

FEBRUARY 2026

LIABILITY DRIVEN INVESTMENT THEMES FOR EUROPEAN MARKETS IN 2026

SUMMARY

European LDI investors entered 2026 facing an evolving environment for risk-management strategies. Long-term interest rates appear to have settled at structurally higher levels, and the ripple effects of reforms, most notably the Dutch pension transition, continue to have the potential to reshape market dynamics at the long end of yield curves.

At the same time, historically tight credit spreads, potential inflation uncertainty, and diverging government bond performance are providing schemes with strong reasons to reassess both their hedge design and the approach they take to hedge management.

We outline some key themes we expect to shape LDI strategies in 2026 across Germany and the broader European market:

- Increasing hedge ratios as investors seek to take advantage of structurally higher yields and adopt a sharper focus on curve precision and instrument selection.
- Adoption of credit-aware hedging frameworks in an expensive credit environment.
- Expansion of risk-management activity to include seeking increased protection against inflation and equity-tail risk.

DEVELOPMENTS AND TRENDS IN HEDGING MARKETS

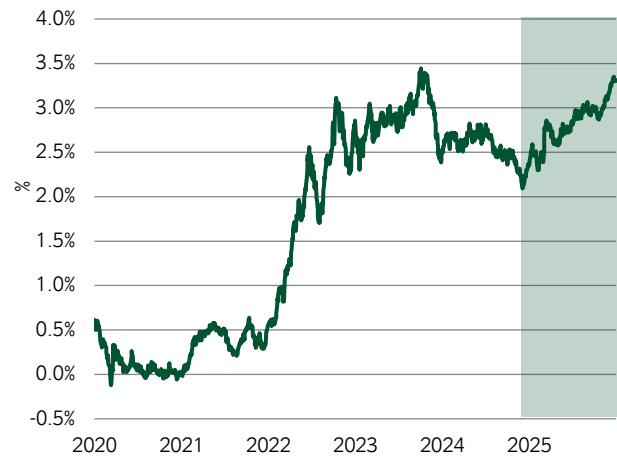
A number of trends have emerged in markets that are worth highlighting.

Rates: bond yields moved higher

Markets have begun to reassess the sustainability of government debt across the developed economies driving yield curves steeper. In Europe (see Figure 1), this may have been exacerbated by the anticipated market impact of Dutch pension reforms (for more information, see page 2).

The roughly 100 basis point (bp) increase in 20-year swap yields in 2025 coincided with curve steepening, as lower inflation allowed official short-term rate cuts to continue.

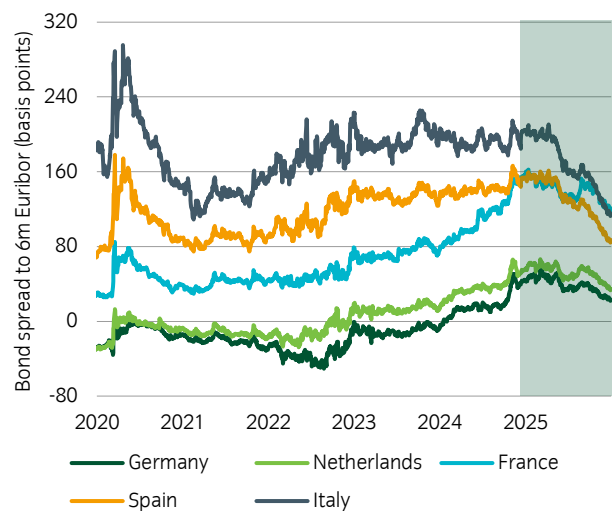
Figure 1: 20-year Euribor swap rate rose steadily in 2025¹



Spreads: significant tightening

Long-dated government bond yields relative to six-month Euribor swap rates (z-spreads) have tightened substantially (by almost 100bp in some cases), particularly over the latter half of 2025, as Figure 2 shows. The tightening was relatively modest at shorter maturities. On a spread basis, Italy and Spain materially outperformed core and semi-core government bonds.

