FOR PROFESSIONAL CLIENTS ONLY

Defaults under the microscope

BlackRock.

Investment strategy for the new regime

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Key Points

1. The time for static defaults is over, research-driven and forward-looking investment design is needed. Volatility is back and it's driving greater focus on what default objectives are and how they are set up to achieve those objectives.

2. Managing defaults is more than risk and return, it considers time and savings. Lifecycle investment insights therefore should drive any changes to portfolios.

3. Schemes across the Defined Contribution (DC) eco-system are striving for more sophisticated solutions and greater insights to achieve their goals.

"...Nor avarice, nor over-anxious care..."

\- Wordsworth

Introduction: "achieving greater precision"

Over recent years, with COVID's market and fiscal policy impacts, rising inflation and uncertainty over the future path of interest rates, DC defaults have been under the microscope to ensure they can meet their objectives and manage member savings throughout the retirement journey.

BlackRock's global target date fund series, LifePath™, celebrated its thirtieth birthday in 2023. Our investment platform has evolved over the last three decades, and we are committed to building retirement solutions that fulfil the evolving needs of our clients. Specifically in the UK, we have undertaken a significant review of our strategy under the theme of "achieving greater precision" which has culminated in three distinct research outcomes:

1. **Gaining precision in fixed income**
2. **Living with inflation**
3. **Evolving our foreign exchange (FX) hedging**

In a series of three thought pieces, we will set out how we evolved our thinking in each of these topics in 2023 and lift the lid on our new approach. This piece will focus on the second topic**: living with inflation.**

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Why should DC schemes think about how they manage inflation risk now?

Over the last 50 years UK inflation can be described as either high and volatile, as it was in the 1970s, or low and stable as it was in the early 2000s. Transition between the regimes is difficult to forecast however once inflation has moved into a regime it has tended to be somewhat persistent.

Inflation, which has risen rapidly since the end of the pandemic, fell in the latter half of 2023. However, we believe that the risk to inflation is likely to remain elevated due to supply chain bottlenecks and deglobalization. In addition, megatrends such as the transition to a low carbon economy can be inflationary, decreasing the productivity of labour and increasing the cost of grain and energy. An orderly transition to net zero emissions will partially mitigate, but not eliminate, some of these inflationary pressures. Therefore, in the new regime, we expect these factors will exert a lingering upward pressure on prices and little chance of returning to the early 2000s. If these forecasts prove to be accurate, then inflation may become a more salient issue for UK DC savers as they progress through their savings lifecycle.

How we think about inflation

BlackRock's lifecycle research considers inflation risk as a key risk factor alongside labour income risk (your ability to earn through your life), longevity risk (the risk of outliving your savings), and market risk (volatility of capital market returns), over the entire life of an individual – which includes both saving for, and spending in, retirement. Within a DC context the ability of members to preserve their financial wealth in real (inflation adjusted) terms allows them to spend consistently throughout their lives.

In 2019, we defined a lifecycle aware, inflation hedging approach which allowed us to more precisely specify the optimal amount of inflation-hedging assets needed across a member's lifetime. Building on the insights from our previous research, we have drawn significant conclusions on the role of inflation in a retirement portfolio:

- **Young Individuals**. Younger DC savers may find it expedient to rely on the long-term positive correlation between wages and inflation. Growth in real wages (i.e., wages after accounting for inflation) tends to be positive at the start of one's career. Therefore, younger DC savers who are working possesses an implicit hedge against inflation. Furthermore, given a sufficiently long investment horizon, many asset class returns will eventually overcome the downside volatility that accompanies inflation shocks. As a result, the demand for short-term inflation hedging for individuals in early- to mid-career is quite low.
- **Older Individuals**. As members move into their fifties, they switch from funding their current consumption from wages to funding their current consumption from savings and consequently need for inflation hedging increases. Human capital (i.e., future wages) is exhausted and its inherent inflation hedge disappears. In LifePath, as is the case with most target date and lifecycle strategies, investment in riskier assets has been reduced. Even if the retirement capital investment mix is still expected to outpace inflation, an inflation shock and downside volatility may significantly affect a retired investor's consumption. As the inflation sensibility of the human capital decrease, it makes sense to begin hedging against shock inflation.

