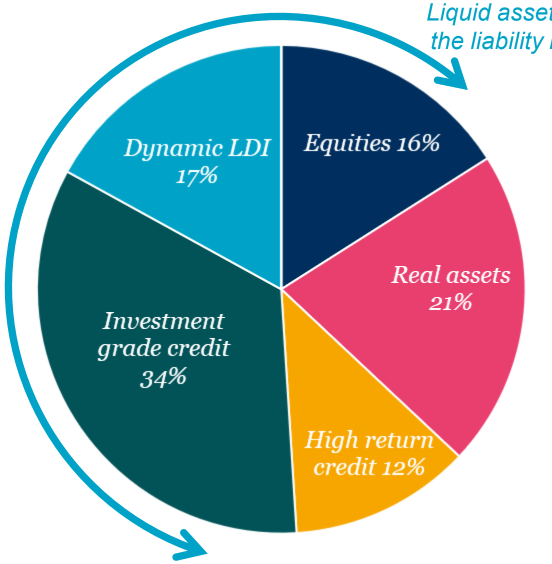
Update on the LCP strategic portfolios

November 2022

Strategic portfolio

Our strategic portfolio highlights the latest ideas from LCP's investment strategy and research teams, and how these ideas can be brought together to construct an efficient asset portfolio.

Liquid assets that are used to support the liability hedging exposures (57%)



Expected return:	Gilts + 2.4% pa
Liability hedge ratio:	100% of assets *including future deficit contributions*
Unhedged currency exposure:	25% of assets

Portfolio	%	Change
Investment grade credit	**34**	**-5**
Long dated buy & maintain credit	6	+1
Asset-backed securities[1]	7	-5
Short duration credit[1,2]	3	-7
Synthetic credit overlay[1]	18	+6

Portfolio	%	Change
Equities	**16**	**+1**
Synthetic equity protection[1]	12	+4
Low carbon global equities[2]	4	-1
Emerging market equities	-	-2
Real assets	**21**	**+4**
Unlisted infrastructure	10	+3
Listed infrastructure	-	-1
Unlisted global property	5	+1
Listed global property	-	-1
Long lease property	6	+2
High return credit	**12**	**-4**
Opportunistic credit	6	+2
Private credit	3	+1
Infrastructure debt	3	+1
Emerging market debt	-	-2
Multi-asset credit	-	-6
Dynamic LDI[1]	**17**	**+4**

The cash and gilts collateral within the bespoke fund (47% of assets) can withstand a c.3.5% rise in yields. Allowing for the other assets within the bespoke fund (57% in total), the strategy can withstand a c.4.5% rise in yields.

[1]Assets all held within a single bespoke fund and used to support the hedging exposures.
[2]These are investments in assets with a specific sustainability bias.
Expected return based on LCP's latest asset class assumptions, and are available upon request.

Asset allocation changes we've made

- Gilt yields rose sharply towards the end of the quarter, and continued to do so post quarter end although they have fallen back more recently. The overall rise in yields meant that the LDI allocation had fallen significantly in value and needed replenishing. We were able to use the high allocations to liquid assets (such as short-dated credit, asset backed securities, listed assets and liquid higher-returning credit) to do this.
- However, as a result of these liquid asset sales, the allocations to illiquid assets have risen over the quarter since it is not possible to sell these holdings at short notice. We have a plan in place therefore to reduce the allocation to illiquid real assets over the next three to six months and replenish the liquid credit holdings (we expect to reallocate to a blend of higher-returning credit and investment grade credit that can support the LDI arrangements).

Rising gilt yields has led to a reassessment of LDI strategies

- Recent experience of just how quickly yields can rise, combined with uncertainty over the government's fiscal intentions, has forced pension funds, consultants and LDI managers to reassess what is a sensible level of collateral to hold in LDI portfolios.
- In order to maintain a scheme's liability hedge ratios and improve the collateral adequacy of the bespoke portfolio, we have increased the proportion of the assets invested in the bespoke LDI fund. The LDI fund's allocation to cash and gilts held can now support a 3.5% pa rise in gilt yields, with a further rise in gilt yields of 1% pa being supported by the assets held in short duration credit and asset-backed securities.
- To compensate for the higher allocation to LDI, and to maintain the target investment return, we have increased the allocations to synthetic credit and synthetic (protected) equities.

Having unhedged currency exposure has benefitted the scheme

- Our portfolio has unhedged currency exposure of around 25% of assets. The fall in sterling this year has helped reduce the drawdown on our growth assets. In our view having some unhedged overseas currency exposure in the strategy (in particular to safe haven currencies like the US dollar) can act to provide protection in stressed markets.

