VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

FM+

The protected run-on solution

Q4 2024

For DB pension schemes that have untapped mileage

With over 5,000 defined benefit schemes in the UK, we realise that one solution doesn't suit all when the time comes to retire the scheme. Not so long ago sponsors and trustee boards had limited options beyond transferring the entire scheme assets and liabilities to an insurer.

Now, particularly for well-funded schemes, there are potentially more attractive options. It doesn't have to be the end and it's not a game – **introducing FM+.**

What is FM+, the protected run-on solution

- **FM+ allows schemes to run-on in a risk-controlled way**, building up a surplus to create additional value for sponsors, DB and DC scheme members.
- The impact of funding shocks is mitigated because of **funding protection** provided by a major third-party insurer.*
- Assets are managed by an **experienced fiduciary pensions team** within a highly bespoke and conservative strategy.
- The **assets are invested to take advantage of investment growth**, with a longer term objective of achieving a cost effective buy-out at a nominated point in the future (typically over 5-10 years).

Is FM+ the right solution for your scheme?

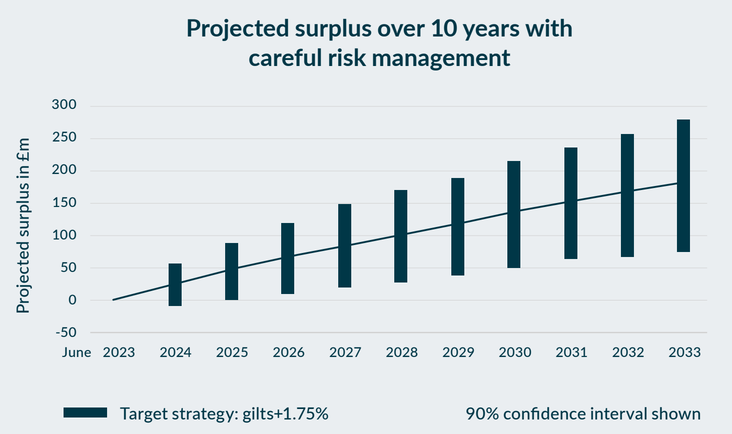
- Assets of £350m or more
- A minimum of 95% funded
- Stronger sponsor (BBB+ or above)

*Insurance is arranged separately

Capturing surplus while managing risk

Schemes are most likely to move to buy-out as they reach full funding rather than run on. However, FM+ meaningfully mitigates the likelihood of a future deficit and removes covenant concerns, see opposite.

In this example the '1 in 20' worst case scenario is that a £1bn scheme starting fully funded, would have generated a surplus of roughly £80m-£90m over the course of 10yrs. The best case scenario is that the scheme would have created a surplus of nearly £300m, net of fees.



Modelling is hypothetical and illustrative, based on a number of assumptions regarding financial markets and relationships between them. A model is necessarily a simplified representation of the real world, with simplifying assumptions made in order to be usable. Please see final page for further details. Past performance is not indicative of future results.

Source: Van Lanschot Kempen 2024

£1bn asset & liabilities values as at 30.6.23 for a hypothetical pension scheme with 15yrs duration, projected forward to 29.6.33 using Monte Carlo simulation to reflect a range of market conditions over that period. The investment strategy assumes a prudent return target of gilts+1.75% pa and a liability discount rate of gilts+0.5% pa.

Core benefits of FM+

- **Financial benefit from investment growth** can be used for DB or DC members or business expansion
- Schemes retain the benefit of **robust governance** from an award-winning fiduciary team while taking advantage of potential growth over 5-10 years.
- Potentially **valuable illiquid assets can be retained** rather than sold at discount in preparation for buy-out.
- Based on a **rigorously tested investment strategy** focused on predictable and reliable returns.

Additional benefits for:

Sponsors

- No additional surplus is required – unlike a buyout.
- Can allow for in-company cash flow from DB to DC members in certain circumstances.
- Scheme becomes an asset rather than a liability on the balance sheet.
- Insurance contract pays deficits – not the sponsor.

Members

- Increased benefits for DB members.
- Potential for increased benefits for DC members.
- Insurance contract can typically provide greater protection than the sponsor covenant.

FM+ Example: typical scenario*

The problem

A sponsor has, along with their DB scheme, a large DC population with an insufficient savings rate, and wishes to improve their retirement outcomes through increased contributions.

Vital statistics

- DB assets of £2bn and a fast growing DC scheme. DB scheme funded to 110% on a gilts+0.5% basis.
- A strong and highly engaged sponsor.
- Initial portfolio targeting gilts+1.5% pa. Few members of the DB scheme remain active employees of the sponsor, which has a large workforce with DC pension contributions set at auto-enrolment minimums.
- The scheme's trustees and sponsor are considering their endgame options, with buy-out being the default option.

Potential outcome

On the back of choosing the FM+ approach for its potential benefits (see on the right), the portfolio would be adjusted to target gilts+1.75%, without impact on overall risk given a refocus on highly rated fixed income assets (liquid and illiquid).

A surplus sharing mechanism was agreed between parties such that if gilts+1.75% was achieved then £5m pa would be used to meet scheme expenses as well as provide an underpin to their existing surplus; £5m from new surplus would be used to enhance discretionary increases to the DB members, and £15m from new surplus generated would be allocated to DC members – with £10m of this representing an offset to the sponsor's DC contributions and £5m representing a 'bonus' contribution to members.

*This is indicative of the potential outcomes for a scheme using FM+ in the circumstances stated, using VLK models and economic projections. Modelling is hypothetical and illustrative, based on a number of assumptions regarding financial markets and relationships between them. A model is necessarily a simplified representation of the real world, with simplifying assumptions made in order to be usable. Please see final page for further details.

Summary of the potential benefits

- The sponsor costs decrease by £15m pa, representing a material increase in its free cashflow.
- A surplus sharing mechanism is agreed between parties such that if gilts+1.75% is achieved then £5m pa would be used to meet all scheme expenses as well as provide an underpin to their existing surplus; £5m pa from new surplus would be used to enhance discretionary increases to the DB members, and £15m pa from new surplus generated would be allocated to DC members – with £10m of this representing an offset to the sponsor's DC contributions and £5m representing a 'bonus' contribution to members.
- DC members benefit from a non-contributory increase in their DC pension contribution of 2% pa, with ambitions of increasing this to 4% within 5 years, which would take their UK workforce to the Living Pension contribution target of 12% p.a.

FM+

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