Cardano Group Outlook to 2024

January 2024

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We are pleased to share the following insights from across our Group – Cardano UK (Advisory and Investment), Cardano NL, and NOW: Pensions – looking ahead to what's in store for 2024.

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DB pensions are on the move but what is the destination in 2024?

For a pensions market that is all but closed to new members, defined benefit (DB) pension schemes and perhaps primarily the Government, are not resting on their laurels. Mansion House reforms and a gently encouraged move into productive assets, increasing numbers of bulk annuity deals, and consolidation, all set against the backdrop of the upcoming General Election, mean that 2024 is set to be a year with many twists and turns.

November's Autumn Statement saw the Government pledge to make far-reaching reforms to the pensions industry; how savers build a pension pot, driving greater consolidation, encouraging investment in productive finance and accessing surplus cash. The potential impact of these measures could be significant.

In particular, we see the move to encourage more investment in UK productive assets as laudable. We have long been proponents of such assets – especially in sustainable and impactful ones, e.g. social housing. However, these illiquid assets have characteristics that aren't always aligned with the DB scheme agenda. Due to the acceleration of endgame decisions, DB schemes have a reluctance to commit to the time horizons that these types of investments need. This is primarily because insurers focus their investment on low-risk bonds, with illiquid/productive assets not fitting within an insurer's investment appetite to any material extent, either due to regulation or preference.

From our calculations, we could see as much as £500 billion of assets being transferred from DB schemes to a handful of insurance firms in the coming years. The Government, PRA and the Bank of England should be asking questions on the long-term economic implications of this shift and alongside the economic impact, they should consider the regulatory ramifications. Have steps been taken to ensure the insurance regulatory landscape is equipped to handle this influx of capital and its associated risks?

Another area is for the Government to destigmatise run-on solutions. This will promote a range of investment decisions in UK companies and greater flexibility on which illiquid assets meet the definition of growth companies to give insurers and the industry confidence when considering risk and liability in the context of investment decisions.

Inspiration from other markets

In our view, the debate also doesn't need to focus solely on private pension funds. Instead, we could look at how public sector and state pensions are funded. The Government could establish a public sector superfund to invest in a range of assets, including productive finance, with its returns ringfenced to (partially) fund public sector pensions and potentially the state pension.

This would not be unprecedented. Across the Nordics, Canada and Australia, public sector superfunds invest in productive assets, such as large infrastructure projects. This provides revenue for Government to fund spending commitments, including state pensions. It would be much easier for Government to mandate a minimum exposure to UK productive assets for a state or public pension fund rather than corporate funds.

Solutions abound

While the road ahead for UK pensions is uncertain, there is real potential for the industry to engage with policymakers for the benefit of the economy and long-term member outcomes.

We should encourage greater investment in illiquids with greater flexibility in terms of their eligibility, creating a standardised approach to move assets from DB schemes to bulk annuities.

We can remove pressure on the insurance market and destigmatise run-on to encourage other alternatives to buyout. And with inspiration from other countries which have done so successfully, a long-term aspiration should be the creation of a new pensions superfund to invest assets for the currently unfunded public and state pensions.

For a long time the UK's DB pension regime has worked incredibly effectively to prioritise delivering members' benefits and we will continue to do so.

Kerrin Rosenberg
CEO, Cardano Investment

How the past can help us prepare for the future

Writing a forward-looking outlook is inevitably a somewhat reflective exercise and even more so this year as I hand over the reins of Cardano Advisory to Matt Harrison and Sinead Leahy as incoming Co-Heads.

Before turning to views for 2024, it occurs to me that we began our business in early 2008 which was – in the first half of that year – the last time I remember the insurance risk transfer business being as feverishly active as 2023.

One of our first advisory roles in 2008 was advising the Delta Pension Plan on a £451 million buy-in with the newly established Pension Corporation (now Pensions Insurance Corporation, PIC). I remember being asked by Josephine Cumbo (Financial Times, Global Pensions Correspondent) at the time why we advised going with PIC. I am glad we did because the alternative transaction was a solution proposed by an investment bank called Lehman Brothers. As I have recently said to the Chair of Trustees, I think we would both have been out of a job had we transacted the entire scheme assets to Lehman Brothers just three months before it collapsed.

I take huge pride from the counterparty advice we gave in 2008 just as I did in 2023 when we led the advice on the largest ever single scheme transaction, being the full buy-in of the Boots Pension Scheme for £4.8 billion with Legal & General. Deploying our broader skillset as Cardano our work involved finding a secure solution for the liabilities but also, importantly, delivering a strategy for the assets too – which involved a considerable proportion of illiquids that needed a bespoke approach.

The past year has been about pensions surpluses becoming a mainstream topic (again) and where all the 'action' has been around what to do with surplus and the pace of risk transfer to the insurance market. For those of us that have long enough memories (i.e. are simply old enough!) we have been here before (more than once) and most recently in 2008 shortly before the global financial crisis.

