VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Risky Risks 2.0

Expect the Unexpected

What risk scenarios matter most for UK DB Pension schemes

February 2025

Snapshot summary

Having already navigated through the first month of 2025 (and what an eventful start it has been), it's time to unveil our predictions for the rest of the year. Let's remember that a 'tail risk' event is like that elusive last bingo number – low in probability but high in impact, although in our case more likely in a negative way.

Last year, we took a deep dive into several tail risk events and their potential impacts on UK private sector defined benefit pension schemes. These weren't our main forecasts for 2024, but rather a collection of 'what if' scenarios to be aware of. Think of it as separating the tabloid headlines from the real news that impacts your portfolio. After all, understanding is the first step to taking action with your portfolio.

In our 2024 analysis, we highlighted two major risks: a US/China conflict over Taiwan and a US banking crisis. Spoiler alert: neither happened. Meanwhile, the ongoing Middle East conflict, though highly newsworthy, didn't impact UK pension schemes investment performance much, as anticipated.

Fast forward to 2025, and we've got a fresh set of risks to consider. Top of the list? The potential bursting of the 'magnificent 7' tech stock bubble and a potential sovereign debt crisis in Europe's sluggish, debt-laden economies.

On the 'newsworthy but less critical' side, we would have UK stagflation making a comeback, mandatory Mansion House reforms tinkering, and the wildcard – Trump 2.0 potentially stirring up global inflation, which may actually end up being beneficial for some pension schemes. Finally, beyond doom and gloom a special entry: 'positive Trump'. What if Trump is the great dealmaker bringing in peace and prosperity? Markets may be pricing a lot of this, but a pension scheme can dream can't it?

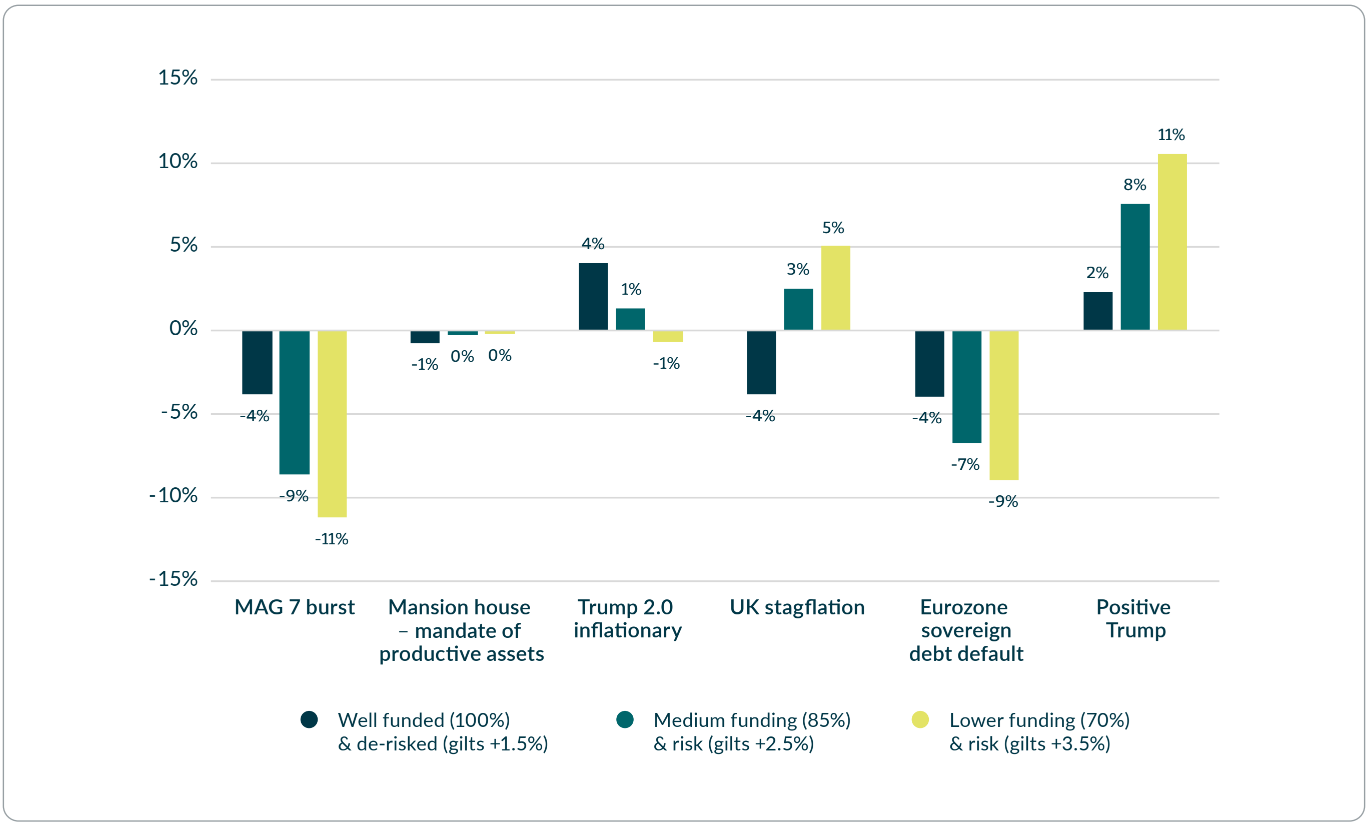
> The potential bursting of the 'magnificent 7' tech stock bubble is a key risk for pension schemes

