Update on the LCP strategic portfolio

July 2021

LCP strategic portfolio – July 2021

Welcome to the fourth 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 second quarter of 2021 was, from a market perspective, quite benign after the volatility experienced since early 2020. Most risk assets have performed strongly since March 2020, but as discussed on page 3, we now prefer equities to investment grade corporate bonds. As a result, we have made a small change to the strategic portfolio, reducing the exposure to investment grade credit and substituting this with a marginal increase in equities to retain the same overall expected return.

In addition, we believe that there is a risk of inflation rising markedly over the next few years. On page 4, we discuss how this may impact pension scheme portfolios and how we have addressed this risk (and opportunity) in the strategic portfolio asset allocation.

What it is

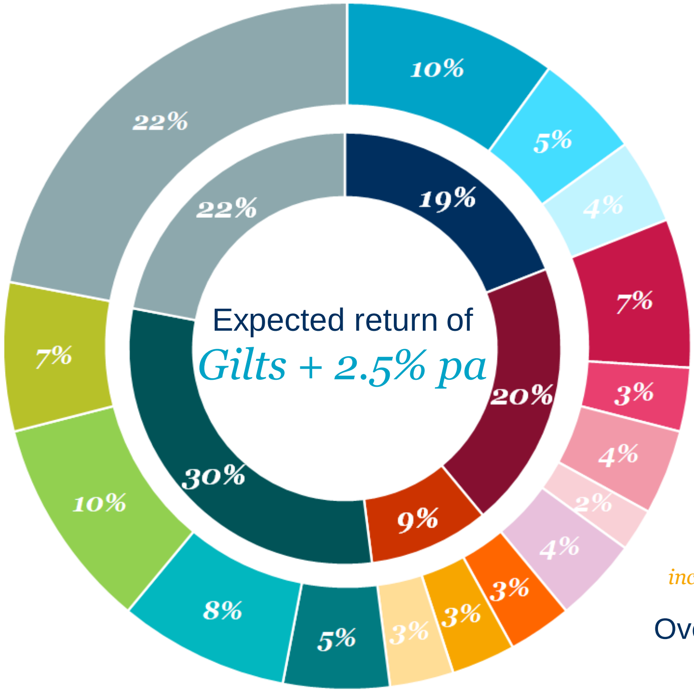
- The latest ideas from our strategy and research teams, and how these ideas can be brought together to build a complete asset portfolio
- A dynamic framework for expressing our views in real time as markets and opportunities evolve
- A transparent representation of our best ideas to stimulate debate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



Liability hedge ratios
100% of assets
including future deficit contributions

Overseas currency exposure
25% of assets

	Portfolio	Change
Equity and emerging markets	**19%**	**1%**
Synthetic equity protection	*10%*	*-*
Low carbon global equities	*5%*	*1%*
Emerging market multi-asset	*4%*	*-*
Real assets	**20%**	**-**
Unlisted infrastructure	*7%*	*-*
Listed infrastructure	*3%*	*-*
Unlisted global property	*4%*	*-*
Listed global property	*2%*	*-*
Long lease property	*4%*	*-*

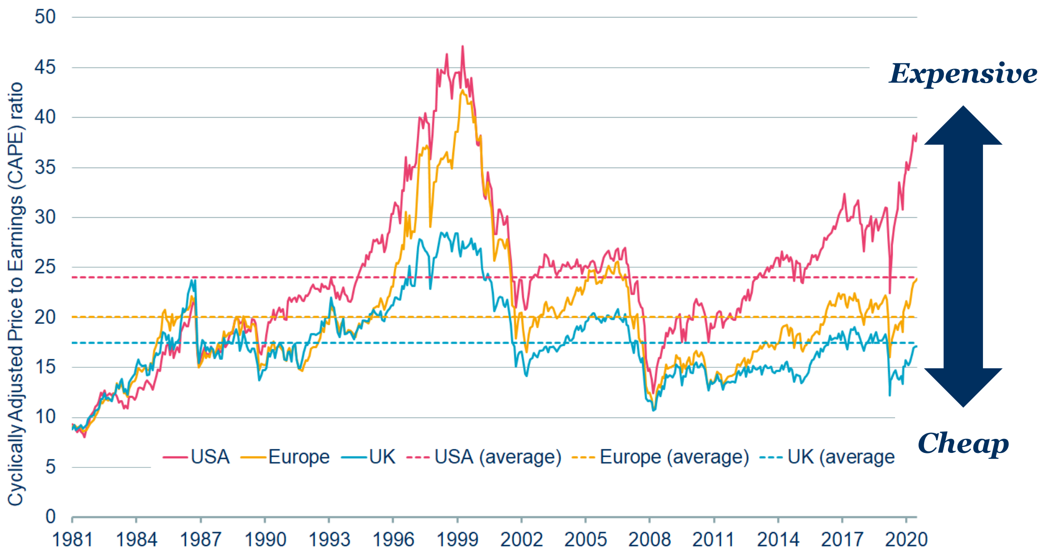
	Portfolio	Change
High return credit	**9%**	**-**
Opportunistic credit	*3%*	*-*
Private credit	*3%*	*-*
Multi asset credit	*3%*	*-*
Investment grade credit	**30%**	**-5%**
Long dated buy & maintain credit	*5%*	*-3%*
Asset-backed securities	*8%*	*-*
Short duration credit	*10%*	*-2%*
Synthetic credit overlay	*7%*	*-*
Dynamic LDI *	**22%**	**4%**

