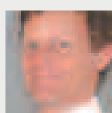
Ask the experts:

The cost of pension promises

Is liability-driven investment the way to plug the pension gap?



Greg Croydon
Group Treasurer, IMI

History has proven to us that, over the long term, equity returns outperform bond returns. Given that liability-driven investment (LDI) implies investments in bond-like instruments in order to reduce risk, then LDI strategies give up on the potential for higher absolute returns from other investment opportunities.

The question is, when does the risk of volatility of your pension deficit/surplus position outweigh the opportunity of greater absolute returns?

In my view there are three answers:

- When the strength of the sponsoring company (the 'company covenant') is questionable;
- When volatility in the pension funding position could give rise to accounting/covenant issues in the sponsoring company; or
- When the funding deficit is significant.

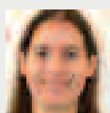
Clearly, these three points are closely related. The big problem is that switching to a total LDI strategy because of one or all of the above is likely to increase the immediate deficit and therefore require more funding – in turn, putting further pressure on the company covenant.

If the funding position is relatively healthy and the company covenant is strong, then one would feel less concerned about taking more risk but chasing higher absolute returns.

The maturity of the scheme is also an important factor. As the liabilities move closer, there is strong logic to matching them with LDI-type investments and removing the risk that equity returns might not provide the short-term gains required. If you knew that you had to repay your mortgage next year, you would probably invest your cash with low capital risk rather than put it all into equities.

Pension funds are taking more notice both of LDI logic and also of risk reduction through diversification of investments, but, with long-term bond yields as low as they are, compared with historic levels, this is not an attractive time for a significant switch in strategy.

LDI is never going to "plug the pension gap" but should be considered as a useful tool to manage the volatility of that gap.



Antigone Theodorou
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The main issues for pension schemes remain the ongoing problem of pension deficits and regulations that aim to govern how a scheme's liabilities are assessed. To address these issues, investment houses are coming up with new ways to manage liabilities. They are reducing the risk and volatility associated with pension scheme investments, while at the same time freeing up assets to generate return and fund the deficit. This addresses the problem from both the corporate sponsor's and the trustees' point of view. The generic term to cover these solutions is liability-driven investment.

To many people, LDI seems to be all about complex risk management, but it is a lot more than that. It should be viewed as a framework within which pension schemes can understand and manage the risks they are exposed to, while taking into account their liabilities.

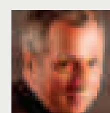
It is a framework to close down some, or all, of the unrewarded risks (such as interest rate and inflation risks) and to deploy capital to take the risks that pension schemes want to take or expect to be rewarded for.

Thus, within this framework, pension schemes can use their risk budget to invest in return-generating assets so they can narrow and ultimately close the pension gap.

Different schemes will choose different means to plug the pension gap. Some prefer to take on a higher proportion of index risk (such as beta) to active management risk (such as alpha). Others schemes might prefer to target a diverse blend of return-seeking assets.

Adopting an LDI mindset is an excellent way to plug the pension gap. To help pension schemes to meet their objectives, strategies can be designed and implemented both to match liabilities and to generate returns, taking into account the specific requirements of each pension scheme.

For its part, Axa does this by combining a 'risk-protection' component with a multi-specialist 'return-seeking' component.



Andrew Barrie
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To answer this question, we need to extend the bath analogy. LDI may offer an ill-fitting plug that at least stems the outflow, but it should not detract from the fact that there is too little water in the bath in the first place. Of equal importance to LDI is how we turn the taps on at the right pace to fill the bath up. For "taps" read asset returns and contributions.

Over the past few years, LDI has developed from being a laudable principle (that an investment strategy should made in recognition of the liabilities) to a narrow cashflow-matching solution that in reality has limited application.

Defined benefit pension funds cannot forever avoid recognising they are inadequately resourced to manage their way out of their difficulties. But all is not lost, as a look at the UK insurance industry shows. Shareholder and regulatory pressures have driven insurers to adopt more sophisticated techniques that eliminate unnecessary risks and deliver more controlled returns.

With the current interest in pension buyouts and bulk annuities (typically insurance products), new technologies are being applied directly to the defined benefit market as pension and insurance products blur. One of the main challenges will be that, while the insurance industry has already come to terms with the true costs of the promises it makes, the pensions industry has only just woken up to it.

There are indeed some true 'extra' margins built into insurance products – namely, reserving costs and margins of prudence. So there are genuine opportunities for pension funds to manage their way out of their current difficulties by taking on board the lessons and technologies of the insurers – without necessarily incurring all the costs.

But the question remains: Do funds sponsors, trustees and advisers have the appetite, patience and resource to embrace these technologies?

Failure to do so will result in ineffective management or inefficient exit.

See *Measure it to manage it*, page 24.