Looking to 2024, the experience of 2008 should remind us that current market conditions may prove to be transient and risk transfer volumes being anticipated may or may not be sustained over the next decade as we work through the remaining schemes which collectively have about £1.5 trillion. I also see two competing macro trends: (1) the runaway train of insurance transactions seemingly only constrained by people capacity to price and process the deals; and (2) an increasingly vocal minority of schemes, politicians and commentators saying "isn't it better to run-on with a good sponsor and investing surplus in the productive economy and/or having impact funding climate transition rather than passing it to an insurance company to put in low risk liquid instruments. Alongside this we have the Pension Protection Fund potentially expanding its role with new leadership on the horizon, and the Pensions Regulator looking to channel its regulatory firepower under its own new CEO.

All this points to advisors like Cardano needing to provide a 'whole of market approach' and not advising schemes on one type of solution – our approach to risk transfer is about strategic advice of the balance of pricing / counterparty strength / structural protections / illiquids strategy etc involving the whole balance sheet – not an actuarial procurement focusing unduly on liability pricing.

When Alex Hutton-Mills and I founded the firm in 2008 we focused on delivering safer financial futures. While the broader mission remains unchanged, our boutique covenant advisory firm has blossomed into a multi-service pensions advisory practice as part of the wider Cardano group. I wish the team every success for 2024 and beyond.

> **Looking to 2024, the experience of 2008 should remind us that current market conditions may prove to be transient.**

Darren Redmayne
Outgoing CEO,
Cardano Advisory

Automatic Enrolment: A new roadmap is needed

2024 is set to be a significant year for NOW: Pensions. We have a number of exciting new scheme developments that we will launch to our members and employers over the next twelve months, and we are expecting a busy public affairs and policy agenda across the topics that Government have engaged with this past year. But we'd like to see more – a Roadmap for Automatic Enrolment that grapples with some of the basic fundamentals needed to address the adequacy challenge.

Automatic Enrolment (AE) has been hugely successful in getting millions more people into saving for their future; 10.7 million people have started saving into their pensions since its introduction in 2012[1]. NOW: Pensions has played an important role in this system from day one – by providing pension services to members and employers that were typically underserved, for example, small businesses, those with lower earnings, and non-traditional working patterns.

Over the years as NOW: Pensions has grown we have also evolved – this year we will be introducing investment choice, services to support members to find and consolidate pensions, a new app, and greater functionality for employers. We are excited to be moving forward with these and other developments, focused on supporting our member and employer experiences and outcomes.

We would also like to see auto-enrolment evolve.

> **The cost of living crisis undoubtedly makes this a difficult topic to explore. But that is why a Roadmap is urgently needed.**

Expansion of AE

We are seeing some encouraging developments. Last year the Automatic Enrolment Extension Bill Expansion received Royal Assent. The Bill implemented the AE 2017 Review recommendations, by extending eligibility from 21 years to 18 years and removing the Lower Earnings Threshold. These are two measures which we have called for and believe they will improve outcomes for members. It is expected that total pension contributions could increase by £45bn over 30 years once these measures are in place[2].

Further consultation is due over 2024 on the practical application on these measures – it will be important to consider the cost impacts for employers and for members, both in terms of contribution level changes, as well as administrative efficiency.

These measures will go some way to supporting better saver outcomes. However, we still believe that a wider strategic consultation on the next steps for AE is needed to ensure AE continues to meet its objectives in the future.

A new roadmap is needed

There have been great successes with AE, however, over a decade into the delivery, it's clear that the original vision of the Pensions Commission has not come to pass. There are still individuals who will not achieve adequate retirement incomes. DWP research found that 38% of working age people (equivalent to 12.5 million) are undersaving for retirement when measured against Target Replacement Rates Before Housing Costs[3]. Whilst auto-enrolment successfully harnesses inertia, resulting in millions of people saving at that minimum, the age old challenge of active engagement and 'saving more' remains. A key part of the Pensions Commission vision was that people would save over and above the statutory level – and the UK AE system has significantly low levels of contributions compared to other similar systems.

The cost of living crisis undoubtedly makes this a difficult topic to explore. But that is why a Roadmap is urgently needed. It is not necessarily about making changes now – it is about exploring the issues, building consensus, mapping out a future that we can all plan for.

Over 2024, we plan to develop proposals on the future of AE and how it can continue to evolve to support savers.

