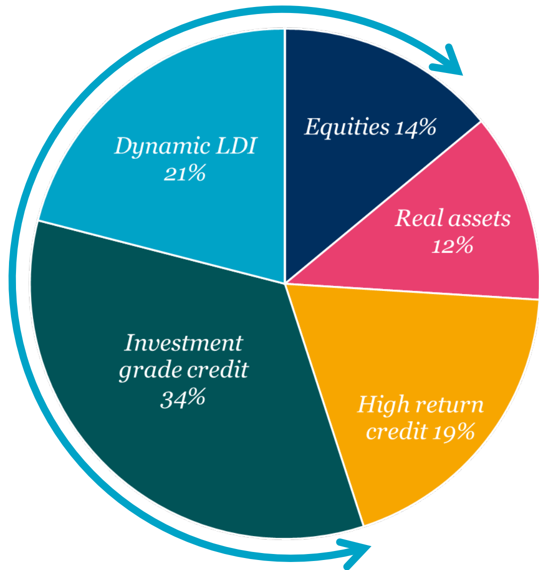
LCP powering possibility

Update on the LCP strategic portfolios

July 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.



Assets that are used to support the liability hedging exposures (65%) include the credit portfolio and synthetic equity allocation

Expected return:	Gilts + 2.1% 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 (ABS)[1]	7	-
Net-zero transition short duration credit[1]	3	-
Synthetic credit overlay[1]	18	-

Portfolio	%	Change
Equities	**14**	**-5**
Synthetic equity protection[1]	10	-5
Low carbon global equities	4	-
Emerging market equities	-	-
Real assets	**12**	**-4**
Unlisted infrastructure	5	-
Listed infrastructure	3	-
Unlisted global property	2	-1
Long lease property	2	-3
High return credit	**19**	**+7**
Opportunistic credit	8	+2
Private credit	5	+2
Infrastructure debt	3	-
Emerging market debt	3	+3
Multi-asset credit	-	-
Dynamic LDI[1]	**21**	**+2**

The bespoke fund, which supports the LDI strategy and synthetic exposures, can withstand a c4% increase in long-dated yields before capital in the fund is exhausted. Allowing for other assets within the collateral waterfall[2], we estimate the overall strategy can withstand a c5.4% rise in yields.

Watch our Webinars: The future of contingent funding where we explore the role that contingent funding solutions has to play in the new pensions landscape.

[1]Assets all held within a single bespoke fund and used to support the hedging exposures. [2]Collateral waterfall includes ABS and short-dated credit. Expected return based on LCP's latest asset class assumptions and are available upon request.

Asset allocation changes we've made

- We have now received some proceeds from our long lease and unlisted global property redemption requests made last year.
- Over the quarter, we saw growth assets deliver positive returns, including global equities. We have therefore decided to bank some of the gains made from that asset class. This reflects our ongoing somewhat pessimistic view of equities, given the challenging global outlook and relatively high valuations, both of which are exerting downward pressure on our equity return assumptions. We've put the proceeds from equities and property redemptions to work in credit, an asset class we currently view more positively, following the rise in yields and the fact that we see credit assets being more resilient than equities in any recessionary downturn. Our new credit allocation is diversified, incorporating private and opportunistic credit, and reintroducing emerging market debt.

Investing in private credit on the secondary market

- Following a period of gilt market volatility, we've been mindful of portfolio liquidity. However, since we've now bolstered our portfolio's resilience to yield shocks and given our LDI manager's access to our broader asset base for collateral purposes, we have confidence to consider opportunities in some less liquid investments.
- Currently, the income generated by private credit is significantly higher than historical norms. In addition, some pension schemes (for example those undertaking insurance transactions, or those with liquidity issues) have been willing to sell their holdings at a discount, creating a unique and attractive entry opportunity.
- We are aware of the risks associated with private credit in the current market, but our approach is to invest in a fully mature, diversified portfolio instead of gradually building up our allocation. To capitalise on any future volatility, we've also increased our allocation to opportunistic credit, an asset class that targets the significant upside from currently non-performing, but still viable, securities.

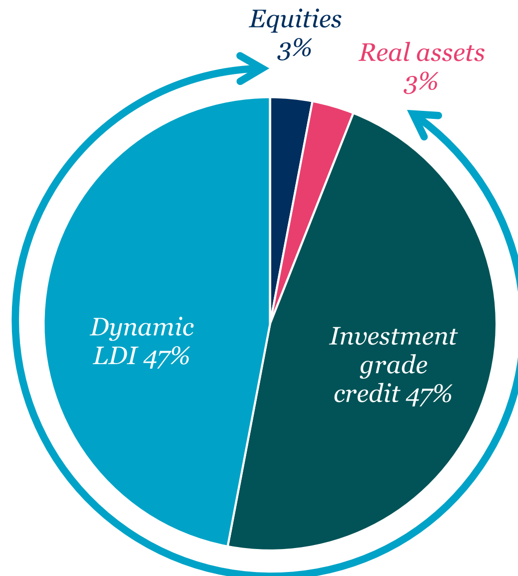
Investing in emerging market debt for diversification