As we continue through 2025, one thing is clear: schemes must remain vigilant to significant tail risk events that continue to pose a threat in the market. This is particularly important for the UK DB sector, where strong funding levels could be undermined by unexpected external risks.

One additional risk for the DB sector, not explicitly considered here, would be a failure to appreciate the greater number of strategic endgame options. Careful consideration of these and alignment to the one most suitable for an individual scheme could be the quickest way to reduce risk.

Results overview

Figure 1. Changes in Funding Level



Source: VLK calculations. 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 refer to the appendix for full details.

The key strategic considerations for risk management

Approaching the finish line

For the UK Defined Benefits (DB) pensions industry, the buzzword of 2024 was '**Endgame**'. Thanks to rising gilt yields over the past few years, many pension schemes are now sitting pretty in surplus, ready to transact with insurers.

But here's the million-pound question:
Can insurers keep up with the expected uptick in demand in the coming years?

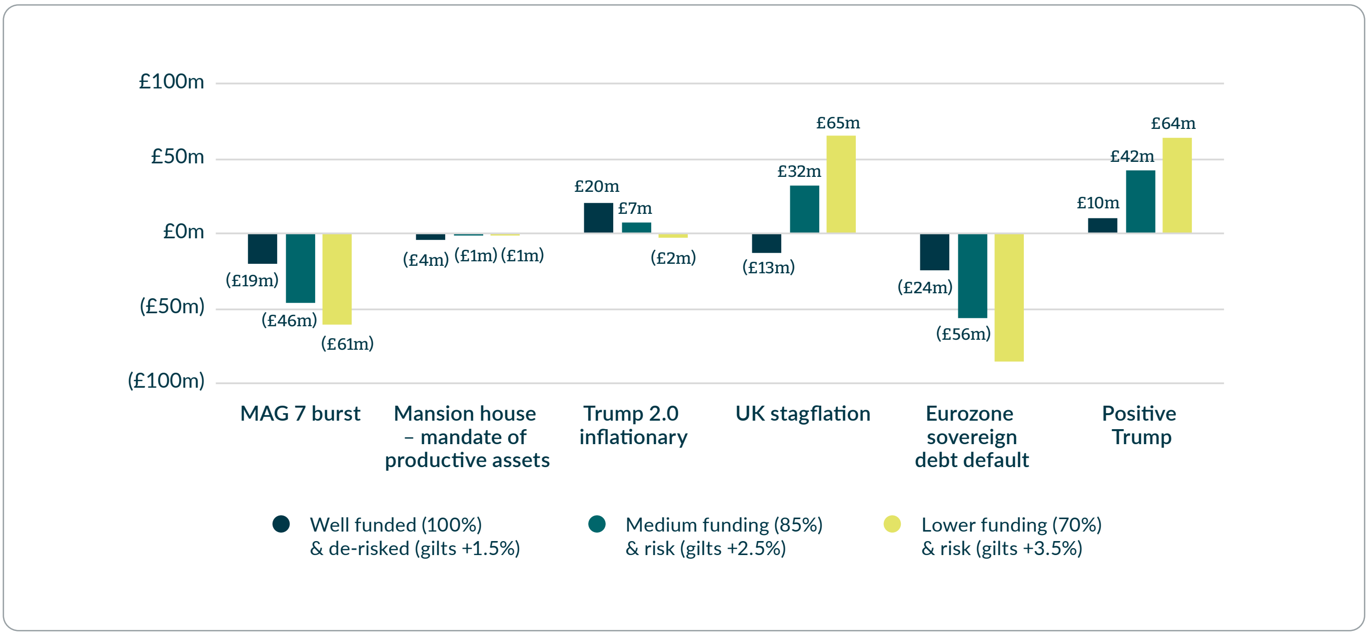
Trustees are increasingly scratching their heads and asking, "What's the right endgame option for my scheme?" More and more are exploring the benefits of 'running on', aiming to make more efficient use of assets in line with the UK government's push towards 'productive assets'. The best choice, of course, will depend on each scheme's specific circumstances.

