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Staying the course.

How defined benefit (DB) schemes can navigate today's macroeconomic environment.

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With market volatility still a concern, we believe active management is a key consideration in managing portfolio risk.

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Introduction.

The need for defined benefit (DB) schemes to build diverse investment portfolios was all too obvious in 2022. But so, too, was the need to make tactical calls in response to unprecedented market volatility.

Defined benefit (DB) schemes have had a lot to contend with in recent years. As the UK economy staggered out of the coronavirus pandemic, the Bank of England (BoE) battled record levels of inflation. The situation came to a head at the end of May 2022, when the consumer price index (CPI) measured 9.1%, the highest it had been since February 1982.[1] Although UK inflation has come down slightly since (the CPI stood at 7.9% as of June 2023[2]), DB schemes have faced fresh challenges.

The liability-driven investment (LDI) crisis, which gripped the UK pensions industry towards the end of 2022, had such serious repercussions that many trustees are now questioning whether their scheme is resilient enough to withstand future market shocks.

In this paper, we look at how experts in SEI's Investment Management Unit (IMU) frame and respond to macroeconomic uncertainty. We argue that whilst being globally diversified helped mitigate the impact of the LDI crisis on client portfolios in 2022, the year demonstrated the limitations of diversification.

With market volatility still very much a concern, we believe active management is a key consideration in managing portfolio risk.

Why is diversification important?

We've all heard the saying, 'Don't put all your eggs in one basket'.

In its simplest guise, diversification advocates exactly this: Distribute the risks associated with running an investment portfolio to avoid overreliance on any one source of liquidity or return. In a well-diversified portfolio, we're told, investments that perform well will compensate for those that do poorly, thus insulating the investor from catastrophic loss.

Whilst this is certainly not a new idea, diversification has received plenty of attention in recent months, thanks in part to the LDI crisis. As the value of gilts took a nosedive in Q3 2022, many DB schemes scrambled to free up the necessary liquidity to meet collateral calls—which often meant selling liquid growth assets at the worst possible time.

Though extreme, these events demonstrate the importance of diversification more generally. To have the best chance of delivering robust outcomes across a range of economic scenarios, we believe a portfolio must incorporate diverse sources of return and liquidity.

But then what are the limitations?

Whilst diversification may seem like common sense—to risk-averse investors, at least—it's worth considering the limitations here.

For one, diversification can mitigate a portfolio's exposure to **idiosyncratic risk**—for example, the risks associated with particular securities or sectors. What it can't do is mitigate a portfolio's exposure to **systematic risk**—the risks that affect the financial system as a whole. Macroeconomic or sociopolitical events, such as the interest rate hikes of recent months or the Ukraine-Russia war, are an example of the latter.

This is troublesome when you consider that in times of economic or market stress, riskier assets can become positively correlated, causing diversification benefits to shrink when portfolios are otherwise at their most vulnerable.[3]

To account for this phenomenon, we take a conservative approach to estimating asset class correlations. If the correlation between two asset classes rises sharply when markets are volatile, then we do not consider there are significant diversification benefits. As such, we adjust our estimates up, such that asset classes that tend to experience sharp falls at the same time are not unduly rewarded.

We also advocate a fully active approach, where the manager is able to make tactical calls in response to macroeconomic events as they unfold.

