LCP INSIGHT CLARITY ADVICE

LCP strategic portfolio – November 2021

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Welcome to the latest update for the LCP strategic portfolio for UK defined benefit pension schemes which showcases the latest thinking from our investment strategy team and specialist asset class researchers.

The third quarter was reasonably benign for most investment markets, apart from inflation expectations continuing to increase (we discuss the implications of this on page 3). As a result, the strategic portfolio has remained relatively unchanged.

However, within the investment grade credit space, we view asset-backed securities as most attractive currently and have continued to increase this allocation further. In addition, we have split out the Emerging Markets allocation into separate equity and debt allocations as we believe it is more effective to manage these separately.

Finally, we have identified attractive opportunities in the newer areas of infrastructure investment, which we believe our clients should explore further (discussed further on page 4).

What it is

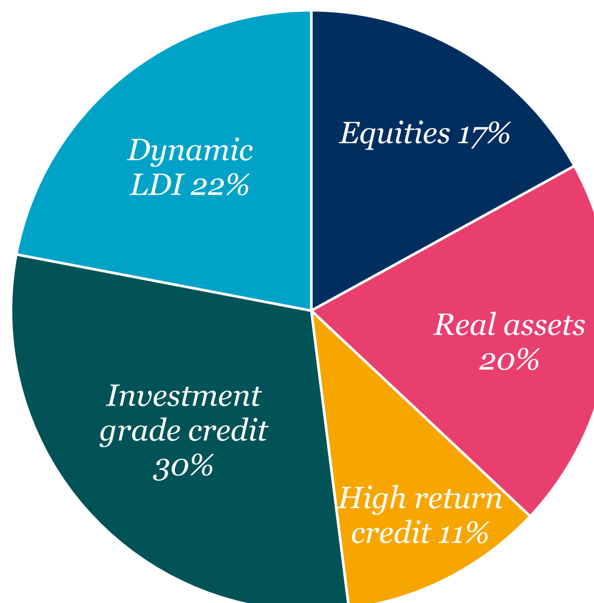
- The latest ideas from our strategy and research teams, and how these ideas can be brought together to build a complete asset portfolio
- A dynamic framework for expressing our views in real time as markets and opportunities evolve
- A transparent representation of our best ideas to stimulate debate and challenge conventional thinking

What it isn't

- A change in our bespoke approach to advising clients
- A benchmark to compare every scheme's portfolio against
- An appropriate investment allocation for schemes with different return objectives
- A substitute for your own beliefs, preferences and constraints
- An optimum solution for all schemes

If you have any questions on the strategic portfolio or any of its constituents, please don't hesitate to contact us or ask your LCP consultant.

Gavin Orpin
Head of Investment Strategy



Expected return of
Gilts + 2.5% pa

Liability hedge ratio
100% of assets
including future deficit contributions

Unhedged currency exposure
25% of assets

Portfolio	%	Change
Equities	**17%**	**-**
Synthetic equity protection	10%	-
Low carbon global equities	5%	-
Emerging market equities†	2%	-
Real assets	**20%**	**-**
Unlisted infrastructure	7%	-
Listed infrastructure	3%	-
Unlisted global property	4%	-
Listed global property	2%	-
Long lease property	4%	-

† We have split out the 4% emerging market allocation into equities and debt. This does not represent a change to the underlying assets held in the portfolio.

Expected return based on the latest LCP asset class assumptions, which are available upon request.

Portfolio	%	Change
High return credit	**11%**	**-**
Opportunistic credit	3%	-
Private credit	3%	-
Emerging market debt†	2%	-
Multi-asset credit	3%	-
Investment grade credit	**30%**	**-**
Long dated buy & maintain credit	5%	-
Asset-backed securities	10%	+2%
Short duration credit	8%	-2%
Synthetic credit overlay	7%	-
Dynamic LDI*	**22%**	

*The dynamic LDI portfolio shares a collateral pool with the synthetic equity protection portfolio and the synthetic credit overlay, together in a single bespoke fund (totalling 39%).

Important considerations in the portfolio

Managing illiquidity

"During the stressed markets of March 2020, many prior assumptions and established market relationships were challenged. Significant margin calls on hedging positions, though substantially met, demanded liquidity which came at a 'price'."