Figure 2: Tightening of 30-year z-spreads across Europe was notable in some countries¹

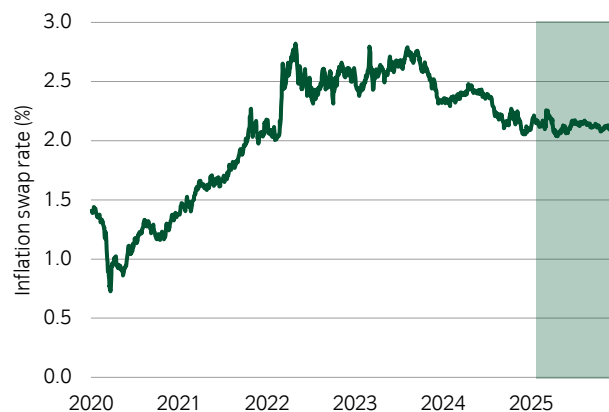


¹ Source: Insight, Bloomberg. As at 31 December 2025. 20-year euro swap rate versus 6-month Euribor

Inflation pricing: less volatile as it trended sideways

The 20-year inflation swap rate referencing the eurozone harmonised index of consumer prices (excluding tobacco) (€HICPxT) ended the year largely unchanged, having spent the year in a relatively narrow range between 2.0%-2.25%. It ended the year just below 2.1%; marginally above the European Central Bank's (ECB) inflation target (Figure 3).

Figure 3: Inflation pricing remained steady through 2025²



Reforming the Dutch pension system

The Netherlands is undergoing a historic transformation of its pension system, as set out in the Future of Pensions Act (Wet toekomst pensioenen, or WtP), which came into effect on 1 July 2023. The legislation shifts employers and pension funds away from final salary defined benefit (DB) schemes toward defined contribution (DC) frameworks.

Under the new regime, pensions are no longer assumed to be guaranteed and underwritten by sponsoring employers. Instead, benefits depend on contributions and investment performance. The transition is characterised by a move to either collective defined contribution (CDC) schemes, or to individualised defined contribution (IDC) pots.

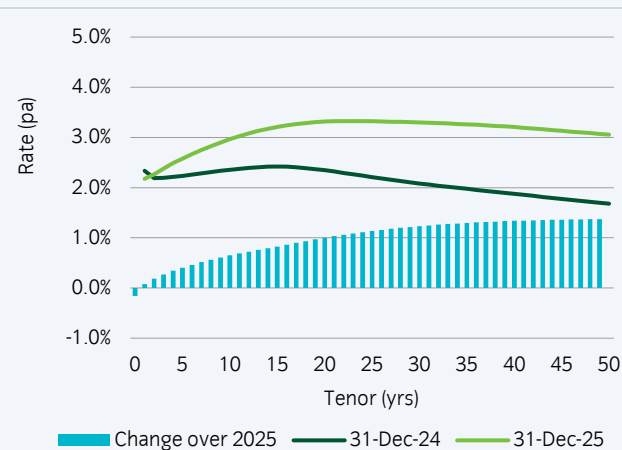
Among the intended benefits of the CDC approach is that investment and longevity risk may be shared between different age cohorts. Our understanding is that a significant majority of schemes in the Netherlands seem to be transitioning to CDC rather than IDC.

The Dutch pension market historically held a material exposure to long-dated interest rate swaps, hedging the sensitivity of long-dated, defined benefit liabilities to interest rates.

