PMI Academy

CASE STUDY

Berenberg Protected Equities
A solution to the decumulation challenge

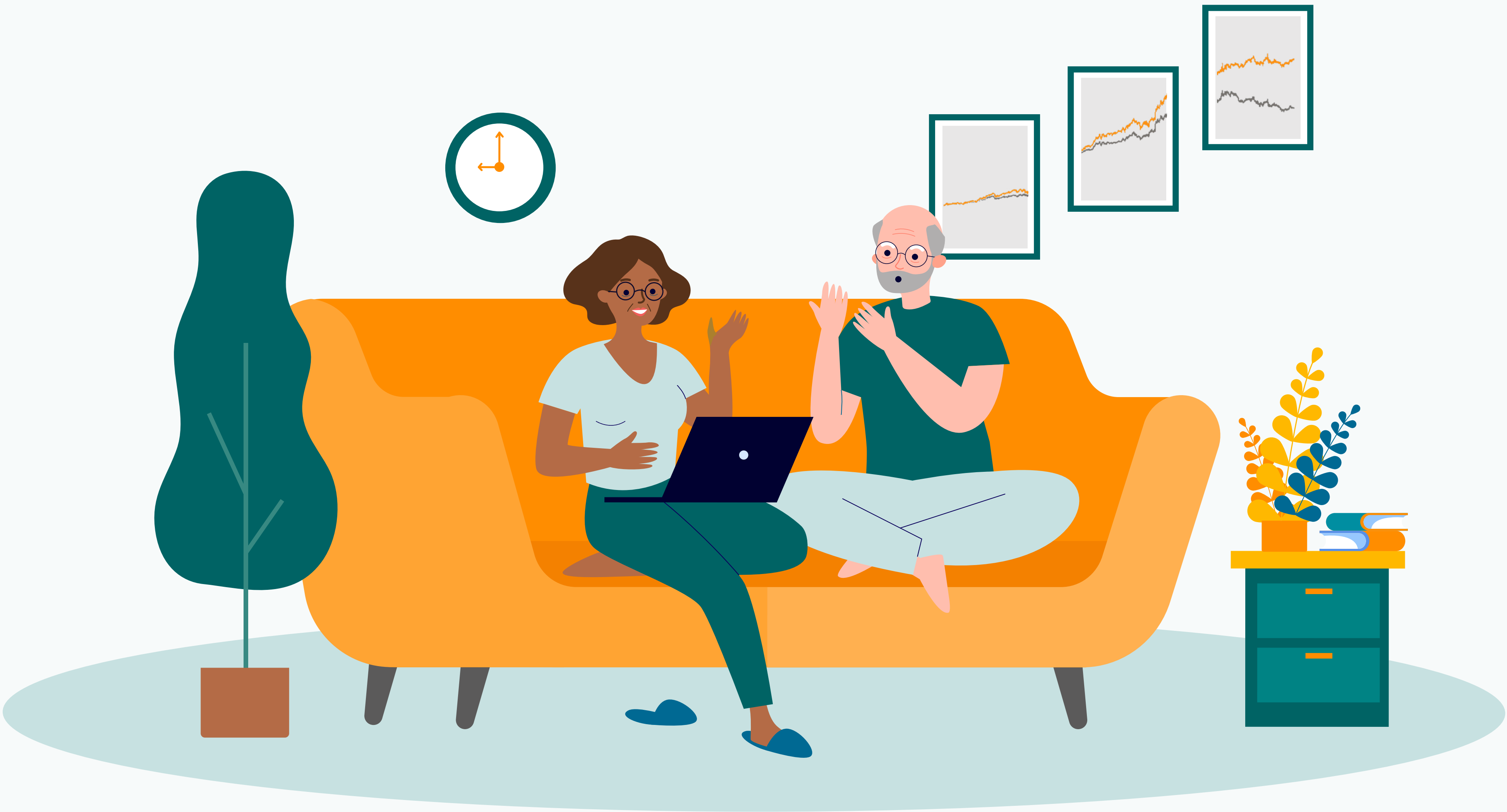
BERENBERG
PARTNERSHIP SINCE 1590

Introduction

Protected equities are an equity investment that utilise options to reduce downside risk, while aiming to achieve attractive returns by participating in equity market upside. In this case study we will show you how they can provide a solution to the decumulation challenge faced by Defined Contribution (DC) pension schemes.

The decumulation challenge

As the UK's DC pension market expands, a critical issue has come to the forefront: the suboptimal asset allocation in the later stages of the lifecycle model. Traditionally, this model dictates a shift towards more conservative investments as investors approach retirement, typically moving from equities to bonds. While this approach aims to protect accumulated wealth, it often leads to inadequate returns, potentially jeopardising retirees' financial security.

