Adapting to change

Jonathan Stapleton talks to Aon's Tim Giles about the pace of change in pensions and key investment challenges ahead

By Jonathan Stapleton

While the past 18 months of Covid-19 have proved to be a torrid time for many in the UK, Tim Giles – a senior partner and EMEA managing director for Aon's investment business – says, from an investment point of view at least, pension funds probably have not had a bad ride.

Indeed, while equities fell back at the start of the pandemic, they have since recovered. And liabilities have fallen too – meaning the funding position of many schemes has improved significantly since last March.

This funding improvement is reflected in the PPF 7800 index, which went from an aggregate section 179 basis deficit of £124.6bn at the end of February 2020, peaked at a deficit of £155.1bn at the end of July 2020, before recovering to an aggregate surplus of £108.8bn at the end of September this year.

Yet, while Giles says the funding experience has been generally positive, there are several things on the investment side that are keeping people awake at night.

Firstly, he says some schemes have been asking themselves what the investment and funding journey was like during the pandemic.

He explains: "If you saw sharp fluctuations in your funding levels during the crisis, you were probably having some nervous moments and are possibly now asking whether your governance was right."

The second theme Giles raises is around inflation – asking what all the money that has been pumped into the economy by banks and governments means for inflation and for assets going forward.

"While we think this is probably going to be okay, you can see some fairly difficult scenarios – especially if inflation takes off in ways we haven't seen since the 1970s, where asset values are falling and inflation is rising. Those sort of scenarios are certainly worrying people," he says.

Giles' final concern is around equity markets and whether the bull run we have largely seen since the global financial crisis of 2007/2008 (barring a blip at the start of the pandemic last year) can carry on going.

"Equity markets have had a good run; they've kept going up. But can they really keep doing this? We have had good performance from most of our investments, when does that come to an end?"

SCENARIO PLANNING

Of the above concerns, inflation is one that is possibly making the most headlines at the current time, with opinions mixed as to whether the increase we are experiencing at the moment will be relatively small and short-lived or a more substantial, longer-term problem.

Giles thinks it is probably "more likely" we will experience a temporary increase rather than having sustained 1970s style inflation creeping in – but warns there is "definitely going to be some short-term impact", noting this is something we are already observing.

Yet, whether or not inflation will become a major problem, Giles is adamant that schemes should be prepared for a range of eventualities.

He says: "As with anything, you want to be making sure you don't survive just one scenario as a pension scheme – you want to be making sure you survive whatever scenario comes. And there is clearly that scenario where central banks can't keep the control they would like, that things take off faster than they expected, and that the amount of money being injected into the economy leads us to a different position.

"I think you worry about these tail scenarios, particularly in light of what we've been through over the past 12 to 18 months. Everybody now is a lot more mindful of what could happen that isn't part of the central scenario. This then comes back to how you make sure you're covering off those scenarios and what you

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would do if those sorts of scenarios did happen."

ASSET ALLOCATION

While Giles is concerned about when the benign market we are currently in might end, he feels that, for schemes that are well-hedged and well-diversified, many are in the right place with regards to asset allocation.

He says: "Pretty much most schemes have got the headline asset allocation piece right. It's then digging a bit deeper into what is within that.

"Take equities, for example. We are facing a huge change in the market because of how climate change is impacting the world economy. Therefore, just picking equities is no longer the asset allocation choice – it is about what type of equities you are picking and how you are managing them."

Giles says he has seen a substantial move away from the "follow the market" approach over the past 12 months – something that has been driven by this drive towards climate aware and more sustainable investing as well as the fact there is a significant difference in how companies are performing because of the changing circumstances.

"Because of the pace of the change in the world economy, picking the winners and losers has become ever more important," Giles says. "The drive towards responsible investment, and the drive towards making sure you have the right type of equities, means there has been a resurgence in active equity management."

This active equity management is not, however, the same as has been seen in the past. "It's about things that are more consistent with the trustees' beliefs and things that are more likely to perform better in a changing economy," Giles explains.

This sort of thinking is also starting to be applied to bonds as well – with schemes moving away from just spreading a mandate across a variety of different credits, to looking more at the ESG characteristics of those credits.

"Again, the choice of the asset within the asset class is becoming a lot more important," Giles says.

Another increasingly important consideration withing asset allocation is how dynamic the process is – with Giles noting schemes that were able to allocate more dynamically were able to both have a smoother journey through the crisis of the past year and improve returns.

He notes: "Picking the right types of assets and also having a degree of dynamic asset allocation means you had a smoother journey."

CARBON TRANSITION

ESG and sustainability are themes that are also dominating investment at the moment – with trustees increasingly looking at the investment issues involved in moving to a low-carbon future and the government substantially increasing the amount of legislation and regulation in the area, most recently with its plans to require trustees to measure and report how their investment portfolios are aligned to the Paris Agreement.

