

NO TIME LIKE THE PRESENT FOR LDI

Pension fund sponsors examine the merits of liability driven investing.

For the past two years, liability driven investing (LDI) gathered steam as pension fund sponsors warmed to the idea of managing defined benefit assets relative to liabilities. Today, LDI's momentum has slowed, in large part because of the slowing of the U.S. economy, falling U.S. interest rates and tumultuous global equity markets.

Yet, it is precisely today's economic environment that should prompt plan sponsors to seriously explore the benefits of LDI. "If pension fund sponsors and endowments go through the process now, they will be prepared for when interest rates rise, equity markets rise and/or funded status improves," says Didier Haenecour, senior fixed-income portfolio manager at Northern Trust, London. Incorporating LDI into an overall investment approach isn't an overnight process, and plan sponsors don't need to take an all-or-nothing approach.

Laying the Groundwork

Haenecour and the LDI team at Northern Trust have found that the first phase of an LDI implementation can take as long as six months. "We go through a five-step approach to find the answers to a number of questions," says Clint Cary, an investment strategist in the Global Investment Solutions group at Northern Trust, Chicago. "What are the plan sponsor's goals and objectives? As fiduciary of the plan, are you striving for full funding or improved financial performance? To answer these questions, the first thing plan sponsors need to do is identify the goals of both the organization and the plan, and then develop a long-term strategy, quantify the risks and create



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a unique benchmark, implement a strategy and then establish implementation milestones."

Cary observes that "pension plans have an interest rate exposure and should close that exposure — unless the plan sponsor has a strong opinion on interest rates." Phased implementation strategies can take many forms and are commonly a function of time, interest rates and/or funded status. Under a time-based approach, the pension fund sponsor would slowly increase the amount of liability hedged every month or quarter. The hedge ratio, or the percentage of interest rate hedged, might start at 10% to 25% and increase in 25% increments each quarter. "Plans sponsors looking for an easy way to phase in an LDI framework might want to include a time-based schedule for implementation," Cary says.

The second approach is to use interest rate triggers. When rates meet a threshold, the plan increases the amount of hedge. For example, one strategy might involve a 20% hedge

that begins when the swap curve hits a 5% annual yield. Increase the hedge to 30% when the yield rises to 5.25% and 40% when yield reaches 5.5%. This way, the interest rate hedge is layered into the portfolio as rates rise.

Even in a low-interest rate climate, it makes sense to explore a phased-in approach, Cary notes. “When you hedge, you lock in interest rates, and in the case of pension funds, the higher the better,” he says. “The goal with rate-averaging is to opportunistically build the hedge as rates rise without missing the market.”

Pension plans at or near a fully funded status, or plans that are closed or frozen, might consider a third approach: a glide path to reducing risk according to funding levels. “A plan might have a 70/30 equity/fixed income split at 90% funding, but 50/50 split at 100%,” Cary notes. “We see this most frequently with frozen plans. As the funded status improves, they take some risk off the table by adding to the interest rate hedge, reducing equities or both. These are independent decisions. By planning for what to do when you become fully funded, you’re more likely to stay fully funded.”

Once overfunded, some plan sponsors might want to use the surplus as a “risk buffer” to increase their equity allocations to seek additional returns, he adds.

Establishing the Hedge

After choosing a hedging strategy, another decision is how to achieve the desired derivative position. “LDI portfolios are combination strategies, using long-term government and corporate bonds, fixed-income derivatives, equities, alternatives and cash,” Cary observes. Allocations to portfolio strategies must balance the short-term needs of the implementation process selected and eventual permanent portfolio allocation.

As the long end of the fixed-income market has liquidity constraints, an efficient implementation can make a big difference in cost. “In general, an optimal use of investment vehicles for pension funds is a blend of collective trusts for core positions and separate accounts to customize exposures where needed,” Cary says. “Using a separate account makes a variety of sophisticated risk-management techniques available, such as one-sided hedging, portable alpha, beta management and asset and liability collars.”

Be Prepared

Still, pension plan sponsors might be hesitant to consider an LDI strategy while interest rates remain low. Haenecour offers three reasons why they should.

LDI is worth exploring if only for the benefits of going through the exercise. “It is very educational for most trustees,”



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he says. “Talking to asset managers, actuaries and strategists can reveal key risks and opportunities of which trustees might not have been aware. It’s best to start talking about LDI now, and to start reporting liability performance to trustees.”

Haenecour adds that interest rates don’t behave the same way on every part of the yield curve. “U.S. Treasury yields have fallen while the credit market turmoil has led pension plan yields to rise. The short-term opportunity this market presents highlights the risk-reward trade-off, and the need for a comprehensive LDI strategy.”

Finally, Haenecour says new measurement tools and a liability-specific benchmark make it easy to integrate liability performance into the core reporting package. There might still be a funding gap for some plans, but it’s controlled, he says. ❖

