Managing your fixed income allocation along the strategic de-risking journey

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As plans continue to progress along the strategic de-risking journey it is important to continue to keep the fixed income allocation mix, liability benchmark and investment style under review.

There are three primary reasons why this is the case:

1. The role of the fixed income allocation and the size of the liability hedge can change depending on the stage of the journey plan.
2. Allocating to a broader range of fixed income asset classes can help to manage returns and bring portfolio diversification benefits.
3. As market conditions change, so too does the optimal allocation.

The role and objective of the fixed income allocation can evolve along the de-risking journey.

Managing the de-risking journey plan

Investors undertaking a strategic de-risking journey plan will often make increasing allocations to fixed income as they progress from the early to late stages. However, where they are on this journey will have an influence on the objective of the allocation and the need to address the precision of liability hedges[1]:

- In the early stages the main goal is simply to reduce funded status volatility and is achieved by diversifying away from growth assets into long duration government bonds and investment grade corporates. The fixed income allocation helps to reduce risk as (i) long duration assets help to increase the sensitivity of the assets to those of the liabilities increasing the liability "hedge ratio" while (ii) long-dated high-quality bonds have tended to provide strong diversification benefits to equities and other growth assets in volatile market scenarios[2]. At this stage, the precision of the liability hedge is not so important, as the investment risk budget tend to remain dominated by growth assets[3].

- During the mid-stages of the journey, the fixed income allocation becomes more material meaning that it is imperative to address both the effectiveness and the efficiency[4] of liability hedges to better manage risk and return. Plans who still have a deficit gap to close may want to consider the merits of increasing the fixed income returns by diversifying beyond government and corporate bonds into other fixed income asset classes[5]. Preparing for the end-stage may also start to take a bigger focus, particularly for closed or frozen plans[6]. At this point it can be beneficial to consider adopting a hedge ´completion´ strategy[7] and to introduce a liability cash flow matching component.

The role and objective of the fixed income allocation can evolve along the de-risking journey.

- At the late-stages the goal of the fixed income allocation becomes to preserve funded status, to deliver the projected liability cash outflows and to control the economic cost of liability defeasance. Meeting these objectives means it is crucial to address hedge precision and to remove all unnecessary sources of mismatch risk. It is also important to plan for the projected decumulation of assets and to avoid becoming a "forced seller"[8]. A pension risk transfer ("PRT") or longevity hedge may also become a primary or secondary objective meaning that building a potential "asset in kind[9]" portfolio or other "in-plan" defeasance solution can be a new consideration.

1. Noting that no two plans have the same exact circumstances, objectives, constraints or de-risking journey paths.
2. This is due to a "flight to quality" and has been true in each of crises during the 2000-2021 period. However, this effect has been arguably possible due to the low inflation (disinflationary environment) meaning that Central Banks can act to reduce rates without being concerned about creating inflation expectations.
3. In other words, the size of the allocation is more important than the exact structure of the fixed income investment.
4. Hedge effectiveness is a measure of how well the investment strategy maintains the target liability hedge ratio through time. As the hedge ratio increases, second order sources of liability mismatch can begin to have a meaningful impact on residual risk. Hedge efficiency considers whether the instruments deployed are capital or return optimal, subject to the constraints.
5. New portfolio risks may also be introduced which need to be managed.
6. A closed plan means that there are no new entrants as they will participant in a new arrangement. Existing participants will continue to accrue benefits. A frozen plan is when there are no new entrants or new accrual.
7. Such a strategy may involve custom STRIPS and/or derivatives overlay strategies.
8. A forced sale is unplanned and can erode returns.
9. An asset-in-kind portfolio is delivered to an insurer under a risk-transfer as part of the contract premium.

Table 1 below provides a more detailed summary of the key phases of a typical de-risking journey plan, illustrating the changing role of fixed income and the evolving benchmark implementation strategy.

