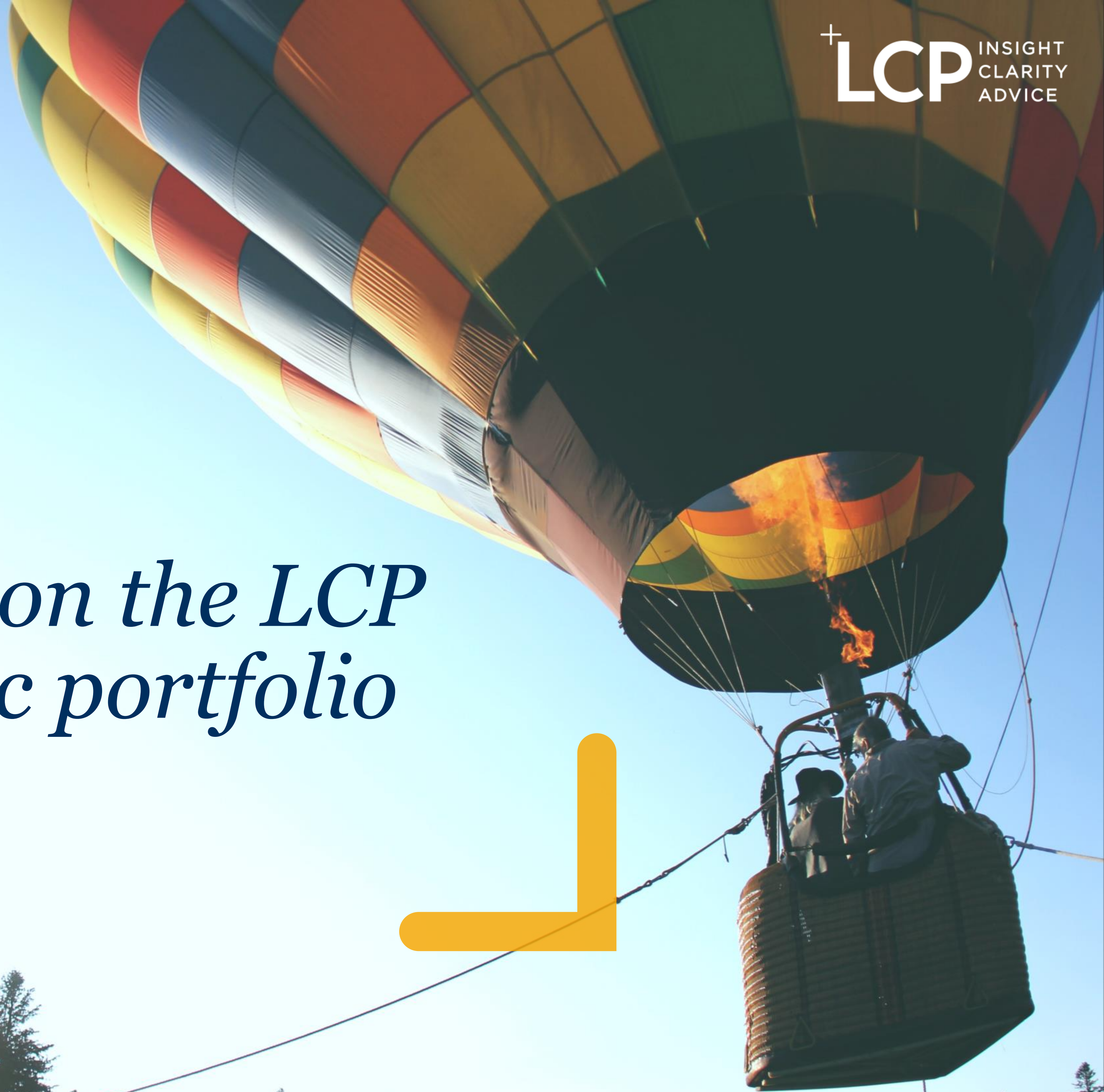
Update on the LCP strategic portfolio

May 2022



LCP strategic portfolio – May 2022

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 big market impact so far this year has been rising interest rates and inflation. This has resulted in several considerations for schemes with significant liability hedges and we outline these on page 5.

