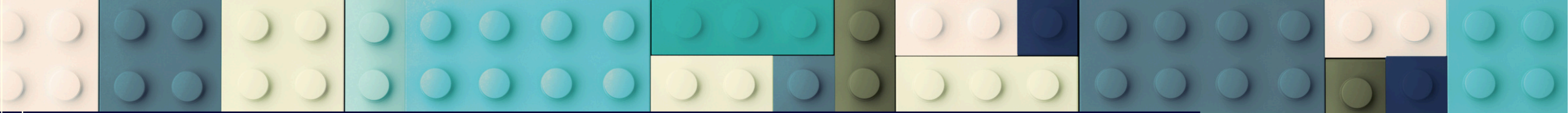

Expert investor series

Learning from Lego – how we build client portfolios

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“When I was your age” is a familiar phrase most children hear regularly.

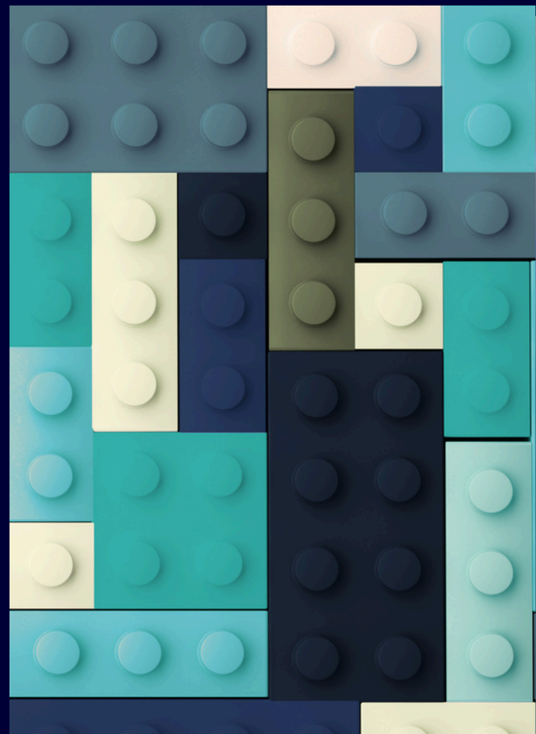
I recently caught myself saying this whilst bemoaning how Lego has evolved from my childhood. “Back in my day”, at least in my memory, we only had a handful of different Lego building blocks and no instruction book. Children were left to their creative imaginations, albeit constrained by the limited number of pieces. Today’s Lego has a seemingly infinite number of building blocks alongside instruction books requiring an engineering PhD!

Portfolio construction today shares similarities with the evolution in Lego’s building blocks. Just as Formula One Lego didn’t exist in the 1980s, super-core infrastructure and senior direct lending were not part of the institutional investors toolkit. And whilst today’s allocators have an abundance of different building blocks, their instruction manuals haven’t kept pace.

Back to the days of my Lego youth, modern portfolio theory made perfect sense and life was simple. We had equities for growth, bonds for income and 60/40 did the trick.

Today we still have equities: but is that US, Europe, Emerging Markets, large, small, tech or a factor strategy? And which flavour of equity: public, private, semi-liquid? And where does infrastructure sit? Or real estate? And for those, do you want core, value-add, or opportunistic?

Ah, I hear you say, but bonds are boring and the easy bit but, no. Is that government or corporate, high grade or junk, corporate or securitised, public or private, CLO or MBS!



Brightwell

You (sort of) know where you are with equities and bonds. What about ILS, SRT's, NAV loans, secondaries.... even engineering PhDs are now worried.

So how can investors today adapt to having a much wider toolkit but a dated and largely tattered instruction manual with pages missing. The Total Portfolio Approach (TPA) that is now widely adopted by many of the largest global investors provides one such solution.

At Brightwell, our One Portfolio Approach is an evolution of the TPA tailored for the needs of decumulating defined benefit (DB) pension schemes. There are 3 key elements our approach:

1. **Function, not form.** In the old days the function and form of assets was largely synonymous. Equities for growth, bonds for income. That is not the case with the range of potential assets today. For example, core infrastructure and core real estate have more in common with bonds, whereas their opportunistic equivalents are very much equity-like.

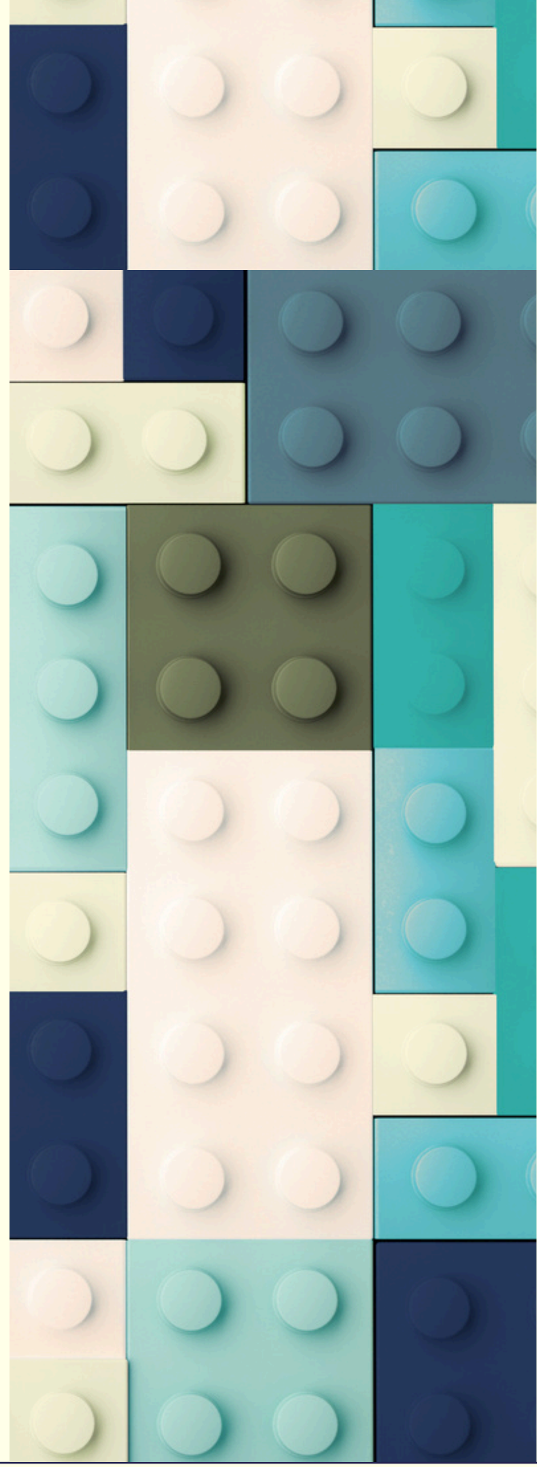
   Our approach considers the functional role an asset performs in a portfolio over its asset class form. We consider assets or strategies across 4 core attributes — risk-return, income, liquidity and duration. And build portfolios based on functional allocations, not asset allocations.

