LIABILITY-DRIVEN INVESTING

A Brave New World Of Fiduciary Issues

Strategic Investment Group®

Fiduciary Insights

LIABILITY-DRIVEN INVESTING IS A RADICAL DEPARTURE FROM CONVENTIONAL ASSET-MAXIMIZING STRATEGIES. It requires new portfolio structures, customized benchmarks, leverage, derivatives, and above all, changes in investment thinking.

Managing The Plan From The Liability Side

A fundamental change has been wrought in the world of pension plans by the promulgation of a new set of standards contained in Financial Accounting Standards Board Statement 158, which govern the accounting treatment of a pension's funded status. The standards require companies to report changes in their plans' funded status (defined as the difference between plan assets and the projected benefit obligation, or PBO) on their balance sheets. No longer are fluctuations in a plan's funded status to be smoothed out over several years, or buried in footnotes. Now, the full volatility of a plan's deficit or surplus is to be transmitted directly to a firm's financial statements.

Such uncontrolled volatility naturally gives heartburn to chief financial officers. The most exposed firms are those with plans that are large in relation to their business, often old-line manufacturers with a lot of retirees. In an adverse capital market environment, such companies could see swings in their financial position, bond ratings, and borrowing costs, as interest rates or asset valuations change. For some firms, the risk is unacceptable, as it could threaten their survival and, therefore, in the event of bankruptcy, their ability to meet their pension and other liabilities. Some have chosen to enter a brave new world, adopting liability-driven investing (LDI), in which plans are managed with the goal of minimizing the volatility of their deficit or surplus rather than maximizing their assets.

Although the first firms to shift to LDI generally have been those whose financials are most at risk, all plan sponsors are potential candidates, especially those whose plans have a surplus. The fact is, current punitive surplus reversion taxes severely limit a plan's ability to benefit from surplus accumulation. Therefore, investing to increase a surplus generally offers a plan sponsor no benefits – only the dreaded risk of a future deficit requiring contributions. If a plan is open to new employees and benefits are still being accrued by active employees, market risks are arguably worth bearing to maximize assets to cover future liability growth. But if a plan is frozen, with benefits capped and new employees barred from admission, liabilities are much more certain and maximizing asset growth is commensurately less justifiable. LDI is an attractive option for such plans, as it increases the certainty of meeting the targeted payouts.

LDI Portfolio Structures

Liability-driven investing is, in part, a form of hedging. Under LDI, the overall portfolio is reconstructed to reduce the volatility of the funded status, particularly that due to interest rates. Equities, which produce most of the volatility of a conventional pension portfolio's assets, are replaced to a large extent by fixed income. The duration of the fixed income exposure is managed so as to offset fluctuations in the liabilities' present value, which varies inversely with prevailing interest rates. Since it is difficult to build and manage a portfolio of physical fixed income securities that accurately matches the long duration of the liability structure – often 15 years or more – interest rate swaps and other derivatives may be used instead of bonds.

In the rare case of a firm that knows its future pension liabilities with perfect certainty, the liabilities can be fully immunized against interest rate fluctuations with fixed income. Most plans, however, have numerous uncertainties about the value of their liabilities, such as those arising from the unknown longevity of the retiree population, continuing or conditional accruals of benefits, or potential benefit supplements. These firms are candidates for LDI, which unlike immunization reserves a portion of the total portfolio for generating asset growth to address the uncertainties. This growth-producing segment may be made up of an allocation to equities or alternatives, such as hedge funds.

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In some cases, leverage provided by fixed income swaps is necessary. For example, a plan may need some leverage to boost its fixed income exposure to match the value of its liabilities. Even a fully funded plan may need leverage in its fixed income exposure to compensate for assets allocated outside fixed income to produce asset growth.

Leverage, coupled with an allocation to illiquid assets, will tend to introduce a liquidity barbell, with opposing overweights in the most liquid and most illiquid portions of the portfolio. For example, to increase return for asset growth, an LDI portfolio may contain alternative investments. But as the alternatives are illiquid, and leverage requires adequate liquidity to support it, more liquid investments that can be borrowed against easily might be needed to compensate.

Different Mindset Required

Fiduciaries will find that adopting LDI necessitates a complete overhaul of their investment orientation. The focus of an LDI strategy is primarily on fixed income, not equity. Removing volatility of the deficit or surplus is the overriding objective. Old investment habits and ways of thinking must change radically.

Benchmarking illustrates the shift in thinking that is required. The primary benchmark for an LDI strategy is made up of a policy portfolio that best fits plan liabilities, largely determined by an asset mix that has the same sensitivity to fluctuations in interest rates as that of the liabilities. The objective is to invest the asset pool so that its value closely tracks the discounted value of the liabilities. Within a single asset class viewed in isolation, a conventional asset class benchmark might be relevant, if there has been no change in the objectives of the asset class.

Importantly, conventional peer comparisons are invalidated by LDI. One of the hardest adjustments for fiduciaries is breaking the habit of trying to keep up with peers. Since every plan's liability structure is unique, and a plan run under LDI is being managed in a customized fashion to minimize deficit or surplus volatility, there are no applicable peers. Even if a sponsor identified a set of peers with a similar liability structure, which is unlikely, the degree of market risk taken as a complement to the hedging portfolio would naturally vary for firms with differing financial characteristics. An enterprise with a large pension liability relative to its assets and a cyclical business, for instance, is less likely to be able to bear the uncertainty as to contributions that may result from taking market risk than a cash-rich sponsor with a balance sheet much larger than its liabilities.