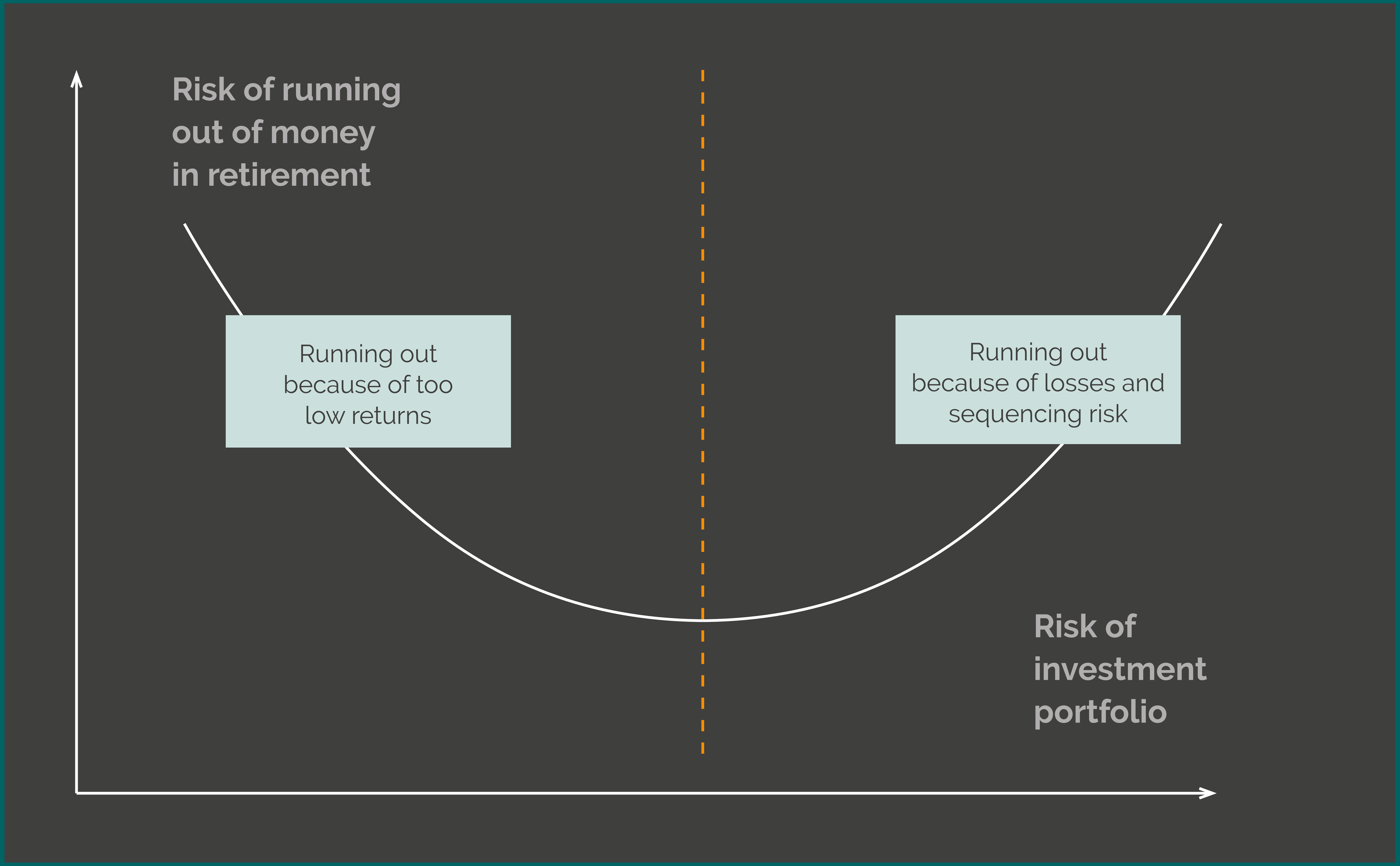


The problem is twofold. First, overly conservative investing can result in insufficient returns, risking the premature depletion of funds. Second, maintaining an aggressive allocation can expose retirees to significant losses that could undermine their capital base. This dilemma is compounded by the fact that most retirees have a low risk tolerance, making it challenging to maintain the equity allocations necessary for generating sustainable returns throughout retirement. A long investment horizon of often 20-30 years usually calls for higher equity allocations. However, due to the low risk tolerance and the threat of sequencing risk, pension members face a real dilemma: risk larger drawdowns with higher equity allocations or risk slowly running out of money over time due to inadequate returns.

The situation is further complicated by the current economic environment. With higher rates of inflation, portfolios generating low investment returns are more likely to be withdrawn prematurely as living costs rise. Most retirees are in the conservative investment camp, facing the risk of outliving their savings rather than having portfolios that are too risky.

In response to these challenges, Berenberg launched the Protected Equities Strategy for DC. The strategy aims to strike a balance between risk and growth potential, specifically designed for the later stages of the lifecycle model. The strategy employs a combination of equities and exchange-listed options to construct a portfolio that aims for long-term growth with reduced risk. By using options to hedge parts of the equity risk, the strategy can offset potential losses during market downturns while still allowing participation in rising markets. The downside protection enables investors to increase their equity allocations without significantly changing the risk profile in their portfolios. This can provide the growth that many pension members in the later stages need for a comfortable and long retirement.

