

IMPLEMENTING LDI IN PENSION PLANS

Tougher funding and disclosure requirements are spurring pension plan sponsors around the globe to reconsider the context of how they view their assets and liabilities.



A growing number of pension plan sponsors are considering liability-driven investment (LDI) as a framework for ensuring adequate funding of future benefits. Proponents of an LDI framework assert that managing a plan's assets in the context of its liabilities is the most prudent way to ensure pension obligations are paid.

Plan sponsors, however, have been slow to implement these approaches. Less than a quarter of pension plans worldwide embrace an LDI strategy, according to a new study by Northern Trust and Greenwich Associates (see "Use of LDI Strategies" chart, page 19). Fewer than one out of 10 pension plan trustees feels "very comfortable" with the approach. Not surprisingly, adoption rates are higher in the United Kingdom and the Netherlands, where regulatory changes have been in place longer. In the United States, these strategies are gaining a toehold. Many analysts, however, expect interest to grow with recent regulations imposing stricter funding and disclosure requirements on pension plans.

Making the Case for LDI

Why the growing case for liability-driven investing? Ravi Gautham, director of risk management and analytics for Northern Trust's global investment solutions team, describes how traditional approaches to funding benefits are falling short.

"The typical pension plan," Gautham says, "has roughly 60% of assets in equity and the bulk of the remainder in fixed income, most likely tracking a medium-duration index of about 4½ years. On the asset side, the plan faces reasonably good returns for the amount of risk — which is defined as the volatility of the assets. But when liabilities are added into the equation, you're looking at a much riskier picture because the duration of the liability is much longer — about 12 to 15 years for a typical plan. These plans were hurt over the past three to five years as interest rates have fallen. The returns haven't kept up with the increase in the present value of their liabilities."

Two fundamental changes are impacting how plan sponsors view their asset-liability mix. The first is the time horizon in which they operate. In the past, plan sponsors had several years to smooth asset and liability valuations to fund their deficits. In the U.S., as elsewhere, that's changed. The smoothing period is now limited to two years. Also, U.S. plan sponsors now must fully fund their obligations — amortizing their deficits over seven years. The second critical change is accounting regulations that require plan sponsors to report the current market value of assets and liabilities on their corporate balance sheets.

“In the past, plan sponsors could afford the luxury of going to perhaps riskier but higher-returning asset classes,” Gautham says. “They now will be judged on an annual basis. Because these liabilities also will impact their financial statements, they really have to rethink the amount and types of risk they can take.”

That's where LDI strategies can provide some solutions, says Duane Rocheleau, managing director of Northern Trust's global investment solutions team. “LDI provides a framework for what



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I call the three M's — measuring, monitoring and managing the inherent risks and tradeoffs in a portfolio — and looking at both the assets and liabilities as key components of the LDI process,” he says. “Within that LDI framework, managers can quantify the liabilities to help determine the optimal investment portfolio.”

Gauging a Starting Point

To get a better picture of a pension fund's optimal investment strategy, it's crucial to begin with an assessment of its current situation, or its starting point.

A plan that starts out overfunded, for example, might put the bulk of its investment in long-duration, fixed-income securities and comfortably meet its benefit obligations, Rocheleau points out. That's assuming the liabilities don't continue to grow.

Underfunded pension plans, of course, need to earn a higher return. That usually means moving money away from fixed income and into equities and alternatives such as hedge funds. “The challenge is to create a mix that is in line with the plan's risk budget. Multiple approaches can be devised,” Gautham says. “One example is to use an overlay strategy to lengthen duration. This frees up capital for investments in areas with higher prospective returns.”

Rocheleau describes the transition to an LDI approach:

1. Analyze and characterize the liabilities;
2. Quantify the relationship between the assets and liabilities;
3. Develop and implement appropriate investment strategies;
4. Monitor the account, rebalance the assets and liabilities mix and tweak the investment strategy as necessary.

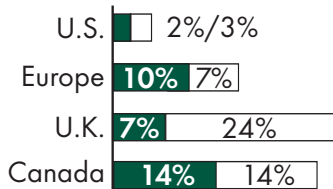
To implement the appropriate strategy, a plan sponsor must involve its accountants, actuaries, custodians and investment managers. “Because every pension plan is unique, each solution has to be customized,” Rocheleau says. “LDI is not a one-size-fits-all cure-all. It provides the appropriate framework for understanding the risks associated with your plans and for setting the investment course for funding future benefits.”

For more information, read Northern Trust's white paper, “Liability Driven Investing: Evaluating a Pension Plan's Assets in Context of Its Liabilities,” at northerntrust.com/pointofview. ❖

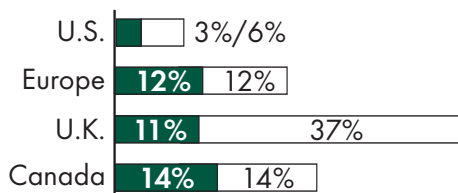
Use of LDI Strategies

Plan sponsors have begun to implement LDI strategies, looking most often to immunize liabilities or to match the duration of assets to liabilities.

Immunization of Liabilities



Asset to Liability Duration



■ Have Implemented
□ Plan to Implement

Note: Based on interviews with managers of 1,050 funds in the United States, 224 in the United Kingdom, 197 in Canada and 217 in Europe.

Sources: Northern Trust, Greenwich Associates