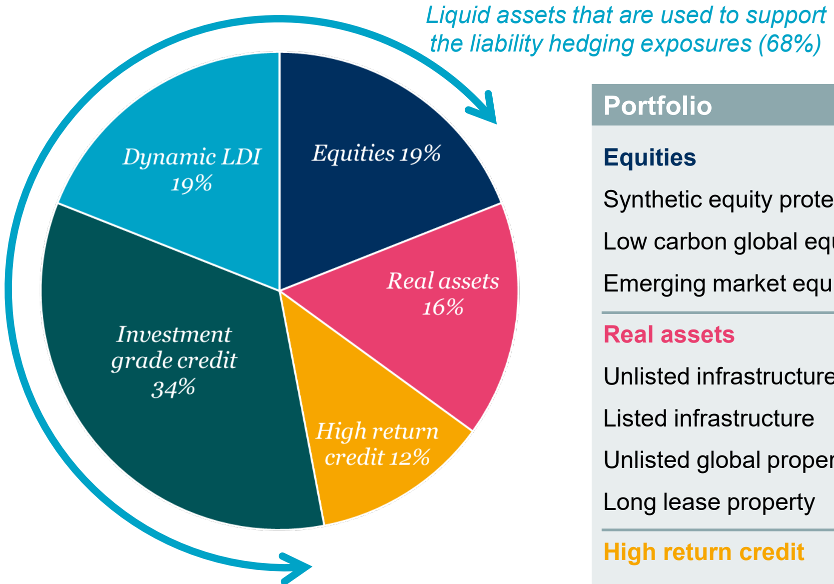
Update on the LCP strategic portfolios

January 2023

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.



Expected return:	Gilts + 2.3% pa
Liability hedge ratio:	100% of assets *including future deficit contributions*
Unhedged currency exposure:	25% of assets

Portfolio	%	Change
Investment grade credit	**34**	**-**
Enhanced ESG long dated buy & maintain credit[1]	6	-
Asset-backed securities[1]	7	-
Net-zero transition short duration credit[1]	3	-
Synthetic credit overlay[1]	18	-

Portfolio	%	Change
Equities	**19**	**+3**
Synthetic equity protection[1]	15	+3
Low carbon global equities	4	-
Emerging market equities	-	-
Real assets	**16**	**-5**
Unlisted infrastructure	5	-5
Listed infrastructure	3	+3
Unlisted global property	3	-2
Long lease property	5	-1
High return credit	**12**	**-**
Opportunistic credit	6	-
Private credit	3	-
Infrastructure debt	3	-
Emerging market debt	-	-
Multi-asset credit	-	-
Dynamic LDI[1]	**19**	**+2**

The cash and gilts within the bespoke fund supporting the LDI and synthetic exposures can withstand a c.**4.1%** rise in yields. Allowing for other assets held within the collateral waterfall in the bespoke fund (ie including ABS and short duration credit), the strategy can withstand a c.**5.4%** rise in yields. The use of long dated buy and maintain can also be used to further support the LDI allocation.

Asset allocation changes we've made

- As outlined in our previous update, we had previously placed redemption requests on some illiquid holdings. Consistent with market practice for those funds, we have now received partial redemption proceeds from unlisted infrastructure and global property.
- To maintain investment returns, proceeds from the illiquid assets were used to reallocate assets to listed infrastructure (see our rationale below), and synthetic equities, which have the added benefit of downside protection – which may prove useful in a recessionary period. The remaining proceeds were used to top up the collateral pool supporting the LDI portfolio, reducing leverage within the Scheme. As a result, the LDI portfolio can now sustain a **c4.1% yield rise**. This is at the upper end of the level suggested in The Pensions Regulator's guidance to DB pension schemes issued in November. Including short dated credit and asset-backed securities, the **total yield shock that can be sustained is now c5.4%**, an increase of around 0.9% from the end of last quarter.

Real assets

- As outlined, we have reduced our allocation to unlisted infrastructure in favour of listed infrastructure. We have a positive view of infrastructure as an asset class (both listed and unlisted funds).
- We believe that the market environment remains favourable for infrastructure. The essential nature of infrastructure ie utilities, power generation and toll roads means that revenues are expected to be resilient in a more recessionary environment. Alongside this, infrastructure has historically delivered strong returns during a high inflation environment, benefiting from the inflation-linked nature of the underlying assets.
- While a listed exposure is generally more volatile than unlisted infrastructure funds (as valuations are marked-to-market on a daily basis), it provides higher levels of liquidity. The features of listed infrastructure also mean that it is often more resilient than global equities in periods of market volatility and higher inflation. As such, we believe the higher allocation to listed infrastructure maintains diversification in the portfolio while increasing liquidity, without materially impacting expected returns.

Enhanced ESG and Net-Zero Credit

- We have reconfigured the long dated buy & maintain credit as an **Enhanced ESG** mandate as we believe longer dated credit assets align with a need for **even greater focus on sustainability-related issues.**
- Issues such as accounting scandals (G), environmental disasters or net zero transition risks (E) or poor labour standards (S) can ultimately impact a company's creditworthiness.
- We note that this mandate sits within the bespoke fund and can therefore be used as last resort as additional LDI collateral after the exhaustion of cash, short dated credit and ABS.