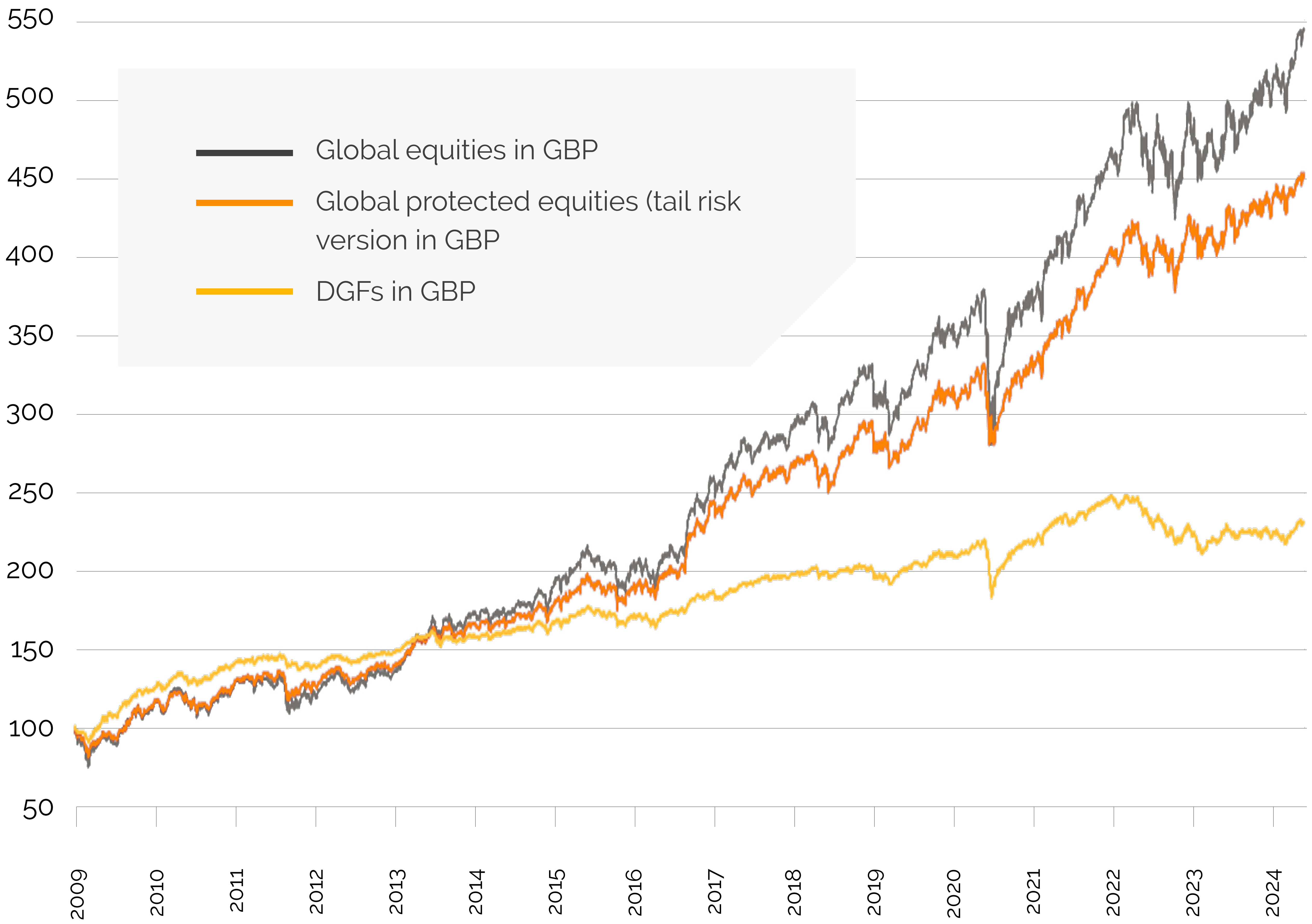
Sequence risk is the danger that the timing of withdrawals from a pension portfolio will damage the pension fund member's overall return. Pension withdrawals during a bear market are more costly than the same withdrawals in a bull market. Portfolio protection can help safeguard your pension portfolio against sequence risk.



The Protected Equities Strategy historically offered several advantages over traditional investment approaches, particularly when compared to Diversified Growth Funds (DGFs) and conventional equity-bond allocations:

- ***Improved Downside Protection:*** Historical simulations show that during major market downturns, such as the 2008 Lehman crash and the 2020 COVID-19 crash, the Protected Equities Strategy outperformed both DGFs and global equities, offering better capital preservation.
- ***Competitive Returns in Bull Markets:*** Despite its defensive nature, the strategy has shown the ability to capture a significant portion of market upside during bull runs.
- ***Flexibility:*** The strategy's different versions allow it to be tailored to various risk tolerances, making it suitable for different stages of the investment lifecycle.
- ***Addressing Sequencing Risk:*** By providing downside protection while maintaining growth potential, the strategy helps mitigate sequencing risk, which is particularly crucial for retirees drawing down their pensions.