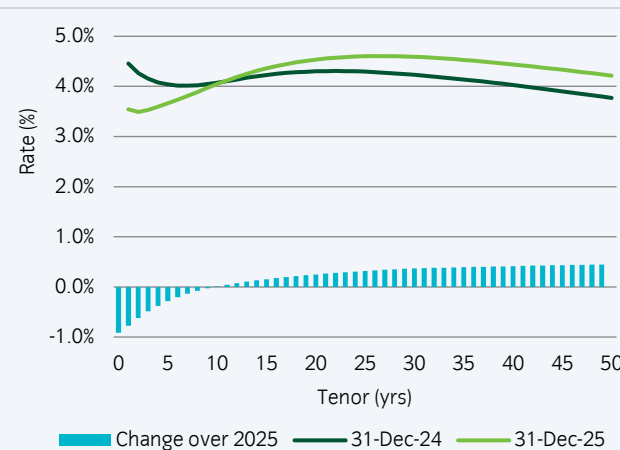
From a market perspective, the expectation has been that a material proportion of this swap exposure will need to be unwound. This has potentially contributed to higher rates and steeper interest rate curves in Europe. The two charts below compare the steepening in the six-month Euribor swap curve and the GBP SONIA curve over 2025.

So far in 2026, the euro swap curve has flattened, not steepened. This may reflect that the percentage of swaps retained has been higher than expected and the implementation period being longer than expected. However, the process is far from over.

Change in EUR swap rates over 2025²



Change in GBP swap rates over 2025²



For employers, the reform imposes a legal obligation to design and implement transition plans by 1 January 2028. As of January 2026, several funds including the Occupational Pension Fund for Veterinarians (SPD), Shell Nederland Pensioenfond Stichting (SNPS) and PFZW have officially moved to the new pension scheme landscape. Some of these schemes have also announced that they expect to retain between a 20%-30% allocation to swap exposures even for younger cohorts. The largest pension scheme in the Netherlands, ABP, which has over €500bn in assets under management, has yet to transition but is expected to do so by 1 January 2027. Market participants continue to assess the potential future impact on the euro interest rate markets.

² Source: Insight, Bloomberg. As at 31 December 2025.

Scheme funding levels

We have observed sustained improvements in funding levels for European schemes. This may be mainly attributed to higher rates and strong growth asset performance.

Mercer recently announced that funding positions of schemes for DAX40 Index companies have improved by 10 percentage points on average in 2025, to 93% on an IAS 19 basis.

In our view, this should help underpin demand for risk management solutions to help schemes protect healthy funded positions from adverse future moves.

LDI IN GERMANY AND EXPECTATIONS FOR 2026

We expect clients to implement and progress their approach to liability risk management in 2026. We estimate that the average hedge ratios are around 70% for DB schemes in Germany, and we expect these hedge levels to increase further as funding level improvements materialise.

There are a range of LDI implementation approaches open to schemes looking to take action to improve their funding positions.

First generation: longer/better bonds to hedge liability risks

The first stage of LDI implementation has often been to increase the duration of existing bond allocations; a strategy often referred to as “better bonds”.

This can often represent an effective first step in reducing outright risk to interest rate exposure and/or inflation, but it may result in material curve mismatch relative to the ‘perfect’ or ‘least risk’ hedge. Over time, this curve mismatch should not be left unmanaged. As hedge ratios increase, we believe discrepancies in the curve match should be repaired often coinciding with the introduction of derivatives.

Second generation: introducing derivative overlays to enable efficient hedge management

The most common constraint to rapid and meaningful hedge increases is lack of available capital and the inability to easily reallocate from growth assets to matching assets, particularly if bonds are the preferred hedging instrument.

Using derivatives may facilitate opportunistic and effective implementation of strategic hedging decisions, as they permit clients to quickly increase or improve their hedges without the need to reallocate capital (subject to them having sufficient collateral). Historically, over-the-counter (OTC) interest rate and/or inflation swaps have been the preferred derivatives for hedging liabilities in Germany, in part due to constraints at the KVG (Kapitalverwaltungsgesellschaft).

However, in 2025 we introduced government bond total return swaps (TRS) within some KVG mandates we manage. This includes being able to transact TRS on non-collateral eligible assets (e.g. peripheral and semi-core government bonds). Using

TRS may therefore help achieve a dual objective of improving collateral sufficiency and optimising the efficiency of the government bond mix in hedging mandates. We expect government bond TRS to become a more prominent feature of German LDI portfolios.

