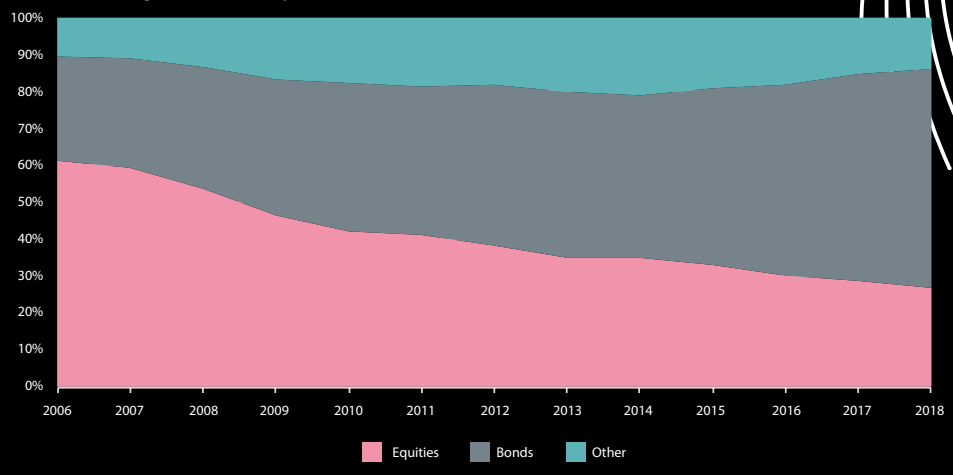
A month in pensions

# Bonds: a licence to kill?

Source: Figure 7.2 PPF Purple Book 2018




For several decades, bond yields (which follow interest rates), have fallen around the developed world. Rather than staying away from bonds, defined benefit (DB) pension schemes across the developed world have continued to buy more. In the UK figures show private sector DB schemes doubling their total allocation to bonds from around 30% to 60% (close to £1 trillion) in just over a decade. Over the same period the proportion invested in company shares (or equities) has more than halved.

## So why is the trend for DB schemes to invest more in bonds continuing?

In short, trustees of DB schemes are trying to reduce risk; sometimes with the sponsoring employer's full support and sometimes with a degree of reluctance!

## Is bond investment the best course of action?

The direction in which you lean on this answer may well depend on whether you represent the trustees or the (sponsoring) employer, as well as a scheme's specific circumstances.

The choice of investments is influenced by benefit promises to members which can easily stretch for 50-60 years for a typical DB scheme (i.e. until the last member dies).

Payments to members are funded from two sources, namely, investment returns and cash contributions from the employer: less from one source means more from the other.

Long-term bond investments provide a guaranteed steady annual income (known as 'coupons'), which DB schemes can use to fund payments to members. This gives schemes more certainty that future payments can be met. Bond prices tend to fluctuate less than other investments and quality bonds (issued by governments and large multinationals) are universally accepted as risk free.

The additional certainty from investing in these kinds of 'matching' assets comes at a premium since DB schemes could alternatively invest in 'growth' investments (e.g. shares in companies) which are anticipated to generate higher investment returns over long periods. Hence over a long term, all other things being equal, a higher bond allocation places a higher demand for cash on the employer. So why not ditch all bonds? Well, a disadvantage of other investment types, relative to bonds, is they do not necessarily provide a steady income, their prices fluctuate, sometimes wildly, and there is a higher risk of downgrades or default e.g. when a company experiences hard times or goes bust.

**There is a fine balancing act for DB pension scheme trustees and sponsors to play when it comes to choosing their investments.**

## Has the pendulum swung too far towards bond investments?

Arguably, yes. Bond yields have been at historically low levels for a number of years. Large allocations to bonds could be placing unnecessary pressure on employers to contribute more cash. In some cases, the employer has the cash and wants to reduce risk. In other cases, the trustees' desire for bonds (perhaps driven by perceived regulatory pressure or adviser pressure), is placing additional cash requirements which could deprive investment in the business. Where this can lead to an employer 'calling it quits', then ultimately this is in neither the employer, the trustees, the members, or employees' interests.

## What's the alternative?

Schemes can explore alternative investment mixtures. This may include making lower allocations to bonds (or at least not making a knee jerk reaction by increasing the allocation). Furthermore, there are an increasing number of more 'sophisticated' affordable investment vehicles which have become available to pension schemes in recent years, including those smaller pension arrangements e.g. diversified growth and credit funds and liability driven investments, which can help trustees maintain a high level of matching assets, with the additional benefit of being able to maintain or even increase investments in growth assets.

These alternative investment mixtures are aimed at helping schemes generate steady returns even if not guaranteed, whilst controlling price fluctuation and helping the employer achieve sustainable growth.

Each individual case must be treated on its own merits, including the employer circumstances, and there is no one size fits all solution.

## Three questions to ask yourself

**1// What is the employer's long-term objective for your scheme e.g. pay the benefits as they fall due, secure benefits in the relatively short term with an insurer? This drives all key decisions.**

**2// What level of investment return would be required to meet payments if the employer stopped contributions immediately? This helps assess reliance on employer as well as the types of investments needed to obtain the return.**

**3// Have you considered the impact different investment strategies have on cash contribution requirements?**

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