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A double hit for **pension funds?**

Key considerations for Swiss pension funds in the current market turmoil

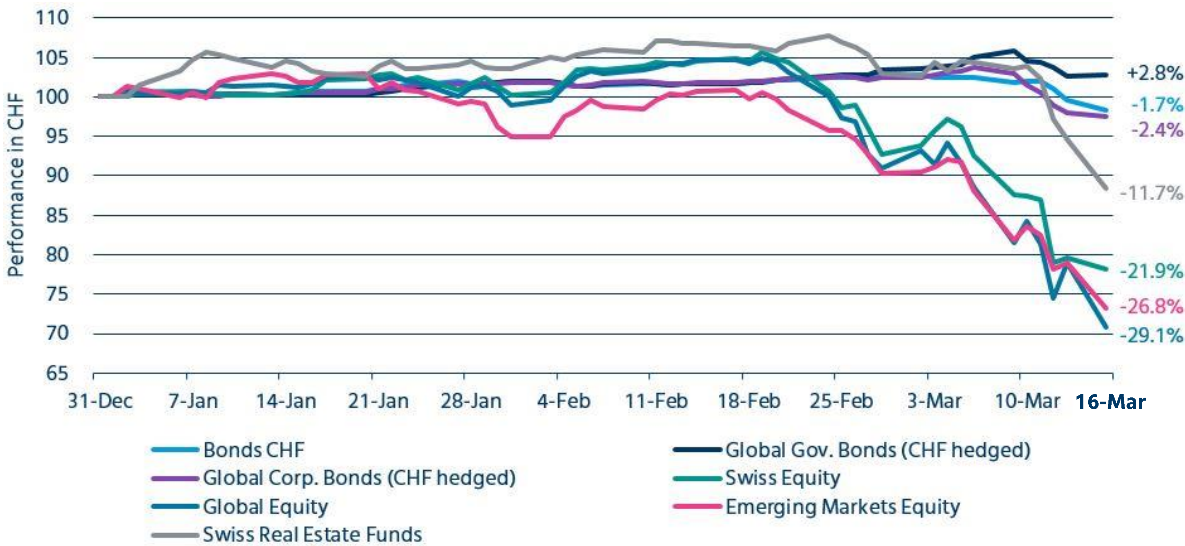
Having fared well during 2019, most risky asset classes have been hit heavily by the panic surrounding COVID-19. This downturn comes after new requirements for the strengthening of pension fund reserving assumptions (FRP4/DTA4) started putting pressure on the liabilities in 2019, while recent interest rate movements may also lead to an additional negative impact on technical interest rates.

During the last few weeks most pension funds have experienced a material decline in their coverage ratios and the hope for a return to a positive interest rate environment in the mid-term seem to have been eroded.

While we advise, in general, that our pension fund clients remain calm during the current period of market turmoil and to stick to their long-term investment strategies, most pension funds will need to consider the implications of these events, even if they result in inaction.

MATERIAL DECLINE IN MOST ASSET CLASSES SINCE 31 DECEMBER 2019

The chart below shows the development of a number of major indices over the period 31 December 2019 to 16 March 2020:



Source: Mercer and Thomson Reuters

Implications on the investments side

Short-term measures

- **Review your current asset allocations** and think about rebalancing towards your strategic asset allocations.

  MAJOR ASSET ALLOCATION SHIFTS SINCE 31 DECEMBER 2019
  The chart below shows the shift without rebalancing in a simplified asset allocation of a Swiss Pension Fund over the period 31 December 2019 to 16 March 2020:

Asset Category	Index	Allocation (%)		Change (PP)
		31.12.2019	16.03.2020	
Fixed Income		**50.0**	**57.0**	**7.0**
Switzerland	SBI AAA-BBB	30.0	33.8	3.8
Global	Bl. Barclays Global Aggregate (CHF hedged)	20.0	23.2	3.2
Equity		**30.0**	**25.1**	**-4.9**
Switzerland	Swiss Performance (SPI)	10.0	9.0	-1.0
Global	MSCI ACWI IMI	20.0	16.1	-3.9
Real Estate		**10.0**	**8.9**	**-1.1**
Switzerland	SXI Real Estate Funds	5.0	3.9	-1.1
Global	FTSE EPRA/NAREIT Global	5.0	5.1	0.1
Hedge Funds	HFRX Global Hedge Fund	**5.0**	**5.4**	**0.4**
Private Equity (listed)	LPX 50	**5.0**	**3.7**	**-1.3**
Total		**100.0**	**100.0**	**-**

Source: Mercer, Thomson Reuters and Pictet Asset Management

Note: The investment strategy is based on the Pictet BVG-40 plus 2005 Index, which includes only liquid listed asset categories. However, the benchmark indices as stated above may slightly differ from the original indices (i.e. Bloomberg Barclays Global Aggregate Index instead of Multiverse Index and HFRX Global Hedge Fund Index unhedged). Private Equity (listed) refers to listed private equity assets only.