Third generation: dynamic bond/swap management to navigate market conditions and ensure a robust hedge

In 2025, the divergence in performance of government bonds relative to interest rate swaps remained a theme. French government bonds outperformed German bunds on an absolute return basis, while Italy was the strongest performing government market relative to swaps³.

Europe enters 2026 with what appears to be a fragmented risk backdrop. Growth remains sensitive to financing conditions, and the distribution of potential outcomes across countries, sectors, and issuers has widened. This is pulling de-risking conversations away from blunt risk-reduction moves (i.e. a static portfolio of high-quality bonds rate AA or better) towards more holistic discussions on how to delegate the management of hedging assets, seeking to navigate diverse market conditions continuously, and more effectively.

Historically, hedging mandates have been concentrated in buy-and-hold allocations to German, French and Dutch government bonds. In 2026, we believe more clients will seek out LDI managers who can manage all components of an IAS 19 hedging mandate in aggregate but particularly seek to dynamically manage a diversified allocation to government bonds in an effort to ensure a robust, but efficient hedge.

CREDIT SPREAD LIABILITY HEDGING IN AN ENVIRONMENT WHERE SPREADS ARE TIGHT

Managing credit sensitivity

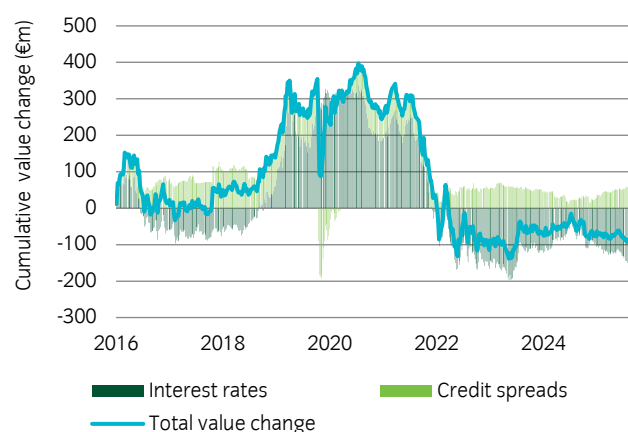
The IAS 19 discount rate is based on the yield of high-quality (i.e. AA rated or higher) corporate bonds. This yield can be broken down into an interest rate and credit spread component. While the interest rate component is often the most volatile (a decrease in interest rates increases the present value of liabilities and vice versa), the credit spread component can at times have a material impact on the value of pension obligations (a decrease in credit spreads increases the present value of liabilities and vice versa).

To illustrate this point, Figure 4 shows the cumulative change in value of a hypothetical set of liabilities (€1bn as of 2016), split by the interest rate and credit spread component, as euro government bond yields and IAS 19 credit spreads changed from 2016.

Overall, the value of the hypothetical liabilities would have declined in value, although partially offset by tightening credit spreads.

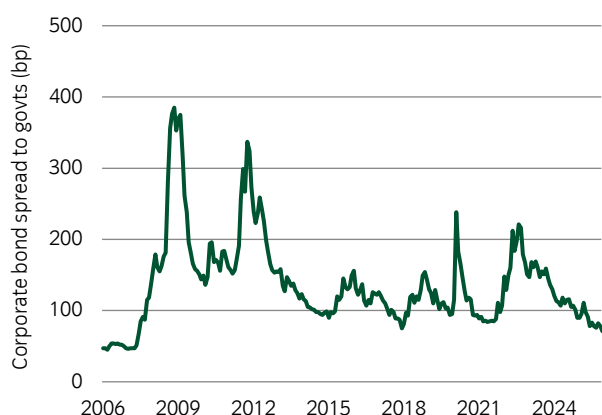
³ Source: Insight, Bloomberg. As at 31 December 2025.