Choosing the right measure of liabilities can also require a change in thinking. It is important to view the firm as a going concern and focus on the firm's true economic liabilities rather than standard accounting definitions. Some firms, for example, use the projected benefit obligation, which includes only current employees and future growth in their salaries and benefits. As a so-called "closed group" measure, the PBO assumes that current employees will not be replaced. Ideally, since the assets of the plan are available to finance all of its future liabilities, the liability measure used for LDI should be calculated by the "open group" method, which includes benefits for potential future employees.

Regulatory And Legal Considerations

Fiduciaries bound by ERISA regulations have a duty of loyalty to the plan, and an overriding duty to act in the best interests of the plan's participants. When these same fiduciaries are corporate officers who are seeking to use LDI to reduce the firm's exposure to the plan's volatility, it may appear that they are in a conflict of interest. Yet despite the fiduciaries' dual roles, their actions in adopting LDI must be in the interest of beneficiaries.[1]

Fortunately, in 2006 the U.S. Department of Labor rendered an advisory opinion as to whether a fiduciary of a defined benefit plan

1 "Liability Driven Investment Strategies - What Erisa Fiduciaries Need to Know," by Matthew J. Renaud and Galen R. Mason, The Investment Lawyer, Vol. 14, NO. 9, September 2007.

2 Advisory Opinion 2006-08A, U.S. Department of Labor, October 3, 2006.

may consider the liability obligations of the plan and the associated risks in devising an investment strategy.[2] Although the opinion did not give a blanket approval of LDI or settle all issues, it found nothing in the regulations to prevent a plan sponsor from taking into account risks associated with liabilities. Moreover, it acknowledged that LDI does offer a principal benefit to beneficiaries in "the reduced need for the plan to rely on the plan sponsor to meet its funding obligations." The fact that LDI offers benefits to the plan sponsor as well can be regarded as incidental.

To lower the risk of legal liability, lawyers[1] advise that fiduciaries take care to document their decisions regarding the adoption of LDI. To be able to show that they are acting on behalf of beneficiaries, fiduciaries should ensure that they have records substantiating that their actions are expected to reduce the beneficiaries' reliance on the plan sponsor and its solvency.

Implementation Of LDI

One way for fiduciaries to lessen the appearance of conflict of interest is to engage the services of an outside, independent fiduciary, such as a consulting or outsourcing firm. Hiring an outside firm creates an operational separation between the plan sponsor and the investment management of the plan. Also, a qualified outsourcing firm is likely to be better suited than a plan sponsor to implement many of the critical but unfamiliar tasks involved in an LDI program. A host of activities, such as asset allocation, derivatives management, hiring and termination of managers, risk budgeting, preparing legal agreements, monitoring, and reporting can be integrated in a bundled approach by an outsourcing firm experienced with LDI issues.

One of the most important services rendered by such firms is devising the LDI strategy, using actuarial information to propose an investment policy that will reduce surplus volatility to levels acceptable to the firm. Trigger levels can be established for downsizing the equity allocation (and risk levels in general) in several steps as successive surplus targets are reached. For example, the first reduction might take equities down from 60% to 30%, the next from 30% to 15%, and the last to 0%, if and when it becomes feasible and appropriate to seek full immunization. The timing of these shifts will depend on many variables, such as interest rates, the market environment, the liability structure, the size of the existing surplus or deficit, and the financial characteristics of the sponsor.

As noted earlier, LDI often involves leverage and derivatives, which may be new to some institutions. Moreover, experience in trading and monitoring these complex instruments is typically not available at the staff level. ERISA plans seeking outside assistance in dealing with swaps are required to use a qualified professional asset manager (QPAM). The QPAM should also be able to take on the burden of negotiating swap agreements, which demand specialized legal expertise.

The extensive asset reallocations involved in LDI often entail portfolio restructurings, account terminations, and new manager agreements. Of course, such sweeping changes can significantly affect longstanding relationships and fee agreements with external managers, especially in cases where the manager has granted a low fee for running a large amount of assets. In general, manager costs for LDI may be lower than for a conventional asset-maximization strategy, as equity managers are replaced by fixed income managers. However, those cost savings may be offset by increased use of portable alpha and alternative strategies, which come with high fees, although they may target higher risk-adjusted returns compatible with an LDI approach.

LDI Is Not Irreversible

Fiduciaries considering LDI can take comfort that although it is a major strategy change for any firm, it does not have to be permanent. Unforeseen circumstances could arise to make it advisable for a firm to revert back to asset-driven investing. For example, a merger of two firms, one with an LDI plan and the

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other with a conventional plan, might result in a need for more asset growth in the combined plans. Perhaps some future change in the accounting treatment of pension deficits and surpluses will reduce the impact of volatility on financial statements. Maybe new government regulations giving firms reasons to bear the risks of running a pension – such as being able to apply a surplus to underfunded retiree health insurance plans, in ways not currently permitted – will someday encourage some firms to return to asset-maximizing strategies.

For the time being, though, LDI will continue to be the real-world choice for many fiduciaries. It is a risk-based approach to investing, with customized asset strategies managed so as to offset the volatility of liabilities, unique policy benchmarks driven by interest rates, leveraged fixed income swaps, and no peer comparators to provide safety or satisfaction. For fiduciaries used to conventional plans designed to beat market benchmarks, LDI is a brave new world.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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