In addition, credit spreads have risen, due to Bank of England actions and the impact of the conflict in Ukraine. Therefore, we have taken some steps to increase the credit allocations. However, spreads are still only in-line with long term averages, so we have retained our bias towards shorter dated credit and trimmed our equity and real asset exposures to keep some "dry powder" for deployment in the future. (Page 4 gives details.) On page 6 we also give an update on our latest manager fee survey with the implications for our portfolios.

Finally, many of our schemes are in a strong funded position, and running low risk "low dependency" portfolios, so we have provided an update on page 3 of our low dependency portfolio which targets gilts + 1% and we will now provide quarterly updates of this portfolio going forward.

What it is

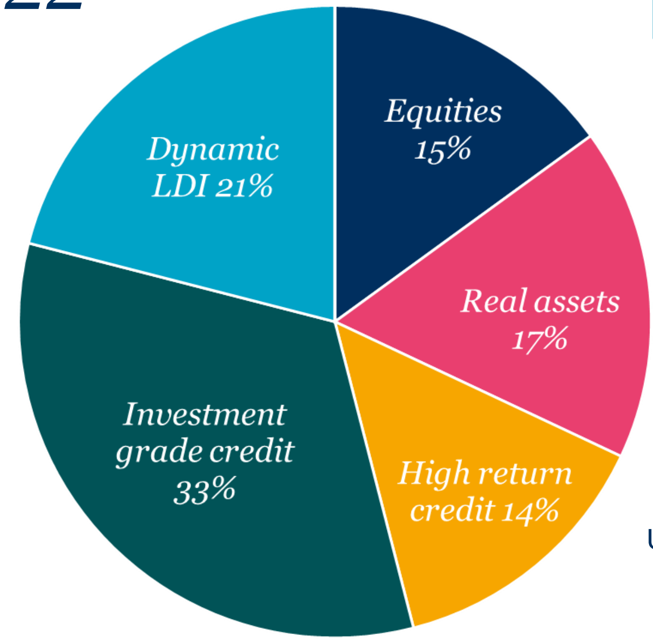
- The latest ideas from our strategy and research teams, and how these ideas can be brought together to build a complete asset portfolio
- A dynamic framework for expressing our views in real time as markets and opportunities evolve
- A transparent representation of our best ideas to stimulate debate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

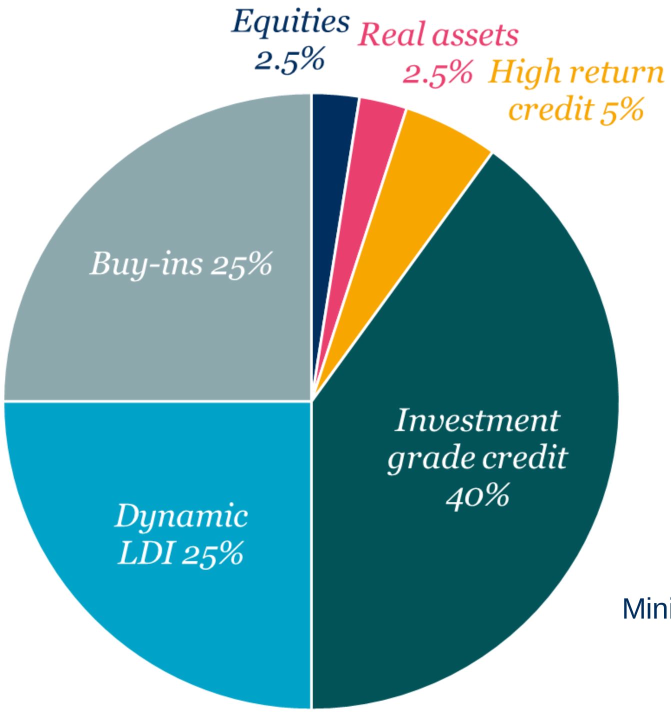
Portfolio	%	Change
Equities	**15%**	**-2%**
Synthetic equity protection	8%	-2%
Low carbon global equities	5%	-
Emerging market equities	2%	-
Real assets	**17%**	**-3%**
Unlisted infrastructure	7%	-
Listed infrastructure	1%	-2%
Unlisted global property	4%	-
Listed global property	1%	-1%
Long lease property	4%	-
Dynamic LDI	**21%**	**-1%**

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%).

