Update on the LCP strategic portfolio

April 2021

LCP strategic portfolio – April 2021

Welcome to the third 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 first quarter of 2021 was notable for the material rise in gilt yields which had a positive impact on many schemes' funding positions. However, it has also meant that many schemes' allocations have moved significantly away from their targets. Our focus in this update is what actions schemes should take as a result. In our opinion, the two key actions are to revisit the liability hedge to reflect the higher yields and increased inflation expectations and to rebalance back to the target by selling growth assets such as equities, which will also "lock-in" some of the profits from recent growth asset rises.

The overall fund management fees incurred by the strategic portfolio are around 0.3% pa, demonstrating that it is possible to implement a sophisticated, diverse strategy in a cost-effective way.

What it is

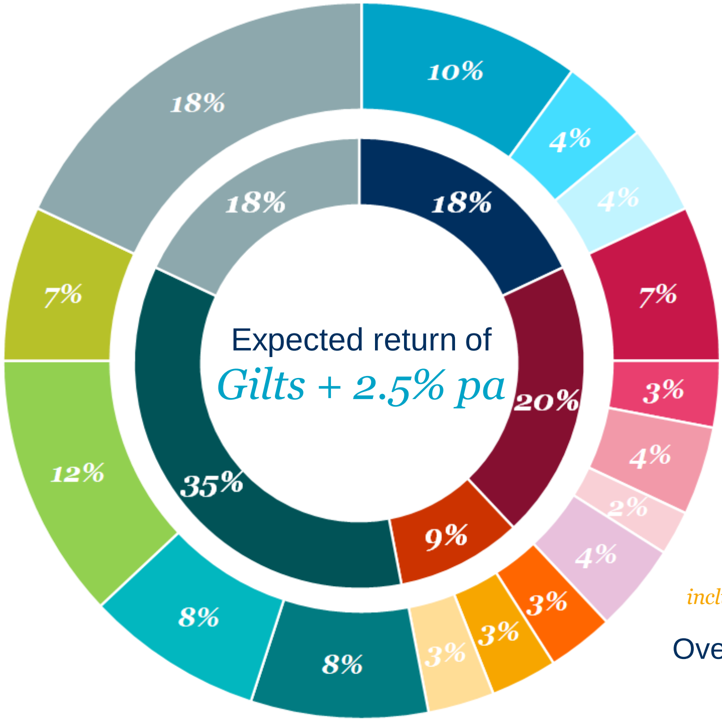
- The latest ideas from our strategy and research teams, and how these ideas can be brought together to build a complete asset portfolio
- A dynamic framework for expressing our views in real time as markets and opportunities evolve
- A transparent representation of our best ideas to stimulate debate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

Strategic allocation is unchanged over the quarter

	Portfolio
Equity and emerging markets	**18%**
Synthetic equity protection	*10%*
Low carbon global equities	*4%*
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
High return credit	**9%**
Opportunistic credit	*3%*
Private credit	*3%*
Multi asset credit	*3%*
Investment grade credit	**35%**
Long dated buy & maintain credit	*8%*
Asset-backed securities	*8%*
Short duration credit	*12%*
Synthetic credit overlay	*7%*
Dynamic LDI *	**18%**

** 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 **35%**)*

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

Rebalancing

Rebalance, rebalance, rebalance…

Market movements over recent months have given us the chance to bank some profits by rebalancing the strategic portfolio. Put simply, growth assets - such as equities - have outperformed matching assets such as government bonds.

Why rebalance?

Timing markets with any degree of consistency is difficult (if not impossible). However, as many academic studies have demonstrated regularly rebalancing portfolios can add significant value over time.

A commitment to maintaining an asset allocation in line with the strategic allocation can help improve outcomes:

- After a period of equity market falls, rebalancing the asset allocation will mean purchasing growth assets when they are cheaper; and
- After a period of equity market rallying, rebalancing will mean selling growth assets thereby locking in some gains.