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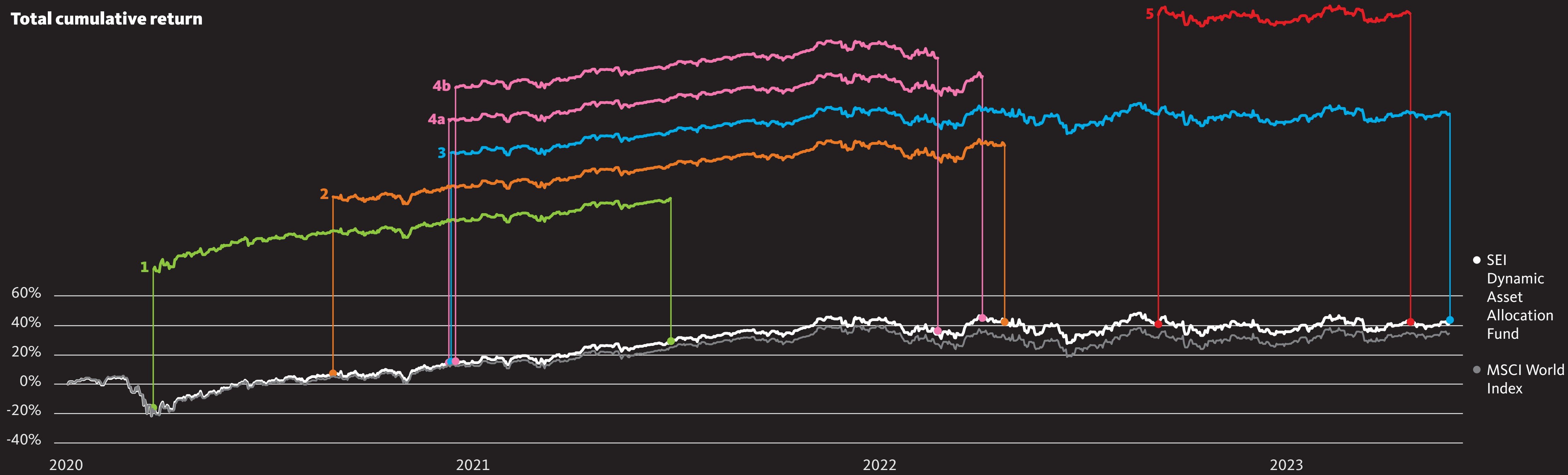
1. 'Consumer price inflation, UK: May 2022', Office for National Statistic (22 June 2022)
2. 'Consumer price inflation, UK: June 2023', Office for National Statistic (19 July 2023)
3. We wrote about this phenomenon in a commentary describing the limitations of synthetic assets. See SEI, 'Two charts that show why synthetic assets might not be such a good idea' (12 December 2022).

FIVE MARKET MOMENTS:

The SEI Dynamic Asset Allocation (DAA) Fund

We express our tactical, shorter-term (12-18 month) views in SEI's DAA Fund. This chart shows how the IMU responded to changes in the macroeconomic environment, as brought about by the COVID-19 pandemic.

Total cumulative return



Source: SEI, Bloomberg. Date range (Dec 19-May 23) chosen to illustrate tactical trades made by the team in response to the COVID-19 pandemic. Past performance does not predict future returns. Cumulative performance is calculated relative to the benchmark (MSCI World), using the institutional share class, and fund's base currency (GBP), net of fees.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

The SGMF Dynamic Asset Allocation Fund is actively managed and not managed in relation to any benchmark.

1.

Responding to increased government debt by investing in gold

With the global fiscal response to COVID-19, which characterised Q1 2020, government debt the world over seemed set to increase.

Faced with the reality of coordinated, ever-increasing debt loads, we believed gold would hold its value over time. We were also of the view that gold would provide additional diversification benefits for clients grappling with low to negative interest rates.

Position added:

- Long gold

2.

Using US 30-year swaps to benefit from higher long-term rates

From Q2 2020, we believed the market was not adequately reflecting the potential for higher, long-end yields in the US.

The US Federal Reserve (Fed) had responded to the pandemic swiftly, reducing interest rates to zero, announcing quantitative easing, and implementing several liquidity-focused programmes. But it was the enormity of the country's fiscal stimulus package that seemed truly unprecedented—over $5 trillion, c.25% of US GDP[4]

Position added:

- US 30-year payer swaption

3.

Using long commodities to hedge against inflation

By Q4 2020, we had even greater conviction in our view that the world's monetary and fiscal response to COVID-19 could prove inflationary. And against this backdrop, we sought a potential hedge.

We initiated a position in long commodities, believing that, after a long period of disinvestment, the commodities market finally looked more balanced. This position is still active, as we believe the fundamentals support our bullish view of the market as a whole.

Position added:

- Long Bloomberg Commodities Index

4.

Seeking outperformance in the face of global reflation

In Q4 2020, we believed the pandemic could lead to global reflation. Central banks seemed to suggest higher inflation was necessary to address the repercussions of national lockdowns, and we were thus expecting additional rounds of fiscal support.

Given global economic policy and positive developments related to the COVID-19 vaccine, we took a view that economically sensitive areas of the capital markets would outperform in 2021.

