For professional clients only.
Capital at risk.

Options for mitigating equity risk

With LGPS funding levels much improved and US equities near all-time highs, what options do LGPS funds have to guard against potential equity market falls?

James Sparshott
Head of Strategic Client Team, Distribution

Robert Pace
Senior Solutions Strategy Manager

Given average equity allocations of c.50%[1] and limited fixed income allocations, LGPS funding positions are at historically high levels. In light of the upcoming triennial valuation on 31 March 2025 for England and Wales, many LGPS funds are likely to be considering how best to maintain these improved funding positions without overly compromising on expected returns. In Scotland (where the valuation was 31 March 2023), LGPS funds will be finalising their valuation results and considering strategy implications given significantly higher funding levels.

Where are we now?

LGPS funds have increasingly adopted more global allocations to equity. With US equities accounting for the majority of global equity indices, we believe investors are likely to have benefited from the dominant performance of US equity and specifically the handful of US stocks that have driven returns.

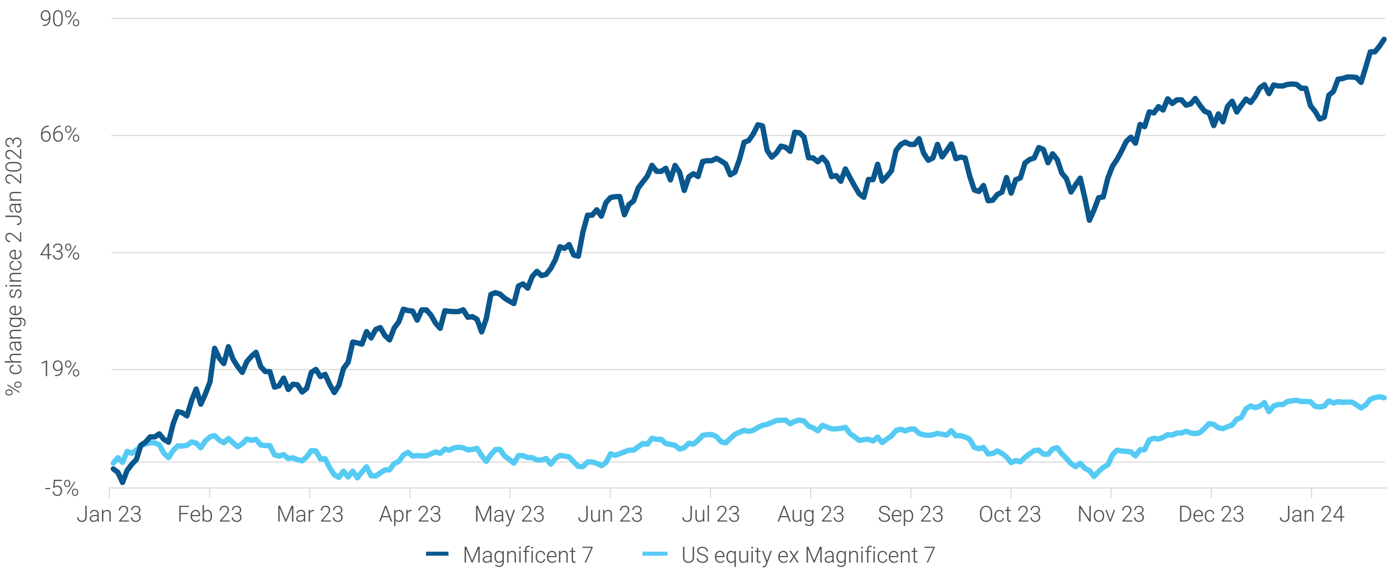
1. Source: PIRC annual review September 2023 LGPS Scheme Advisory Board - Investment (lgpsboard.org).

Key risk: The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

These stocks[2] (Alphabet*, Amazon*, Apple*, Meta*, Microsoft*, Nvidia* and Tesla*), colloquially referred to as the 'Magnificent 7', have vastly outperformed over the last 12 months as the chart demonstrates and are now approximately the size of the UK, Japanese and Canadian stock markets combined[3]. At the same time the S&P500 recently hit all-time highs[4].

The flip side of this coin is that any structural outperformance of US equity markets and the technology sector may, unchecked, leave equity allocations as an increasingly concentrated 'bet'.

Figure 1: US equity at all-time highs driven by the 'Magnificent 7*' stocks



Source: Bloomberg, 3 January 2023 to 24 January 2024. **Past performance is not a guide to the future.**

Where from here for equity markets?