Patrick Luthi
CEO, NOW: Pensions

1 https://www.gov.uk/government/news/ten-years-of-automatic-enrolment-achieves-over-114bn-pension-savings#:~:text=Automatic%20Enrolment%20has%20completely%20transformed,this%20easy%20to%20use%20scheme.
2 https://publications.parliament.uk/pa/bills/cbill/58-03/0255/DWPImpactAssessmentMarch2023.pdf
3 https://www.gov.uk/government/statistics/analysis-of-future-pension-incomes/analysis-of-future-pension-incomes

The Dutch pension market in 2024

Our colleagues in the Netherlands have had quite the turbulent, yet fascinating, time of late and it is only set to continue following the recent election result. The following article outlines the current situation for the Dutch pension market and why it is difficult to predict how the year ahead will pan out.

Predicting the future is challenging. However, one thing is certain: 2024 will be a turbulent year for the Dutch pension reform. There are three key reasons for this.

First, 2024 marks the year of coalition formation discussions for the new government. The pivotal question revolves around what will happen with the new Dutch pension law, Wet Toekomst Pensioenen (WTP), which passed the Senate a few months ago.

Opposition parties were furiously against it because it allows pension funds to convert existing DB rights into DC pension pots without member approval. After the November elections, the parties that are against the new pension law have gained a majority. So, the question is now whether, a new coalition will alter the pension law, and how.

The most likely scenario is that the Netherlands will get a right-wing government with four parties: Party for Freedom (PVV, nationalist party), Farmer-Citizen Movement, (BBB, pro-farmers party), New Social Contract (NSC, a new conservative party) and People's Party for Freedom and Democracy (VDD, liberal party). Of these, only the VVD supports the pension law. Both the PVV and BBB want to completely reverse the pension law and go back to the existing DB system. Newcomer NSC is also not a proponent of the WTP. However, its position in the election program is nuanced—recognising the WTP as a "new reality", yet advocating for participant approval regarding the conversion of DB rights into DC pension pots. For instance, this could involve a mandatory referendum per pension fund, requiring, for example, 60% of members to vote in favour of the transition. These political dynamics add an element of suspense. Can the PVV, the big winner of the election, form a new coalition with VVD, NSC, and BBB? How much of their "political negotiation capital" will these parties invest in pensions during the formation? It appears that the role of social partners may diminish, and political initiatives will take precedence.

Second, 2024 is the year of the so-called 'adjustment law'. This legislation follows the pension law, comprising numerous minor amendments and additions. Originally expected to be published for consultation in the fall of 2023, this has been delayed, and it now appears to be postponed until spring 2024. This delay complicates matters since it typically takes about a year for such a law to be officially enacted. The consultation period must transpire, consultation input must be processed, the Council of State must provide its opinion, and then it must pass through the House of Representatives and the Senate. Consequently, it may be spring 2025 before this 'adjustment law' takes effect. If the pension law itself remains intact, the first pension funds may have already transitioned to the new pension system by 1st January 2025. Another complexity arises if a new government proposes adjustments to the pension law. Will it exercise restraint and wait for a second amendment law, or will we witness the merging of two amendment laws?

Third, 2024 is a crucial year for social partners, pension funds, and executors to realise this legislation and progress plans to implement. While a new coalition is formed, we expect preparations for the pension transition to continue. But while implementation plans are established, there could be setbacks, e.g. IT projects at pension administrators.

This is all set against the backdrop of fundamental unpredictability in financial markets. Will inflation and interest rates gradually decline? Or will central banks find reasons to revert to a tightening monetary policy?

We cannot predict the future - and neither can others - but it is better to think of scenarios in advance and plan ahead. This enables us to act faster in situations where these scenarios actually occur.

In conclusion, 2024 will be a year full of uncertainties, not least for the Dutch pension reform. Fasten your seatbelt!

Harold Naus
CEO, Cardano NL

Roel Mehlkopf
Pensions Advisor, Cardano NL

Sustainability

Sustainable investing outlook 2024: key issues and developments

Until recently, sustainable investing was viewed as a no-brainer – but over the last 12 months it's lost popularity.[1] Returns from sustainable investments have been under increasing pressure, while differing approaches to standards and definitions of sustainability have caused confusion and increased concern about 'greenwashing'.

The world has accepted that the climate has changed and will continue to change. We are slowly – but surely – shifting from a focus on preventing climate change (mitigation) to how we adapt to a new reality (adaptation) to protect ourselves, our environment and our communities. But how far do adaptation measures go? The danger lurking is that they will not go far enough. War in Ukraine has heightened concerns around energy security and affordability, resulting in a focus on alternative energy sources but also new investments in oil and gas fields.

In our view, investment in fossil fuels and the impact on climate change will remain a major discussion in 2024 but in our mind there are four other key issues and developments that we are likely to see:

1. **New approaches to managing and measuring biodiversity**
   In 2024, we will see increasing focus on the consequences of biodiversity loss for investors. To date, measuring the impacts of biodiversity loss has been strangled by a lack of quality data, but we expect a leap forward in ecological data development. Cardano is already using the latest data tools, such as determining physical risks using 'geospatial data'. We're also developing measurement methodologies using new techniques such as bioacoustics – an affordable, speedy, and non-invasive tool for measuring biodiversity richness and abundance in a certain area.