Portfolio	%	Change
High return credit	**14%**	**+3%**
Opportunistic credit	3%	-
Private credit	2%	-
Infrastructure debt	2%	-
Emerging market debt	2%	-
Multi-asset credit	5%	+3%
Investment grade credit	**33%**	**+3%**
Long dated buy & maintain credit	5%	-
Asset-backed securities	10%	-
Short duration credit	8%	-
Synthetic credit overlay	10%	+3%

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

LCP low-dependency portfolio – May 2022



Expected return of
Gilts + 1.0% pa

Liability hedge ratio
100% of assets

Minimal unhedged currency exposure

Portfolio	%
Equities	**2.5%**
Low carbon global equities	2.5%
Real assets	**2.5%**
Listed infrastructure	2.5%
Dynamic LDI	**25%**
The dynamic LDI portfolio shares a collateral pool with the synthetic credit overlay, together in a single bespoke fund (totalling 30%).	
Buy-ins	**25%**
Schemes may wish to use a combination of pensioner buy-ins and other insurance solutions such as longevity swaps	

Portfolio	%
High return credit	**5%**
Multi-asset credit	5%
Investment grade credit	**40%**
Long dated buy & maintain credit	15%
Asset-backed securities	11%
Short duration credit	9%
Synthetic credit overlay	5%

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

An update to our low risk portfolio appropriate for well funded schemes, that can opportunistically take advantage of buy-out opportunities

Return seeking assets

(10% comprising of low carbon global equities, listed 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

(40% comprising of buy & maintain credit, asset-backed securities, short duration credit and synthetic credit)

- Mix of shorter-dated and longer-dated corporate bonds to **balance credit default, downgrade and re-investment risks**. Allocations to shorter-dated credit also **reduces volatility and provides some protection against rising credit spreads**, whilst continuing to generate meaningful returns.
- 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 an end game, eg buy-out. It also provides **more flexibility to rebalance** the portfolio and additional hedging benefits compared to insurer pricing.

Dynamic LDI

(25%)

- Use a bespoke fund for a tailored, flexible and efficient hedge, which could also broader facilitate future insurer transactions.
- Although dynamic LDI can lead to short-term volatility versus a gilt-based funding target, the additional expected returns can help close the gap towards full funding on other end game targets, eg buyout.

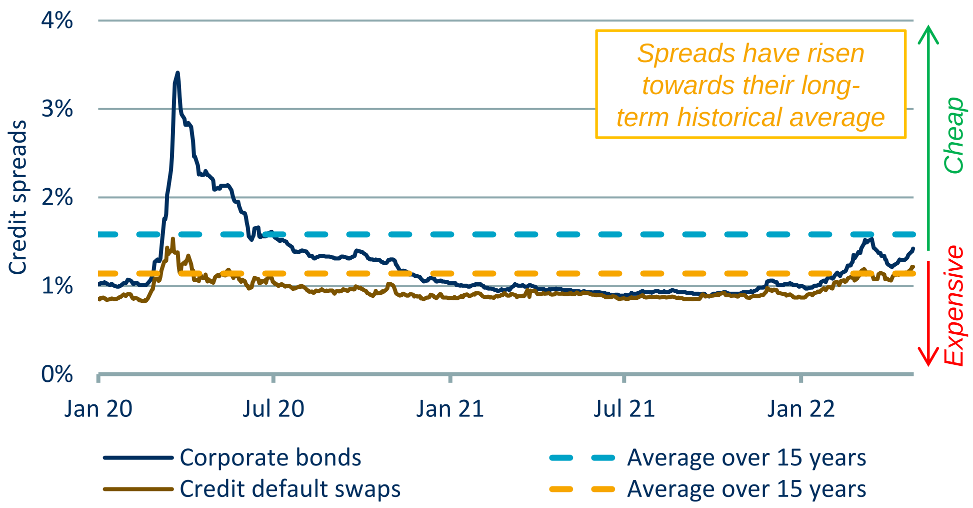
Buy-ins

(25%)