Figure 4: Evolution of liability values – rates versus credit components⁴



As it is not generally possible to invest directly in IAS 19 spreads and credit spreads themselves are trading close to their tightest historical levels (Figure 5), managing credit sensitivity is expected to be an important challenge for risk management strategies in Europe.

Figure 5: Euro corporate spreads are low by historic standards⁵



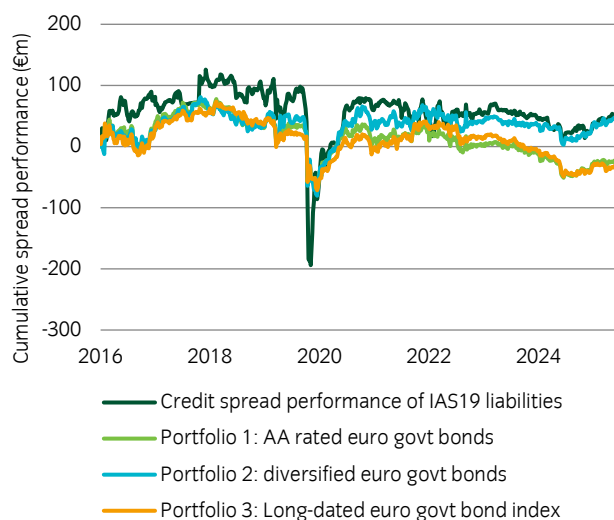
We believe the following to be the most appropriate approaches given the existing tightness of credit spreads.

- **Duration management:** Invest in shorter-duration credit to reduced interest rate sensitivity but still capture the additional carry available on corporate bonds, with the intention of switching to longer maturities if spreads widen.
- **Active management:** We believe there is considerable potential to add value through active management. Credit markets are generally structurally less efficient than equity markets, potentially providing opportunities for skilled managers to uncover mispriced assets and inefficiencies.

Consequently, it may be beneficial to look beyond pure yield levels and place careful emphasis on manager selection, focusing on those with a proven ability to achieve outperformance against market benchmarks.

- **Government bonds as a proxy hedge:** Over certain periods, government bonds may provide a reasonable hedge for the corporate bond component of an IAS 19 discount rate. The back test shown in Figure 6 demonstrates the cumulative value changes arising from movements in credit spreads across a range of alternative illustrative hedge portfolios:
 - Portfolio 1: Credit spread performance of a portfolio of AA-rated EUR government bonds⁶, equally weighted in terms of interest rate sensitivity at inception.
 - Portfolio 2: A portfolio of EUR government and EU supranational bonds, equally weighted in terms of interest rate sensitivity at inception⁷.
 - Portfolio 3: A passive allocation tracking the performance of a 20 year+, AA- rated and above, government bond index⁸.

Figure 6: Illustrative value change using different hedging assets



Overall, but particularly in the post-pandemic period, portfolio 2 (a diversified portfolio of government bonds from seven eurozone governments) appears to have tracked the spread performance of IAS 19 discounted liabilities most closely.

Accessing attractive credit opportunities

When credit spreads have widened in the recent past, they rarely stayed wide for an extended period, as Figure 5 shows. Consequently, if schemes intend to add credit exposure in order

⁴ Source: Insight, Bloomberg. As at 31 December 2025. We created a cashflow profile such that when discounted on the Insight EUR IAS 19 curve, the liabilities had a present value of €1bn and a duration of 20 years as of 31 May 2016.

⁵ Source: Bloomberg. As at 31 December 2025. ICE BofA Euro Corporate Index option adjusted spread to governments.

⁶ Source: Insight, Bloomberg. As at 31 December 2025. French, Austrian and Belgian government bonds as of 31 May 2016.

⁷ Source: Insight, Bloomberg. As at 31 December 2025. German, Dutch, Spanish, Italian, French, Austrian and Belgian government bonds plus EU supranational bonds where in issue.