- During the gilt market crisis, we redeemed our holdings in emerging markets, both equity and debt, to provide liquidity to support the LDI portfolio.
- Despite lingering geopolitical risks, our outlook on emerging market debt is positive. This reflects the positive way in which central banks in those markets responded to inflationary pressures, hiking rates quicker and more aggressively compared to developed market counterparts. As a result, investments in these regions now provide a positive real yield.
- When allocating to emerging market debt, we recommend a blended approach (investing across local and hard currency sovereign alongside corporate bonds) allowing our manager invest in the best opportunities from what is a well-diversified and broad asset class. Overall, allocating to emerging market debt can add diversification to our overall portfolio without materially affecting the liquidity profile.

Low-dependency strategic portfolio

Our low-dependency portfolio is appropriate for well-funded and/or significantly mature schemes while also being designed to provide flexibility in taking advantage of insurance opportunities. This portfolio is consistent with a low dependency investment allocation, and in particular "Fast Track", as outlined in TPR's draft new funding code.

Portfolio	%	Change
Equities	**3**	**-2**
Low carbon global equities	3	-2
Real assets	**3**	**-**
Listed infrastructure	3	-
Investment grade credit	**47**	**+2**
Enhanced ESG long dated buy & maintain credit[1]	32	+2
Asset-backed securities[1]	10	-
Net zero transition short duration credit[1]	5	-
Dynamic LDI[1]	**47**	**-**
The bespoke fund, which supports the LDI strategy and synthetic exposures, can withstand a c9% increase in long-dated yields before its capital is exhausted. Taking into account other assets within the collateral waterfall, such as Asset-Backed Securities (ABS) and short-dated credit, we estimate the overall strategy can withstand over a 10% rise in interest rates before hedging is removed.		



Assets that are used to support the liability hedging exposures (94%)

Expected return: Gilts + 1.0% 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.

Ask your consultant

- What additional yield rise could we sustain if our LDI manager incorporated corporate bond repos into the collateral waterfall?
- Should I consider an allocation to emerging market debt?

Asset allocation changes we've made

- In Q2 2023, our low dependency portfolio experienced volatility due to rising yields whilst growth assets delivered positive returns. However, the overall impact of these movements on the portfolio was modest.
- Whilst we are not making major changes at this time, consistent with the update made to our higher-returning strategic portfolio, we've scaled back our equity holdings. Given the low-risk nature of this portfolio, we have invested proceeds into high quality credit.
- This decision was prompted by our current market views. We find credit assets to be more appealing, given the elevated yields and the protection on offer for economic uncertainty.

Using corporate bond repos for additional liquidity in the portfolio

- LDI has been the subject of much debate (some bits of it more enlightened than others) since the gilt crisis in October 2022. With the majority of regulatory changes now in place, the industry is developing new ways to make investment portfolios efficient and well collateralised.
- The Bank of England has concerns that a run on UK credit could create a systemic market risk and is currently investigating how this might unfold. We therefore believe it is important for investors to develop mechanisms to ensure that they are not a forced seller of credit at inopportune times. One such idea for pension schemes with segregated/bespoke LDI portfolio is to use corporate bond repos to generate additional liquidity.
- So how do repos work? If your scheme owns bonds (government or corporate) the scheme's LDI manager can enter into a "repo" agreement with a counterparty. This involves two transactions:
  1. **The sale of the bonds to the counterparty** – this will raise an amount of cash.
  2. **The agreement to buy back the bonds at a future date, at an agreed price** – the agreed price is expected to be higher than the sale price, and this difference reflects the implicit repo interest rate, but crucially the mechanism allows an investor to retain exposure to the underlying bond.
- The combined transactions make the arrangement similar a collateralised loan, with the bonds acting as underlying security on the loan. This allows funds to be raised to top up the collateral pool without selling bonds and crystallising potential losses when liquidity is needed.
- Other solutions are also being developed, such as using corporate bonds to directly collateralise derivative positions and improve the position of a scheme to withstand yield rises.
- For smaller investors, such as those limited to pooled funds, credit repo is not usually available, but forced selling risks can be mitigated through other tools. One such approach is to hold larger cash buffers and access credit through a derivatives overlay (often referred to as "credit-linked LDI") thus reducing forced selling risks and maintaining hedges. Compared to holding both LDI and corporate bonds, this approach worked well during the LDI crisis.

Watch our Webinar: Powering possibility in pensions – making the most of £1.5trn DB assets where we discuss our proposal for using DB pension schemes to invest in growth.

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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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