Insight

Reforms for running on DB schemes herald new investment opportunity

Alex Soulsby
Head of LDI,
Columbia Threadneedle
Investments

In a bid to release billions of pounds for investment in corporate Britain, the government is planning to make extracting surpluses from well-funded defined benefit schemes easier. For the pensions industry, it's a game changer that makes running on a scheme a more attractive alternative to buyout.

The measure is included in the Pension Schemes Bill, designed to reform how workplace and private pensions operate. Introduced in June 2025, the bill is currently making its way through Parliament.

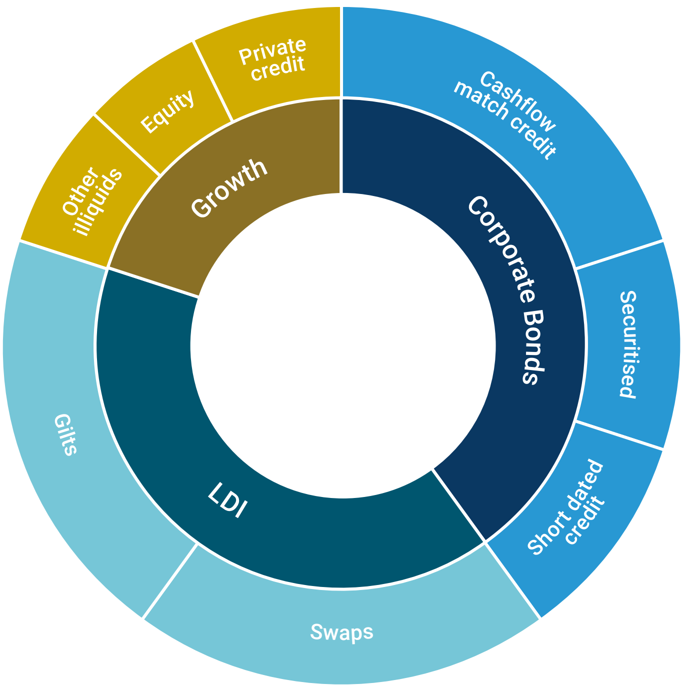
To illustrate the potential gains of running on, a fully funded £100m scheme with a conservative investment strategy targeting 1.25% above gilts could produce a £15m surplus over 10 years (assuming actuarial demographic prudence of 0.3% per annum). Taking into account the fixed costs of running a scheme, in our opinion around £100m is the minimum size for which running on makes sense.

This could be achieved with an investment strategy that is familiar to trustees and does not involve taking excessive or unusual risks. What's more, it's possible to do this while significantly reducing the governance administration that comes with continuing to manage a DB scheme rather than buying out the liabilities.

A familiar investment approach

To be clear, we're not suggesting a return to heavier equity allocations or gilts plus 3% performance targets. Instead, our illustrative investment portfolio for running on schemes includes strategies to complement long-dated UK corporate bonds. For the illustration of the £100m scheme, we have allocated 40% to liability-driven investment (LDI) using gilts and/or swaps and 20% to growth assets such as equities or private credit. There's also 40% in credit such as cashflow matching, shorter-dated credit and asset-backed securities (ABS).

Figure 1: Generating return in run-on
Illustrative asset allocation



The portfolio provides hedging through the combination of corporate bonds and LDI, so interest rate and inflation fluctuations do not affect the funding level. The LDI investment is leveraged, so there could be a need to add more assets, which could be funded from the shorter-dated credit or ABS. Finally, members' payments could be paid from cashflow-matching credit or cashflows generated in other parts of the portfolio.

Turning to solvency risk, it's important to have a buffer before paying out any surplus. Taking this precaution allows a scheme to carry on should the sponsor become insolvent.

Focusing on the credit part of our portfolio, there are two broad parts. Firstly, the default strategy is a long-dated cashflow matching strategy, predominantly in the UK. It has a high credit rating and an average duration of nine years. That currently offers a spread (extra yield over government bonds) around 0.8%.

Secondly, the rest of the credit strategy is designed to generate more yield. It's partly made up of short-dated credit, with a diversified global strategy hedged back into sterling. As the credit is shorter dated, there is greater ability to select companies through rigorous research analysing cashflows and business models. The average credit rating is BBB and a spread over government bonds of 0.9%.

The balance of this part of our proposed credit strategy is in US ABS. This market is big and broad, giving the scheme diversification in terms of geography and the market's investor base. Additionally, ABS delivers exposure to mid-market companies and the consumer by way of credit cards and auto loans. The average credit rating is AA, with a yield over risk free rate of about 1.6% at time of writing.

Quite how much a scheme allocates to each credit strategy depends on its situation and objectives as well as market pricing. Our approach has flexibility to blend the strategies.

Reducing the pain of implementation

Turning to the governance and implementation of schemes, it can be a barrier to running on portfolios.

Columbia Threadneedle has, however, been offering an implementation management service for more than a decade that takes care of the allocation decisions on behalf of the scheme trustees. Rules can be set up in advance about management of the flows, covering for example the collateral waterfall and where cash can be raised.

To be clear, it's not a fiduciary service. Your adviser remains your adviser. Instead, it's a service designed to remove some of the governance challenges when running on portfolios.

Keeping it simple, familiar and effective

As the government makes running-on portfolios more viable and trustees consider their options, they should note that a run-on investment strategy can be familiar. There's no need to reinvent the wheel.

It's also important to think about the types of credit strategies in the portfolio. Doing so makes the most of the investment opportunity and maximises the surplus – to the advantage of both scheme beneficiaries and sponsoring company.

Finally, running on a scheme does not have to be a governance headache. Implementation can be outsourced to keep life simple for trustees and advisers alike.

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