Giles believes the transition to a lower-carbon economy – and its impact on scheme investments – will probably come much more quickly than many expect.

He says: "Ultimately people need to be making the investment decisions about this now because transition pricing is already starting to feed through."

Giles says Aon has already started reducing the carbon content of some of its equity approaches and is also taking positive positions in both equities and credit to benefit from the changing economy – positions that have performed strongly.

"If you look at how well some impact-related equity portfolios performed and compare them to how poorly some carbon-heavy portfolios performed, you are already seeing the pricing differential," Giles explains. "This is why I'm saying it's not just about picking the equities; it's about picking the right style of managers."

KEY FACTS

Governance, the threat of inflation and the potential end of the bull market are key concerns

Giles says there has been a substantial move away from passive strategies over the past 12 months

Dealing with the huge amount of change within pensions will be a key challenge for schemes

An increasing number of schemes are now starting to put climate change policies in place – with a growing number coming up with a net-zero policy. Indeed, over recent weeks, schemes including the £10.6bn Transport for London Pension Fund, the £4.5bn Avon Pension Fund, and the £55bn Border to Coast Pensions Partnership have all set out their climate targets.

Giles says that of the schemes with net-zero targets, many are now targeting a reduction of around 50% in their portfolio's carbon footprint over a timescale of often less than ten years – a move he believes will have a transformative effect on portfolios and pose risks for those who get left behind as well as opportunities for those who move early.

He says: "This is a substantial change and if you are not starting to build that into your portfolios now, you're exposing yourselves to substantial risk – as soon as everybody has recognised it has happened, the pricing will have already moved."

Giles adds: "The time to be doing this is now and many pension schemes are already moving on this."

WEEDING OUT THE GREENWASH

In terms of products, Giles says there is a significant interest among his firm's clients in areas such as impact equity, carbon overlays and more systematic equity styles as well as bond strategies with strong ESG credentials.

But the challenge for trustees, he says, is understanding how good managers really are at this amid a proliferation of information and products.

"Virtually everybody has strong ESG credentials or purports to have strong ESG credentials and while there is a lot more data available around ESG capability, not all of it is reliable," Giles says. "It's interesting how pretty much everybody you talk to will have had responsible investing and ESG at the heart of what they're doing forever – but that doesn't seem to have always been the case."

Giles says Aon's responsible investment team is currently the fastest growing part of its business – a build-out that happened against the backdrop of an increasing need from trustees with help in "weeding out the greenwash" as well as gathering information and presenting it in a consistent, understandable way.

Increasingly, however, trustees are also asking for help with monitoring policies too.

Giles explains: "If you go back again and look at statements of investment principles, they would have left most of this with the managers. That is no longer acceptable – actually holding managers to account for what they're doing is an increasing task."

THE ROLE OF THE CONSULTANT

But while the role of the investment consultant is evolving in many ways, in others the core of what they do remains the same.

Giles says the single all-encompassing investment consultant "is a thing of the past" and has been replaced by a lead consultant who will make sure they understand the client's circumstances, beliefs and appetite to risk but bring on expertise from elsewhere within the business or externally as and when it is needed.

He explains: "We've always prided ourselves on our depth of expertise and on being able to serve clients however they want to be served – it is about getting the right people to the client at the right time."

This brings Giles onto the topic of fiduciary management, which he says can help with some of the "heavy lifting" for trustees.

"Most clients will have aspects, they always have had, where they don't want to get involved in the decisions. The fund solutions and fiduciary services we have can give the client flexibility in how they do that."

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Ultimately, Giles believes this approach – of bringing the right solution to the right client at the right time – will become commonplace.

He says: "It's not fundamentally changed anything we've done – we're just reacting to the market and reacting to the needs of different clients.

"Over time that will become the part of every consultant firm's makeup. We pretty much work with most other investment consulting firms who will bring in our solutions for their clients at the right time – either they're working with a firm such as ours that can bring those solutions to clients, or they have it within their arsenal already."

He adds: "Consultants across the piece are recognising what clients want and are having more experts to call on."

THE PACE OF CHANGE

Perhaps one reason so many more experts are required is down to the relentless pace of change within the industry.

As Giles notes: "The expectation of change within strategy and the requirement to make change because of things like regulation and climate change is huge. I don't think we can underestimate that.

"Clients can't deal with all the changes that are coming at them unless they've got the governance to do so – and that's the overarching theme of everything that's going on at the moment."

CV

Investment expertise

Position Tim Giles is a senior partner and EMEA managing director for Aon's investment business and has over 25 years' experience within pensions and investments.

Previously Giles joined Bacon & Woodrow, the firm that later merged to become part of Aon, in 1998. Prior to that he worked at the predecessor firms of Willis Towers Watson, PwC and Royal Sun Alliance. He qualified as an actuary in 1996 and holds a degree in Economics from Warwick University.