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AI concentration

(and other risks)



Investment briefing

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AI concentration risk

The Pensions Regulator (TPR) has recently issued guidance to help trustees identify and manage AI concentration risks.

Whilst we agree this is an area of potential risk, it is of course not the only one. Expansion of the conflicts in Ukraine and Iran, a sovereign debt crisis or a liquidity crisis are examples of other events that could have a materially adverse impact on investment markets.

In our view trustees should consider how a wide range of potential adverse scenarios might impact a scheme's investments.

On the pages that follow, we consider the key risks that might affect different asset classes and what action trustees can take to mitigate those risks.

This document does not constitute investment advice. Trustees should not make any changes to a pension scheme's investments without first obtaining formal investment advice from a suitably qualified adviser.

TPR's suggested action *and how we will help.*

- assess total portfolio exposure, including direct and indirect AI-related exposure across asset classes

We are engaging with investment managers to understand AI exposures, and we will summarise our findings in our quarterly monitoring reports. However, it remains to be seen how consistent, or indeed useful, the information provided will be.

- use scenario analysis to test portfolio resilience under severe but plausible stressed market conditions
- review whether diversification would remain effective if correlations changed during a downturn
- challenge investment advisers and managers on how market developments could affect the scheme's investments and objectives
- take proportionate action that reflects the scheme's circumstances

In our view, scenario analysis is not necessary for most small schemes. It will be costly and it is debatable whether the output would be of any real value. However, trustees should consider all risks within their investment portfolio and this document is intended to help with that assessment.

Equity

It is clearly impossible to call markets, but equity markets are close to historically high levels. AI stocks have been a key reason behind the equity market rally of recent years and a bursting of the AI bubble (if it is a bubble) might result in a material correction. Indeed, any global shock is likely to have an adverse impact on equity markets.

With an equity investment, the time horizon is crucial. Trustees expecting to buy-in or transfer to a superfund within 5 years should consider whether bearing the risk of an equity market downturn is appropriate.

If a global passive market capitalisation fund is held, then AI exposure will be high. This risk could be mitigated by diversifying the equity holding across other funds – for example, actively managed or capped weights index tracking funds.

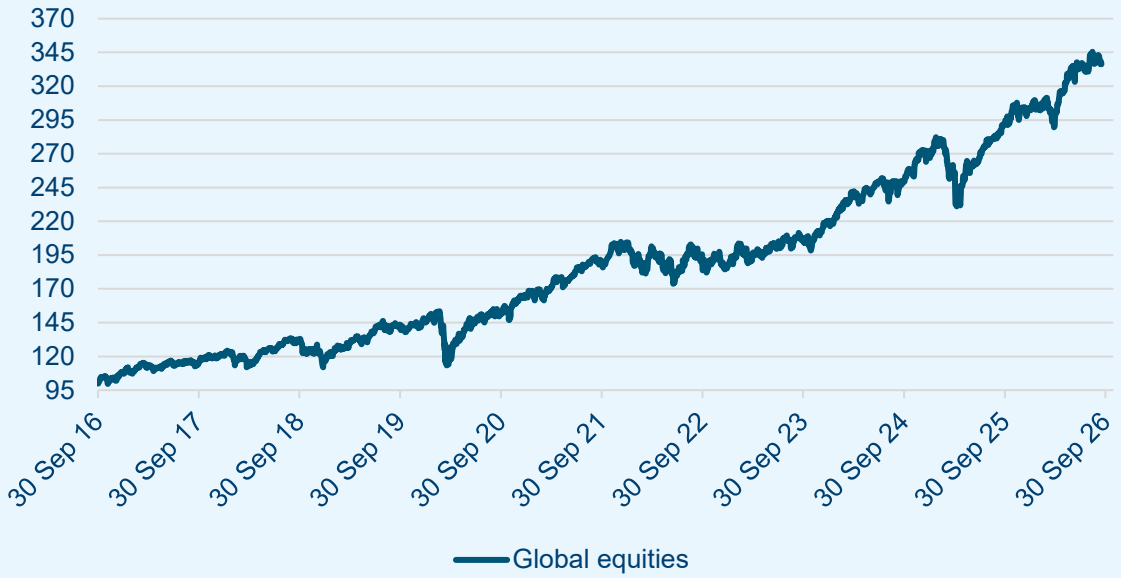
For smaller schemes, investing via an investment platform makes the addition of another fund to increase diversification a straightforward solution to implement.

Action required:

- Consider if the existing equity allocation is appropriate for the scheme's investment horizon.
- Consider whether exposure to the AI sector should be reduced by introducing an equity fund with a different approach.