** 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%**)*

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

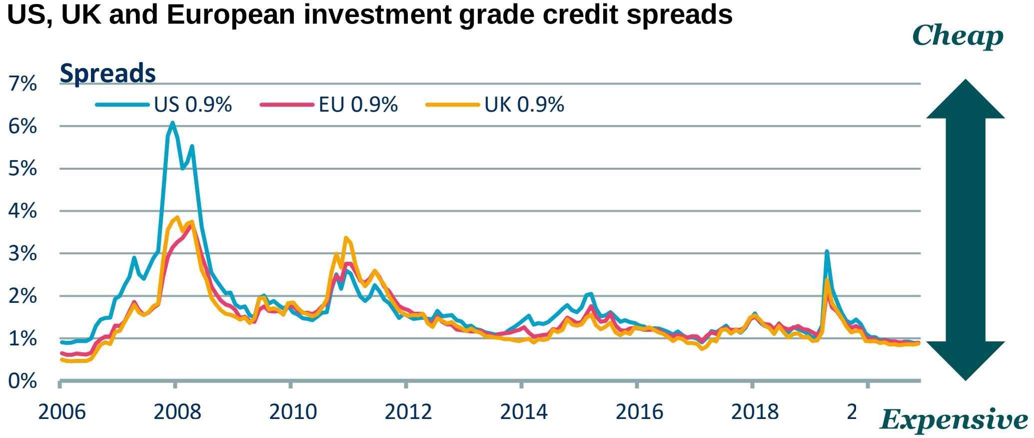
Changes since last quarter

How expensive are equities relative to history?



How expensive are corporate bonds relative to history?

US, UK and European investment grade credit spreads



A small pivot from investment grade credit (↓5%) to equities (↑1%)

Since March 2020, almost all asset classes have been on an impressive rally, leading some people to ask whether asset valuations are over-elevated.

As shown by the charts on the left, it does appear both equities and corporate bonds are expensive relative to history. That said equities have seen loftier valuations in the past and some equity regions are more in line with their long-term averages. Furthermore, today's low interest rate environment may justify equity valuations that are higher relative to history. We also expect governments and central banks to maintain an accommodative policy stance to support the economic recovery.

Conversely, credit spreads (the additional yield investors receive from lending to companies rather than governments) are very tight relative to history. This is against a backdrop of arguably deteriorating credit quality within investment grade (for example, the proportion of BBB (the lowest investment grade credit rating) is significantly higher now than in the past). They also look unlikely to provide a real return, once inflation is accounted for (see page 4). And unlike with equities, there is a cap to the return on corporate bonds. Holding a bond to maturity, the best outcome is full repayment of coupons and principal from the bond issuer, unlike equities where you share in upside.

Given the above, while we're not in love with valuations for equities or corporate bonds, we feel that equities are a better asset class with which to generate returns in the current market environment. We have chosen to increase the allocation via passive, low carbon equities, which is our favoured way of managing climate risks within equity markets.

Equities are generally higher risk / higher return than corporate bonds. As such, we are able to reduce the corporate bond allocation by 5% and broadly maintain overall return on the portfolio by increasing the equity allocation by 1%. This leaves another 4% allocation, which we place into cash / liquidity funds in the LDI collateral pool for two primary reasons:

- It provides "dry powder" for us to invest should other investment opportunities arise; and
- It gives further liquidity to collateralise the liability hedging derivatives.

Source: Bloomberg, iBoxx, Barclays, BofA Merrill Lynch. Equity chart shows the data to 30 June 2021

Protecting against rising inflation

Why is there so much focus on inflation at the moment?

Inflation is a hot topic at the moment given the news headlines, unprecedented levels of economic stimulus provided by governments and central banks, and release of pent-up demand following the easing of lockdowns. While of course there are many potential inflationary scenarios, two scenarios that are on many investors' minds are:

1. **A transitory inflation blip –** A relatively short period of high inflation (1-2 years) before returning around 2% pa, which is what most central bankers, economists, and businesses expect.

2. **Higher inflation for the long-term –** A sustained period of high inflation for a number of years, potentially alongside a relaxation of central bank targets.

In the first scenario, we expect the strategic portfolio would perform well as accommodative monetary policy would benefit equities and bonds whilst transitory inflation would support investments with an explicit inflation linkage, such as real assets.

How have we mitigated the impact of high inflation on the strategic portfolio?

It is **the second scenario that has us more worried** in terms of portfolio performance. Equities could be in for a rocky ride, bonds may sell off substantially, and property prices could fall. So, we've taken the following actions to help mitigate the impact of high inflation on the strategic portfolio.

Asset class / area	Mitigation within the strategic portfolio
Equities	• Our synthetic equity protection structure is used to provide some **downside protection** should equity markets fall (which has happened historically in response to sudden or unexpected inflation).
Real assets	• The long lease property investment has income that is **contractually linked to inflation** and valuations that are less susceptible to property market downturns. • The other real asset investments also have an **indirect link to inflation**.
High return credit	• Opportunistic credit tends to **perform well when markets or the economy struggles**. • Private credit and some investments within the multi-asset credit portfolio (eg loans or asset-backed securities) are explicitly linked to base rates and expect to **deliver higher returns in rising rate environments**.
Investment grade credit	• Bonds in this allocation are highly rated and therefore **less likely to default**. • Synthetic credit is **less volatile** in times of market stress compared to equivalent corporate bonds. • Short dated credit is **less susceptible to widening credit spreads**, with the ability to benefit from wider spreads when re-investing capital.
Liability hedging	• In the strategic portfolio, we hedge a high proportion of the inflation sensitivity of the liabilities.

In my blog, I explore the role that shipping is playing in pushing prices upwards around the world.

Lee Dodds
Partner

In my article, I look at why inflation may, or may not, be an issue in the coming years.

Dan Mikulskis
Partner

In my article, I consider what investors could do in the face of looming inflation risk.

Matt Gibson
Partner

Contact us

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At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and employee benefits.

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