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60-second summary

Opportunistic de-risking in the LGPS

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As funding positions and bond yields rise, is de-risking on the table? Philip Pearson considers the next steps for LGPS funds.

Market background

Many LGPS funds have seen significant improvements in their funding position in recent years. At the same time, the lower-risk assets commonly used to protect portfolios by providing some degree of funding stability are looking much more attractive. Index-linked gilts and sterling corporate bonds, for example, are trading at higher yields than they have for the last 15 years. It seems reasonable, therefore, to consider whether now is a good time to de-risk portfolios.

The answer will be very specific to individual funds. However, in our experience, there's often less scope to de-risk than one might expect. There are two main reasons for this. First, investment strategies are designed to deliver the returns required to meet not only the past service liabilities reflected in current funding levels, but also the costs of future service. These costs have faced significant upward pressure in recent years from higher-than-expected inflation and benefits changes such as McCloud. Asset values have also fallen over the last year, which means, all else being equal, that asset portfolios will need to deliver higher returns.

Most funds have been de-risking for many years by reallocating capital from equities into real assets and other income-producing assets, a process which continues today. This has enabled them to capture the benefits of diversification – lower risk with similar expected returns – which, naturally, is a preferable approach to risk mitigation.

Nonetheless, if real yields and credit spreads remain at or above current levels, there may be the opportunity for some funds to lock in additional protection through a moderate reallocation of capital into protection assets. Whilst this will reduce expected returns (compared to no de-risking), lower investment risk should improve the stability of future contribution rates.

Decision factors

It follows, then, that the decision to de-risk is complex. A wide range of factors need to be considered including:

- current funding position
- risk appetite
- the value stakeholders attach to lower contribution rates today versus stability of rates in the future

- impacts on the wider portfolio and the associated transition costs

Next steps

What should funds do to prepare themselves to take the decision on de-risking and then, if appropriate, implement it? We suggest the following actions:

1. Undertake analysis to understand the circumstances under which de-risking would improve long-term funding outcomes, and to determine how much capital should be reallocated.
2. Establish an appropriate mix of protection assets and select appropriate investment vehicles.
3. Identify sources of funding for the capital to be reallocated.
4. Ensure that delegated authority is in place to implement the necessary transactions, noting that the high levels of volatility in government bond and credit markets mean that attractive entry points may be short-lived.
5. Set clear criteria for initiating/phasing the reallocation ('trigger levels') and ensure a process is in place to monitor them.

Hints and tips for de-risking success

Many funds have historically reduced investment risk and protected funding positions using gilts and investment-grade sterling corporate bonds or, in some cases, derivatives with similar investment characteristics. These assets will continue to play an important role in portfolios, not least because they're naturally well matched to funds' sterling-denominated liabilities. Consideration of alternatives has been limited in part by an understandable desire to avoid unnecessary portfolio complexity.

A material increase in the allocation to protection assets may warrant further consideration of alternative asset types. These include alternative asset classes such as overseas bonds (including green bonds), investment-grade loans (often secured against real assets) or asset-backed securities. Such assets can add value by providing exposure to alternative return premia for risks like liquidity and complexity. They may also offer potential diversification because they respond differently to economic drivers. Alternatives also include different approaches to managing existing asset classes, such as buy-and-maintain credit, for example.

Identifying the source of funding may be less exciting than picking new investments, but it's no less important. The simplest approach may be to scale back other allocations pro rata. But a more nuanced approach can allow funds to deal with longstanding issues like concentrations of risk elsewhere in the portfolio and to take into consideration other factors such as asset liquidity. Whatever the drivers are, we believe it's worth investing time to properly consider this aspect of any de-risking transaction.

Another option is thinking about improving the quality of the assets in which you invest. This could be through pivoting from lower grade credit to higher grade credit assets. Opportunities to implement this sort of shift could be in the liquid space, moving from high yield to investment grade, or focussing new commitments to private credit on senior secured lending as flows come back from existing allocations.

Major shocks to economies and financial markets often lead to fundamental changes in market structure and investment strategies – albeit usually with a delay. After the Global Financial Crisis, for example, we saw private debt replace bank lending and dramatic growth in private markets generally. It will be fascinating to see what impact the shocks that affected the global economy in 2022 will have on portfolios, both generally and specifically in relation to the mix of return-seeking and protection assets.

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