TPR's blog Now is the time to manage liquidity risk, 28 May 2021

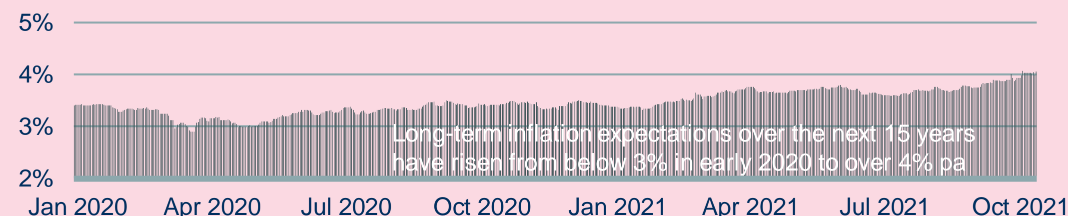
Investments in illiquid assets can offer us an opportunity to capture an "illiquidity premium" and enhance returns. However, pension schemes need liquidity in their investment strategies to pay members' benefits, meet collateral calls on their derivative holdings and have flexibility to change asset allocation if needed, especially in times of market stress. Within the strategic portfolio we think of liquidity risk through three lenses:

	How we manage liquidity risk in the portfolio
1	**Do we have enough liquid assets to support our liability hedging and other derivatives?** We have a sizeable allocation to money market instruments and gilts within the LDI portfolio, which allows the portfolio to withstand large market movements. The LDI portfolio can withstand a c.2% pa rise in yields before needing to be topped up.
2	**Do we have enough liquidity to support expected and unexpected calls for cash (eg paying benefit payments, transfer values, capital calls, etc)?** • We have put in place a cashflow management plan to ensure we are able to meet our expected cashflow needs in the short-term, which give us confidence that we won't become a "forced seller" of growth assets in distressed markets. • We also have significant allocations to short duration, low risk, liquid assets that can be used to meet unexpected cashflows if required.
3	**Do we have enough liquidity to allow for required changes in strategy?** c.75% of the portfolio could be liquidated at short notice, which allows us to take advantage of investment opportunities and also respond to changes in market conditions or changes in the sponsor covenant.

Of course, in addition to these liquidity risks, there is also a cost and associated risk of not having investments in attractive (but less liquid) markets. It is for this reason we still hold c.25% in illiquid markets to benefit from the attractive and reliable returns on offer. **By analysing the portfolio through the above lenses, using techniques such as stress testing and having a clear liquidity risk management plan, we can maintain an allocation to illiquid assets, which may help improve scheme outcomes.**

Rebalancing inflation hedging

Long-term inflation expectations have risen materially over 2021 to above pre-pandemic levels, suggesting the market is pricing in the likelihood of prolonged, higher inflation.

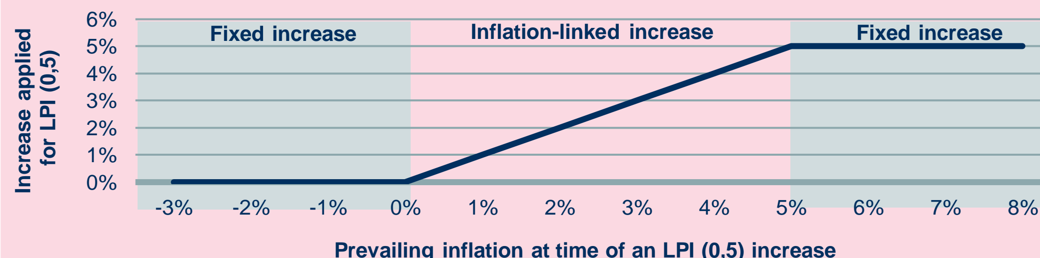


Why might pension schemes be over-hedging inflation?

1 Pension scheme benefits typically include complex features, such as caps on inflation-linked pension increases (5% is a common cap).

2 When inflation expectations rise (as we've seen over the past year), this results in reduced inflation sensitivity as the likelihood of hitting the cap increases. See the chart below for an illustration.

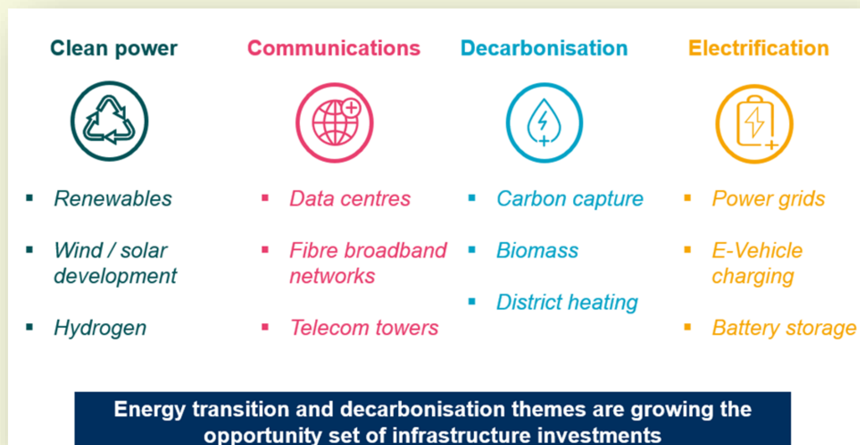
3 Assets generally don't have inflation caps, meaning your inflation hedging ratio has likely drifted upwards. As such, **in the strategic portfolio we are revisiting the hedge, and rebalancing back to our target hedge ratio** (equal to the funding level, accounting for future contributions). This has the nice side effect of locking in some of the profits made over the past year, particularly relevant given inflation hedging could be considered to be more expensive.