   We also expect that more biodiversity-related market standards will become mandatory, such as the Taskforce for Nature-related Financial Disclosures (TNFD). New EU regulations on deforestation-free products are likely to be translated into local practice. In the Netherlands, for example, the Dutch Central Bank has highlighted the importance of recognising biodiversity loss as a financial material risk.

2. **More focus on the social impact of sustainability**
   There can be no doubt we also need to make social themes more transparent and measurable. While the potential impact of ecological aspects on company profitability is greater than social aspects, the interaction between different themes are increasingly clear. For example, in the case of climate refugees. Can the transition to a sustainable society be done in a fair way, with attention to human and labour rights, and in such a way that everyone receives a living wage?

3. **Getting to grips with defining sustainability**
   The debate about what sustainability really is rumbles on: what is the definition and how do I apply it? Looking ahead to 2024, we believe 'sustainability' will be redefined for investors as this area becomes more transparent and data-driven, and will address the level of integration in investment portfolios.

   In the absence of an unambiguous definition, investors have embraced the Sustainable Finance Disclosure Regulations (SFDR) as a stamp of approval. In September 2023, a new consultation on the future interpretation of SFDR was launched and so we expect there will be significant adjustments in this area in the year ahead. Meanwhile, investors and regulators are seeking alternatives to ensure as much objectivity as possible.

   We welcome this discussion wholeheartedly and encourage 'real world impact' to play a central role. Implementing all this objectivity in just one year is probably too short a timeframe, but its good news that discussions have begun.

4. **Investors increasingly favour engagement over exclusion**
   Geopolitical tensions and rapidly alternating environmental disasters directly affect the discussion on ethics, the transition to a sustainable world, fossil exposure and more. We believe that institutional investors are going beyond complying with sustainability-related legislation, and beyond simply having an opinion on climate. They are embracing the overall transition to a sustainable society – not just looking at single themes such as climate, but more broadly to include water, biodiversity and circularity, for example – and this is reflected in investment choices.

   From simply excluding certain investments on the grounds of sustainability or ethics, we believe 2024 will see more investors take up an engagement approach, because real change is not taking place on paper in investment portfolios, but in the real world.

Dennis van der Putten
Chief Sustainability Officer, Cardano NL

1 https://www.theaic.co.uk/aic/news/press-releases/esg-investing-declining-in-popularity-as-fears-of-greenwashing-grow

COP 28: what is in it for investors

The word is out: no more oil – that is by 2050, maybe sooner, maybe later. For some encouraging, for some disappointing.

Looking back at COP28 a number of important major joint efforts have been launched, both on Climate Mitigation and Adaptation.

In sync with the stated structural phase out of fossil fuels, 130 countries committed to triple renewable energy generating capacity in the next decade while improving energy efficiency by a factor two.

Clear signals were that the highest need for renewable capacity is in developing markets. Developing countries find themselves often in a poverty trap; as they are unable to make large upfront investments to finance renewable energy projects, they rely on the use of fossil fuels which are more expensive in the long run. By getting access to cheaper funding, developing countries can invest in renewable energy and escape from the poverty trap and benefit from cheaper and cleaner energy. Putting their money where their mouth is, UN Agencies, Multilateral Development Banks, private sector finance and philanthropy leaders united in a Scaling Climate Finance Capacity Building to initiate, support and fund renewable energy projects throughout developing markets. The hope is that it will build the knowledge base and development capacity needed to succeed in the formidable task to install this new capacity in the next 10 years with an estimated total USD 2.4 trillion in annual investments.

On climate adaption, 150 parties representing 75% of global food production signed the "COP28 Declaration on Sustainable Agriculture, Resilient Food Systems and Climate Action" essentially announcing their intentions to integrate food and agriculture into their climate plans. Countries commit to put food systems and agriculture at the heart of their climate ambitions, addressing both global emissions and protecting the lives and livelihoods of farmers living on the frontline of climate change. As a guidance the UN Food and Agriculture Organization (FAO) unveiled a road map to bring the world's food production in line with global climate goals. It emphasizes cutting methane emissions from livestock by 25% and halving food waste emissions by 2030, recommending growing a more biodiverse range of crops than the world currently relies on.

While the above stated targets will need to be further formalized in national commitments in the next two years, to us, there are clear signals for investors. These include:

1. Investing in fossil fuels is a dead end whilst renewable energy generation is once again confirmed to be a significant growth sector, backed by global governments, supported by development banks, aiming to de-risk needed investments in order to mobilize commercial capital. While this process had been started already, COP28 validated this approach. The acceleration of the energy transition will lead to increased demand and competition for (scarce) raw materials, manufacturing, labour, land and access to energy infrastructure which could cause bottlenecks and most likely will affect time to delivery and locations of capacity being built. At the same time, geopolitical tensions could rise as a result of increased competition, which could further pressurize global trade and supply chains. Nevertheless, the direction globally is clear and confirmed.