Solving the deficit and funding level puzzle

One of the quirks of UK pension schemes is that a market event can be a double-edged sword: it might be negative for the funding level (the percentage ratio of asset value to liabilities) but positive for the £ deficit (the value of assets minus liabilities). The chart below shows the impact of the 2025 tail risk events on the £ deficit effect on schemes.

If in funding level terms a bursting of the MAG 7 was the biggest risk, in terms of an increasing £ deficits the Eurozone sovereign debt crisis is more significant; particularly for schemes which aren't as well funded.

Figure 2. Changes in £ Deficit for a £500m Scheme



Source: VLK calculations. 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 refer to the appendix for full details.

Which metric matters more? That depends on the scheme's specifics, but the primacy that funding ratio has enjoyed for the last few decades is increasingly challenged reflecting the backdrop.

1. Funding Ratio:

This is crucial for schemes where asset returns are key to hitting strategic funding goals.

2. £ Deficit/Surplus:

This is vital for schemes where 'real money' is either being funnelled into the scheme (contributions from the sponsor) or, to some extent, being paid out (as surplus). This becomes especially relevant when schemes have tentatively agreed to significant one-off contributions from a sponsor to achieve a goal (like a buy-out or Clara) but aren't shielded from market swings.

For schemes with weaker sponsors, large increases in deficits, which may need to be reflected on sponsor balance sheets, could be particularly painful. Especially if the low funding level is largely a reflection of longer-term sponsor weakness and inability to pay into the scheme.

Can a scheme just sell everything to avoid risk?

In a word, no – or very rarely. Risk is generally directed to generate reward in the way of returns. Often, this risk is short-term – markets dip but eventually bounce back (if you give them enough time). Most UK schemes desire return and should be able to ride out short-term risk.

Constantly focusing on short-term risk can lead to an unnecessary sacrifice of returns over the longer-term, which ultimately puts more pressure on sponsors and schemes to meet pensioner payments down the road.

So, the moral of the story? Manage risks, but don't shy away from them.

Reflecting on which metric is deemed more important to your scheme (or if they both matter equally) can help prioritise risk management and portfolio action.

Summary of analysis

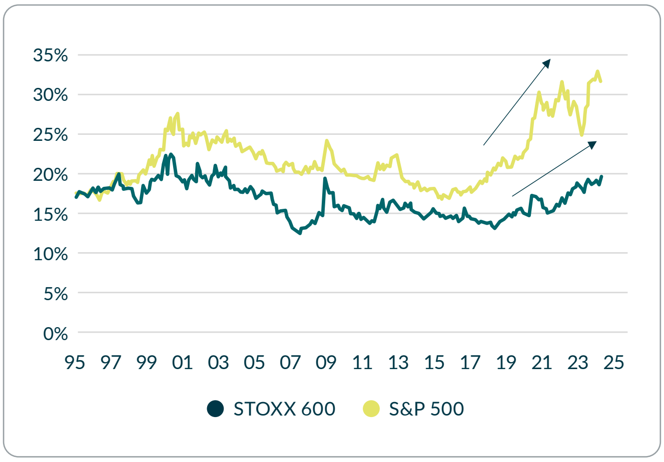
Bursting of the MAG 7 bubble – a significant risk for pension scheme investors