Protected equities – start date 2009 / Simulated results: Starting after Global Financial Crisis



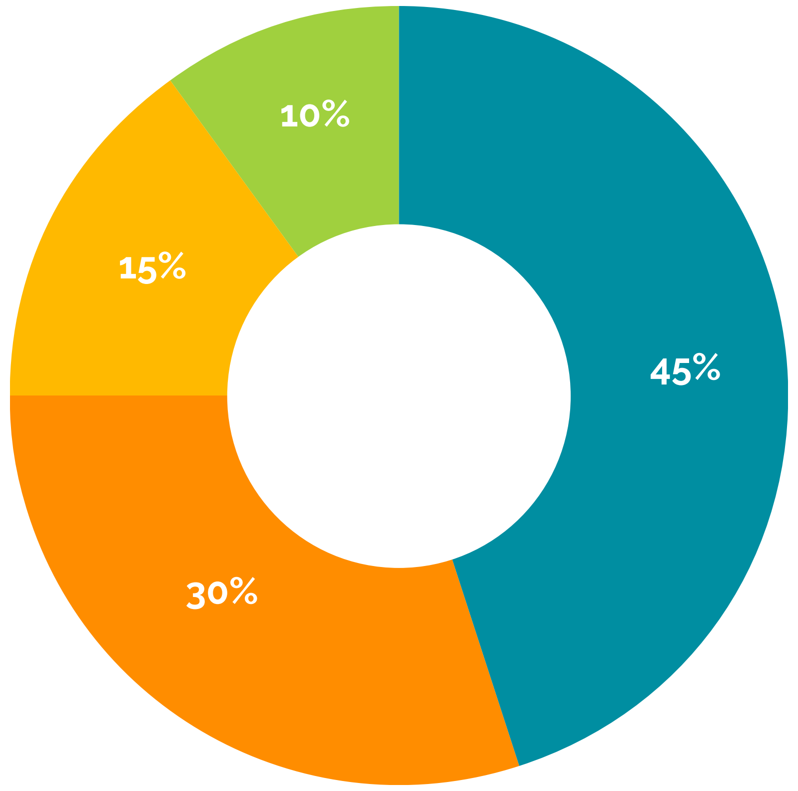
	Global equities in GBP	Global protected equities (tail risk version) in GBP	DGFs in GBP
Total return	491%	423%	137%
Return p.a.	13.4%	12.4%	6.3%
Vol p.a.	15.6%	12%	6.0%
Sharpe ratio	0.79	0.95	0.87
Max DD	-26.1%	-18.3%	-16.7%

Source: Bloomberg, BNP, Berenberg, internal calculations

Effect of adding Protected Equities to a portfolio

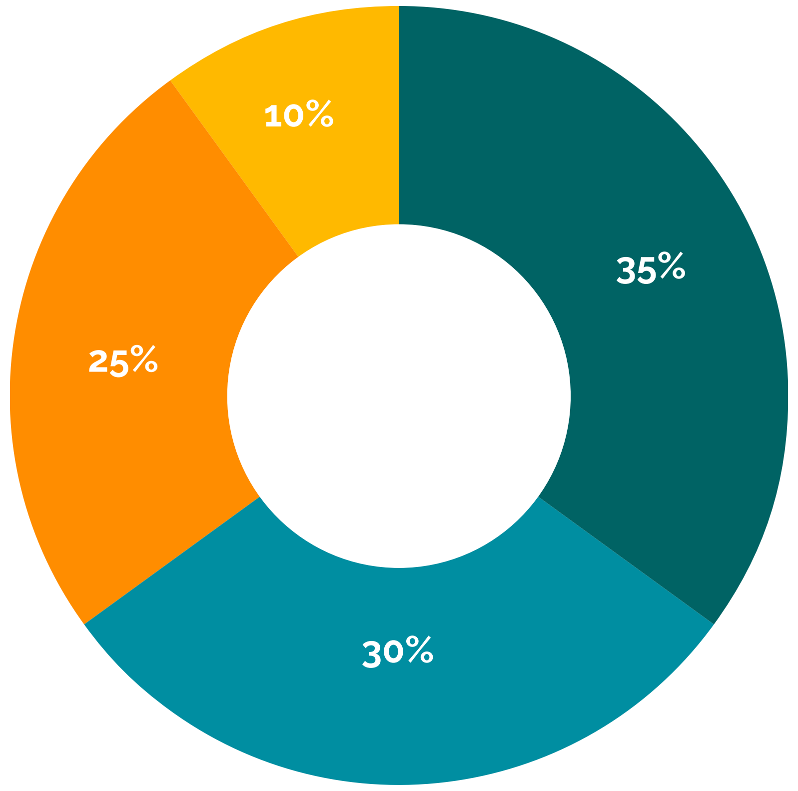
Below we look at the example of two portfolios, one resembling a typical pension member portfolio in the later stages with low equity allocations. We compare this to a portfolio with higher equity allocations via an investment in Protected Equities, showing the benefit for the risk-return profile and portfolio growth that Protected Equities can bring over the long term. As you can see, the addition of Protected Equities resulted in higher equity allocations which lead to higher growth without changing the risk profile of the portfolio.