2. Structural changes in the Food and Agriculture sector are clearly on the climate action calendar of governments across the world. We do expect relevant frameworks to emerge for the industry to operate within allowing commercial investors to invest in new business models.

3. Both developments are increasingly supported by the United Nations, development finance institutions and leading charitable organizations aiming to de-risk investments where they are needed most in order to mobilize commercial capital.

Overall, these structural developments we think are positive and signal for increased investment opportunities in climate finance going forward into 2024 and beyond.

Rik Klerkx
CIO LDI & Private Markets,
Cardano NL

Alexander Lubeck
Senior Portfolio Manager
Impact Investing,
Cardano NL

The Global Investment Environment

Macroeconomics in 2024: hunkering down and being patient once more

2023 proved to be a curious year for the global economy and for global investment markets. The global economy has continued to recover from its post-pandemic shock and, rather surprisingly, has remained resilient in the face of rising geopolitical risks and the ongoing cost-of-living crisis This overarching resilience, especially in the US, is notable because it has taken place within an environment that has seen the world's central banks deliver their most aggressive interest rate hiking cycles of recent economic history.

But, in our view, the global economy is limping-along rather than decisively establishing a new upward trend.

Across regions, there has been growing divergences. In the US and, to a lesser extent, in Japan, strong growth momentum through the Spring and Summer of 2023 has led many market commentators to upgrade their expectations for 2024. Whereas, in China, a muted response to the post-lockdown reopening of the economy has disappointed the more optimistic expectations of how China might support global growth.

On balance, 2023 definitely surprised us to the upside. Yet we see darker clouds on the horizon.

The higher global interest rate environment is starting to bite; tighter credit conditions are weighing on housing markets; upon corporations' capital expenditure plans and upon consumer activity. Corporate bankruptcy rates and credit card and auto loan delinquency rates have started to increase.

> “We are very much in the “higher for longer” camp and, accordingly, see the overall interest rate environment as being a headwind well into 2024.

We think that the prevailing consensus may be overestimating the strength of the present underlying growth momentum. Accordingly, whilst our expectations are pushed out a little further into the future, we expect the onset of a US recession in mid-to-late 2024. Ahead of this downturn in the US, we expect a recession to commence in the UK, and in the euro-area too, a little earlier in the year to come.

Should 2024 play-out according to our expected pattern, a real dilemma will face the world's central banks. Whilst inflation is set to fall, it will remain elevated relative to central bank targets largely due to relatively tight labour markets. Premature easing (as might be expected as a traditional counter-cyclical monetary policy response) risks giving away the gains made by the past tightening cycle. We are very much in the “higher for longer” camp and, accordingly, see the overall interest rate environment as being a headwind well into 2024. Shallow post-recession recoveries are expected. Importantly, we don't think that corporate earnings forecasts nor price to earnings ratios properly reflect this outcome. Equity markets start the year too high in our view.

Where does this leave investment markets and the prospects for UK pension schemes' growth portfolios?

Unfortunately, our forecasts show very few asset classes as having return expectations higher than cash over the forthcoming 12 months. For investors with high allocations to global equity markets this probably means that a review of the adequacy of protection overlay strategies is warranted. For schemes that are already substantially de-risked, ‘less excitement’ from rising government bond yields now looks to be more likely.

This promise of ‘less excitement’ does lead us to being a little more optimistic on the returns available from government bonds and credit. The higher yields that now prevail at least are starting to properly discount future economic conditions.

For 2024, it may be a case of hunkering down and being patient once more.

Shweta Singh
Chief Economist,
Cardano

Asset class spotlights: Global equities

After a year when equity markets defied expectations to hold up well, the jury is out on 2024. Companies are increasingly facing rising input costs from tight labour markets, which puts pressure on operating margins. The 'higher for longer' interest rate backdrop that we expect, and its lagging effect upon the real economy, is set to slow economic growth across most major developed economies. This is increasingly weighing on both corporate and consumer sentiment and presents a challenge to equity market performance.

Amidst economic slowdown and the heightened probability of recession, cyclical sectors will likely suffer. Even if we were to assume that interest rates have peaked it will be equities that are most exposed to the economic cycle that will likely underperform. The first signs of this risk became evident during late-2023's reporting season; cyclicals across many different industrial sectors had the most profit warnings, whilst utilities had the least.

We expect that defensive sectors should fare better in 2024, alongside rate sensitive sectors, both of which struggled in 2023. The relative performance of cyclicals versus defensives shows a very close relationship to the direction of bond yields. Defensive sectors are now moving into favour and accordingly we are defensively positioned as we start the New Year.