Position added:

- a) US 10-year inflation (CPI) swaps)
- b) Long S&P 500 (equally weighted) and Long MSCI EAFE Index (non-US equities))

5.

Adding exposures highly correlated to tighter financial conditions

In Q3 2022, we considered US inflation might remain stubbornly high. Whilst financial condition indexes (FDIs) suggested things had been improving over the summer, investor sentiment begged to differ, with talk that the Fed would abandon their hawkish stance and even pivot from rate hikes altogether.

We expected the Fed to continue tightening for the remainder of 2022 and into 2023.

Position added:

- Short S&P 500 short investment-grade credit spreads (via CDXIG)
- Short US interest rates
- Long USD

[4] Mark Zandi, et al., 'Global Fiscal Policy in the Pandemic', Moody's Analytics, 24 February 2022.

We believe responding tactically to macroeconomic events has bolstered the SEI Dynamic Asset Allocation Fund's cumulative performance since 2020.

Calendar year returns (%)

Year	SEI Dynamic Asset Allocation Fund	MSCI World Index
2013	17.25	18.66
2014	5.18	0.74
2015	0.87	-1.32
2016	18.25	9.96
2017	9.96	11.95
2018	-11.55	-8.06
2019	19.74	22.74
2020	14.55	12.32
2021	25.36	22.94
2022	-5.56	-7.83

Source: SEI, Bloomberg. Annual performance is shown as at 31 December 2022, relative to the benchmark (MSCI World). The institutional share class, and fund's base currency (GBP) is used, with returns calculated net of fees. Past performance does not predict future returns.

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What's next for DB pension schemes concerned about market volatility?

If the ups and downs of recent years have taught us anything, it's that adopting a 'wait-and-see' approach to market volatility is incredibly risky.

And whilst trustees looking to navigate the challenges presented by today's macroeconomic environment should naturally consider their investment strategy, we believe they need to also consider the way their scheme is resourced.

For some schemes, delegating investment management to a fiduciary manager like SEI could make all the difference. Such an arrangement may give a scheme the ability to respond to macroeconomic change more nimbly and effectively, providing investment expertise when it's needed the most.

Introducing SEI's Investment Management Unit (IMU).

As the name suggests, the IMU acts as SEI's investment arm, conducting rigorous market research and manager due diligence to support a diverse range of clients globally.

For DB pension schemes, having access to investment expertise—by way of a team like the IMU—represents a significant advantage, particularly when markets are volatile. The IMU not only builds investment portfolios for clients, they actively manage those portfolios day to day to get the best from the macroeconomic environment, however challenging.

At a glance: SEI's Investment Management Unit (IMU)

125+
professionals, with an average of nine years' industry experience

70%
of team members are CFA charterholder and/or hold an MBA or other advanced degree

$418B
in AUM, running 200+ portfolios, on behalf of SEI as a global company

Source: SEI, as at 30 June 2023.

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Key terms

30-year Treasurys: Bonds issued by the U.S. government with a maturity of 30 years.

Credit default swap: A financial derivative through which a buyer pays an ongoing premium, similar to the payments on an insurance policy. In exchange, the seller agrees to pay the security's value and interest payments if a default occurs.

Fiscal stimulus: A government's attempt to increase economic activity by reducing taxes, increasing government spending, or both.

Swaption: An option position. There are two main types of swaption: a payer swaption and a receiver swaption. With a payer swaption, the purchaser has the right, but not the obligation, to enter into a swap contract where they become the fixed-rate payer, and the floating-rate receiver.

Index descriptions

Bloomberg Commodities Index (BCOM): Tracks the prices of futures contracts on physical commodities, providing broad exposure to energy, agriculture, and industrial and precious metals. No single commodity, or commodity sector, dominates the index.

Credit default swap index (CDX): A benchmark financial instrument made up of credit default swaps (CDS) issued by North American or emerging market companies. The index is broken down by two different types of credits: investment grade (IG) and high yield (HY).

MSCI EAFE Index: Tracks the performance of mid- and large-cap stocks across Europe, Australasia, and the Far East (EAFE).

MSCI World Index: Tracks the performance of large and mid-cap companies across 23 developed countries.

S&P 500: Tracks the performance of the largest 500 companies listed on stock exchanges with in the United States.

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