Portfolio construction with Protected Equities



Original portfolio

- IG Bonds (45%)
- Govies (30%)
- Money market (15%)
- Equities (10%)

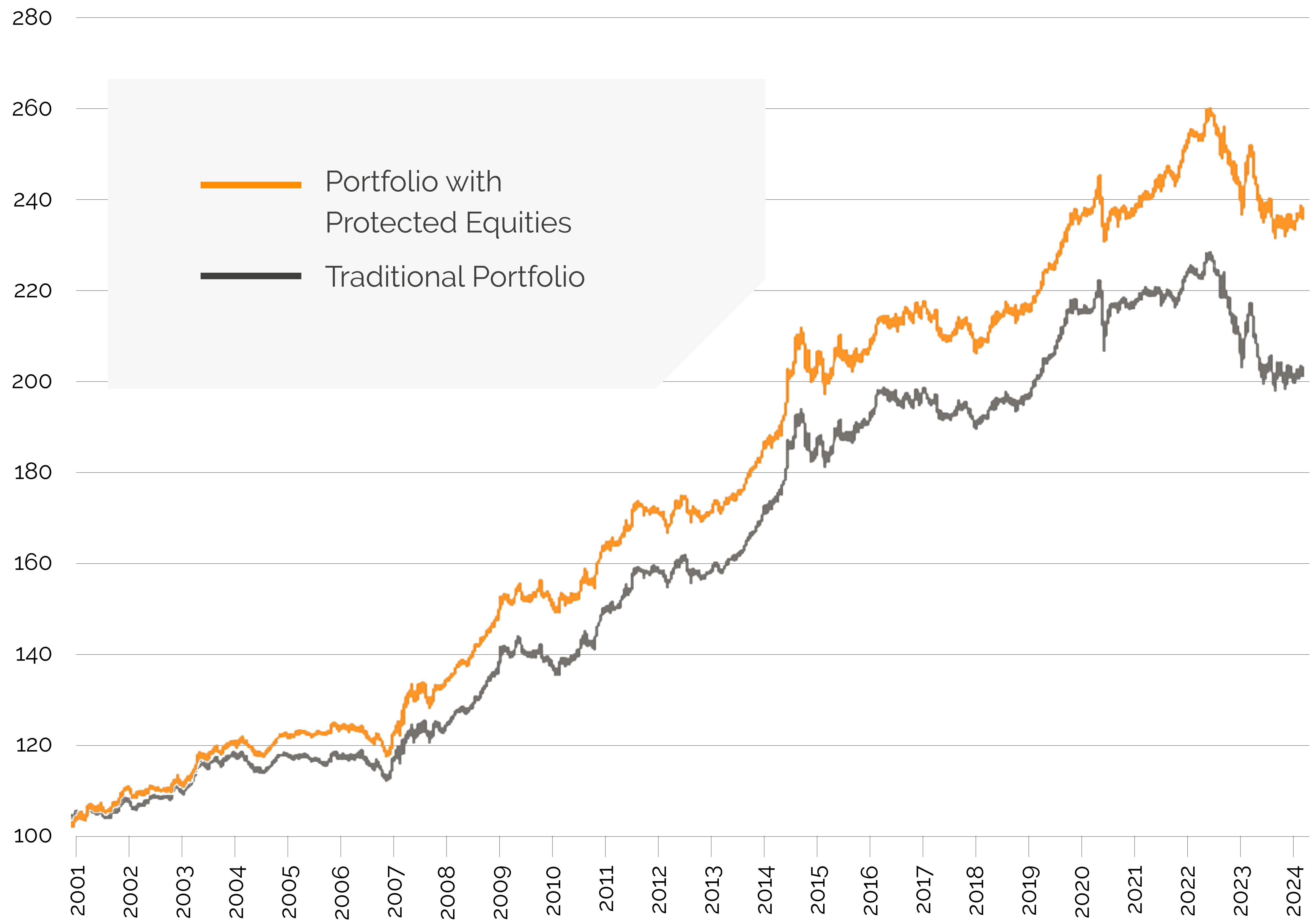


Portfolio with Protected Equities

- Protected Equities 'High Protection' (35%)
- IG Bonds (30%)
- Govies (25%)
- Money market (10%)