Hans Slomp
Senior Portfolio Manager
Equities, Cardano NL

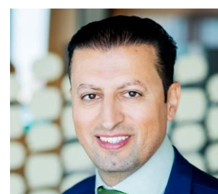
Government bonds

From a global perspective, the outlook for government bonds looks brighter in 2024. The most aggressive interest rate hiking cycle of recent economic history has probably run its course. As growth starts to slow, bond market returns are set to improve.

That said, inflation is likely to prove stickier than is usual during an economic slowdown and that will prevent central banks from cutting interest rates until well into the New Year. Also acting as a headwind will be supply; governments are likely to have to maintain issuance at high levels. This year, structural factors (energy related transition finance, demographics / higher social care provision etc.) will converge with cyclical factors (weaker growth and lower tax receipts) to add to supply pressure.

Regional differences will remain. For example, the euro-area is more vulnerable to energy related shocks or stagflation risks than the United States and, Japanese government bonds will remain exposed to the effects of the Bank of Japan continuing to exit from its yield curve control policies. We see the strongest government bond market performance (in local currency terms) to be amongst the more cyclical economies; Australia and UK for instance. In these markets, starting yields are generally higher and the potential to see yields fall is more pronounced.

In the euro-area we expect that Bund yields will slowly trend lower over the coming 12 months but there are conflicting forces in play for intra-regional spreads. Support from the European Central Bank is set to weaken but reinvestments under the Pandemic Emergency Purchase Programme is continuing throughout 2024. The risk of very much wider spreads is contained. However, further into the future we still see ongoing pressure due to weaker growth and higher funding needs amongst peripheral euro-area nations.



Mehdi Abdi
Head of Government Bonds,
Cardano NL

Credit

Credit markets enter 2024 in good shape. Corporate credit quality is stable and the excess yield above government bonds appears to be attractive. However, as growth slows into the New Year, we do expect default rates to rise. Higher defaults will be challenging for High Yield and Emerging Markets Debt (performance of the two are quite closely related albeit Emerging Markets enjoy a relative valuation advantage as 2023 closed). Investment grade market valuations look adequate to compensate for the tougher environment ahead.

Primary issuance in the UK has been growing more slowly than has been seen in the US and in the euro-area assisting the Bank of England's corporate bond buying programme to be successfully wound down. Demand from sterling investors remains robust and we expect this to continue into 2024. Nevertheless, despite high demand, we judge sterling and euro corporate bonds to represent better value than comparative securities issues in US dollars.

Justin Hatch
Head of Credit,
Cardano Investment

Core themes in DB

The evolution of fiduciary management

The last year has been one of dramatic change.

2023 began with the fallout from the Gilts crisis. For many schemes, journey plans accelerated and deficits became surpluses. Buy-ins and buyouts reached record levels, including the Walgreens Boots Alliance transaction on which Cardano acted as lead advisor.

One superfund stepped forward, another back, adding a new pitstop on the way to buyout. Professional trustee (PT) firms consolidated, and we saw an increase in corporate sole trustee (CST) appointments. Once a solution for small schemes, CST is increasingly popular for schemes of all sizes. That all means companies' and trustees' needs are changing, so fiduciary management will continue to evolve.

Looking ahead to 2024, the Pensions Regulator's new DB Funding Code and "Mansion House reforms", while somewhat mysterious, may lead to more change in an election year.

We foresee the following changes, most of which are already underway:

- Fiduciary management and outsourced chief investment officer (OCIO) approaches will play a growing role in some PT firms' initiatives to centralise, scale and quality-control governance and implementation for small and mid-sized schemes, many with CSTs. This will require flexibility in fiduciary managers' services, innovation in client reporting, and new approaches to pricing.

- Bespoke liability driven investing (LDI) strategies, whether segregated mandates or pooled funds-of-one, will be a competitive advantage for some fiduciary managers as trustees and third-party evaluators reflect on the lessons of the Autumn 2022 Gilts crisis, the importance of scheme-specific collateral flexibility, and the speed in trading into insurers' price lock portfolios. Why wouldn't you opt for bespoke LDI over commingled pooled funds at similar price points? The price points are similar for schemes with £150million+ in total assets or a £60million+ capital allocation to LDI?

- Fiduciary managers will up their reporting games on sustainability and ESG issues. The gold standard means going beyond descriptive portfolio statistics. It means providing management information to help trustees understand trade-offs and hold fiduciary managers to account on decisions. It means analytics that go beyond just carbon to focus on water usage, biodiversity, human rights, etc.

- Fiduciary managers will more explicitly offer dual-track solutions for schemes who want:

  - **Buyout:** Fiduciary managers will continue to monitor and report on funding versus buyout liabilities. But they'll also do more to help clients cross the finish line. They'll take a more active role in critical workstreams, choreographing activities with administrators and other advisors at least a year before full funding. Fiduciary managers will be held accountable for transitions to price lock portfolios, including the disposal of illiquids. We're also likely to see some fiduciary managers broker risk transfers themselves.