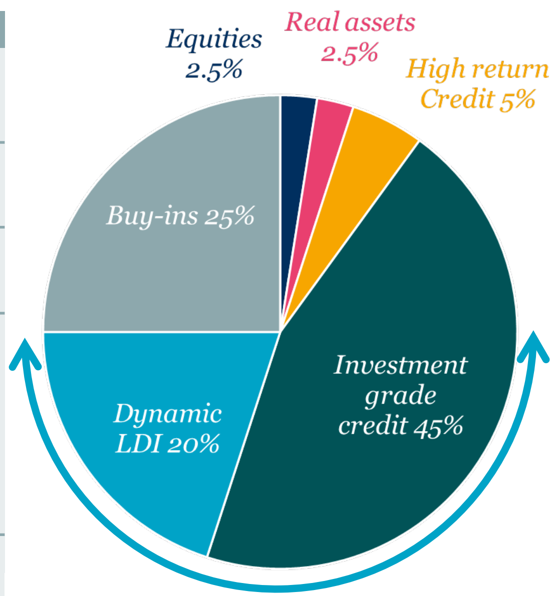
Investment actions that you should urgently be considering

In this webinar, LCP partners Paul Gibney, Ken Hardman and Steve Hodder explained what happened to UK gilt markets over late September, how LDI managers and insurers reacted and what investment actions all UK pension schemes need to now be considering.

Low-dependency strategic portfolio

Our low-dependency portfolio is appropriate for well-funded schemes, and has also been designed to provide flexibility to take advantage of buy-out opportunities.

Portfolio	%	Change
Equities	**2.5**	**-**
Low carbon global equities[2]	2.5	-
Real assets	**2.5**	**-**
Listed infrastructure	2.5	-
High return credit	**5**	**-**
Multi-asset credit	5	-
Investment grade credit	**45**	**-**
Long dated buy & maintain credit	15	-
Asset-backed securities[1]	15	+2
Short duration credit[1,2]	9	-2
Synthetic credit overlay[1]	6	-
Dynamic LDI	**20**	**-**
The cash and gilts collateral within the bespoke fund (26% of assets) can withstand a c.2.0% rise in yields. Allowing for the other assets within the bespoke fund, the strategy can withstand a c.5.0% rise in yields.		
Buy-ins	**25**	**-**
Schemes may wish to use a combination of pensioner buy-ins and other insurance solutions such as longevity swaps		



Assets that are used to support the liability hedging exposures (50%)

Expected return:	Gilts + 1.2% pa
Liability hedge ratio:	100% of assets
Minimal unhedged currency exposure	

[1]Assets that are held within a single bespoke fund and used to support the hedging exposures.
[2]These are investments in assets with a specific sustainability bias.

Ask your consultant

- What yield rise can my LDI portfolio sustain and where can I source additional monies if yields rise significantly?
- How liquid is my investment strategy and should I reassess my liability hedging strategy in light of the ongoing changes in the LDI landscape?

Asset allocation changes we've made

- As with the higher-returning strategic portfolio set out on the previous page, the rise in gilt yields over the quarter has meant that the LDI portfolio has fallen in value and needed rebalancing from growth assets which are significantly overweight.
- However, when rebalancing assets to top up the LDI, we took the opportunity to bias the reallocation towards asset-backed securities, reflecting our favourable outlook for the asset class (see slide 6).

The benefits of maintaining liquidity are clear

- Pension schemes need liquidity in their investment strategies to pay members' benefits, meet collateral (ie cash) calls on their derivative holdings and have flexibility to change asset allocation if needed, especially in times of market stress.
- This is a topic we touched on in more depth in the November 2021 edition of our strategic portfolio and something TPR has written about previously.

> "*…structural weaknesses, including the potential for inter-dependencies to amplify liquidity demands and give rise to systemic risks in the wider financial system, were identified.*" TPR's blog Now is the time to manage liquidity risk

- Our low dependency strategic portfolio is highly liquid and has a sizeable allocation within the bespoke LDI fund to cash and gilts collateral which are used to support the liability hedging exposures. As a result, we have been able to maintain the scheme's liability hedge ratios without needing to make a substantial change to our asset allocation or overhaul the investment strategy.

New developments in ESG for short dated credit

- It's increasingly easy to find an ESG-focused equity fund, with multiple options for investors, including: screened funds, ethical funds, funds with a net zero target, combinations of these and more.
- Historically, there have been fewer options for corresponding funds in the credit space. Of course, responsible investment is a key consideration when rating funds, so any products we recommend will be rated on its integration of responsible investment. However, some investors want to go further than this.
- As a result, we've been working with fixed income managers to set up both long dated buy and maintain and short dated credit funds with explicit net zero targets. We believe this allows investors to access credit in a more sustainable way, and in line with any net zero targets that out clients may have. Please contact your usual consultant or Peter Abrahams, if you would like more information.

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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