True Partner Capital

Planning amidst uncertainty: How would transition plans fare if things get worse?

April 2025

Executive Summary

2025 is an important year for many Dutch pension funds. Several funds are expected to transition to the new pension system on January 1, 2026, with most others transitioning between then and January 1, 2027. Many funds have increased interest rate hedging into the transition, but scenario analysis suggests that many funds would still see major drops in coverage ratios in the event of a significant equity market downturn.

We see an elevated potential for tail events given: i) high equity valuations and low credit spreads; ii) high policy uncertainty; and iii) stagflation risks constraining monetary policy. Equity risk is the main driver of asset risk for most funds, and options markets are still offering relatively attractive levels for hedging. **We believe that pension funds should be actively considering adding hedges to ensure a smooth transition.**

Introduction

DNB Governor Klaas Knot's recent comment is striking: "We are now witnessing the world being turned upside down… this no longer feels like an era of change, but a change of era.".[1] When central bank governors speak in such ways, you know uncertainty is, as Federal Reserve Chairman Jerome Powell put it the day before, "really high". With markets also having a rocky start to the year and the Trump administration following through on its tariff threats, what should be top of mind for pension fund CIOs?

We see material risks on the horizon. To quote Powell again, "it's really hard to know how this is going to work out".[2] What is easier to discern is that the current uncertainty comes into a context where equity valuations, particularly in the US, are still unusually elevated. To take one of the better long-term valuation measures, the Cyclically-Adjusted P/E for the US is still in the 96th percentile even after the -5.6% decline in the S&P 500 in March.[3] Coming into the year, most equity strategists had a very bullish perspective, but these views are now hastily being revised. Rather than the growth that is priced in, the forward looking economic and political picture suggests there is also a meaningful potential for earnings disappointments and multiple contraction.

We deal at length with the economic and market outlook in our recent piece, "Does America First signal the end of American exceptionalism?" Here, we would like to turn specifically to the implications for pension funds who are thinking about their transition to the new pension system over the next 6-24 months. In our November 2023 white paper with Northern Trust, we looked at how market risks can impact the transition, how asset allocations were likely to change post-transition, and provided insights into the impacts at both the fund level and the age cohort level. With transitions now imminent, we will now look at how funds' positions have changed, update our scenario analysis and discuss the pros and cons of hedging.

What have funds done so far?

As pension funds have designed their transition plans, several have assumed that their coverage ratios would be at or above a certain minimum level coming into the transition, often around 105%. Below this level, further compromises often involve difficult trade-offs, such as cutting pension benefits. If coverage ratios fall far enough, funds may need to delay the transition. A material delay would be costly,

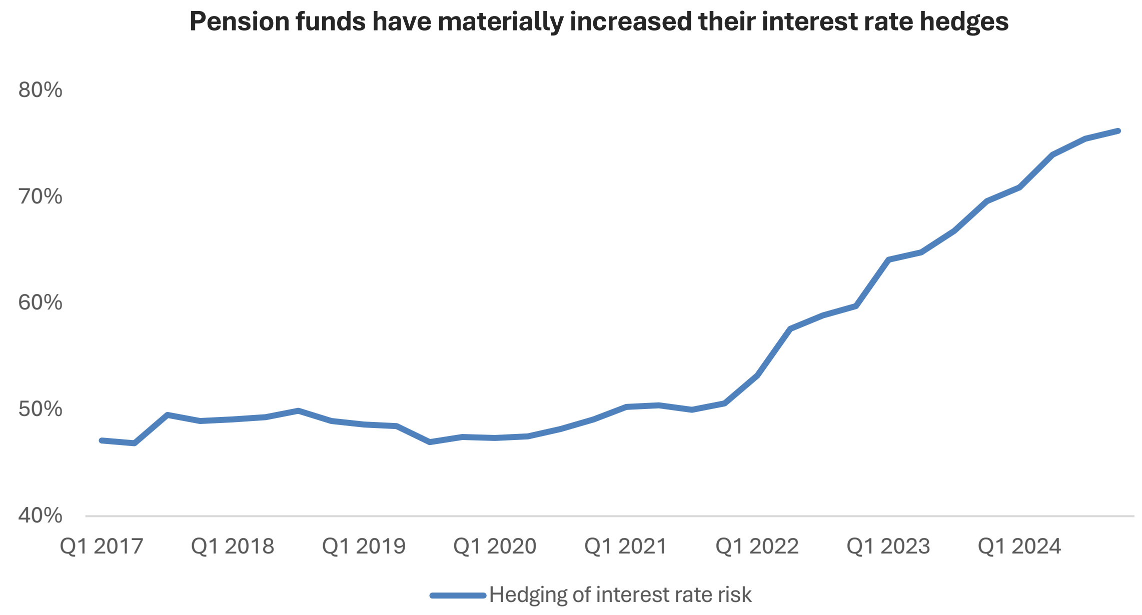
[1] From a speech by Klaas Knot, DNB Governor, March 20, 2025