  - **Run-off:** Fiduciary managers' governance frameworks, investment portfolios and risk controls will look more like insurers'. Market risk will narrow to interest rates, inflation, and credit (sovereign, public, private, and secured). At the same time, other risks will grow in relative importance e.g. liquidity risk, operational risk, and counterparty risk. The expertise required will be deep and practical, favouring asset managers i.e. the fiduciary providers who are direct market participants, not managers-of-managers.

With all considered, new thinking and new skills will definitely be required in 2024 to navigate the changes affecting pension decision-making and fiduciary management services. Diversity in all its forms – identity, biography, cognition – will be critical in driving good outcomes for scheme members and commercial success for the firms that serve them.

Patrick Cunningham
Partner and Co-Head of Clients, Cardano Investment

Endgame: preparation is key

The risk-transfer market continues to build momentum across its various products. 2023 saw a record number of transactions over a billion pounds priced by insurers. This translated into record-setting transactions, namely the full buy-in transactions between the Boots Pension Scheme and Legal & General, which Cardano led, and between the two RSA pension schemes and PIC. We also saw the long-anticipated first consolidation transaction between the Sears Retail Pension Scheme and Clara. With new entrants expected in 2024 and a supportive regulatory backdrop, the risk-transfer market is set to be one of the most dynamic corners of the DB pensions industry.

Billion-pound transactions will dictate the key themes for the bulk annuity insurance market, with at least 20 such pension schemes expected to be priced in 2024. These 'mega' transactions have brought about a spur of innovation to address the challenges posed by underwriting benefits and illiquid assets at scale. Capacity is supported by a buoyant reinsurance market which has increased the appetite for annuity business following growth in mortality business being underwritten, primarily in the US, and substantial capital flowing into offshore funded reinsurance structures. No wonder the number of providers looking to enter the bulk annuity market is at an all-time high! We expect at least two of these to start writing new business during 2024.

Regulatory change should also be supportive of insurers, albeit the picture is somewhat nuanced if you look more closely. Solvency UK, the revised regulatory regime for insurers, should be in full swing towards the end of 2024. Key changes include the ability to invest in a wider spectrum of yielding assets and a reduction in the amount of capital insurers need to hold back to protect policyholders. However, there appears to be a general undertone of nervousness coming out of the PRA, who has made no secret of its reservations with some of the trends in the insurance market. The increased use of funded reinsurance and the larger transactions insurers are taking on are some of the key themes picked up by the PRA. Trustees and corporates looking to transact with an insurer in 2024 will want to carefully consider how they manage the resulting counterparty exposure.

But it is not all about buy-ins. There was a number of sizable longevity swaps transacted during 2023. The drivers vary from schemes looking to lock-in reinsurance capacity to those seriously considering a run-on strategy. This latter driver could be supported by the tax changes recently muted by the Government.

Consolidation is also on the agenda of some schemes still struggling to improve funding levels and exposed to a weaker employer covenant. The recent Sears transaction plus the watering down of capital requirements by TPR could inject some excitement back to the superfunds space. The other form of consolidation we will be keeping a close eye on in 2024 is the expanded role the Government is proposing for the PPF. This change could be transformational to a highly fragmented DB pensions landscape, but with a general election around the corner we think this one may well drop into 2025 and beyond.

The bottom line is that there has never been so many options for trustees and corporates to transfer the risk embedded in their pension schemes. The single most important word for pension schemes looking to tap the insurance market is preparation. This is especially true for small and medium sized schemes who are having to work harder to make it through the insurers' triage process. Expert advice along the way is not only advantageous, it is necessary.

> **"Billion-pound transactions will dictate the key themes for the bulk annuity insurance market, with at least 20 such pension schemes expected to be priced in 2024.**

Adolfo Aponte
Managing Director, Risk Solutions, Cardano Advisory

Core themes in DC

The 2024 Policy & Political Agenda: thorny issues yet to be resolved

It has been a busy time for DC pensions over the last few years with lots on the government's agenda – but 2023 saw an acceleration of government output, all filtered through the single lens of 'UK productive growth'. The raft of consultations and debates on some longstanding and wide ranging matters - such as small pots, value for money, decumulation, CDC, trustee skills, to name but a few – have been refocused to align with this overriding objective. Positions have been won or lost depending on the impact on illiquid investment, or the associated enabler of driving scale and consolidation of the market. We can expect a continuation of this agenda in 2024, along with the pattern of issuing significant pension framework-altering proposals around fiscal events.

Government has also been busy delivering some swift responses to consultations – but it is fair to say there is still a considerable amount of detail to be worked through across most of the topics. Here we focus on three areas.