Phase	Objective	Implementation strategy	Liability benchmark
Early stage **Fixed income allocation is generally 40% or lower**	Reduce funded status volatility	Allocate to liability matching assets via long duration government and/or investment grade credit Begin to monitor drivers of funded status sensitivity, key hedge ratios and performance Potentially introduce liability de-risking triggers and risk management dashboard	"Liability aware" public market index benchmark
Mid stages **Fixed income allocation is generally between 40% and 60%**	Increase hedge ratio Consider fixed income diversification strategy to optimize portfolio risk and return Prepare for end-phase	Increase fixed income allocation and sensitivity hedge ratio Ensure a more effective alignment between fixed income allocation and liability profile Consider ´liability completion´ strategy Consider allocating to broader fixed income asset classes Introduce cash flow matching allocation	Custom liability benchmark (also called "blended benchmark")
Late stages **Fixed income allocation is generally greater than 60%**	Manage shortfall risk If appropriate, build-up an "Asset In-Kind" portfolio to act as the premium for a pension risk transfer "PRT" to the insurance market	Optimize all sources of fixed income risk and return Address the efficiency and effectiveness of liability hedges Manage the risks of decumulation with a dedicated cash out-flow and liquidity strategy	Liability cash flow benchmark and/or complementary mix of custom liability and cash flow benchmark

Allocating to a broader set of fixed income along the glide path

Plans deciding to diversify beyond government and corporate bonds can consider a broad range of potential public and private strategies, including multi-asset, diversified/ opportunistic, emerging market debt, high yield, structured and/or private lending etc.

- A key motivator is that returns can often be enhanced - sometimes materially so – at the same time as improving return diversification.
- Alternatively, better managing credit risk may be the driver of the broader allocation, as it may be possible to reduce default risk while preserving the target return[10].

Allocating to a broader range of fixed income along the glide path can improve returns, increase diversification, and potentially reduce credit default risk.

As with any investment strategy changes, it is necessary to consider the optimal portfolio construction, as some asset classes will work better than others in a liability construct[11]. Additionally, moving into a broader range of asset classes can bring new governance risks and challenges which will need to be managed[12].

For example:

- It may be difficult to find long duration matching assets[13] and/or the liability hedge ratio can go down if duration is not extended elsewhere in the portfolio[14].
- Credit underwriting is more involved: this is because the strategy will often include a broader investment universe including private lending and/or more complex structured credits. Additionally, these investments may not be as well covered by rating agencies and/or may not have a public rating at all. It is therefore critical to undertake due diligence to find appropriately experienced investment managers (and advisor!) to help with execution.
- There may be a need to adapt the manger investment style to take account of lower liquidity and higher trading costs, as these factors can materially erode returns if not well managed. The different style approaches can include active, “buy & maintain[15]”, “smart-beta” and passive etc.

10. This is the case if the plan is willing to accept higher illiquidity risk
11. Assets of higher credit quality and with better liability matching properties (e.g., duration, convexity) are generally preferred
12. These can include manager selection, liquidity, complexity, new sources of asset-liability mismatch etc.
13. We exclude mortgages due to the negative convexity associated with prepayment risk.
14. Adding a liability “completion” manager or “quarterback” into the line-up is a common way to help address this.
15. This can be thought of as a “semi-active” investment style.

Liability benchmark considerations

The approach to managing liability hedges needs to adapt along the journey path. This is because it becomes ever more imperative to control asset-liability risks as the fixed income allocation increases and as growth assets are reduced[16]. This is often managed and controlled through the benchmark selection.

- In early stages of de-risking, a standard public market index is often used as the fixed income benchmark, as the de-risking goal is to be "liability-aware" rather than hedging all sources of risk. However, this simplistic approach does not fit as well at the mid stages when higher precision is important.
- At the later stages, plans tend to be in an asset decumulation phase with net cash outflows[16]. This makes it desirable to consider adding liability cash flow benchmark as a complement or potentially fully adopting this approach.

It becomes ever more imperative to control asset-liability risks as the fixed income allocation increases and as growth assets are reduced

Public	Public indices with similar characteristics and duration to the liabilities are often deployed in a liability-aware strategy. This approach is suitable when hedge precision is not important.
Custom liability index	The index is highly customized or optimized to the liability profile using a blend of public indices. It can help to hedge a broader range of characteristics including interest rate duration, key-rate duration and credit spread.
Liability cash flow	A liability cash flow benchmark is, by definition, fully customized. Investments are therefore not constrained by a public market index. This approach can be deployed for all assets or to complement a public or custom liability index.

16. Periodic benefit payments exceed planned contributions and investment income. Also referred to as "cash flow negative".

Concluding comments

Fixed income plays an important role in the strategic de-risking journey. However, the objective of the investment allocation, the optimal implementation approach and most appropriate benchmark and investment style can change subtly as de-risking progresses. Broadening the fixed income allocation beyond government and corporates can be beneficial as the fixed income allocation grows. This can help to manage risk and returns. Notwithstanding the journey plan evolution, plan circumstances and market conditions may also warrant periodically reviewing the fixed income allocation and mix.

The optimal approach to fixed income allocation can change subtly as de-risking progresses

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