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INVESTMENT MANAGERS

Investment viewpoint

Enhance de-risking by rethinking growth allocations

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Lessons from 2022's 'triple shock'

UK pension funds suffered a volatile 2022. In many cases, schemes endured a triple shock: a liquidity event, rebalancing difficulties and asset drawdowns. But a fall in liability values also helped to improve funding ratios for many plans.

For some corporate schemes with liability-driven investment strategies, the liquidity squeeze was particularly acute: they had to raise collateral within a short timeframe and review asset allocations, which impacted rebalancing ranges.

As public markets declined, many corporate and local authority plans also had to reconsider their allocations to private markets as the denominator effect significantly increased these weightings. In other words, lower valuations for liquid assets reduced the overall asset values of portfolios, while simultaneously increasing private-markets allocations as a percentage of the total, leading to these allocations becoming significant overweights.

Overall, while funding ratios improved for many schemes, a key issue persisted: the continued maturation of the average pension plan brought forward its time horizon (potentially increasing its cashflow-negative status) and further reducing its tolerance for liquidity and drawdown events.

How can schemes resolve this problem? While a lot of focus is on their low-risk portfolios (and rightly so), we believe an answer also lies in how they structure growth allocations. In our view, a resilient and liquid growth portfolio can provide pension plans with the flexibility to both embrace private markets if necessary and reduce the risk of having to adjust the low-risk or liability-matching portfolio – which is even more important as schemes de-risk.

Rethinking growth portfolios

How can a pension scheme's growth portfolio be improved, and what tools are available to implement these changes? How can they become more resilient, providing greater support during a plan's de-risking journey? In our view, investors should consider how the positive features of growth portfolios can be best harnessed while still ensuring that trustees can manage the governance challenge.

Key beneficial characteristics of growth allocations include the following:

- **Diversification potential.** Diversification remains the last free lunch in investment. Unfortunately, when both bonds and equities fall, there are very few places left to hide. So other exposures and strategies are needed, which can be built into growth allocations
- **Sustainability integration.** As the quantity and quality of sustainability data – especially that linked to climate risk – improves, so does the effectiveness and credibility of integration. This potentially benefits performance and improves alignment with growing regulatory demands
- **Access to liquidity.** Ensuring access to diverse liquid instruments, and embracing tools like equity and bond futures – which often have more liquidity during crisis periods – increases the efficiency of implementation
- **The cash option.** Many growth portfolios de-risk internally by increasing bond exposures while reducing equity holdings. However, this makes little difference when both asset classes are falling. In these situations, moving into cash provides the ultimate protection
- **Adapting to the unexpected.** Some events are impossible to predict and have materially negative portfolio impacts that require long recovery periods. This is where overnight or short-term insurance delivered through options strategies is key. But these hedges have a price, and need to be scaled relative to the overall risk being taken so that a portfolio is not under- or over-exposed

What have we done?

We have designed a diversified growth fund (DGF) strategy, through our All Roads range, that aims to embrace all of these beneficial features. Stability of returns, liquidity and capital protection are the central pillars of our investment philosophy. In particular, our capital-protection framework is built on drawdown management.[1]

Two recent market drawdowns demonstrate our agility in this respect:

- **2020 covid sell-off.** Our dynamic drawdown methodology (DDM), which has been live since our January 2012 inception and improved since then, enables us to maintain diversification throughout periods of stress by scaling down the entire portfolio while allocating to cash. During the acute stages of the pandemic sell-off, we reduced overall portfolio exposure to 35% in March 2020, while taking profit on overnight insurance throughout the tumult. We were fully invested again by July 2020[2]
- **2022 market rout.** During last year's real rates and energy-price shock, our commodities exposure contributed positively, combining with DDM to help limit the severity of the drawdown

Central to the pursuit of our objectives are two risk-management features:

- **Treating drawdown, not volatility, as a risk measure.** We explicitly reduce market exposure when our diversified portfolio is affected by negative markets. This approach has enabled us to deliver our return target with one-third of the volatility of equities[3]
- **Enhanced liquidity.** Efficient implementation and daily rebalancing are crucial to achieving the risk exposures our clients seek, and the stable returns and drawdown limitations we aim to deliver

All Roads: a liquid growth exposure

Through All Roads, we offer a balanced strategy targeting a total return of cash plus 3-5%, which is similar to the performance objective of a traditional DGF. We have an explicit maximum drawdown budget of 10%, equivalent to about one-third of drawdowns experienced by equity markets historically, which drives our risk management.[4]

Our growth-oriented strategies seek cash plus 6-8% or even cash plus 8-10%[5]: goals that could enable an invested pension fund to release more cash without diluting returns from its growth portfolio.

1 Capital protection/capital preservation represents a portfolio construction goal and cannot be guaranteed.
2 Source: LOIM as at January 2023. Asset allocation/portfolio composition is subject to change. For illustrative purposes only.
3 Source: LOIM, Bloomberg as at January 2023. Comparison based on the 5% volatility of the All Roads NA EUR share class and the 15% volatility of the MSCI World Index (EUR, net) on 30, 50 and 100-day measures dating back to January 2012. All Roads inception date: 19 January 2012.
4 Source: LOIM, Bloomberg as at January 2023. All Roads targets a one-year maximum drawdown of 10%. Comparison based on All Roads NA EUR share class's -10% drawdown since inception and the MSCI World Index's -33% drawdown over the same period. All Roads inception date: 19 January 2012.
5 Source: LOIM. Target performance/risk represents a portfolio construction goal. It does not represent past performance/risk and may not be representative of actual future performance/risk.

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