Opportunities in infrastructure

There are emerging Net Zero trends in infrastructure

We believe that an allocation to infrastructure provides both strategic benefit: exposure to mature, stable operating assets with predictable revenues over the long term; as well as opportunity. Investment in infrastructure is needed to address key trends and themes we face as a society today:



The primary themes we have identified in infrastructure are:

- **Clean power:** renewable energy infrastructure to support efforts to transition energy generation away from fossil fuels.
- **Communications:** infrastructure that supports the digital economy.
- **Decarbonisation:** investments to decarbonise areas other than power generation, such as heating homes.
- **Electrification:** infrastructure to improve and expand electricity grids in anticipation of the growing reliance on electricity for transport and industry.

These newer areas of infrastructure investment are a rapidly growing opportunity set for well-established infrastructure funds. Managers are increasingly making allocations to these areas.

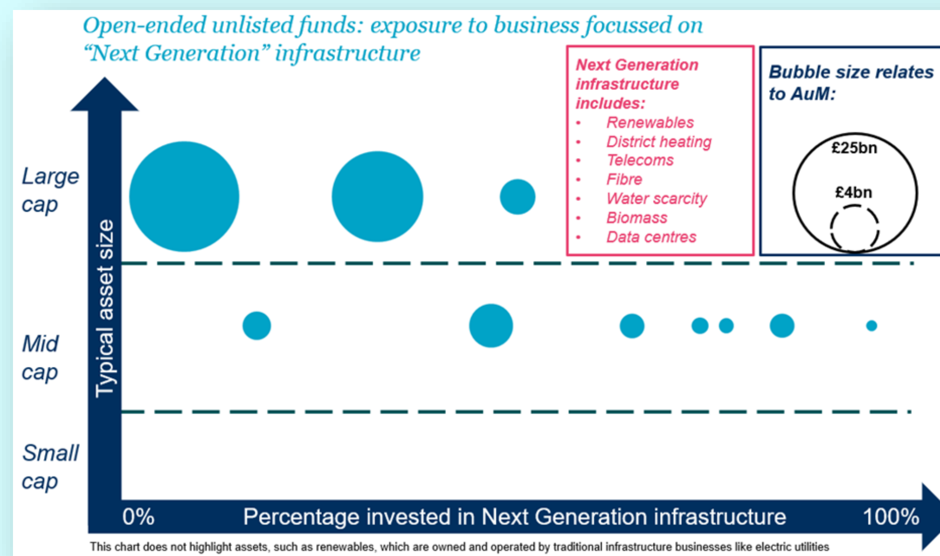
With 'Net Zero' an increasing focus for many investors, successful infrastructure funds will take need to take advantage of the opportunities presented by the energy transition. The strongest managers will be able to navigate managing the climate-related risks associated with higher emissions assets.

...with a range of options to access them

We have seen new infrastructure funds being launched that take advantage of these emerging trends. For example, unlisted funds with more focus on new infrastructure sectors – more wind farms and fibre than utilities and airports – or listed infrastructure funds where Net Zero alignment is a more prominent feature of the investment process.

We believe that open-ended, globally diversified infrastructure funds best suit the strategic needs of most investors and we have identified funds more focussed on this newer 'Next Generation' infrastructure. These are managed by experienced teams even though the funds have shorter performance track records.

While there is appeal to these new strategies, there are trade-offs to consider carefully if comparing them to more well-established infrastructure funds. Newer funds are often significantly smaller with fewer assets than more established funds, and as they have a narrower sector focus, they also tend to invest in smaller assets or assets with a shorter operating history that may be less 'tried and tested'. In the chart below the blue circles represent various different open-ended infrastructure funds that are available for investment.



The universe of fund options is growing, which is a good thing for investors. If you are considering making an allocation we can help you consider the spectrum of approaches (highlighted in the above chart) and compare the trade-offs of different approaches to what best suits your needs.

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Contact us

For further information please contact our team or your usual LCP contact

Gavin Orpin FIA
Investment Partner
gavin.orpin@lcp.uk.com
+44 (0)20 7432 3778

Rory Sturrock FIA
Senior Consultant
rory.sturrock@lcp.uk.com
+44 (0)20 3824 7241

Jacob Shah FIA CERA
Senior Consultant
jacob.shah@lcp.uk.com
+44 (0)20 3824 7270

David Wrigley FIA
Investment Partner
david.wrigley@lcp.uk.com
+44 (0)1962 873 358

Celia Shen
Associate Consultant
celia.shen@lcp.uk.com
+44 (0)1962 872 749

Oliver Allen
Associate Consultant
oliver.allen@lcp.uk.com
+44 (0)20 3314 4684

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Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock
Ireland Limited
Dublin, Ireland
Tel: +353 (0) 1 614 43 93
enquiries@lcpireland.uk.com

Lane Clark & Peacock
Netherlands B.V.
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com

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