We have also expanded our portfolio construction process which now explicitly targets a reduction in the probability of negative real returns in periods of high inflation.

- **Cost of hedging inflation**. Hedging against inflation shocks may entail an opportunity cost — that is, giving up some expected return by replacing the potential growth of an asset class with the lower expected returns of hedging assets. And lower expected returns require an adjustment in either saving or spending behaviour.

There is no guarantee that research capabilities will contribute to a positive investment outcome.

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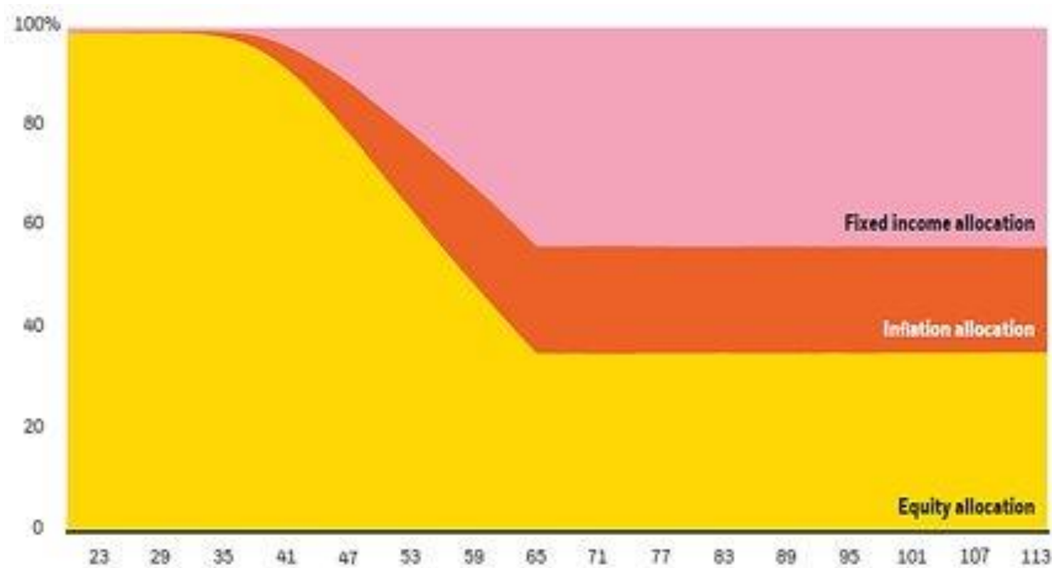
Chart 1: Inflation protection over a lifetime



Our lifecycle model provides us with a single, unified framework for making investment, savings, and spending decisions. It is this framework that will help us move from more qualitative statements like "investors should be more concerned about inflation as they approach retirement" to a precise allocation to inflation-hedging assets as a function of age.

Our portfolio evolution

1. We have analysed multiple asset classes' sensitivity to UK inflation historically to understand how best to evolve our investment toolkit. Our analysis reviewed a wide range of investible assets, looking further than the asset classes we owned previously.

Changes resulting from our new research have impacted our commodities and fixed income exposures. Research showed that short-term nominal yields are currently more affected by inflation expectations than real yield changes. By contrast, long-term nominal yields are more affected by real yields. For this reason, we have shortened the duration of inflation-linked bonds introducing short UK linkers in our portfolios. Please note that 'nominal' interest rates reflect current market and economic conditions, and 'real' interest rates are adjusted for inflation, to show the real (inflation adjusted) cost and purchasing power of money that is lent or invested.

We have also reduced our exposure to commodities as research shows that their ability to hedge unexpected inflation is significant (hence even a small allocation will be beneficial in unexpected inflation scenarios), but there is a return opportunity cost in stable inflation environments in holding commodities compared to traditional asset classes such as equities.

These changes are not discretionary choices among asset classes, but rather the result of an extended portfolio optimization that takes the insights coming from our lifecycle engine and takes into consideration inflation when seeking to build an efficient portfolio at each life stage.

2. We extended our portfolio construction modelling to consider the real return (expected returns after inflation) across asset classes, which now explicitly targets to reduce the probability of negative real returns in periods of high inflation.

We believe the expansion of our modelling framework and the additional precision gained in dialling up or down our inflation hedging ability in the portfolios will prove important in future market regimes.

