LGIM Buy-out Aware fund range
Preparing for the endgame

A fund range specifically designed for DB pension schemes targeting buy-out
Is your scheme looking towards buy-out?

There is an increasing focus for pension schemes to reduce both the funding level risks in pension schemes and the reliance on the corporate sponsor for schemes’ future health.

A popular way for pension schemes to achieve this is to transfer this risk to insurance companies. This process is traditionally known in the pension industry as buy-out. There was £10.2bn of market activity undergoing buy-out in 2016 in the UK alone. A buy-out can also be an attractive way for companies and trustees to reduce the resources dedicated to managing the scheme.

By making use of a buy-out aware investment strategy, scheme assets can also be more aligned with changes in buy-out pricing, helping schemes on their journey towards their endgame objective of achieving a scheme buy-out.

CONSIDERATIONS FOR A BUY-OUT AWARE INVESTMENT STRATEGY

When focussing on a buy-out (or buy-in) aware investment strategy, it is important to consider what drives changes in buy-out prices. We believe that buy-out pricing is driven by a number of factors. No one factor determines them over the medium term, but government bond yields and credit (corporate bond) spreads are certainly fundamental to the changes.

KEY FACTORS WE CONSIDER:

- Annuity pricing from a range of insurers
- Insurance industry regulatory and investment constraints
- Corporate bond and gilts market data

Combining these three inputs helps develop a picture of the average insurance company asset allocation used to price buy-out policies.

To build a buy-out aware portfolio we invest in assets that are similar to those that a typical insurance company would hold and are sensitive to the key factors. In this way, as buy-out pricing changes, a scheme’s assets should move in a similar way.

Credit allocation is a key factor; we scale our credit exposure according to our analysis of what credit allocation insurers are using in their pricing assumptions.

Actively managing corporate bond exposure

Source: L&G/LGIM calculations

1. LCP pensions de-risking report 2016: Buy-ins, buy-outs and longevity swaps.
2. LGIM’s view of the proportion in corporate bonds which is most consistent with current annuity prices. Tilting shown for the Pre-retirement Fund.
LGIM BUY-OUT AWARE FUNDS

Our Buy-out Aware Funds offer a simple-to-access solution to allow schemes to create their own tailored buy-out aware investment strategy.

To achieve your scheme’s endgame requirements the funds focus on three key objectives:

1. Minimise buy-out funding level volatility
   ...by investing in assets that reflect the primary drivers of buy-out pricing 100% hedged for rates and inflation.

2. Improve buy-out funding level
   ...by investing in credit assets to generate an expected yield above the evolution of the buy-out price.

3. Minimise buy-out transition cost
   ...by investing in assets which can be transferred efficiently at low cost to the life insurer.

The range is comprised of four funds which can be combined according to a scheme’s needs to achieve a tailored solution reflecting the proportion of its liabilities that are real (i.e. inflation-linked) or fixed (i.e. with no inflation linkage) as well as the age profile and life expectancy of its membership. The funds will each have reference to a specific liability profile.

The four funds each have the same underlying components, implemented using established building blocks from LGIM’s pooled fund range.

- **Buy and maintain credit**: Aims to deliver the benefits of an annuity-style investment approach, providing a degree of matching to buy-out pricing

- **Buy-out aware credit**: We scale overall credit exposure via our index funds to maintain the relevant exposure to credit. By using our index funds, we are able to make adjustments efficiently to the funds

- **Liability matching assets**: It is also crucial to minimise interest rate and inflation risks relative to the liabilities. We do this using a combination of liability matching pooled funds, including cash, government bonds and LDI funds

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Illustrative asset allocation

- **45%** Buy-out aware credit
- **30%** Buy and maintain credit
- **25%** Liability matching assets
USING THE FUNDS IN PRACTICE
The funds can be used by clients that are in various stages of their progression towards their ultimate target of buy-out.

1. Matching portfolio asset
Providing a gilts + target performance and 100% matching, with the ultimate target of buy-out.

2. Well funded on a buy-out basis
An investment to de-risk into while reducing buy-out funding volatility and the buy-out funding gap.

3. Ready to buy-out
An investment to reduce buy-out price volatility whilst buy-out execution is finalised.

WORKING WITH LEGAL & GENERAL RETIREMENT
We believe that LGIM maintains its position at the forefront of developing DB pension scheme solutions because we are driven by the changing needs of our clients.

Pension schemes can also benefit from our close links with Legal & General Retirement (annuity business).

We are able to offer improved speed of transaction with price monitoring and execution and a buy-out price lock: Legal & General Retirement can lock a buy-out price to changes in the Buy-out Aware Funds for a period of exclusivity, free of charge, to help manage execution risk.

Pension schemes using the LGIM Buy-out Aware Funds will be able to transfer the units of these funds to Legal & General Retirement at zero cost. In a buy-out transaction this could provide schemes with a significant cost saving, as underlying holdings will not have to be liquidated prior to the buy-out.

Legal & General Retirement confirms that it will always supply a bulk annuity quotation to investors in Buy-out Aware fund units for transaction sizes of over £10m up to a maximum of £250m.

CONTACT US
For further information, or to see how these funds could be modelled for your situation, please contact Toby Orpin, Senior Solutions Distribution Manager:

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Important information
The value of these investments and the income they provide may go down as well as up and may return less than invested.

The asset allocation for the fund are based on an average of individual defined benefit (DB) pension scheme liability profiles appropriate to the specific fund objectives. By considering the average, each fund will seek to broadly mitigate the relevant risk(s) for a large number of DB schemes at an acceptable cost. The profile of the average DB pension scheme cannot by definition be the same as for every individual DB pension scheme and therefore there is a risk that the objective of the fund will not necessarily match each DB pension scheme’s member profile and/or investment term horizon.

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