Qualitative considerations

As always there are strong cases that could be made for a continued rally in equity markets or indeed a correction (or worse). For possible factors supporting further increases in equity prices, we must first look to monetary policy and the US Federal Reserve (Fed).

In our view, it is now looking increasingly likely that the Fed can engineer that rare outcome of a 'soft landing' which could give equities room to perform. The upside case for equities could then feed from improvements in technology, productivity gains and the 'magnificent seven stocks*' playing a part given their heavy weighting in the index. Or perhaps the wider index plays catch up and that is the catalyst for further gains in equity markets.

On the other hand, there are concerns around regulatory risks faced by many of the large technology stocks and, as our equity colleagues have noted, 2022 performance included a 40% drawdown at one point so clearly this could happen again. On top of this, a trigger could come from geopolitical risk with a knock-on impact on supply chains (the events in the Red Sea being a recent example) or energy shocks.

Furthermore, with so much of the world going to the polls this year, elections represent a political risk factor for equities. Add in the possibility of central banks holding policy tight for too long or the fact that history shows how difficult it is to create a soft landing for the economy, and suddenly things do not appear as rosy.

1. Source: PIRC annual review September 2024 LGPS Scheme Advisory Board - Investment (lgpsboard.org)
2. *For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.
3. Source: FT Podcast, 25 January 2024
4. Source: Bloomberg SP500 level 4869 at 24 January 2024

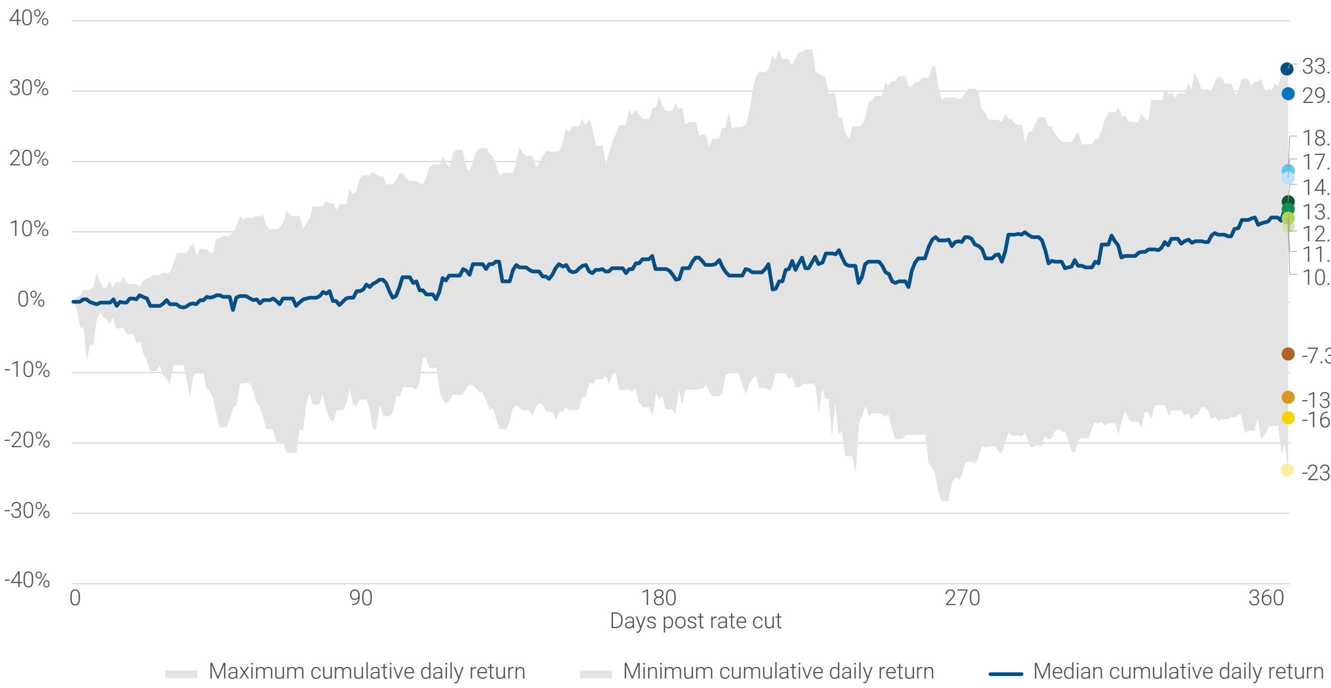
Key risk: The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

What does history tell us?