Portfolio construction with Protected Equities / Backtest: 2001 – 2024

HIGHER RETURN WITH LOWER DRAWDOWNS



	Traditional portfolio	Portfolio with Protected Equities
Total return	113%	157%
Return p.a.	3.6%	4.5%
Vol p.a.	2.5%	3.3%
Sharpe ratio	1.05	1.08
Max DD	-11.8%	-9.5%

Source: Bloomberg, BNP, Berenberg, internal calculations

Portfolio construction with Protected Equities

Source: Bloomberg, BNP, Berenberg, internal calculations

To further illustrate the potential impact of the Protected Equities Strategy over the long term, Berenberg simulated a "notional member journey" comparing a traditional allocation of equities, bonds, and DGFs to an allocation that includes Protected Equities. The simulation, running from 1990 to 2024, demonstrated that significant divergence occurred in the mid-growth and later stages where Protected Equities are added to the portfolio.

The portfolio incorporating Protected Equities allowed for higher equity allocations with similar levels of portfolio risk. This resulted in substantially better performance in the later stages, where traditional portfolios often contain minimal equity exposure. The cumulative effect over the entire lifecycle showed a marked improvement in the final portfolio value where the Protected Equities are included.

Notional member lifecycle / Simulated results: 1990 - 2024

Growth phase (age: 21-35)

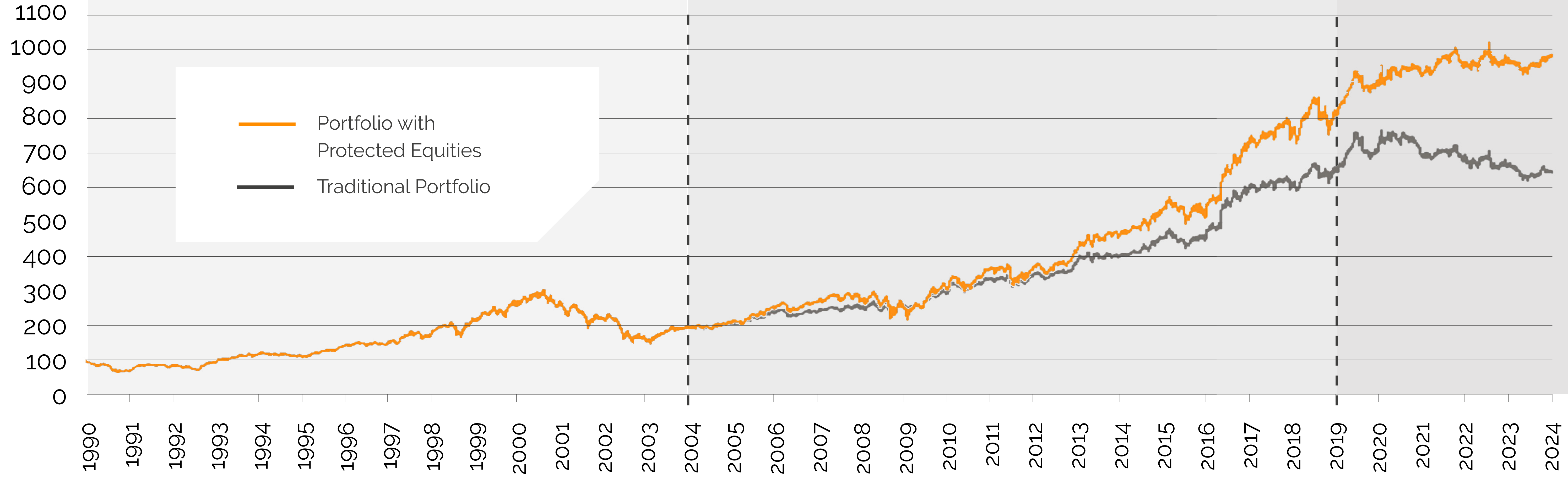
Return p.a.: 4.7% / 4.7%
Vol p.a.: 15.9% / 15.9%
Max. drawdown: -52% / -52%

Mid-growth phase (age: 35-50)

Return p.a.: 7.8% / 9.3%
Vol p.a.: 9.9% / 12.2%
Max. drawdown: -18% / -28%

Pre-retirement phase (age: from 50)

