Structural future-proofing: Easy wins for the long term?

Local Government Pension Scheme (LGPS) funds face long-term structural challenges including geopolitics, the environment, aging member demographics and cost pressures. All of these could potentially damage investors’ outcomes.

As asset allocation is the main driver of outcomes for LGPS funds’ allocations, modest allocation changes potentially offer easy long-term wins for schemes. These wins include reducing geopolitical risk by adjusting regional allocations, increasing diversification by asset class to reduce overall risk and applying part of the active risk budget to asset allocation which is a key driver of investment outcomes. Within the LGIM Asset Allocation team, we face similar decisions to those of LGPS funds; the asset classes, regions and currencies we invest in, as well as the opportunities and costs that come from how actively we manage those exposures.

HOW EXPOSED ARE SCHEMES’ FUNDS AND WHAT CAN BE DONE?

By considering how exposed portfolios currently are to these themes, LGPS funds can identify simple, structural solutions that reduce risk to specific outcomes that we do not expect to be rewarded. For example, climate change and environmental damage could be viewed as a significant risk that the most exposed companies all face at the same time and so it is worthwhile understanding total exposure and potentially reducing it.

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How funds deal with issues they identify depends on their investment beliefs such as their conviction in active or index tracking investment. Importantly, solutions can be found in a wide range of asset classes and regions that are consistent with different investment beliefs.

To illustrate the potential wins that can be achieved in terms of long-term challenges we now turn to LGPS funds and their average asset allocation and focus on how, as an example, geopolitical risk can be mitigated. We then move on to also address issues raised by recent draft regulatory guidance.¹

GEOPOLITICS: THE RISKSPOSED BY THE RISE OF POPULISM
For the Asset Allocation team, the rise of populism as part of a ‘New Political Paradigm’ has been an important theme in recent years. The world has seen a shift towards anti-establishment politics and policies, driven by factors including rising inequality. President Trump’s election and Brexit immediately spring to mind but there are plenty more examples across developed countries (Figure 1).

While it is easy to be fooled by hindsight, the outcomes were hard to predict in many cases. As a result, we focus on preparing for the risk of different outcomes, rather than predicting any particular one. This means we would avoid too much exposure to any single region or country so that we are not overly exposed to the dynamics in any particular place.

Of course, one reasonable explanation for a large allocation to a particular region would be if investors expected it to outperform consistently over the long term. But in a recent conference, only 16% of delegates thought that one region should be expected persistently to outperform others².

Alongside the economic risks that come from investing in a particular region, we think it is also important to recognise how political risks can also undermine investor outcomes. To understand what this means for the LGPS, we turn to our estimate of the average fund’s investment strategy.

1. Draft statutory guidance on asset pooling in the Local Government Pension Scheme, 2019
2. LGIM Investment Conference, Investing In A Future World, January 2019
ESTIMATED AVERAGE LGPS FUND OVERLY EXPOSED TO US AND UK ASSETS

Based on our estimate of the average LGPS fund (Figure 2), they could be overexposed economically and politically both the US and UK. This includes exposure within assets like private equity, infrastructure, corporate bonds and real estate.

**Figure 2: Estimated average LGPS fund asset allocation**

Source: PIRC annual review 2018 and LGIM

**EASY WIN #1: INCREASING DIVERSIFICATION BY ADJUSTING REGIONAL ALLOCATIONS**

**Diversifying US exposure**

Given the combination of beliefs on regional performance and the risks posed by the New Political Paradigm, we would tend to reduce US exposure more and diversify it elsewhere.

**Diversifying UK exposure and pensions’ inflation risk**

Over-concentration in UK growth assets should be a particular concern for LGPS funds. If the UK performs poorly relative to the world economy, then UK equities, corporate bonds and property would be likely to underperform at the same time as local government income falls. Not only that, but if sterling falls as a result, inflation-linked pension payments could also rise. For example, certain Brexit outcomes such as a disorderly exit, could lead to poor UK growth asset performance and significantly weaker sterling.

The solution for growth assets is similar to the US case; all else equal LGPS funds should consider diversifying regional exposure further. However, mitigating the UK inflation risk is more difficult, because UK inflation-linked gilts appear to be poor value relative to similar markets abroad. Market pricing implies that the Bank of England will miss its inflation target by about 0.6% per annum over the next thirty years (Figure 3). That’s a very different picture than in US or eurozone inflation markets, where the central banks are expected to undershoot their inflation targets. We do not believe that is because inflation expectations are really so different, but rather that UK Defined Benefit corporate pension scheme derisking is distorting the UK market, making it relatively expensive compared with the US and eurozone.
For us as diversified growth investors, and for LGPS as defined benefit funds that remain open to future accrual and new members, it may therefore be more attractive to access inflation sensitivity elsewhere. To the degree that a diversified multi-asset strategy is more worried about global than local inflation, US and eurozone inflation may be alternatives (Figure 4). This can be paired with significant overseas currency exposure, which helps provide protection against a localised UK crisis or sustained unexpectedly high UK inflation, either of which would likely see sterling weaken – approaches we take in our multi-asset growth strategies.
EASY WIN #2: INCREASING DIVERSIFICATION BY ASSET CLASS

It’s noticeable that relative to our own portfolios, the average LGPS fund’s allocation to alternative credit is low. Given the unpredictability of how different asset classes perform through the economic cycle, and also that within any country the reaction of different assets to political shocks will differ, we also tend to allocate more to diversifiers like high yield bonds and emerging market debt. For example, while emerging market debt performed poorly in Q1 2018, it held up well when US growth concerns surfaced from October 2018 onwards. Infrastructure too gets a particular mention in the recent draft guidance on pooling, because of the attractiveness of long-term, stable cashflows and physical assets backing the investments.

EASY WIN #3: APPLYING PART OF THE ACTIVE RISK BUDGET TO ASSET ALLOCATION COULD HELP LEAD TO BETTER OUTCOMES

The recent draft LGPS guidance on pooling reinforces the government’s cost conscious approach to investment. It comments that pool members should include more passive investments if active funds underperform, which feels like a one-way shift given no similar commentary on when to consider more active strategies.

The current level of active fund use implies that many LGPS funds believe it adds value to the range of potential investment outcomes. The pool members and pool companies then need to consider how to reflect those investment beliefs most effectively given the drive towards lower overall fees.

Given the importance of asset allocation, it makes sense to apply part of that risk budget in that area. For tactical asset allocation, the guidance suggests that tactical asset allocation should be done primarily by the pool company. However, it may be that a combination of the pool company and pool members believe that the resources or opportunity set needed are better suited to a specialist firm, just like with active management within asset classes. If so, that could lead to a strategic allocation to a third party manager, chosen in a similar way to the other active managers.

Applying part of the active risk budget to asset allocation could be one way to combine pool members’ beliefs with the drive for lower overall fees, as unconstrained asset allocators vary exposures across asset classes and regions in a similar way to how some individual active managers increase and decrease total risk within their asset class mandate.

STRUCTURAL FUTURE-PROOFING

We believe that by adjusting regional allocations, increasing diversification by asset class and applying part of the active risk budget to asset allocation investors can build more structurally resilient portfolios that tackle issues like politics, costs, sustainability risks and cashflow requirements to pay pensions. In general, the wide range of index-tracking and active solutions allows LGPS to stick to their beliefs on the benefits and costs of active management and illiquid asset classes while tackling these concerns. Prioritising these decisions has the benefit of transforming the high level risks to which LGPS funds are most exposed.