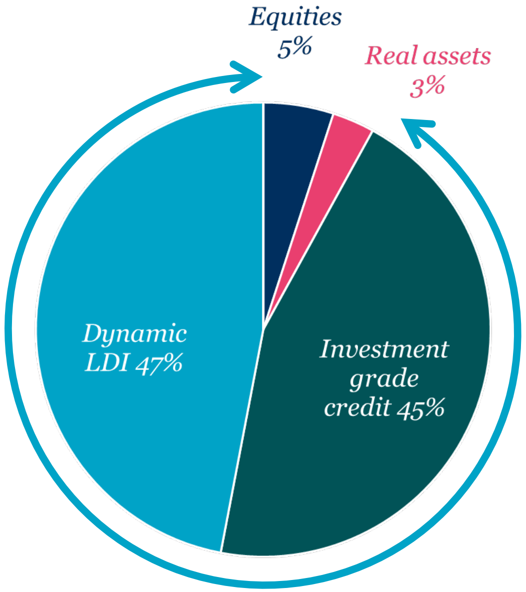
[1]Assets all held within a single bespoke fund and used to support the hedging exposures.
Expected return based on LCP's latest asset class assumptions, and are available upon request.

Low-dependency strategic portfolio

Our low-dependency portfolio is appropriate for well-funded and/or significantly mature schemes, and has also been designed to provide flexibility to take advantage of buy-out opportunities. This portfolio is designed to be consistent with the low dependency investment allocation, and in particular "Fast Track", as outlined in TPR's draft new funding code.

Portfolio	%
Equities	**5**
Low carbon global equities	5
Real assets	**3**
Listed infrastructure	3
Investment grade credit	**45**
Enhanced ESG long dated buy & maintain credit[1]	30
Asset-backed securities[1]	10
Net zero transition short duration credit[1]	5
Dynamic LDI[1]	**47**
The cash and gilts within the bespoke fund can withstand a c.**8%** rise in yields. Allowing for the other assets held within the collateral waterfall within the bespoke fund (ABS and short duration credit), the strategy can withstand a c.**10%** rise in yields. The use of long dated buy and maintain can be used to further support the LDI allocation.	

[1]Assets that are held within a single bespoke fund and used to support the hedging exposures.



Assets that are used to support the liability hedging exposures (92%)

Expected return: Gilts + 1.2% pa

Liability hedge ratio: 100% of assets

Minimal unhedged currency exposure

Ask your consultant

- How does the funding code consultation impact my current investment allocation and the investment allocation I should be heading towards?
- Am I in the position to consider an insurance transaction and if so how should I position my portfolio to prepare for this?

Watch our Webinars: The new DB funding code – the good, the bad and the (potentially) ugly on demand to learn more about the proposal and our follow-up The new DB funding code – a whole new world for covenant advice.

The Pensions Regulator's funding code consultation

The second UK pension scheme funding and investment code consultation was released in mid December. Despite not yet being written into law, this is a significant development in the pension space and will impact every UK DB pension scheme.

Once the new funding code has been finalised, we expect most schemes will be required to set out their low-dependency investment allocation and set out a journey plan for the investment strategy to transition towards this portfolio. Given every scheme will be required to do this, and not every scheme may wish to use insurance solutions, we have also taken the opportunity to remove the reference we previously had opposite to partial buy-in assets, to make the presentation of the portfolio applicable to every scheme. For those that already have/intend to have partial insurance solutions, the portfolio opposite could be considered the strategy for the uninsured members.

Under the draft code, the low dependency investment allocation must be in place for significantly mature schemes, and must have the following investment characteristics:

- broadly cashflow matched, with significant (an expectation of at least 90%) interest rate and inflation hedging;
- highly resilient, with a low allocation to growth assets (with an example of 15% provided); and
- a limit of 4.5% change in funding level in a modelled one year 1-in-6 year stress event.

Furthermore, in addition to the above requirements, to meet the new "Fast Track" requirements in complying with the above requirements, the low dependency investment allocation should also have a stressed funding level change of no more than 1.9%, under a prescribed formula, which encourages further hedging and risk reduction.

Therefore, when setting the allocation for our low-dependency strategic portfolio, we decided that the portfolio should:

- hedge 100% of liability interest rates and inflation sensitivities;
- target an investment return of at least gilts + 1.0% pa, whilst meeting risk limits;
- maintain a low level of leverage in the LDI portfolio, with an appropriate level of assets to support the LDI portfolio; and
- have a material allocation to credit assets, to provide contractual income.

Our resultant portfolio targets an investment return of gilts + 1.2% pa, with an 8% allocation to growth assets. Although this expected return is higher than the required, we note that the Pensions Regulator's low dependency example portfolio includes a 15% allocation to growth assets. The portfolio also meets the low dependency investment allocation's risk test, with a 1-in-6 stressed funding level causing less than a 2% deterioration to the funding level, as well as within the Fast Track stress limit.

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At LCP, our experts help to power possibility by navigating you through complexity to make decisions that matter to your business and to our wider society. We are powered by our desire to solve important problems to create a brighter future. We have market leading capabilities across pensions and financial services, energy, health and analytics.

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