Impact of AI-related shock: **high**

Chart 1: The equity market is close to an all-time high



Source: Refinitiv Datastream – MSCI World Index

Long-dated credit

As with equities, it is very difficult to call credit markets. However, they do look incredibly expensive at the moment. The credit spread (the extra yield offered above government bonds) is close to the tightest level experienced since the global financial crisis.

It's not hard to envisage that a global economic shock, whether triggered by an AI shock or other cause, would result in a correction in the long-dated credit market.

For schemes with exposure to long-dated credit, it is worth considering whether this remains the most appropriate way to achieve liability hedging, or whether a combination of short-dated credit and alternative hedging assets might offer a better risk/return trade-off.

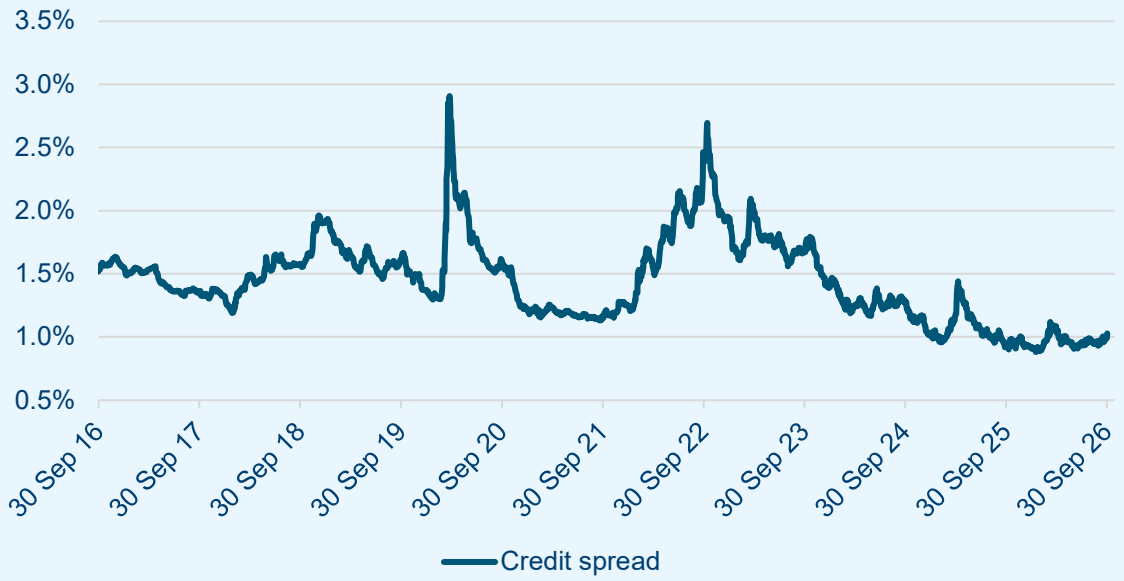
In addition, where a long-dated credit allocation is held, it is worth considering the exposure to the AI sector. We will report on this in our performance monitoring reports.

Action required:

- Consider replacing with a combination of LDI and short-dated credit.
- We will report on AI exposure within long-dated credit funds.
- Be ready to switch into long-dated credit if conditions become attractive.

Impact of AI-related shock: **modest**

Chart 2: The credit spread is tight



Source: Refinitiv Datastream - iBoxx £ Corporates - Option Adjusted Spread

Short-dated credit

Short-dated credit is an increasingly important asset class - the low return but low risk profile is well-suited to well-funded schemes looking for modest future growth.

The nature of this asset class means that it should be resilient against market shocks, whatever the trigger. We would expect the greater the allocation to investment grade credit, the more resilient the fund will be.

Where AI exposure is present within a short-dated credit fund, an important mitigation is provided by active management. The funds we favour are actively managed, meaning the fund manager will consider risks (including the risk of an AI shock) before lending money to companies.

With any actively managed fund, a key risk is that the manager's views prove to be incorrect. This risk can be mitigated by diversifying across funds where managers employ different management styles. This is something that is easy to implement if investing via a platform.