   For example, our cash-flow or income allocations comprise all assets with contractual income and limited terminal value risk — clearly this includes bonds but also assets like core, non-GDP sensitive infrastructure.

2. **Outcomes, not optimisation.** The mean-variance optimisation of a small number of (mostly public) asset classes formed the basic instruction manual for portfolio construction. Whilst there have always been certain limitations of this approach it can work relatively well with a small number of inputs which are relatively diversified and differentiated in their risk-return characteristics.

   Optimisation problems are exacerbated when the number of inputs increase as public and private assets are combined, which presents challenges from a modelling perspective. The growth in private markets allocations within investors' portfolios compounds those issues by making a portfolio rebalancing more difficult, as we have seen in the recent years since interest rates began to normalise.

   Our approach is to build portfolios that look to deliver outcomes in a range of scenarios that align with our clients' expectations and tolerances.

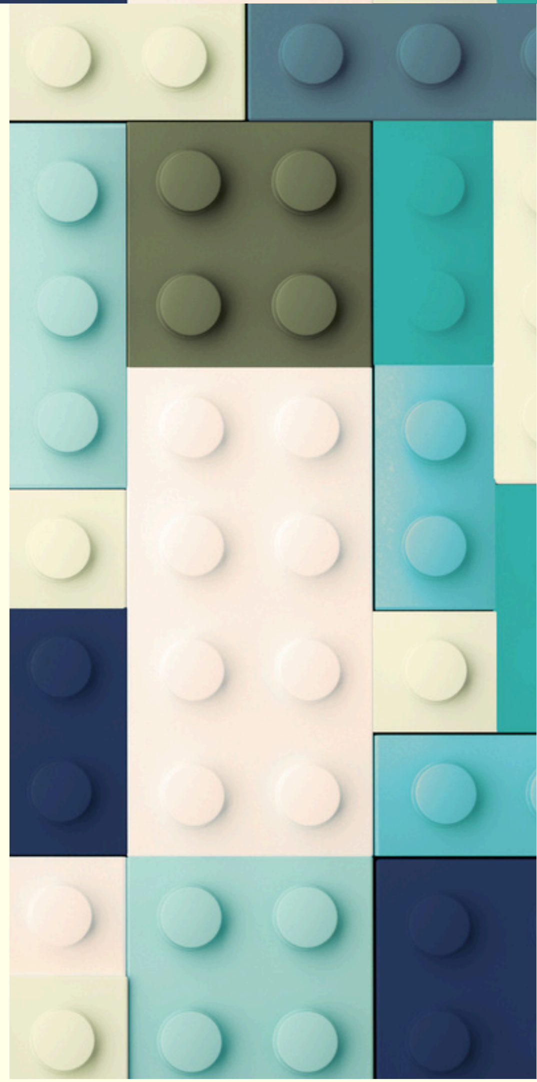


And, importantly, regularly updating and reporting scenario analyses to clients helps them understand the range of funding outcomes in a more tangible way. It also stimulates discussions that better tease out sensitivities to different outcomes in more depth, which helps us better shape the portfolio. Predictability is key.

3. **Cashflows, not co-variance.** Modern portfolio theory is based on the merits of diversification. By allocating to a range of assets that have historically performed at different points in the economic cycle, and with differing levels of price volatility, you can build an optimal portfolio where the risk adjusted sum of the parts is far better than that of the individual underlying assets that comprise the portfolio.

   This is still true, albeit with the caveat that forward looking risk-adjusted returns are hard enough to predict, before even considering the more challenging correlation assumptions!

   For mature defined benefit pension schemes, risk is no longer defined just as asset or even funding level volatility. What matters more is having robust and predictable income or asset cash-flows to meet member benefits at the precise time they are due. The risk that schemes increasingly face is not the value of assets going up or down. It's that their corporate bonds may experience defaults or be sold after a downgrade, thus locking in a loss. Or that tenants of their property assets fail to make lease payments or whether their infrastructure investments are providing resilient dividends.



In a world where the number of portfolio building blocks has multiplied, our instruction manual which focuses on the functional role of assets, range of outcomes and cashflow risk provides a more intuitive, practical and innovative way of building portfolios.

Most importantly, it helps our clients achieve their scheme funding goals in a predictable way. It's no longer just Lego that has made progress over the last 40 years!

For more information about Brightwell's One Portfolio Approach please contact Emily Benson
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