The first rate cut priced into US markets is around June or July 2024[5]. The following chart shows how equity markets have performed after the first rate cut in historic cycles dating back to 1971. What is clear is that a large range of possibilities exist (even based on history alone) ranging from the potential for very positive equity performance over the next 12 months all the way to large falls in equity markets.

We believe that much will depend on growth and whether there is a recession. While the base case for many is a soft landing (and no recession), there are clearly a number of risks (as discussed above) which are potential catalysts for a less benign outcome. The increasing concentration of equity markets also means that the risks (be they to the upside or the downside) are themselves more concentrated.

Figure 2: US equity markets have historically exhibited both very positive and very negative performance after the first cut in interest rates



Source: Refinitiv and LGIM analysis as at 26 January 2024. **Past performance is not a guide to the future.**

What can LGPS funds do?

Evidently, predicting the exact outcome for equity markets with any certainty is very difficult. However, we can observe that current market pricing remains sanguine around the possibility for future equity volatility. We believe that this means that there is potentially an attractive opportunity for LGPS funds to seek some risk mitigation against falling equity markets, and in doing so seek to provide stability to their funding position with minimal outlay. Equity protection aims to provide a way of implementing this opportunity. Appendix 1 recaps on how equity options can achieve this.

5. Source: Refinitiv 26 February 2024

Given average equity allocations of c.50%, this would imply the impact on total portfolio return could potentially be achieved with only a very modest reduction in the expected return of 1% or less (depending on exactly how much risk mitigation is targeted and the structure used).

It would be possible to consider tailoring any strategy to the equity portfolio.

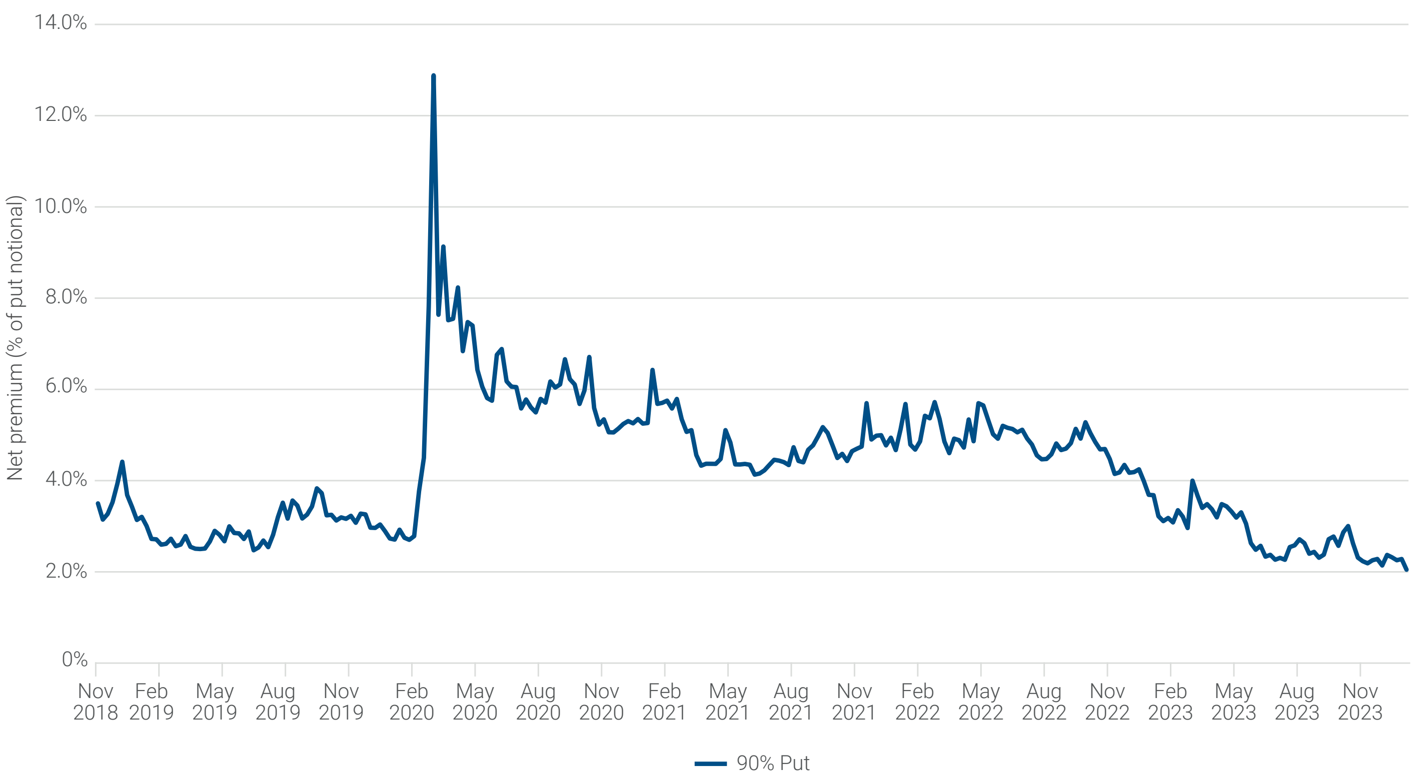
The next chart shows pricing for 90% put options ('puts'), which seek to protect against a fall in equity market returns over 10% (see appendix for example pay-off charts of a 'put', 'put spread' and 'put spread collar'). We believe this can be an effective way of looking to take advantage of current market dynamics because of the low level of implied volatility and relatively high level of interest rates.