[2] FOMC press conference, March 19, 2025

[3] S&P 500 return is for the total return index. Valuation percentile calculated relative to monthly data from 1900 to 2025 using the total return version of the CAPE. Source: Robert Shiller / Yale University through February 2025. March 2025 data calculated by True Partner.

as many participants stand to benefit from the post-transition model. It would also cause additional transition-related expenses.

Two factors drive coverage ratio risk: changes in the value of assets and changes in the value of liabilities. The dominant factor on the asset side is typically equity risk, while the dominant factor on the liability side is (long-term) interest rates. In preparation for the transition, many funds have focused on the liability side and have increased their interest rate hedging ratios, generally through linear derivatives such as interest rate swaps. We have seen the median fund increase its interest rate hedging ratio from 51% at the end of 2021 to 76% as of the end of 2024.[4]



While the earlier part of this increased hedging can also be explained as a response to the rise in interest rates in 2022 (which materially boosted coverage ratios), we have also seen hedging rise 10 percentage points since the WTP act came into force on 1 July 2023, despite coverage ratios being broadly stable since the end of 2022. Anecdotal evidence from individual funds points in the same direction: funds are also looking to hedge transition risks.

Have funds done enough?

Thus far we have seen less focus on potential risks to the asset side of the balance sheet. We believe this should now be a priority and are seeing some funds starting to move.[5]

On the asset side, the primary exposures for most funds are public equity, private equity, corporate bonds, real estate, mortgages and government bonds. When we also consider the different weights and risk profiles of each asset class, equity risk is typically the biggest risk factor, followed by credit risk and interest rate risk. As interest rate risk also drives changes in liabilities, this risk factor can be seen as somewhat offsetting countervailing risks on the liability side, though there are often significant duration differences.[6]

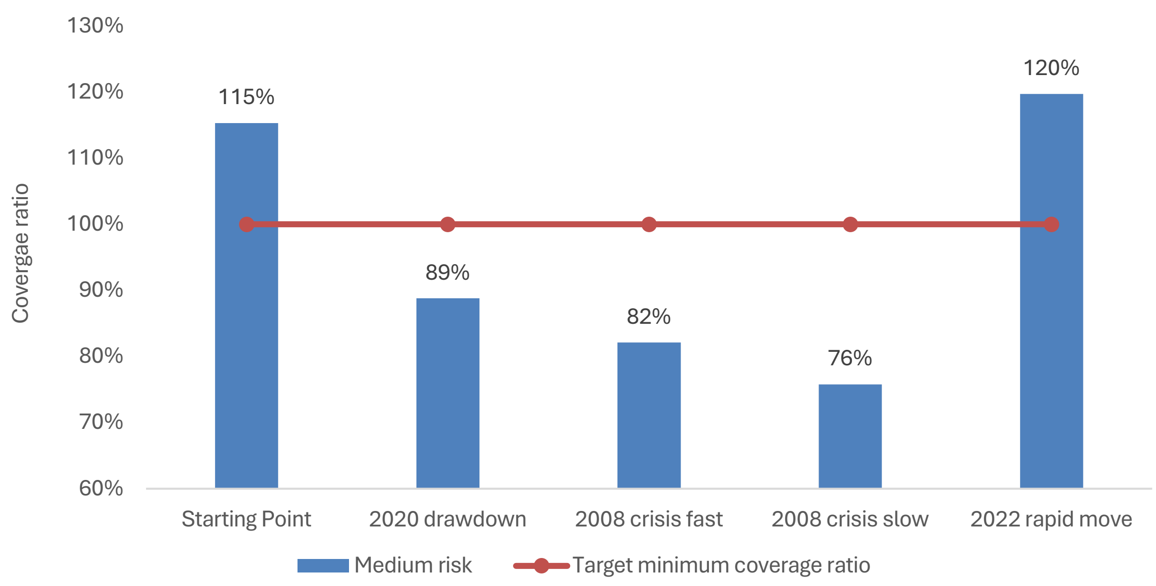
[4] Sources: True Partner, DNB, data as of Q4 2024
[5] As noted for example by IPE, "Dutch pension funds hedge equity risk in run-up to DC transition", 25 March 2025
[6] This can also give rise to significant exposure to changes in yield curve shape, but that is outside the scope of this paper

Equity risk is not only present in public and private equity, but also positively correlated to the credit risk components of corporate bonds, real estate and mortgages, particularly for higher yielding varieties of these assets. Our analysis suggests that many funds would have a difficult experience were a market shock to occur.