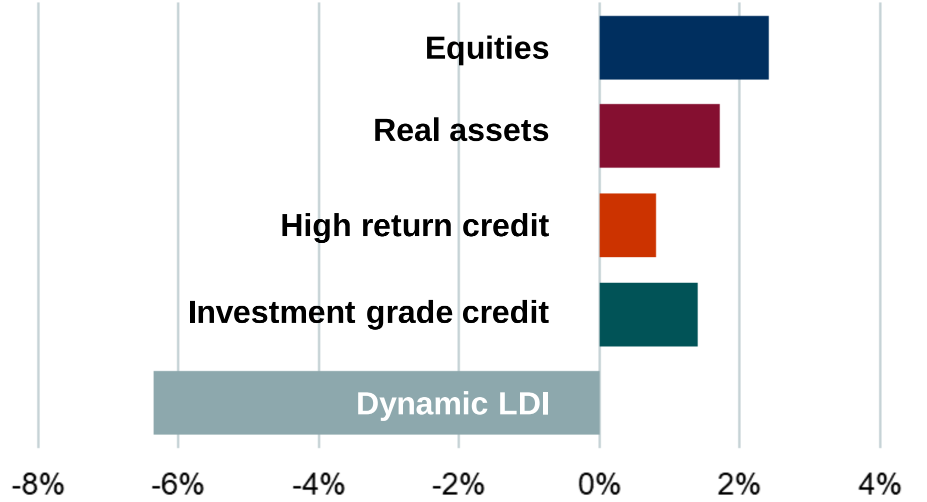
Following a disciplined approach to rebalancing can also help avoid behavioural biases in investment decision making.

In the absence of rebalancing, assets that have returned more can begin to dominate a portfolio. As these are often higher risk assets (such as equities), that can lead to a portfolio becoming riskier than intended.

Managing costs of rebalancing

One challenge of rebalancing is the costs associated with buying and selling securities, which is particularly pertinent in less liquid asset classes. The strategic portfolio utilises listed real asset exposure for this very reason to improve the liquidity of the portfolio and help overcome these challenges – leading to a more dynamic overall portfolio.

Allocation relative to strategic allocation prior to rebalancing

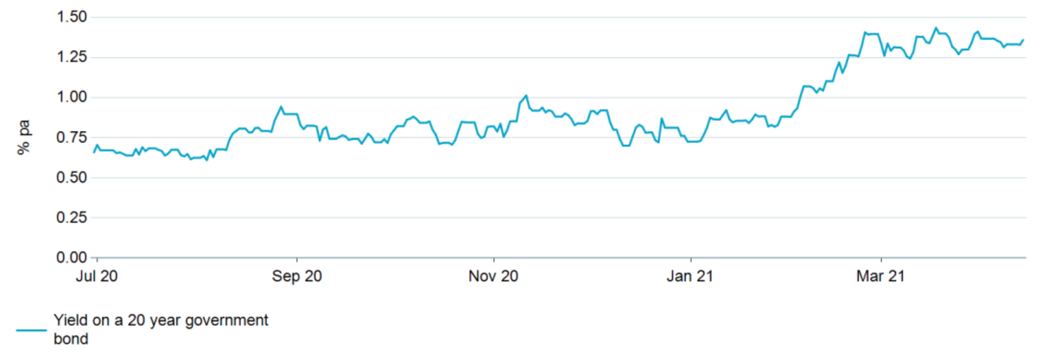


	How the strategic portfolio has rebalanced
Equity and emerging markets	Rebalance synthetic equities for close to zero cost. Sale of some of units of low carbon / emerging markets allocations.
Real assets	Sell some of the allocations to listed infrastructure and listed property. Unlisted investments have not been traded.
High return credit	Multi-asset credit has been sold for rebalancing. Private market assets have not (and cannot) be traded.
Investment grade credit	Synthetic credit has been traded for close to zero cost and short duration credit is highly liquid also.
Dynamic LDI collateral pool	This will be replenished using sale proceeds of other assets.

Rebalancing allows us to systematically "bank gains" of around £50m (assuming a portfolio size of £1bn) over the last six months

Rising rates

Gilt yields have nearly doubled over 2021 – make sure you have enough collateral and take advantage of any opportunities to increase hedging



As lockdowns ease and the expectation increases that people return to shops, hairdressers and pubs, the economic outlook has improved. This has been reflected in higher bond yields (associated with higher inflation and a rosier economic outlook). Government bond yields are now at pre-pandemic levels.