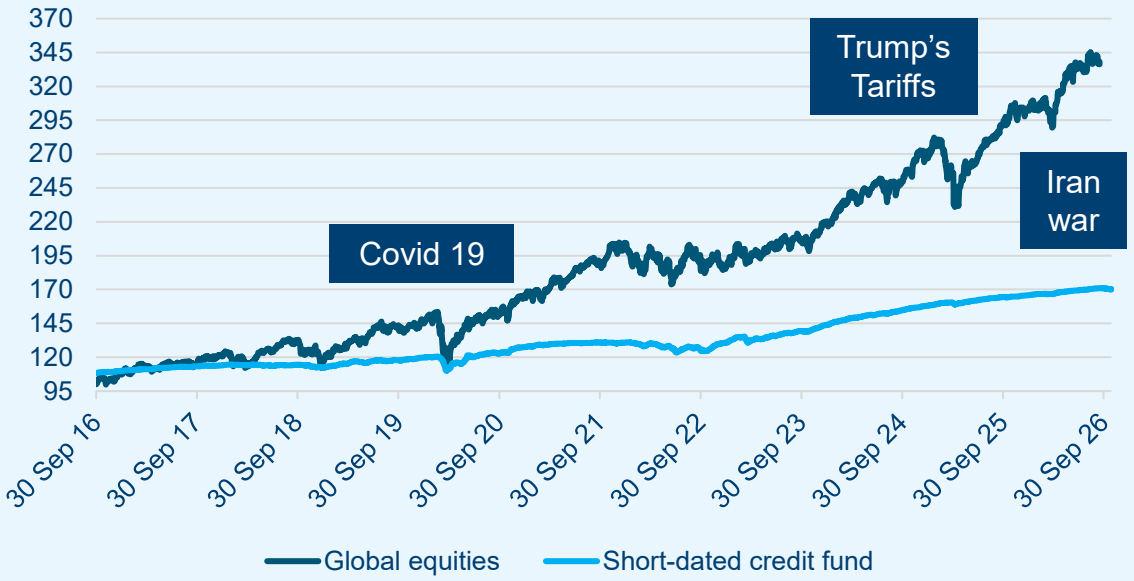
Action required:

- Consider increasing the number of short-dated credit funds held.

Impact of AI-related shock: Investment Grade / Balanced Funds: **modest**

Impact of AI-related shock: High-Yield Funds: **high**

Chart 3: Short-dated credit against equity markets



Source: Refinitiv Datastream

Gilt-based liability matching assets

Gilts and gilt-based LDI funds are increasingly important investments as schemes become very well funded.

We would not expect gilt-based liability matching assets to have material direct exposure to an AI-related market correction.

However, we all remember how this sector of the market was affected by the events of October 2022. Where LDI is held, trustees should ensure they have robust leverage management in place which will enable the liability matching to be maintained even in extreme market conditions. This is a key part of the quarterly monitoring service that we provide.

Impact of AI-related shock: **low**

Action required:

- Ensure LDI rebalancing arrangements are robust.
- Where we provide quarterly performance reports, we routinely check LDI rebalancing arrangements.

Illiquid assets

AI exposure within the illiquid market is likely to be very fund specific. As with any active fund, the investment manager will be mindful of all potential risks before making an investment and this provides some mitigation.

The biggest risk trustees face with illiquid assets is that the slow timeframe for exit may disrupt plans if buy-in becomes feasible sooner than anticipated. Trustees should consider if there is any chance of buy-in or transfer to a superfund in the next five years. If there is a chance, a plan to exit illiquid holdings is required.

Impact of AI-related shock: **fund dependent**

Action required:

- If buy-in may become feasible within the next five years, review the scheme's illiquid assets and establish an appropriate exit plan.

Currency

A global economic shock is likely to result in significant movements in currency markets. Some currencies, particularly the US dollar and Japanese yen, have historically strengthened during certain periods of market stress, although this should not be relied upon in every scenario.

For a UK pension scheme, an unhedged overseas investment will be affected both by the performance of the underlying asset and by movements in sterling. A fall in sterling will increase the sterling value of overseas assets, while a rise in sterling will reduce it.

Some unhedged currency exposure within growth assets may provide useful diversification. However, currency movements can overwhelm the relatively modest expected returns from defensive assets. For that reason, overseas bond funds will generally be expected to hedge most, or all, of their currency exposure back to sterling.

Action required:

- Consider the currency exposure across the entire portfolio.
- Retaining some unhedged currency exposure within growth assets may provide diversification.

Wider considerations

Our analysis considers asset classes individually, but it is also important to look at the impact of risks across the entire portfolio - that is a key point made in TPR's guidance.

When the risk of an investment portfolio is modelled, diversification is seen to be beneficial as it is unlikely that all asset classes will struggle simultaneously. TPR's observation is that an AI-driven crisis might diminish the beneficial impact of diversification.

Trustees should remind themselves of the investment risk previously modelled and consider whether a higher number (consistent with diversification benefits being diminished) could be tolerated. As with any strategy considerations, the strength of the sponsor covenant and the expected investment time horizon will be important factors.

And finally, to finish on a positive note, AI is clearly changing the world, but it is possible that the benefits have not yet been properly priced in by markets. Maybe the AI boom has only just begun.

Action required:

- Consider the potential impact of several asset classes falling simultaneously.

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