Update on the LCP strategic portfolio

January 2022

LCP strategic portfolio – January 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.

Government bond markets were very volatile over the fourth quarter again emphasising the importance of LDI portfolios for managing risk.

This quarter we have introduced a new asset class, infrastructure debt, to the portfolio. This asset class currently offers attractive yields of around cash + 5%, backed by secure contractual income and underlying assets that are resilient to high inflation (see page 3 for more details).

On page 4, we reflect on 2021 and some key decisions that we made that have had a positive impact on performance and risk management for the portfolio. Already, 2022 looks to be a potentially challenging year to navigate but we look forward to uncovering more investment opportunities as the year unfolds.

What it is

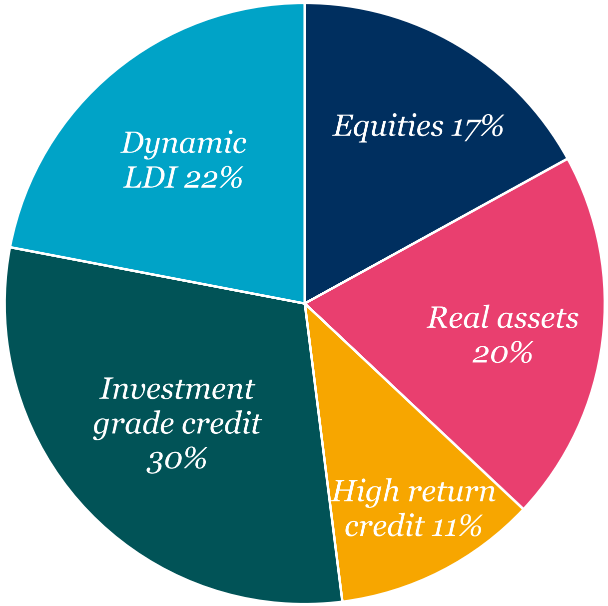
- The latest ideas from our strategy and research teams, and how these ideas can be brought together to build a complete asset portfolio
- A dynamic framework for expressing our views in real time as markets and opportunities evolve
- A transparent representation of our best ideas to stimulate debate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

Portfolio	%	Change
High return credit	**11%**	**-**
Opportunistic credit	3%	-
Private credit	2%	-1%
Infrastructure debt	2%	+2%
Emerging market debt	2%	-
Multi-asset credit	2%	-1%
Investment grade credit	**30%**	**-**
Long dated buy & maintain credit	5%	-
Asset-backed securities	10%	-
Short duration credit	8%	-
Synthetic credit overlay	7%	-

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

Changes to the portfolio since last quarter

Introducing junior infrastructure debt

- Regulatory and industry changes have limited the capacity of banks to lend to infrastructure deals, leaving institutional investors such as pension schemes with a key role in financing projects by investing in **infrastructure debt**.

Typical infrastructure investments

Energy generation	Water networks	Data centres	Ports and transport

- When we talk about investing in infrastructure debt, we typically mean funds that invest in the **junior debt** of projects. This sits between senior debt (most secure and lowest expected return) and equity (least secure) in the capital structure, and therefore avoids the first-loss risk of infrastructure equity while offering an attractive return to investors.
- We advocate accessing via closed ended funds that invest globally.
- The following features make infrastructure debt an attractive investment for pension schemes:

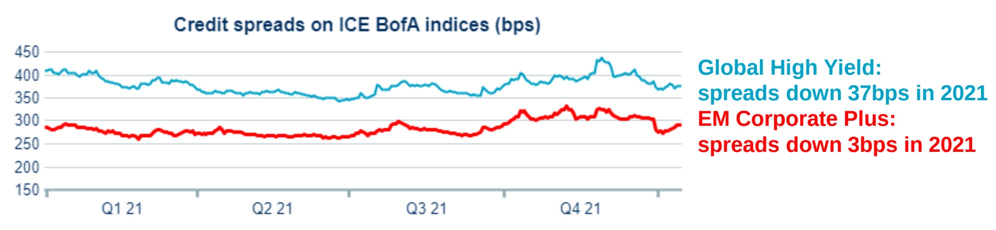
Attractive returns (yields of cash +4-6% pa)

Returns are driven largely by secure, contractual income

- Investors should be aware of the risks associated with infrastructure debt, such as illiquidity and the exposure of certain assets to climate risk. However, in a world where yield can be hard to come by, infrastructure debt has an attractive risk-return profile and we feel that an explicit allocation is justified.
- In the current climate, we are encouraged that the underlying infrastructure assets are expected to be resilient through a high inflation environment.