Equity markets steam-rolled their way through 2024. Global equity markets finished up over 20% for the second year in a row year-to-date, partially buoyed by continued exuberance related to Artificial Intelligence (AI).

Global equities have now reached extreme levels of market concentration, with the U.S. equity market reaching its highest level of market concentration since 1970. Although there are some similarities to the dot-com era of the late 1990s, today's high stock valuations are underpinned by seemingly robust fundamentals, such as strong earnings growth, return on equity, and profit margins.

However, investors should be aware of risks in worst-case scenarios. In a shock event like the Dot-com bubble burst, we expect a sharp equity market sell-off, especially in the technology sector and Mag 7 stocks. Other risk-on assets would also be impacted, leading to lower market liquidity and a flight to quality assets. Lower funded schemes exposed to riskier assets (e.g. equities) would be hardest hit.

Figure 3. Weight of the top 10 stocks in the US and Europe



Source: Goldman Sachs Global Investment Research, 11 March 2024

> Using structured equity strategies can protect against extreme downside moves, though it may limit some upside potential.

One point which may be less appreciated, is that credit spreads may widen significantly due to due to increased economic uncertainty and perceived risk. Whilst all schemes would be affected by this, well-funded ones with higher credit asset allocations would suffer the most.

The emergence of DeepSeek (a rival Chinese AI company) and the resulting $1 trillion dollars of market capitalisation which was wiped from US tech stocks in a single trading day highlights the risks that remain for investors, if the status quo of the very large tech companies are undermined.

Innovation in this space is constant and may not always be won out by the biggest players but a few brilliant minds.

Mansion House reforms – likely a non-event for DB corporate schemes

Rachel Reeves' first Mansion House speech in November was primarily directed at the Local Government Pension Scheme (LGPS) and Defined Contribution (DC) sector. However, reforms are imminently expected for the DB sector too, with a particular focus on how all sectors could increase investment in 'productive UK assets' and possible extraction of surplus.

In an extreme scenario, UK DB schemes might be required to invest up to 10% of their assets in these productive UK assets. If this happens quickly, it could create a frenzy as schemes rush to sell low-yield credit assets, leading to a scarcity of qualifying productive assets and driving up prices faster than bitcoin post Donald Trump's victory.

While such mandates would definitely grab headlines, our analysis shows they would have minimal impact on funding levels, regardless of a scheme's funding status. However, well-funded, de-risked DB schemes could find themselves with increased exposure to 'risk-on' assets. And for those aiming for a buyout with an insurer, potential illiquidity constraints could be another concern.

In reality, while this approach might work for DC and LGPS schemes – thanks to their longer investment horizons and cashflow profiles – we believe any mandatory commitment for (mostly closed) DB pension schemes would be less generally appropriate – for some it may make sense. Ultimately, **any UK 'growth' asset still needs to pass the test of having a good investment case in its own right**, and in comparison to global opportunities both listed and unlisted (and importantly, net of fees).

> While we all want the UK to thrive, that ambition takes a backseat to our duty to trustees and members of individual pension funds—for whom risk and security might be the top priorities.

Is the UK at risk of stagflation? A killer economically, but positive for some schemes?

The latest UK growth figures are giving the new government a serious headache, with the economy unexpectedly contracting in October for the second month in a row, defying expectations of marginal growth. Despite a strong start to the year, the economy has been on a downward trajectory since Labour took office.

Adding to the drama, rising unemployment and inflation are stirring up fears of stagflation. The Bank of England is caught in a tricky spot, as slowing growth and sticky inflation (which may rise), limits their ability in cutting interest rates. But what does this mean for the UK Defined Benefit (DB) sector?