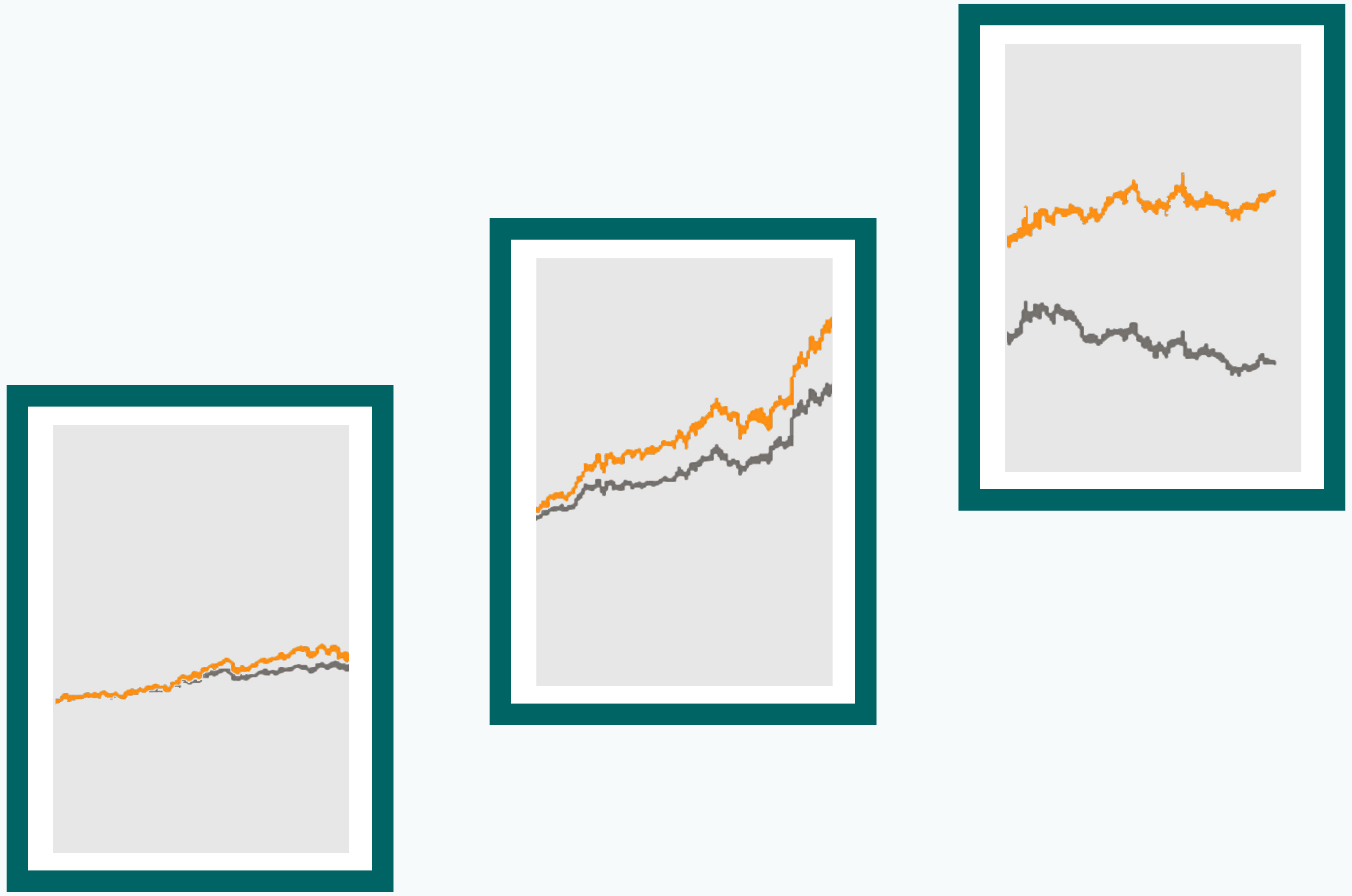
Return p.a.: 0.5% / 4.6%
Vol p.a.: 8.0% / 7.2%
Max. drawdown: -19% / -9%



