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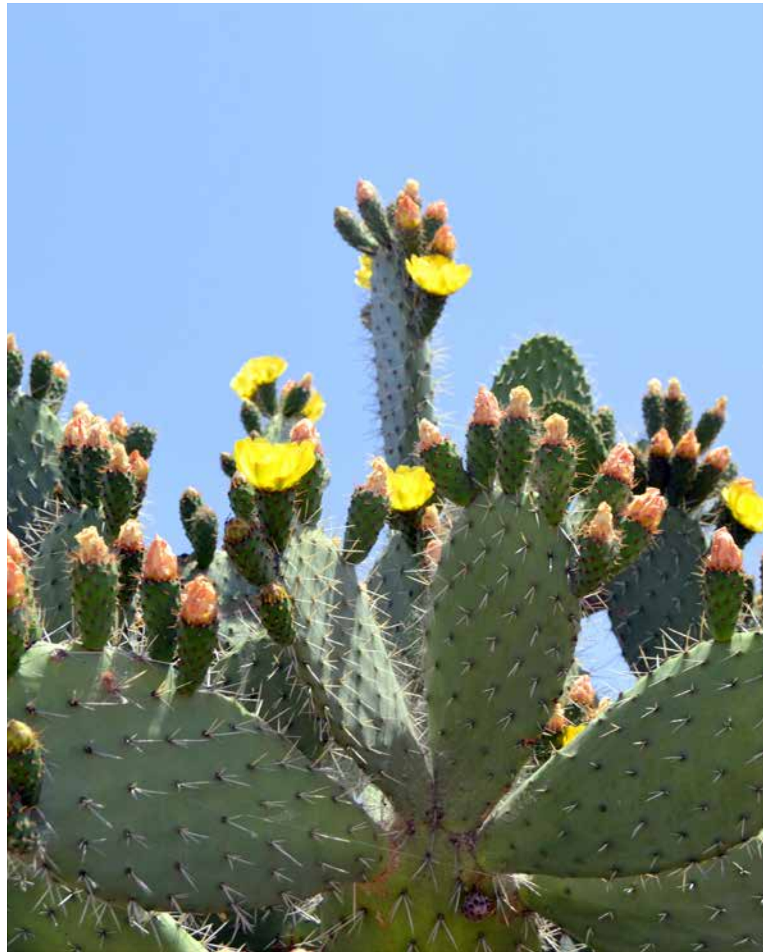
Four ways to make DB strategies even more resilient

We discuss how schemes can navigate a thorny investment landscape – and prepare themselves for buyout.



In light of the unprecedented volatility exhibited by UK markets this year, many defined benefit (DB) schemes are reviewing their investment strategies to ensure they are as resilient as possible in the face of a macro environment that is likely to remain challenging.

In this piece, we outline four key areas we believe to be critical to this objective, which will enable schemes to meet their ultimate goal: paying members' pensions as they fall due.

1 Lower leverage

Liability-driven investment (LDI) portfolios will likely have lower levels of leverage in the future, with more collateral now required to support a specific level of exposure to ensure portfolios remain robust as gilt yields fluctuate. Collateral assets held within LDI portfolios are typically held as gilts and cash. In addition to this, we believe pension schemes should consider holding other assets alongside LDI portfolios to enable their collateral buffers to be replenished rapidly in the event of extreme market moves.

In our view, other investments held alongside LDI strategies should be both liquid and readily accessible. Where schemes hold corporate bond portfolios alongside their LDI portfolios, credit repo could be used, where appropriate, to access some additional liquidity on a short-term basis.

2 Diversifying sources of liquidity and returns

Seeking liquidity (and potentially investment returns) from a diverse mix of assets is another way of helping DB strategies to weather market squalls and make them better-placed to replenish collateral buffers, where required.

Such sources, which can offer liquidity and returns in excess of gilts – alongside aligning with different environmental, social and governance (ESG) objectives where relevant – include the following strategies:

- Absolute return bonds
- Short-duration credit
- Multi-asset credit
- Diversified growth strategies
- Other equity and fixed income strategies

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3 Accessing assets that can pay pensions

Assets with contractual cashflows that can be used to pay pensions, such as buy and maintain (B&M) credit strategies, contribute to liability hedging (without increasing leverage) and offer the potential for additional returns in excess of gilts.

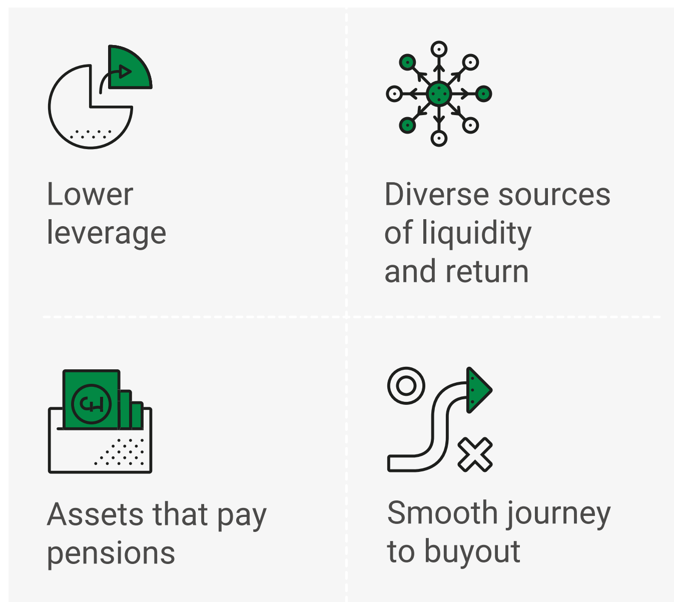
Other examples include secure income assets, which may be more appropriate for schemes with lower levels of leverage and a focus on matching long-term cashflows, given their liquidity profile.

4 Integrated portfolio management

To make DB strategies even more resilient, we believe it can be helpful to manage these elements on an integrated basis to enable a rapid response to changing market conditions. We sketch below an illustrative investment strategy for an example scheme that is aimed at doing just that.

Example portfolio

- Gilts & cash - 40%
- Absolute return bonds - 4%
- Short duration credit - 4%
- B&M credit - 12%
- Diversified growth - 40%
- Interest rate hedge - 100%
- Inflation hedge - 100%



Source: LGIM, for illustrative purposes only. Illustration as at 1 November 2022 based on example scheme with c16-18 years duration.
The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Our analysis suggests such a scheme would be able to maintain significant collateral headroom by allocating about 40% to gilts and cash; a further 20% to a combination of absolute return bond, short-duration credit and B&M credit strategies; and with 40% allocated to diversified growth strategies. The allocations could be managed on an integrated basis to maintain the headroom held in gilts and cash at the appropriate level over time.

What's more, the integrated portfolio could be evolved over time to help pay pensions or to move towards buyout. LGIM, for example, could manage the portfolio to deliver a specific schedule of cashflows tailored to the scheme's pension payroll. In addition, where schemes are targeting buyout, we could manage the portfolio towards that target with a credit allocation designed to reflect the drivers of buyout pricing, which evolves over time, to help achieve the scheme's ultimate goal.

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Contact us

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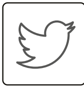

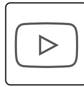

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