Within the strategic portfolio, the high hedge ratio means the changes in interest rates and inflation expectations have had little impact on the overall funding level. However, in light of volatile markets over the quarter, there are two key rebalancing steps we've taken within the strategic portfolio:

1. **Increase the hedge ratio**. The target hedge ratio for the strategic portfolio is to hedge the full value of the assets, including future deficit contributions. Hedging levels have been rebalanced to reflect the strong performance in return-seeking assets.
2. **Top up the capital supporting the hedges**. The sharp rise in interest rates has deplenished the collateral within the LDI portfolio. As a result, we have topped up the portfolio using the growth assets sale proceeds.

For less well hedged schemes, the rise in interest rates (and strong performance elsewhere in the portfolio) provides an ideal opportunity to lock-in gains and increase the hedge ratio up towards full hedging (including potentially hedging future deficit contributions).

Updating inflation hedges

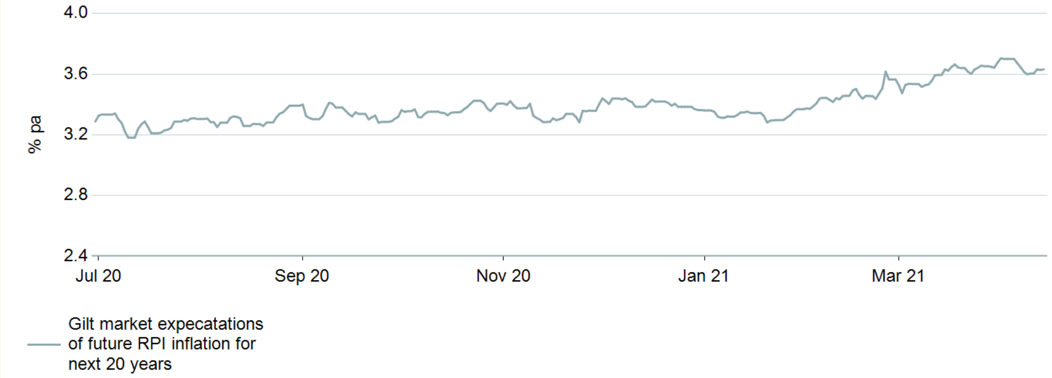
Part of the reason for the large rise in long-term interest rates over the quarter was the rising inflation expectations. With economies re-opening and significant government spending (including helicopter money in the US) it is hardly surprising investors are now worried about the threat of inflation.

Within the strategic portfolio we undertook the same rebalancing activity as for interest rates (ie increase the target hedge ratio in line with improvements in the funding position; and increased the capital supporting the hedges).

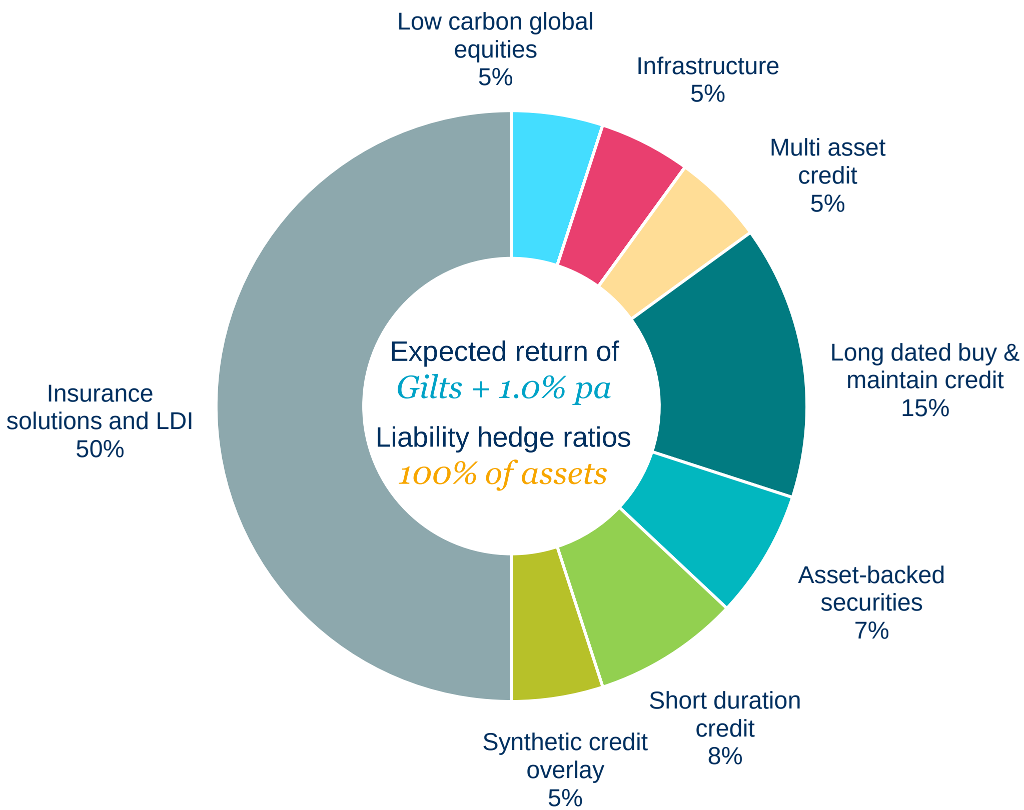
However, when inflation expectations rise significantly, there is a further rebalancing step that trustees may need to take to ensure the inflation hedge is in line with target:

