well thought out actions can create the greatest benefits, but ill thought out actions and inaction can cause the most damage! Our future selves will look back and be grateful for the good decisions we make today.

Craig Malenga – Investment Partner

Summary

We are in unprecedented times and whilst it may not be at the forefront of members' minds, their DC pensions should not be neglected. Trustees need to continue providing clear and unambiguous support to members. Trustees should also remain cognisant of evolving investment markets and if it requires additional monitoring.

XPS remain on hand to help you, and your members, to support their retirement goals and generate positive retirement outcomes.

About us

XPS Pensions Group is the largest pure pensions consultancy in the UK, specialising in actuarial, investment consulting and administration. The XPS Pensions Group business combines expertise, insight and technology to address the needs of over 1,000 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 870,000 members and provide advisory services to schemes of all sizes including 25 with over £1bn of assets.

For further information, please get in touch with Chris Barnes, Craig Malenga or Alan Greenlees. Alternatively, please speak to your usual XPS contact.

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