⁸ Source: Insight, Bloomberg. As at 31 December 2025. Bloomberg Euro Agg Treasury 20+ Year Index (AA- up) Total Return Index Unhedged EU.

to capture attractive opportunities on spread widening, we believe the following approaches may be the best way to do so.

- **Add credit default swaps (CDS) to the toolkit:** Selling CDS (which involves selling credit protection and receiving a cash premium for doing so) may be an efficient and effective way to quickly capture attractive spread levels. This allows pension schemes to switch into physical credit at a later date, once the required re-allocation of assets has been arranged.
- **Utilising trigger mechanisms:** For credit mandates already in place, triggers may provide a helpful framework to ensure credit spread hedges get applied once pre-identified, entry points are reached.

OTHER RISK MANAGEMENT OPPORTUNITIES

Inflation

Inflation can typically come in waves. In 2025, we observed a marginal cheapening in inflation, particularly at the shorter and longer tenors.

Unhedged inflation risk is not only a valuation risk – it also increases a scheme's cashflow risk (i.e. potentially needing to realise more assets than expected to meet benefit payments where inflation is not adequately hedged). Balanced with the substantial political and economic uncertainty, current inflation pricing, in our view, provides an attractive entry point for clients to introduce or increase the inflation hedge they have in place

Equity protection

While equities have delivered material long-term returns, they have historically had a significant susceptibility to substantial drawdowns following market shocks and during periods of uncertainty. This is particularly relevant as the price-to-earnings ratios of the S&P 500 Index constituents currently sit around the 90th percentile dating back to 1990⁹.

Current elevated valuation levels, which may be partly reliant on the potential for AI to underpin future earnings growth, help reinforce the case for considering disciplined, cost-managed, downside protection.

Systematic and diversified equity protection approaches may be able to do more than limit drawdown. They may also help retain upside potential. Some of the main protection approaches available to clients are:

- **Fixed term protection:** Option strategies implemented for a fixed time period.
 - Benefits: provide simple with pre-defined, transparent outcomes.

- **Systematic protection:** Rolling protection strategy based on agreed rules (e.g. 1/12th of exposure rolled each month for one year).
 - Benefits: option strikes are not static throughout the life of the strategy; they can broadly track market levels in a low-governance solution.
- **Diversified protection:** Ongoing protection with a diversified mix of systematic strategies used to achieve agreed objectives.
 - Benefits: low initial and ongoing governance due to increased delegation. Potential that more of any equity upside may be retained.

CONCLUSIONS

Several clear themes are emerging as investors seek to strengthen their risk management strategies and position portfolios for the macro environment in 2026 and beyond:

- Increasing hedge ratios as improved funding levels allow schemes to lock in attractive long-term yields and protect position against future rate declines
- Evolving the management and integration of LDI portfolios to better adapt to market developments and idiosyncratic sovereign risks
- Considering ways to better manage credit spread sensitivity, particularly in a tight credit spread environment
- Consider other risk factors such as inflation and equity markets, should it be deemed to be a particularly attractive time to hedge

Together, these themes reflect a shift towards more holistic, multi-factor risk management strategies. Investors who integrate interest rate, credit, inflation, and equity hedging mandates stand to potentially benefit from better governance and resilience and may be better placed to convert today's challenges into a robust yet efficient, long-term risk management strategy.

⁹ Source: Insight, Bloomberg. As at 31 December 2025. As measured using data from Bloomberg from 31 December 1990.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance and simulated performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, investment exposure to international markets, and exchange rate fluctuations.

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Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due. The return risk to a portfolio is higher where a portfolio is highly concentrated in such an issuer.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large impact on the portfolio.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Where high yield assets are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- Property assets are inherently less liquid and more difficult to sell than other assets. The valuation of physical property is a matter of the valuer's judgement rather than fact.
- The specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Also, many loans are not actively traded, which may impair the ability of the portfolio to realise full value in the event of the need to liquidate such assets.
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