Below we show the results of a stress scenario analysis using our proprietary risk models. We take a fund with a starting coverage ratio of 115.3% - the average for industry-wide funds at the end of January 2025 – and what we term a medium risk asset allocation (50% equities, 25% government bonds, 20% corporate bonds and 5% mortgages) and 75% of interest rate risk hedged (the median value for all funds over EUR 1 billion at the end of 2024). We then apply a series of historical stress scenarios.[7]

We show three events that each happened quickly: the Covid-related drawdown in 2020, the peak of the 2008 global financial crisis, and the rapid interest rate move in mid-2022. These events each took between one and three and a half months to occur (the interest rate rise in 2022 was the slowest and the most benign scenario for coverage ratios). We also provide the result for one slower move, the full 2008 crisis (which took 20 months). We show the starting point coverage ratio (115.3%) and the new coverage ratio after applying each shock. The red line is at a coverage ratio of 105% - the level that many funds are targeting as a minimum coverage ratio into the transition. An occurrence of a crisis equivalent to that seen in Q1 2020 or 2008 could see funds breach the 90% coverage ratio level and not only have to delay the transition but also cut pension payments.

Coverage ratios could drop significantly in a market shock



How much does asset allocation protect a fund? In the next chart we look at the results using a variety of different starting asset allocations. To limit the impact of alpha and beta assumptions around illiquid and more complex assets, we assume relatively simple asset allocations and use public market returns. Many funds will also hold private equity, private credit and private mortgage or real estate allocations. These may have higher or lower risk than their public market equivalents, and some have well known lagged pricing effects (meaning the impact of losses may take another quarter to be fully seen).[8].

[7] We assume that at the starting point the present value of liabilities is equally distributed across 10 different age cohorts, with an average participant age of 45. As we assume a high degree of interest rate hedging, this offsets a significant part of the impact of changes in liabilities. Helpfully, for purposes of this analysis, that also reduces the impact of the assumptions around the distribution of liabilities across age cohorts.

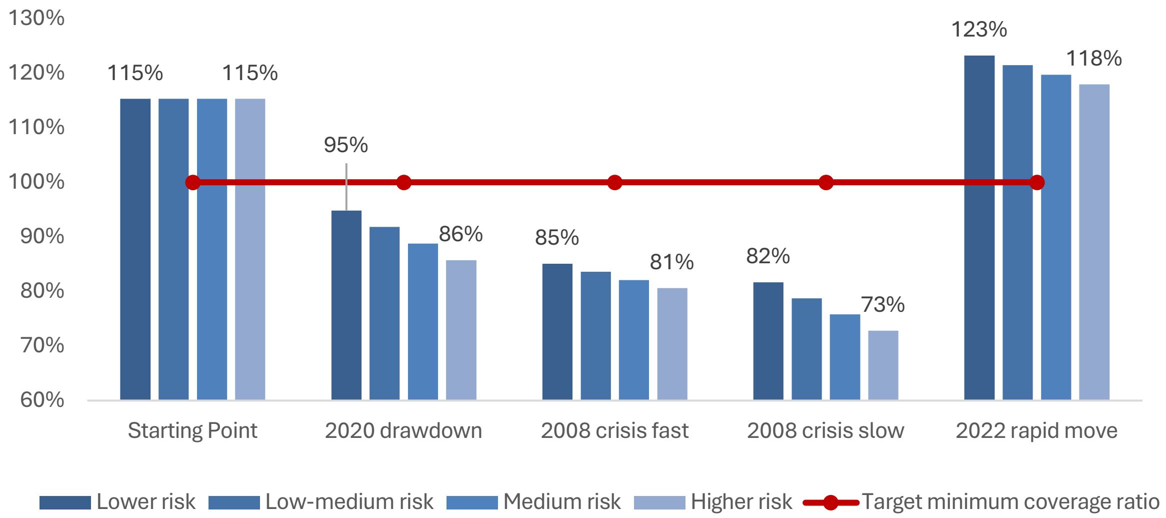
[8] See for example "Lag effect in Private Equity, or "Where are my returns?", Meketa, July 2023, or "Private Investment Valuations Lag the Market. Two Sigma's Venn Wants to Change That", Institutional Investor, January 2023

However, empirical research on these markets suggests that public market proxies are a useful guide to risk.[9] The results suggest many funds would dip substantially below the 105% level in a shock.