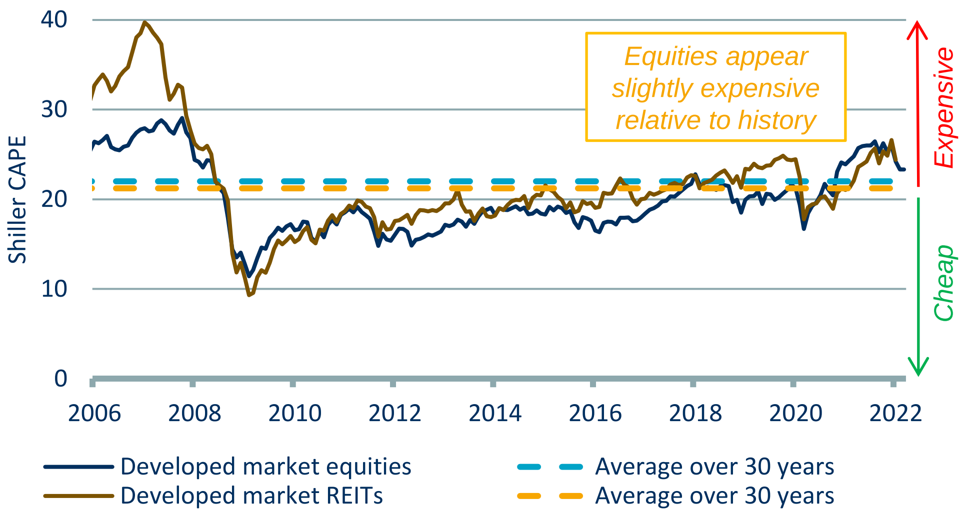
- Opportunistically adding pensioner buy-ins to the portfolio when pricing is attractive can provide an attractive yield, support cashflow management, reduce longevity risk and ultimately manage the transition towards any eventual buyout.

Why are we increasing the allocation to credit?

How expensive / cheap is credit relative to history?



How expensive are equities relative to history?



Source: Refinitiv Datastream, OECD CPI inflation. Corporate bonds is the ICE BofA Global Corporate Index (G0BC). Credit default swaps is the iTraxx Europe (10 year) (DIXETEC)

Our view on credit has improved with the rise in credit spreads so far this year

In 2021, we had a less positive view on credit and made a pivot from investment grade credit to equities to reflect this (see the July 2021 edition of our strategic portfolio). With global inflation rising to levels not seen in decades, the prospect of rising interest rates and economic growth stuttering, global credit markets have suffered significant losses so far this year. This means credit spreads[1] have increased, bringing them closer in line with historical averages, and leading to an **improvement in our view on credit to a more neutral view**. As a result, we've chosen to pivot from equities and real assets back to credit.

- We've increased the allocation to multi-asset credit, which gives us exposure to a board range of credit, including floating rate investments, such as loans. These investments can be **more attractive than bonds in a rising rate environment** due to their floating rate coupons.

- We've increased the allocation to synthetic credit, which is a **capital efficient** way of increasing our allocation to investment grade credit. In addition, history has shown synthetic credit to be **less exposed to large drawdowns** in times of market stress compared to corporate bonds.

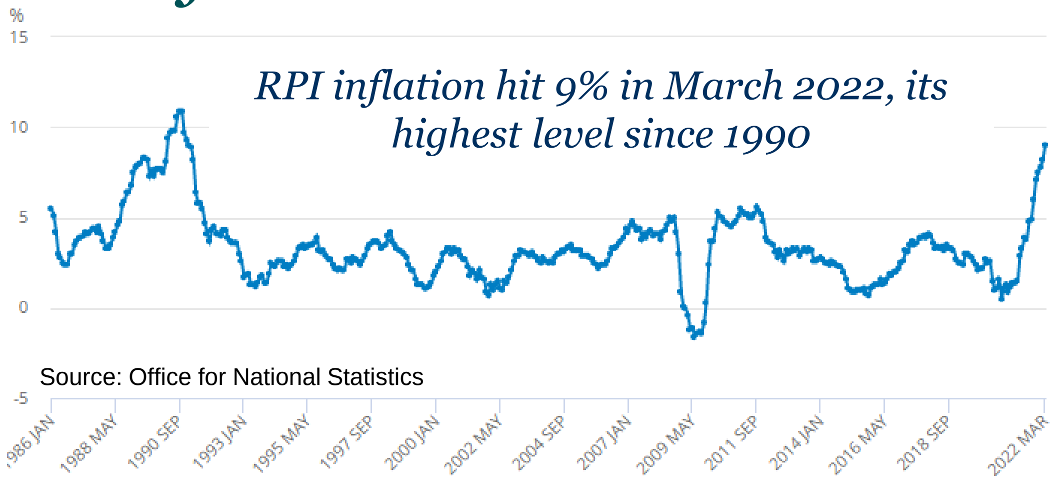
- By reducing the allocation to equities and real assets, we are able to maintain the overall level of return of the strategic portfolio, whilst reducing risk, and also **crystallise some of the strong returns** these asset classes have experienced since March 2020.