Value for money

In January 2023 Government and regulators issued a joint consultation on Value for Money, followed by their response in July. November saw a continuation of this challenging pace with the launch of 16 working group meetings to explore the detail – all to be concluded in early January. We are participating in the working groups, and expect to see a formal FCA consultation in the Spring informed by those discussions. It will be essential for that consultation to be long enough to enable more considered and detailed engagement and input from the pensions industry, as well as employer and consumer representative groups.

Small pots

Small Pots policy development also enters a more in-depth stage in the new year – with the promised government/industry Delivery Group looking at implementation of the Government's chosen solution – the 'Multiple Default Consolidator Model'. This model, in broad terms, is one which we have long lobbied for – as we think this works better for members and addresses the issue where it is most concentrated. This model will ensure each member who has one or more of these small-deferred pots, will have the opportunity to have those small pots combined into one of a few authorised, super regulated, consolidator schemes. Key issues to be resolved in 2024 include the processes and infrastructure to achieve this. We will continue to work with industry and government, seeking support for our proposals which put the member at the heart of the process, and which address the potential inefficiencies – including those in the transfer system and potential new entities. Our proposed solution seeks to harness the learnings and tech solutions from the Dashboard and wider projects. We also propose a phased implementation to support a broader sequencing of policy initiatives that supports the member journey and experience.

Provider for Life

In November we saw the formal opening of a Government led exploration of another big structural change – Provider for Life or Lifetime Provider model. Along with all the other big topics from Government this year, there are some significant questions about intent, impacts on member outcomes and also sequencing. Presented as an open discussion about a potential future vision we are keen to explore the opportunities but also the risks, especially for those less engaged and lower earning members. This conversation is set to run into 2024 and beyond – a potential disruptor to other policy projects in flow, and a potential distraction to the challenging question of pensions adequacy and the Roadmap for the next decade of Automatic Enrolment.

With the government's policy making machinery undertaking such a considerable number of initiatives in 2023, 2024 will likely prove to be just as busy. All indications are that the general focus on the illiquids agenda is here to stay for the foreseeable future – given the looming General Election, the current economic climate, and Conservative and Labours stated positions. But – even without a Bill – we may see a shift towards more detailed policy work necessary for implementation. The ultimate measure – the impacts and outcomes for members - will be felt far beyond the immediate time horizon, but must remain front and centre of today's policy discussions.

Lizzy Holliday
Director of Public Affairs and Policy, NOW: Pensions

What is the right thing to do with your hard-saved DC pension pot?

2023 saw the DC commentariat go into overdrive to solve the problem of how to help people use their pension pot when they retire. This is a novel problem as previous generations had a lifelong income paid from their DB scheme or, if they saved in DC the majority had only one option - to take their tax-free cash and buy an annuity.

George Osborne changed this status quo with his pension freedoms but it has taken until now for the industry to really get going with proposing solutions for what Nobel prize winner Bill Sharpe has said is the "nastiest hardest problem in finance".

Why is it the nastiest, hardest problem in finance? Because we're asking individuals to manage what may be the most valuable asset they'll ever have to provide an income for life where they don't know how long they will live and where investment returns are unknown and volatile.

The answer to this problem used to be annuities. They give certainty of an income in pounds and pence that last for life. But many don't want to commit all of their savings to achieve that, and sensibly, they realise that future needs are uncertain and committing everything to a nominal income for life leaves little room for the life we don't yet know.

What are the industry solutions?

The current wisdom of the crowd approach is to give individuals solutions that focus on giving a level income for whole of life. One suggestion is that we need a pooled investment and mortality vehicle, a Collective Defined Contribution Scheme (CDC). Another popular approach to is the multi-pot approach where your money is separated into different pots, including one pot to be used for buying an annuity around age 80 or 85.

The problem comes with the practical implementation which leaves people not taking enough investment risk, allocating too much of their future consumption to their extreme old age and is not flexible enough to cope with the inevitable changes of life. And, perhaps crucially, that many retiring today just haven't saved enough to meet all of these objectives.

A better way?

As with many problems in life, we should spend more time on defining the problem than in reaching for a solution. If we do the groundwork, the solution will present itself.

There are three trade-offs that can help us to design better retirement solutions:

- Preferred income profile – flat, linked or decreasing
- Guarantees vs variability – better member outcomes can come from accepting variability
- Flexibility vs mortality gains

Through this lens the current solutions can be explained using these design choices. Most solutions are built for people with large savings pots, but that doesn't address everyone's needs. We need better solutions for those who have limited resources and who can benefit from taking more risk with their pension savings as the security they need is provided by the State pension.

For those who just haven't saved enough to supplement their State pension with a lifelong income we should:

- Let savers define an income schedule that gives them the most personal 'value' from their savings
- Invest their money for them to meet that schedule
- Have a 'no-regrets' structure so that their plan can adapt to whatever happens in their life.

Shouldn't we build solutions for the real world situations that most people face, rather than prescribing theoretical solutions designed for those happy few who are over-pensioned?

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