Key risk: The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Equally, it is possible to also sell away some potential equity market upside (known as a collar when combined with a put) to reduce the premium. This may be deemed a good strategic fit for LGPS funds if higher funding levels mean that it is not necessary to have quite as much upside potential from equities as historically.

In order to determine a suitable strategy, we believe it could be useful to think about how you would feel given certain scenarios. For example, if upside is sold above, say, 15% then would there be a large amount of regret if returns ended up at, for example, 20% but the scheme only earned 15%?

Figure 3: Cost of 1 year protection on S&P500 Total Return Index at the lows versus history



Source: LGIM analytics 24 January 2024. **Past performance is not a guide to the future.**

Drawing strategic conclusions

In conclusion, while we observe the potential bullish case for equities, there are also notable downside risks which investors can seek to mitigate. In our view, strategies seeking equity protection offer pension funds a potentially attractive way of preparing for more uncertainty in 2024 by seeking to:

- Take advantage of the current low levels of option pricing
- Where appropriate, retain notable upside exposure in the event that equity markets rise significantly
- Simultaneously provide more stability in scheme funding levels ahead of the next valuation cycle

We would be happy to work with you to structure an appropriate solution specific to your goals and objectives.

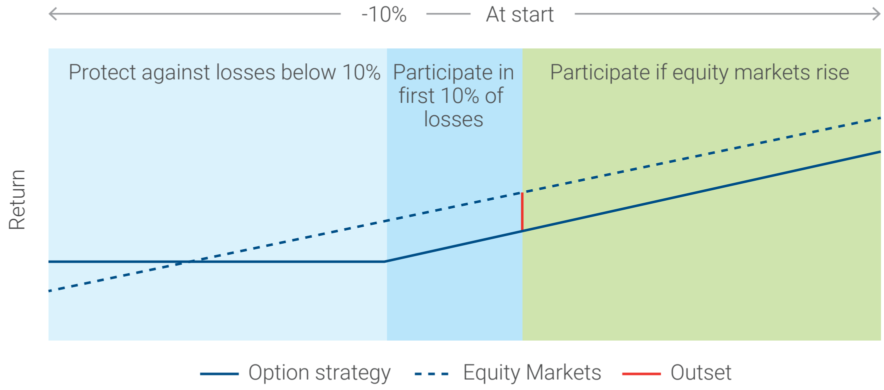
Key risk: The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Appendix

1. Example of a Put Option

Purchasing downside protection

Protection against equity market falls below a certain level



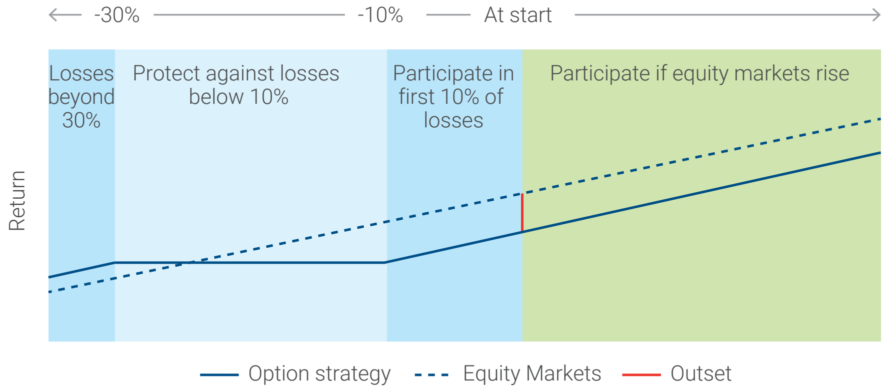
Decreasing the level of protection by participating in the first 10% of losses.

