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. We have evolved our FX hedging approach with the aim of reducing volatility and managing short-term FX rate fluctuations. The strategy involves monitoring factors such as volatility, correlations, and the share of foreign-denominated assets to determine appropriate hedge ratios.

2. FX risk significantly impacts UK investors due to the high proportion of foreign-denominated assets in their portfolios. The weakening pound against currencies like the US Dollar has materially influenced investment outcomes over the past decade.

3. In 2023, we adjusted our FX hedging model by reducing the smoothing period from 36 to 12 months to better respond to changes in correlation between GBP and non-sterling assets.

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.

This year BlackRock’s global target date fund series, LifePath™, celebrates its thirtieth birthday. Our investment platform has evolved over decades, and we are committed to building retirement solutions for our clients for decades to come. Specifically in the UK, we have undertaken a significant review of our strategy under the theme of “achieving greater precision” and we have completed the following research:

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 have set out how we evolved our thinking. You can find the previous two articles on our website. This piece will focus on the third topic: **evolving our foreign exchange (FX) hedging.**

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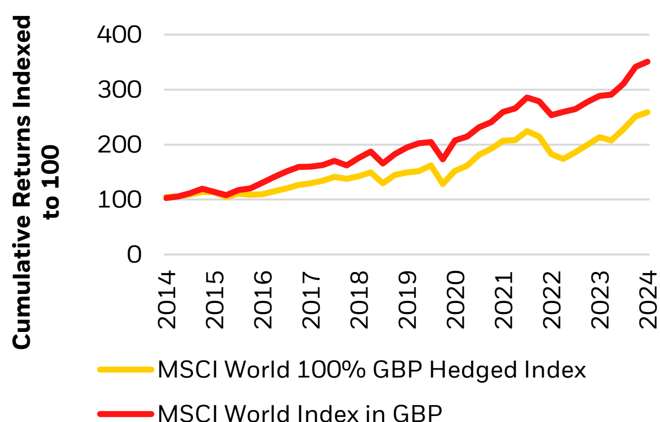
Why does FX risk impact DC defaults?

Defined Contribution default investment strategies make extensive use of overseas investments across equities and bonds with many reducing their home country bias in equities and fixed income over the last ten years. The proportion of assets denominated in foreign currencies can be of heightened importance for UK investors, given the relatively low weight of UK securities in global market-cap indices. For example, the UK equity market currently represents less than 5% of the MSCI World Index (Source: BlackRock and MSCI as of 28 June 2024).

For UK investors, FX hedging decisions have had a material impact on outcomes over the last ten years. This is largely driven by the weakening pound versus other currencies such as the US Dollar. The reason the US Dollar vs. the pound has such an impact is because 72.08% of the MSCI World index is US equities (Source: BlackRock and MSCI as of 28 June 2024) so as the US dollar appreciates relative to the pound the value of these equities goes up in pounds due to the currency move. The impact of hedging can be seen in the chart below.

Figure 1. The chart below shows the 10-year performance of MSCI (GBP) and MSCI (Hedged to GBP)



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. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock, 30 June 2024. Data from 1 July 2014 to 30 June 2024.

FX risk is therefore a critical component for default design. Understanding the risk and return drivers of defaults is an important investment and governance consideration for managers and evaluators. By examining these factors, one can assess whether the FX hedge ratio observed in the portfolio reflects an explicit view on the future direction of foreign exchange rates or whether it is driven by cost or operational factors (hedging is typically higher cost and can introduce operational complexity).

How we think about FX

Our primary motivation for hedging foreign currency exposure is to reduce volatility, not to increase returns. We don't believe that developed market foreign currency exposures earn a risk premium over the long-term time horizons relevant for DC pension investors. However, FX rates do fluctuate over the short-term, therefore the risk must be managed. The Lifepath portfolio construction process considers FX risk with other investment risks. We determine the FX hedge ratio based on volatility, correlations, the share of assets denominated in foreign currency and each fund's time horizon. We monitor these factors and apply the target FX ratios to each Target Date fund. We deal with any operational issues related to the FX hedge execution.

a. LifePath's Currency Hedging Approach

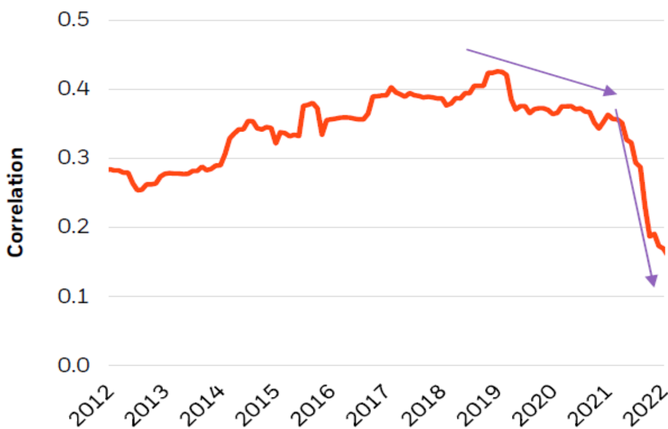
We adopt a "whole portfolio" approach when thinking about FX in the context of our lifecycle funds. This means that for each target date portfolio or “vintage” we consider the exposure to overseas currencies given the amount of foreign assets (after costs and operational considerations are incorporated); the correlation between FX and the assets we own; the volatility of those assets; and the investment time horizon of each fund. These factors are used to determine an FX hedge ratio which is the level of overseas developed markets' currency hedging applied to each portfolio.