Stagflation is a hugely difficult economic situation for central banks and governments – the 1970's saw interest rates pushed up to 17% to try to combat it.

We do not model such an extreme outcome (actuarial deficits would be tiny, but that might not be of much comfort, particularly when thinking of the path to get there). This is because for the UK DB sector, rising gilt yields are generally positive. On one hand, they reduce the present value of liabilities, which is a win.

On the other hand, sharp rises – like the 2022 gilts crisis – can cause liquidity nightmares for schemes with a highly levered or pooled LDI approach. With UK corporate credit spreads hovering near multi-decade lows, slowing growth could widen these spreads, increasing default risks and putting schemes, especially those heavy on credit assets, in a tight spot.

And what about the UK equity market? Any falls here would likely have a minimal impact on pension schemes, thanks to their reduced exposure to the UK market over the past couple of decades.

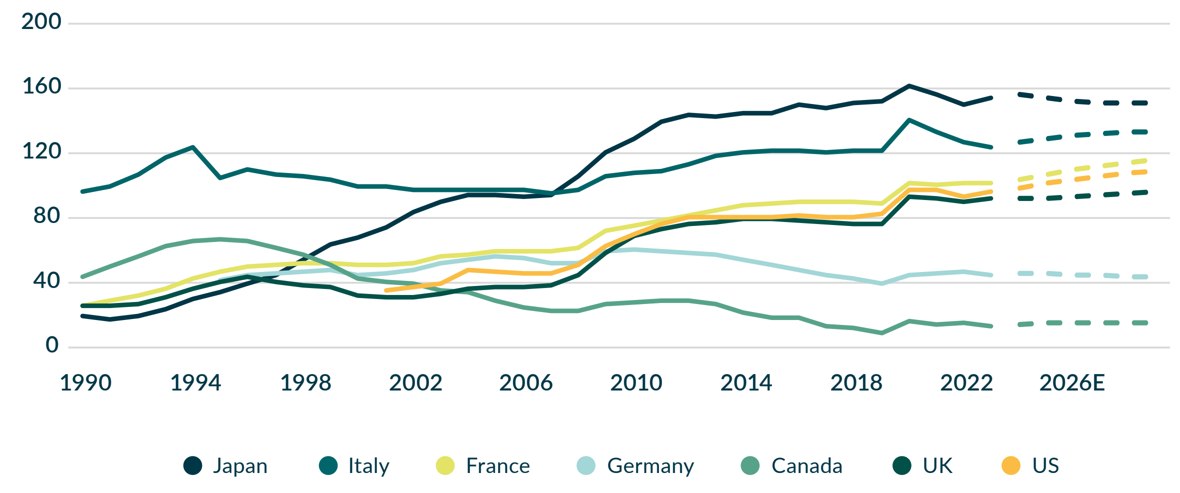
Eurozone sovereign debt default – a wider peril

High national debts, combined with primary budget deficits, high policy rates, and low growth expectations, have raised concerns about debt sustainability. This is especially true given the US deficits and Japan's recent currency devaluation.

While G7 countries might look like they're in the same boat, their outcomes and investment consequences are likely to differ. Take the US and Italy, for example. Both have similar debt-to-GDP ratios, but the US has the luxury of issuing the global reserve currency, while Italy does not issue its own currency. So, would an Italian (or Eurozone) debt crisis impact the UK DB sector?

A sovereign debt crisis in Europe could trigger a fall in interest rates, bothin the Eurozone and globally.

Figure 4. Net national debt, % of GDP



Source: IMF, Van Lanschot Kempen

Directly, maybe not. But indirectly? Absolutely. Financial contagion could spread like a bad cold, leading to increased volatility in global financial markets.

A debt crisis could trigger a fall in interest rates, both in the Eurozone and globally. If investors make a mad dash for safe-haven assets, this could drive down yields on UK gilts, increasing the present value of pension liabilities. A flight to safety would also hit risky assets hard, which would be especially tough on lower-funded schemes.