Funding the infrastructure debt allocation

- We introduce the infrastructure allocation by taking 1% from private credit (in practice using proceeds from mandates as they mature) and 1% from the more liquid multi-asset credit.
- We decided to fund the allocation to junior infrastructure debt from within the "high return credit" asset class as we believe that the landscape has not changed sufficiently to justify changes to the key asset class groups.
- The choice of private credit proceeds to fund the infrastructure debt allocation reflects:
  - We see advantages from diversifying illiquid credit exposures between infrastructure and the assets that back private credit (direct lending to small / medium enterprises and / or real estate).
  - The resultant overall allocation is consistent with our view that pension schemes, as long-term investors, should take advantage of their ability to invest in less-liquid markets, which can offer an attractive additional return over liquid markets (the **illiquidity premium**).
- The decision to disinvest a portion of the multi-asset credit proceeds reflects:
  - Given the tightening in higher yield spreads, we are slightly less positive on liquid multi-asset credit. Therefore, we have biased slightly more towards illiquid credit assets.
  - We continue to see value in emerging market debt. However, while some multi-asset credit funds do allocate to emerging markets, their flexibility to do so is generally limited.



Source: Refinitiv Eikon

The strategic portfolio in review

Reflections on the year

The turn of each year is often a time of reflection. This is particularly true for our strategic portfolio, as we come to the end of the first full calendar year since the portfolio was put in place. We have taken this opportunity to reflect on four key decisions that have shaped the portfolio and impacted performance over 2021.

Maintaining high hedge ratios, with extra return delivered by the synthetic credit overlay

What decision did we make?
Not hedging liability risks offers little (if any) expected return, with a high potential adverse impact on the funding position. As a result, since the portfolio's inception, we have taken the decision to hedge 100% of assets (including the investment of future contributions). We have also included a synthetic credit overlay (sometimes referred to as "credit-linked LDI") in order to boost the expected return of the LDI portfolio.

What was the impact of our action?
Pension scheme liabilities went on a rocky journey over 2021 amid new COVID strains, surging inflation and easing of lockdowns. By maintaining high hedge ratios, we have **minimised the volatility of the funding position** and the returns we need the strategic portfolio to deliver. Meanwhile, the synthetic credit overlay has provided a **capital-efficient source of additional returns** in the portfolio.

Further information can be found in the October 2020 edition of our strategic portfolio.

Re-allocating from corporate bonds to ABS

What decision did we make?
While credit spreads (the additional return investors receive for lending to companies rather than governments) fell over 2021, spreads on equivalently-rated asset-backed securities ("ABS") remained materially higher. This is in part because ABS has not been subject to the same degree of purchases by central banks. Over the year, we increased the ABS allocation from 5% to 10%, and trimmed the corporate credit allocations.

What was the impact of our action?
Trimming credit assets in response to falling spreads allowed us to bank monetary gains, which were reinvested in higher-yielding ABS, which we viewed as more attractive at the time.

Further information can be found in the January 2021 and November 2021 editions of our strategic portfolio.

Increasing the amount of equity protection

What decision did we make?
In September 2020, we established the portfolio with 7% allocations to physical global equities and synthetic protected global equities. Later that year, equity markets soared in response to positive vaccine developments and so in January 2021 we switched from physical to protected equities to protect against future falls.

What was the impact?
Equity markets have continued to rise, so the protection will have acted as **a drag on returns** over 2021. However, a great deal of uncertainty remains about the world's recovery from the COVID pandemic, and so we feel the decision to **manage this downside risk** remains justified.

Further information can be found in the January 2021 edition of our strategic portfolio.

Rebalancing using liquid assets

What decision did we make?
Market movements over Q4 2020 and Q1 2021 gave us the chance to bank some profits by rebalancing the strategic portfolio. Put simply, growth assets - such as equities - outperformed matching assets such as government bonds. We hold a mixture of liquid and illiquid growth assets (such as listed and unlisted property) in order to help make regular rebalancing viable.

What was the impact?
We estimate that rebalancing the portfolio allowed us to **"bank gains" of around £50m** (assuming a portfolio size of £1bn) over six months. A disciplined approach to rebalancing also helps us avoid behavioural biases in investment decision making.

Further information can be found in the April 2021 edition of our strategic portfolio,

In the '2021 wrap' episode of our Investment Uncut podcast, we review the year through an investment lens

Contact us

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