We continuously monitor this correlation over time to determine whether the changes observed warrant a change in the hedge ratios applied across LifePath portfolios. Finally, FX markets can be volatile in shorter time periods which could lead to frequent changes in a hedging policy. Therefore, when implementing our FX hedging in portfolios, we smooth the target FX Hedge ratio to mitigate the costs associated with the implementation of the hedge as well as future costs if we were to a adjust the hedge again a short time later. The smoothing component therefore reduces the need to frequently adjust the hedging ratio and ensures the changes are strategic in nature.

b. Evolving our FX hedging approach in 2023

The correlation between FX and assets in the portfolio has fallen materially (diversification benefits of holding unhedged FX exposure have increased). Over the last five years, we have seen a material fall in the correlation between GBP and non-sterling-denominated assets. In 2022, this accelerated when global equity markets fell, UK gilt markets fell, and USD appreciated (GBP depreciated). The speed with which this happened resulted in a material fall in correlation between domestic assets' returns and FX returns. This can be seen in Figure 2.

Figure 2. The chart below shows the correlation of GBP and non-sterling assets we monitor in LifePath portfolios

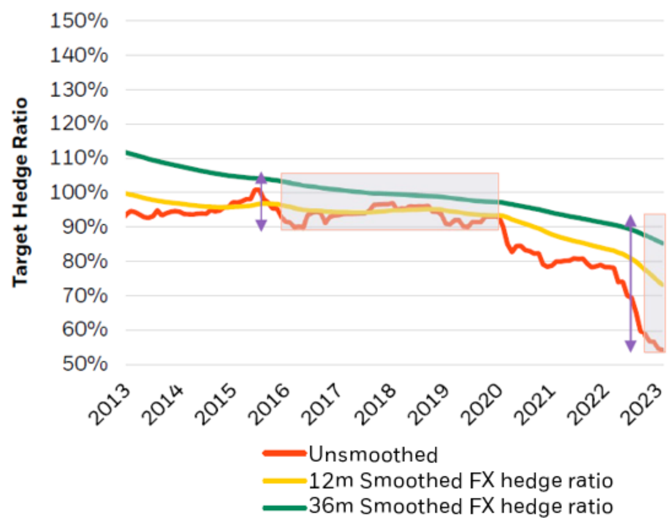


Source: BlackRock, 31 October 2023.

As part of our commitment to continuously evolve LifePath for the benefit of the members, we undertook an in-depth review of our currency approach in the UK. The outcome of this review was that:

- We maintained conviction in managing FX risks through our FX methodology detailed above, which considers FX's impact on risk and how FX risk interacts with other risks in the portfolio (e.g. equity, interest rates, corporate bond spreads).
- We have adjusted the smoothing period to improve the model's responsiveness to changes in correlation (See Figure 3). Where we had previously deployed a 36-month rolling moving average, we have tightened the window for the smoothing from 36 months to 12 months. The implementation of FX hedging is, therefore, now more sensitive to changes in the target hedge ratio without sacrificing short-term stability.

Figure 3 Illustrates two different approaches to smoothing the FX hedging model that drives our approach.



Source: BlackRock, 31 October 2023.

c. How we changed hedging ratios

The correlation between sterling and assets has become increasingly more negative in recent periods. The effect of the change in implementation smoothing is that the target hedge ratios have been reduced in all LifePath UK vintages. We will continue to monitor developments in the currency markets to ensure that our FX hedging strategy and implementation approach remain appropriate for LifePath UK.

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Conclusions

As the DC default becomes the primary source of retirement income for many in the UK, understanding the risks we take and how returns have been generated are key to evaluating, managing, and evaluating defaults. Achieving a level of hedging we have conviction in is therefore of paramount importance.

FX moves for GBP investors have impacted the risk and return of portfolios over the last decade and the regime of greater macro volatility will mean they should continue to impact portfolios. Our lifecycle framework aims to consider FX as a key part of our investment approach that ultimately seeks to build the optimal portfolio at each stage of the investment journey. The target date structure allows the investment team to evolve the asset allocation as our FX research evolves specifically for each cohort in the default. These inputs allow the portfolios to be more precise in the asset allocation and aim to improve the resilience of the portfolios relative to many of the simple hedging approaches adopted by DC defaults.

What's next

DC defaults need to continually evolve to capture the evolution in retirement thinking, regulation and the investment and technology toolkit. To better meet the needs of the retirement market, the LifePath team continue to evolve our lifecycle research. Here's a summary of our priorities:

- Spending in retirement – how the UK DC market should approach decumulation.
- Resilience via accessing alternatives in defaults – building the next generation of defaults.
- Sustainable investment insights – continued review and enhancements in building blocks, data, and insights
- Personalisation - through tools and technology

We will continue to update our clients and the industry with our latest thinking and we are committed to deliver:

Strong member outcomes and value

The highest levels of governance

Support for our partners' proposition

Ongoing product and solutions innovation

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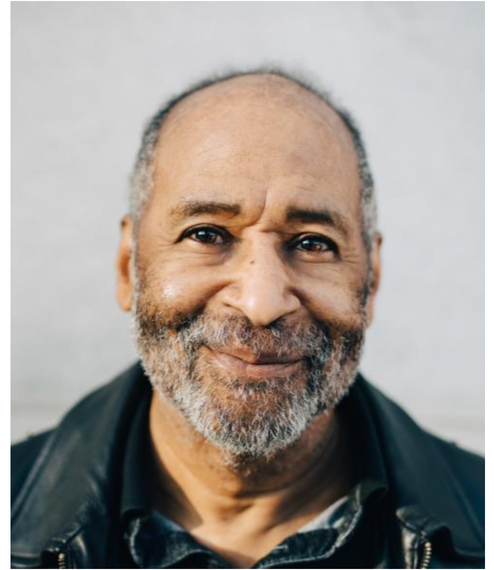

Delivering Confidence

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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Investors should refer to the prospectus or offering documentation for the (fund's/funds') full list of risks.

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.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time and depend on personal individual circumstances.

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