Then there's the increased credit risk and currency fluctuations to worry about. The risk of default would negatively impact Eurozone corporate and sovereign bonds held by UK pension schemes, potentially leading to losses in their fixed-income portfolios—a major risk for well-funded schemes with credit-heavy portfolios. While currency hedging strategies might offer some protection against FX risk, not all schemes may be fully hedged, and implementing these strategies can often be complex and challenging.

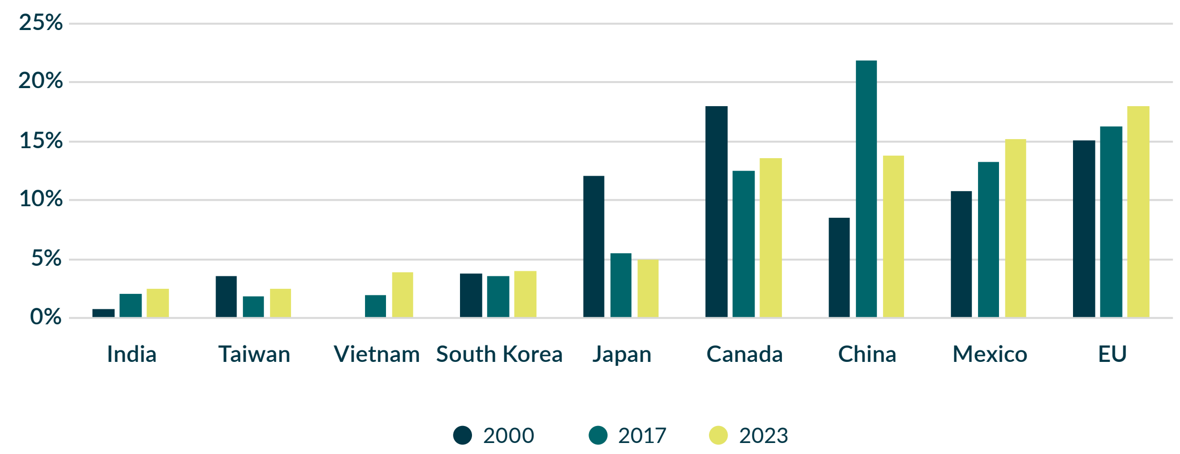
Trump 2.0 reinflationary concerns

With President Trump reiterating his plans for hefty US tariffs, we might be in for a wild ride with global repercussions. While China, Mexico, and Canada are the main targets, both the EU and UK have also been threatened.

These tariffs could turbocharge deglobalisation, leading to inflation that's not just higher but also more unpredictable.

Picture a tit-for-tat scenario where the US slaps a 50% tariff on all imports – we'd be looking at a short-term inflationary shock not too dissimilar to the 'transitory' COVID-19 inflation shock (which we are just about getting over).

Figure 5. Share in US import %



Source: LSEG, DataStream, ING

While high inflation may be a nightmare for every-day consumers, for pension scheme funding levels, it may be positive in certain scenarios. Our analysis suggests that well-funded schemes could actually see a slight uptick in their funding status.

As most DB pension schemes cap pension increases between 2.5% and 5% per year, this potentially creates a mismatch for an Liability-Driven Investment (LDI) strategy. The real kicker would come when inflation hits or surpasses 5% – whilst schemes holding index-linked gilts may receive a relative benefit, they may find themselves over-hedged. This is especially critical for schemes keeping an eye on insurer pricing for bulk annuity transfers.

So, while the world braces for tariff-induced turbulence, pension schemes might find themselves in a peculiar spot – balancing the benefits of high inflation against the risks of over-hedging and mismatched strategies.

Our analysis suggests that well-funded schemes could actually see a slight uptick in their funding status under this scenario.

The upside of tail risks: A Trump card for pension schemes?

When we talk about tail risks, our minds usually jump to worst-case scenarios. But let's not forget, tail risks can also swing to the upside. Imagine, if you will, a low probability (but possible) scenario where Trump's policies turn out to be a unanimous win for economic growth and global markets. In this rosy scenario, pension schemes could be in for a pleasant surprise.