Source: Bloomberg, BNP, Berenberg, internal calculations

Accessibility

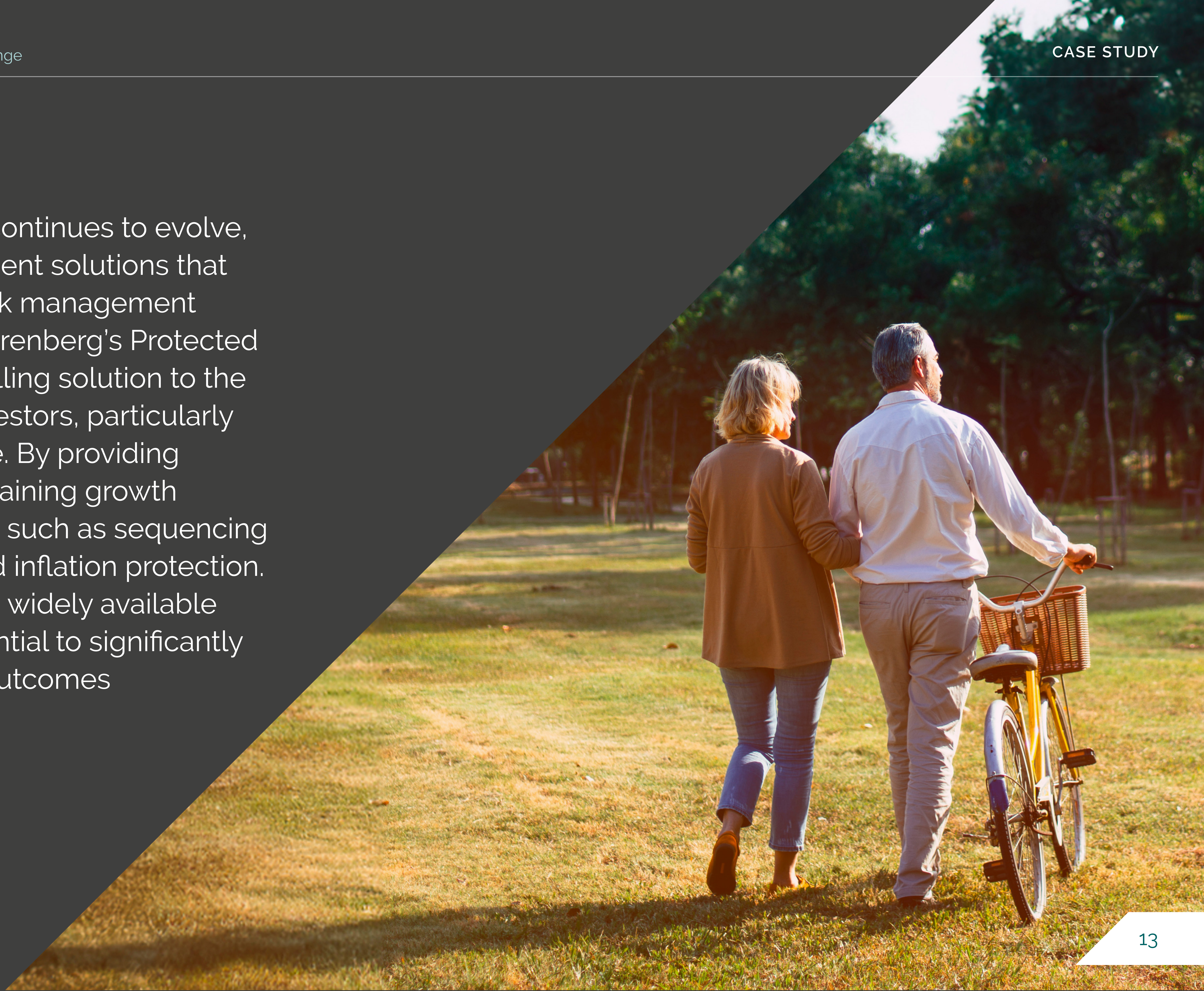
Berenberg has designed the Protected Equities Strategy to meet the specific requirements of the DC market. Key features include:



- ***Low Cost:*** The strategy aims to provide value for money, an essential consideration in the cost-sensitive DC market.
- ***ESG and Climate Considerations:*** The strategy incorporates environmental, social, and governance factors, aligning with growing industry requirements.
- ***High Liquidity and Transparency:*** The strategy offers daily pricing and trading, ensuring accessibility and clarity for investors.
- ***Platform Accessibility:*** It can be easily accessed via various investment platforms, facilitating integration into existing DC schemes.
- ***Regulatory Compliance:*** The strategy satisfies all DC-related regulatory reporting requirements, ensuring seamless adoption by pension providers.

Conclusion

As the UK's DC pension market continues to evolve, the need for appropriate investment solutions that balance growth potential with risk management becomes increasingly critical. Berenberg's Protected Equities Strategy offers a compelling solution to the challenges faced by pension investors, particularly in the later stages of the lifecycle. By providing downside protection while maintaining growth potential, it addresses key issues such as sequencing risk, needed portfolio growth and inflation protection. As the strategy has now become widely available to the DC market, it has the potential to significantly improve long-term investment outcomes for millions of pension savers.



Important Information & Risk Warnings

Important information

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Backtest assumptions: DGF comparison

Relevant information and parameters

General Information

- Past performance is not a reliable indicator for future performance
- Backtests are not a reliable indicator of future performance
- Backtests are simulated results that are based on a number of assumptions that have limitations and are not realised returns
- The returns include transaction costs but exclude management fees which are negotiated on a case by case basis.

Backtest Information

Source:	Bloomberg, BNP, Berenberg, internal calculations
Time period:	5/1/2006 to 27/02/2023
Currency:	All figures are in GBP and unhedged
Rebalancing:	Quarterly rebalancing
Overlay:	10p /20c: -10% Put delta, 20% Call delta: tail protection, 40p/25c: -40% Put delta, 25% Call delta: high protection
Global equities:	Global equities: MSCI World tracker
(initial weights:	50% SPX, 20% SX5E, 15% NKY, 15% UKX)
Protected equities:	Global equities plus option overlay
DGFs:	SLABRBD LX Equity, NOGDBIG LX Equity, BABGMCG LN Equity, MRLTGAI LN Equity, SCHDGWI LN Equity, MDVGM2S ID Equity, ABDGPZA LN Equity, BGDGANA LN Equity (equal-weight portfolio)

Berenberg: Protected Equities Strategy for DC

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