Source: BlackRock, 31 January 2023.

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Why is it innovative?

Our 2019 inflation research was innovative because it considers when to begin inflation-hedging and how much to allocate to the hedging asset class. This extends the portfolio construction problem from a point in time optimization to one that is through time and aligns with the reality that inflation is of greater risk to a member as they age.

Our lifecycle model incorporates a holistic understanding of income, saving, investing and longevity. We consider the inherent erosive impact of inflation on savings and how inflation varies over time. The framework means we are not required to make a judgement on timing inflation hedging (which is inherently challenging), but that it's rather a fundamental outcome of our investment process. Our 2023 inflation research builds on this unique approach we employ in the UK, moving from the "when" to an even more precise "how" and "how much" for asset allocation policy. Our 2023 inflation research builds on this unique approach we employ in the UK, moving from the "when" to an even more precise "how" for asset allocation policy.

Conclusion

- No single asset or portfolio can perfectly hedge inflation, longevity, and market risk. If we allocate to inflation-hedging assets, particularly in the accumulation phase, we may reduce the expected return of our portfolios. This research therefore provides schemes with a robust framework to help manage their savings and ultimately facilitate spending in retirement.
- As the DC toolkit grows with greater granularity and even expands into alternative and private markets, we can continue to utilise this new framework to assess the role of existing and new asset classes in the default and monitor the asset allocation. The true benefit of the lifecycle approach is to go further than traditional asset allocation and seamlessly adjust these exposures as the need for inflation hedging becomes greater towards retirement.

Put simply, inflation risk is one of the most perilous enemies even for someone at the age of 65 and expecting to live another 25 years. We believe it to be a key feature in designing robust DC defaults, and that is why we have built a precise framework to guide LifePath portfolios going forward as we build the next generation of DC defaults.

Source: BlackRock, 31 January 2023.

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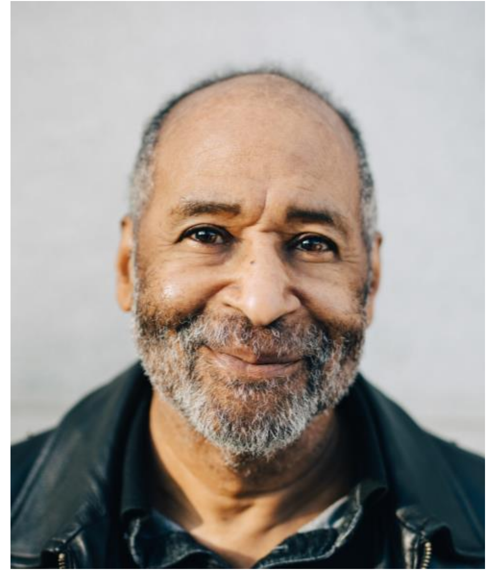

Delivering Confidence

On behalf of our clients, BlackRock manages the pensions savings of over 12 million people in the UK.[1] We believe that people deserve financial security across their lifetime, and that retirement should be within reach for everyone.

To make this a reality, we are aiming to build better solutions, and making them more accessible.

Learn more at blackrock.com/uk

1 Source: BlackRock as of 31 December 2023.

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BlackRock DC LifePath UK Specific Risks

Credit Risk: The issuer of a financial asset held within the Fund may not pay income or repay capital to the Fund when due.

Equity Risk: The values of equities fluctuate daily and a Fund investing in equities could incur significant losses. The price of equities can be influenced by many factors at the individual company level, as well as by broader economic and political developments, including daily stock market movements, political factors, economic news changes in investment sentiment, trends in economic growth, inflation and interest rates, issuer-specific factors, corporate earnings reports, demographic trends and catastrophic events.

Derivative Risk: The Fund uses derivatives as part of its investment strategy. Compared to a fund which only invests in traditional instruments such as stocks and bonds, derivatives are potentially subject to a higher level of risk.

Liquidity Risk: The Fund's investments may have low liquidity which often causes the value of these investments to be less predictable. In extreme cases, the Fund may not be able to realise the investment at the latest market price or at a price considered fair.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Tax treatment depends on the individual circumstances of each client and may be subject to change in the future.

Risk Warnings:

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

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