- Many pension schemes have "caps" on their inflation increases (eg at 2.5% or 5%) and with the sharp rise in inflation expectations it is considerably more likely these caps will bite in the future. In turn, this means liability values will be less sensitive to inflation and schemes that don't take action may find themselves over-hedged.
- Within the strategic portfolio we rebalanced the LDI benchmark to take account of the big changes in market conditions and rebalanced the inflation hedge accordingly. These steps were taken at the same time as other rebalancing activity to minimise transaction costs.

For many pension schemes this represents a profit taking opportunity to rebalance inflation hedges that were put in place when market levels were considerably cheaper.



Low dependency strategic portfolio



In my blog I share my view on how schemes may wish to position their strategies when preparing for the insurance market and compare that to how insurers invest.

Tom Farrell
Partner

In my blog, I set out my ideal investment strategy for schemes who are targeting long-term run-off as their "endgame".

Andrew Linz
Consultant

A low risk portfolio appropriate for well funded schemes, that can opportunistically take advantage of buy-out opportunities

Return seeking assets *(15% comprising of low carbon global equities, infrastructure and multi-asset credit)*	• These return seeking assets help to **bridge any funding gap** on a scheme's journey towards its end game, for example a buy-out. • A higher return target also provides mitigation for emerging risks, such as longevity risks and reflects the fact that the cashflow projections are only an estimate. • Low carbon global equities to provide **low-cost exposure to climate-tilted** global equities. • **Avoid allocations to new illiquid mandates** given the potential for buy-out (or other end-games) being achievable sooner than expected. • Preference for global infrastructure within real assets given that it has proven **resilient in market downturns**. Depending on the scheme's liquidity requirements, this allocation may be **split between listed investments and unlisted investments** that are being wound down.
Investment grade credit *(35% comprising of buy & maintain credit, asset-backed securities, short duration credit and synthetic credit)*	• This allocation is designed to be **widely acceptable by insurers (a buy-out provider) and to also generate returns**. • However, not all credit is invested in longer-dated bonds commonly held by insurers, as the short-dated credit provides protection against rising credit spreads and reduced credit risk. • Likewise, higher credit spreads on asset-backed securities currently appear **attractive** relative to corporate bonds and they provide **diversification of credit risk**. • Synthetic credit overlay is a **capital efficient** approach to enhancing returns and helping to bridge the journey towards buy-out. It also provides **more flexibility to rebalance** the portfolio and additional hedging benefits compared to insurer pricing.
Insurance solutions and LDI *(50%)*	• Use a bespoke fund for a tailored, flexible and efficient hedge, which could also better facilitate future insurer transactions. • Opportunistically adding pensioner buy-ins to the portfolio when pricing is attractive can provide an attractive yield, support cashflow management, reduce longevity risk and ultimately manage the transition towards any eventual buyout.

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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