As expected, global equities would surge, driven by the stellar performance of US equities, which now make up about 70% of global equity indices. Lower funded schemes, with their higher allocation to risk-on assets, would be the biggest winners here. But our analysis shows that all schemes would benefit, with well-funded schemes also seeing a boost in their funding levels. While credit spreads are already at historically tight levels, any further tightening would give a nice lift to well-funded, credit-heavy portfolios. And let's not forget, if central banks decide to raise policy interest rates, all schemes would stand to gain.

So, as we consider the potential tail risks, let's remember that sometimes, the unexpected can turn out to be surprisingly beneficial.

Conclusion

As we wrap up our exploration of tail risks for 2025, remember what we said at the start 'tail risk' event are like the final bingo number. While we certainly don't expect (and fervently hope) that these events will occur over the next year, it's crucial to stay aware of the risks your scheme might face.

> Even with the recent improvement in funding levels, it's important to note that well-funded, de-risked schemes aren't immune to risks. They can still encounter significant downside risks when specific scenarios play out.

Our analysis underscores the importance of considering individual scheme situations and tailoring risk management approaches accordingly. While certain major market risks may not be significant for some schemes, less obvious events can present significant risks. The specific risks and the portfolio that effectively manages them will vary based on factors such as funding level and risk tolerance.

It is important to note that this paper primarily focuses on the funding level risks associated with market events and does not fully consider additional risks routinely monitored and managed by fiduciary managers on behalf of trustees nor individual circumstances of each scheme.

So, as we continue through 2025, keep an eye on those tail risks.

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Appendix

Definition of risk scenarios

Risk scenario	Definition
Mag 7 burst	A 'Mag 7 burst' scenario refers to a sudden and significant decline in the stock prices of the seven largest technology companies, often referred to as the 'Magnificent Seven'. This sharp downturn may lead to substantial market volatility, eroding investor confidence and potentially triggering broader economic repercussions due to the outsized influence of these companies on the overall market.
Mansion House – mandate of productive assets	This scenario refers to the situation where the UK government mandates DB pension schemes to invest in 10% of total assets into productive assets which are aimed at boosting the UK economy productivity. This would be aimed at investments in infrastructure, technology, and other sectors that can drive long-term economic growth and efficiency.
UK stagflation	A UK stagflation scenario involves a period where the economy experiences stagnant growth, high unemployment, and persistent inflation simultaneously. This creates a challenging environment for policymakers, as measures to combat one issue can exacerbate the others, leading to economic and social difficulties.
Eurozone sovereign debt default	This scenario refers to a situation when a member country of the Eurozone is unable to meet its debt obligations, leading to a default on its sovereign debt. This situation may trigger financial instability across the Eurozone, potentially causing a banking crisis, increased borrowing costs for other member states, and significant economic and political repercussions within the affected country and the broader region.
Trump 2.0 reinflationary concerns	This scenario refers to a situation where Trump's second presidency term leads to policies that significantly boost inflation, such as increased government spending, tax cuts, and protectionist trade measures. This could result in higher consumer prices, increased borrowing costs, and potential challenges for the Federal Reserve in balancing economic growth with inflation control.
Positive Trump	This scenario refers to a situation where Trump's second presidency term leads to policies which are unanimously positive for economic growth and global markets.

Financial market shocks

	Mag 7 burst	Mansion House – productive assets mandate	UK stagflation	Eurozone sovereign debt default	Trump 2.0 Inflationary	Positive Trump
UK equities shock	-15.0%	-5.0%	-10.0%	-10.0%	-10.0%	20.0%
Overseas equities shock	-30.0%			-20.0%	-10.0%	20.0%
UK interest rates shock	-0.5%		3.0%	-2.0%	0.5%	1.0%
Overseas interest rates shock	-1.0%			-2.5%	1.0%	1.0%
Inflation shock	-0.5%		1.00%	-0.5%	2.0%	
UK credit shock	0.80%	0.25%	1.50%	1.00%	0.50%	-0.25%
Overseas credit shock	0.80%			2.00%	0.50%	-0.25%
Inflation – cap/floor shock	-0.56%	0.00%	0.70%	-0.56%	0.88%	0.00%

Source: VLK, indicative. 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 refer to the appendix for full details.