- Given the rise in interest rates so far this year and increase in volatility in markets, we are reluctant to fund the increases solely from the collateral pool underlying the LDI portfolio. We want to ensure our **LDI portfolio is well collateralised** and can withstand a significant rise in rates before the collateral is exhausted.

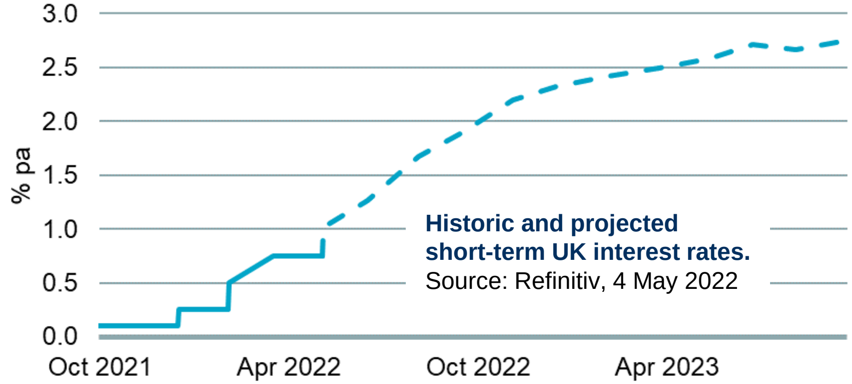
Whilst we generally view asset-backed securities as more attractive than corporate bonds, we haven't increased this allocation to avoid a concentration risk to this asset class. In addition, whilst spreads for emerging market debt have increased significantly, we haven't increased this allocation as we see significant headwinds and risks facing this asset class in the form of the Russia-Ukraine crisis, rising interest rates in the US, onshoring of supply chains, and surging COVID cases and renewed lockdowns in China.

[1]This is the extra yield demanded by investors for investing in a corporate bond versus a comparable government bond

What are we doing about rising interest rates and inflation?



Short-term interest rates are forecast to rise to above 2.5% pa



The impact on the strategic portfolio of big swings in inflation and interest rates is muted

The LCP strategic portfolio has high hedge ratios (equal to the funding level plus future contributions), meaning that the key scheme-level metrics (funding level, deficit and required return) are all relatively immune to the dramatic changes in inflation (both realised and future expectations) and interest rates.

We continue to advocate high hedge ratios in this environment as these are big sources of volatility for a pension scheme and it is notoriously difficult to speculate whether interest rates / inflation will rise faster or slower than priced into market. We note that central banks have a great challenge in balancing the need to quell higher inflation with higher interest rates with the desire to not choke off economic growth with over-zealous policy tightening.

In LCP's latest Vista magazine, I explore what investors should watch out for in this cycle.

Karen Ward
JP Morgan (guest author)

Preparing for a high inflation world

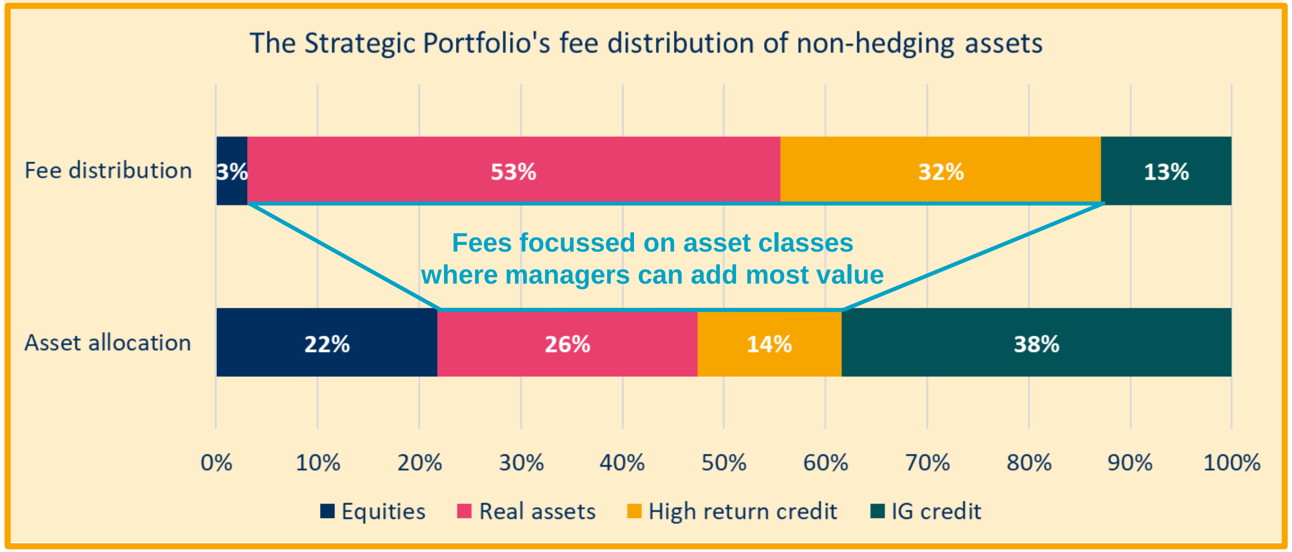
Key actions we have taken in the strategic portfolio that we recommend all trustees and sponsors take in response to the threat of rising rates are:

- Stress test your assets in a "rates rise sharply" environment to understand your exposure to this risk.
- Review your policy for recapitalising your LDI portfolio – which assets would you sell to rebalance LDI?
- Consider deleveraging your LDI portfolio, if this is feasible within the constraints of your current investment strategy.
- Consider the appropriateness of any illiquid allocations in your strategy.
- Make sure you have appropriate monitoring of inflation hedge ratios as market conditions change and your pension increase caps become more/less likely to bite.

LCP fee survey

Limit large manager fee spending to areas where it has largest impact

- For large, efficient capital markets (such as the global stock market) we prefer not to use expensive active management products. Cheaper, passive approaches (which can incorporate tilts, such as a low carbon tilt) have generally matched or outperformed expensive, active approaches net of fees.
- For some asset classes, there are benefits to paying higher manager fees, eg where:
  - there is no passive approach available, so it is worthwhile to pay for active management to access attractive asset classes;
  - quality underwriting and assessment of risks is performance additive. For example, in private credit it is important to have experts assess the covenants underlying lending agreements.
- This is reflected in the areas of the strategic portfolio which incur the greatest proportion of fees:



Equity allocation achieved via low-cost passive approach (with low carbon tilts)

Real asset allocation implemented via specialist managers to provide access and quality underwriting / management

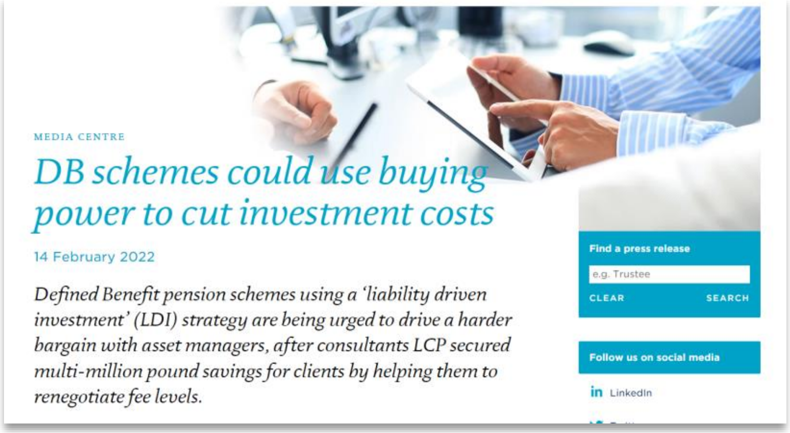
High return credit accessed via specialist managers to provide quality underwriting / management, access to private markets and discretion between different types of credit

IG credit accessed using low cost approaches (such as buy and maintain) which address issues with credit indices in a cost-proportionate manner

LCP INSIGHT CLARITY ADVICE

Read more in our 7th biennial fee survey...

Excellent value for money achieved for our clients across a range of asset classes including LDI...



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

Oliver Allen
Associate Consultant

oliver.allen@lcp.uk.com
+44 (0)20 3314 4684

Jennifer Davidson
Associate Consultant

jennifer.davidson@lcp.uk.com
+44 (0)1962 672 882

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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.

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