Downside protection which starts from 10% losses has a lower premium as it decreases the level at which protection kicks in. The scheme continues to participate in all equity market gains.

2. Example of a Put Spread

Purchasing partial downside protection

Protection against equity market losses between certain levels



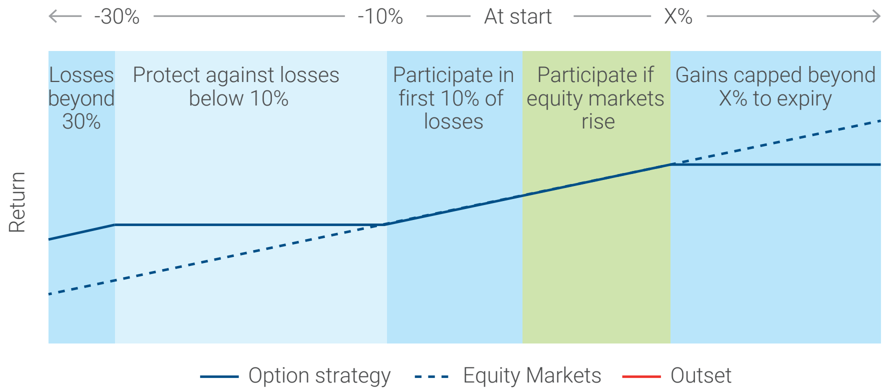
Example protects against equity market falls between 10% and 30%.

A net premium is paid at outset to purchase this type of equity protection. The scheme is exposed to the first 10% of losses, protected for the next 20% of losses and then will participate in equity market losses below 30%. The scheme continues to participate in all equity market gains.

3. Example of a Put Spread Collar

Purchasing downside protection by capping upside participation

Protection against market equity falls paid for by forgoing participation in strong market rallies



Example shown for protection against market falls between 10% and 30%.

No net premium paid at outset instead the scheme sells away equity gains above the upside cap. The level upside is capped at is solved for a nil-premium structure.

Key risk: The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

LGIM talks

The LGIM blog

LGIM is the global asset management business of Legal & General

Legal & General

Key risks

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.

Important information

The information in this document is for professional investors and their advisers only. This document is for information purposes only and we are not soliciting any action based on it. The information in this document is not an offer or recommendation to buy or sell securities or pursue a particular investment strategy and it does not constitute investment, legal or tax advice. Any investment decisions taken by you should be based on your own analysis and judgment (and/or that of your professional advisors) and not in reliance on us or the Information.

This document does not explain all of the risks involved in investing in the fund. No decision to invest in the fund should be made without first reviewing the prospectus, key investor information document and latest report and accounts for the fund, which can be obtained from https://fundcentres.lgim.com/.

This document has been prepared by Legal & General Investment Management Limited and/or their affiliates ('Legal & General', 'we' or 'us'). The information in this document is the property and/or confidential information of Legal & General and may not be reproduced in whole or in part or distributed or disclosed by you to any other person without the prior written consent of Legal & General. Not for distribution to any person resident in any jurisdiction where such distribution would be contrary to local law or regulation.

No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the information in this document. The information and views expressed in this document are believed to be accurate and complete as at the date of publication, but they should not be relied upon and may be subject to change without notice. We are under no obligation to update or amend the information in this document. Where this document contains third party data, we cannot guarantee the accuracy, completeness or reliability of such data and we accept no responsibility or liability whatsoever in respect of such data.

This financial promotion is issued by Legal & General Investment Management Limited.

Legal and General Assurance (Pensions Management) Limited. Registered in England and Wales No. 01006112. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, No. 202202.

LGIM Real Assets (Operator) Limited. Registered in England and Wales, No. 05522016. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 447041. Please note that while LGIM Real Assets (Operator) Limited is regulated by the Financial Conduct Authority, it may conduct certain activities that are unregulated.

Legal & General (Unit Trust Managers) Limited. Registered in England and Wales No. 01009418. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119273.

CODE D007376_27C