Starting portfolios

	Lower risk	Low/medium risk	Medium risk	Higher risk
Equities	30%	40%	50%	60%
Government Bonds	35%	30%	25%	20%
Corporate Bonds (IG)	30%	25%	20%	15%
Mortgages	5%	5%	5%	5%
Total	100%	100%	100%	100%
% of interest rate risk hedged	75%	75%	75%	75%

Funds with a wide range of asset allocations could see coverage ratios drop significantly



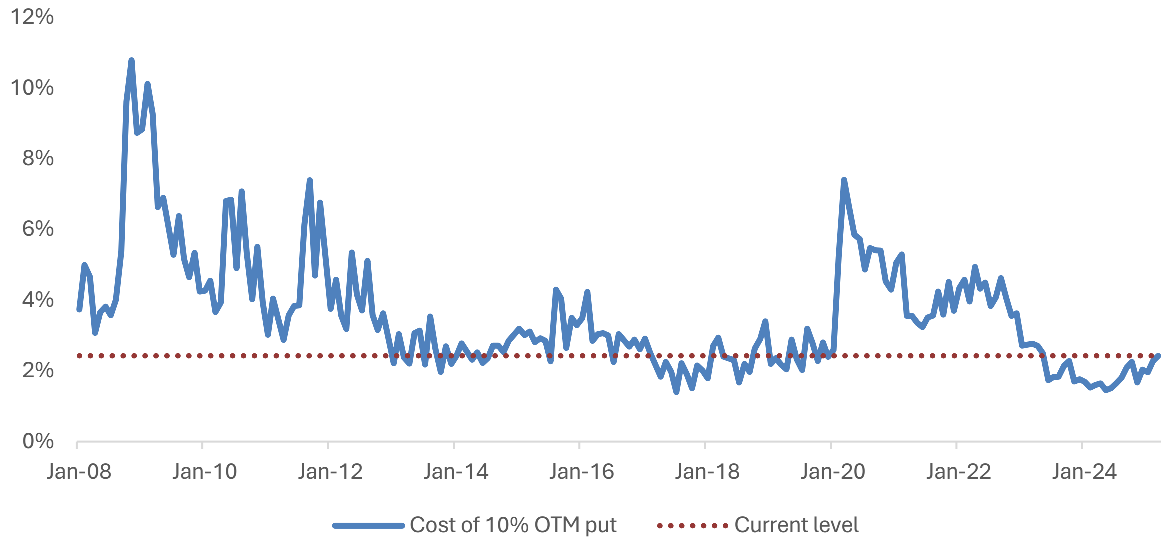
What hedging options are available?

The simplest form of risk management is to take off risk by moving to cash. We have seen some funds choose this path. However, taking off risk also has a significant cost. Funds invest in higher risk assets to generate higher returns, and taking off risk gives up those excess returns. For example, if a fund expects equities to deliver a long-term return of cash + 4% per year, the fund gives up an expected excess return of 4% on every euro it divests. Transaction costs will also detract from returns. Materially reducing equity risk is also at odds with many funds' post-transition plans, as equity allocations are broadly expected to increase. The alternative is to consider non-linear hedges.

[9] For example, Hamilton Lane's analysis of private equity concluded that: "even a modestly diversified portfolio of private equity funds has volatility similar to that of listed equities. Buyout funds likely have a beta a bit above one (vs. ~0.4 on an observed basis)." Private credit typically has a lower than investment grade credit rating, so credit losses may be larger than assumed here. Real estate is the most idiosyncratic as many funds hold significant exposure to Dutch mortgages and there is dispersion in the available public proxies,

The simplest hedge is to buy put options on equity indices; this mitigates the downside risk. Funds can choose the level of downside at which they wish to cap losses, and target positions around this level. The cost of hedging varies over time but is currently still near all-time lows. In the chart below we show the cost of a 9-month (i.e. roughly to year-end 2025), 10% out-of-the-money put on the S&P 500, as a percentage of the notional amount hedged.[10]

Hedging costs have rarely been lower



To cheapen this, or potentially offset the cost entirely, funds can also sell call options, earning a premium and in exchange temporarily limiting the potential upside return of their equity holdings. This is known as a 'collar' strategy. For example, a fund could buy put options 10% below the current market price and sell call options 10% above the current market price. Using current market pricing, that kind of structure in the S&P 500 with an expiry date of 31 December 2025 would cost around approximately 0.5% of the notional exposure.[11] One consideration is that when selling call options, funds may be required to post collateral if the market rises above the call strike. There are several ways to proactively manage and mitigate this risk.