The resulting investment return for the Pictet BVG-40 plus 2005 Index over the period 31 December 2019 to 16 March 2020 was -13.4%.Clients should consider maintaining their discipline with their approach to asset allocation. Rebalancing limits for some pension schemes will have been tested given the large market movements. However, careful consideration and planning is required for successful implementation in volatile markets to avoid erosion of returns due to out of market risk.

- **Check your foreign currency exposures.** We advise all pension schemes to have a currency hedging policy in place and to periodically review the appropriateness of those policies. This does not mean taking active currency decisions, but consideration should be given to the level of overall currency hedging within the context of “fair value” levels when they are set. Pension schemes that employ overlay currency hedging portfolios may also find that the level of currency hedging is not what they expect due to market movement and some adjustments may be required.

Once the dust settles

- **Reflect on the resilience of your investments** to down side events through reviewing your investment strategy. While you may feel comfortable with the positive fixed income performance offsetting some of the equity market losses, it may be very difficult to achieve your target returns in the long-term with negative yielding CHF bonds, while riskier assets may have become more attractive. Some investors may have experienced that the level of diversification within their investment strategies was not sufficient. While selling assets that have experienced sharp declines may not be warranted, it is still an appropriate time to consider the future evolution of your investments in order to build portfolios that are more robust. Consider developing a plan to respond to future market volatility. This plan should be strategically consistent with your investment objectives, loss tolerance, governance framework and implementation considerations.

- **Closely review your investment managers**. Adverse market developments often help identify investment managers with real skill to navigate the markets and deliver outperformance. Use the next weeks and months to challenge your current managers, how they have been positioned and how they have reacted to the market event – test their investment thesis and whether they are acting in a manner as expected given their stated investment processes.

- **Take the opportunity to (re)assess your pension plan governance framework.** The speed and magnitude of the latest market moves have caught many off-guard. Do you have internal governance and risk management processes to ensure a smooth operation of the plan activities? Have you asked the various providers of your plan about their business continuity plans? Monitoring exposures and maintaining clear decision-making for implementation and rebalancing are essential in uncertain times. Take time to review your internal policies and ensure every decision can be implemented swiftly and correctly. Consider outsourcing certain tasks related to portfolio management in order to benefit from a more robust and efficient risk oversight.

Mitigating actions on the liability side

Short-term measures

- Many pension funds are considering granting (or have already granted) relatively high levels of interest credit following strong asset performance in 2019. Until the decision regarding the interest credit has been formalized in a Foundation Board meeting, the Foundation Board has the opportunity to **reduce the planned 2019 interest credit to relieve some of the pressure** on a plan's financial position. The initial feedback we have had from clients is that many are hesitant to take this type of short term action, particularly where it appears that the plan is still over 100% funded. Foundations should monitor their asset performance until the meeting where the interest credit is finally decided, to ensure they are using the most current information available.

- **Foundation Boards may also consider deferring any strengthening of their technical provisions** which was planned for their 2019 financial assessment. This decision does not need to be taken until the pension fund submits its accounts. Hence, Foundation Board has the ability to observe the asset-side developments of the coming weeks before determining their final position.

Any downward pressure on market interest rates will have an implication on pension funds' technical interest rates. The immediate impact of any such falls on FRP4/DTA4 interest rates would be relatively modest as:

- rates are set based on a 12-month average of market yields from September to September (i.e. 6 months of "ordinary" rates are already captured in this average); and

- pension funds have a 7-year transition period to fully implement FRP4/DTA4.

However, pension funds should monitor developments closely and consider carrying out scenario or stress testing on their liability calculations.

Mid/long-term measures
Market downturns such as this expose the potential risks that pension funds (and sponsoring companies) are exposed to and illustrate the advantages to strategic reviews of the benefits and financing models used by plans. For example:

- companies or pension funds who have implemented benefit optimization exercises (such as: introducing 1e plans, reducing conversion rates, placing upper limits on benefits being taken as pensions, etc.) will have been partially protected from the market downturns; and

- pension funds that have taken steps to insure retirees or have transferred them to a separate retiree fund will have lower financing pressure.

Pension funds and companies that have not already implemented such measures should consider reviewing their options (noting that, while now may not be the appropriate time to enter implement such a solution, it may be an opportune time to develop a road map for future de-risking).

About Mercer

We are experienced in advising institutional investors across the whole spectrum of investment advice and would be happy to support you with any of the challenges you are facing with managing your assets and liabilities.

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Contact

Reach out to us and learn more about how Mercer can support you in your challenges:

Geraint Griffith, CFA CAIA
Head Investments
+41 79 248 68 78
geraint.griffith@mercer.com

Daniel Tonks, FIA
Head Retirement
+41 79 557 89 26
daniel.tonks@mercer.com

Tobias Wolf, CFA
Head Advisory
+41 79 559 94 17
tobias.wolf@mercer.com

Mercer Switzerland
Tessinerplatz 5
8027 Zürich

www.mercer.ch

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