Funds can also consider more sophisticated hedging strategies, such as combining put options with long volatility positions, or dynamic hedging strategies. These generally offer cheaper risk mitigation and higher convexity in major shocks (e.g. a 2020 or 2008 scenario) but have lower certainty of return. A combination of approaches can help to add convexity while reducing costs, but funds may also prefer the simplicity and certainty of solely using outright put options. It's important to note that while equity hedging has not been a significant component of most Dutch pension funds over the last decade, all these strategies have a long history of being deployed by large pension funds elsewhere in the world.

A common argument against hedging is cost: when a pension fund has a long-term horizon, why incur a cost to hedge? It is possible to create zero-cost hedges. But for many the right solution will involve a cost. The pension fund transition brings many benefits, but to get there it is necessary to transition. As that has to happen at a specific date, that brings short-term risks to consider and manage. Hedges should be seen in the context of the portfolio. In a portfolio every component has a complimentary role, just like every player in a sports team. As Dutch football legend Johan Cruyff said: "What would you rather have? One good 11 or 11 good 1's." Hedging should be seen as enabling risk taking in other parts of the portfolio, enhancing overall returns.

[10] Sources: True Partner, Goldman Sachs, data from January 2008 to March 2025

[11] Based on indicative pricing as of 31 March 2025 and for illustrative purposes only. Source: Bloomberg.

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How can funds approach hedging?

Pension funds may find it helpful to think about the following questions:

Stress testing	• What would happen to the portfolio in different market scenarios? • How will this impact the coverage ratio and assets? • How will it impact different age cohorts?
What is the cost of protection?	• What hedging solutions would mitigate the risks? • What are the potential costs and benefits? • Are there attractive trade-offs that can help to reduce the cost of protection?
How should any protection be managed?	• If markets drop substantially and the hedges increase in value, would the fund consider adjusting its protection? • Are there other scenarios where it could be beneficial to adjust hedges?

An experienced partner can help to identify attractive hedges with the best risk/reward for the fund, and to implement and manage these over their life. At the outset, they should understand a fund's risk tolerance and what scenarios a fund wants to avoid. It is also important to assess potential basis risks between the portfolio and potential hedges. For example, equity risk may be spread across public and private markets, and equity portfolios may deviate from common benchmarks. The impact of other asset classes can also be considered. For example, corporate bond exposures may be hedged separately, or their expected returns could be taken into account when establishing the appropriate level of equity hedging.

Another factor to consider is having a plan of action if a market shock happens prior to the transition. Currently, hedging costs are around long-term average levels. In a shock, hedges will likely deliver high returns for the funds. That is good news! However, at that point the forward-looking cost of continuing to hold the same hedges will be higher – for example, options may become substantially in-the-money. At what point should you monetise hedges, or adjust positions? Working with an experienced partner can help to plan for and take advantage of opportunities.

Hedging can seem like a complex topic, but we believe it is an important one for pension funds to consider. While market anxiety is increasing, the pricing of hedges is still attractive – it's a good time to work out if they are right for your portfolio. To quote Johan Cruyff again: "You have got to shoot, otherwise you can't score."

True Partner Capital, founded in 2010 by a team of Dutch options specialists, has experience in creating hedging solutions for pension funds, and proprietary models that enable us to model the impact of historical or hypothetical shocks for specific funds down to the age cohort level. True Partner manages relative value and directional options strategies on behalf of a global investor base and offers both commingled and customized portfolios. We have offices in Europe, the US and Asia, including in Amsterdam.

For further information, please contact investorrelations@truepartnercapital.com

Disclaimer

Data as of March 2025 unless indicated otherwise. Sources are noted in footnotes; additional data sourced from True Partner, Bloomberg, Goldman Sachs, Bank of America. Chart data is from Bloomberg / True Partner unless noted above. Data sourced from third parties is believed to be accurate, but no representations are made as to its accuracy. This document has been prepared and issued by True Partner Advisor Limited ("True Partner"). True Partner Advisor Limited is a CFTC registered Commodity Pool Operator and Commodity Trading Advisor. Its affiliates include True Partner Capital USA Holding, Inc., a SEC registered Investment Adviser and True Partner Advisor Hong Kong Limited, a Hong Kong SFC licensed Type 9 Asset Manager. This piece is being provided by True Partner Advisor Limited, not its affiliates. This presentation is confidential, is intended only for the person to whom it has been provided and under no circumstance may a copy be shown, copied, transmitted, or otherwise given to any person other than the authorized recipient without the prior written consent of True Partner. Nothing herein constitutes an offer to sell, or solicitation of an offer to purchase, any securities, nor does it constitute an endorsement with respect to any investment strategy or vehicle. Past performance does not guarantee or indicate future results. There is no guarantee that the objectives of any investment strategy will be achieved.

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