# Virtues of protection strategy spreading

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Liability driven investing has come a long way from its humble roots. Where it once meant moving from volatile equities into safe bonds to better reflect a pension fund's long-term liabilities, it has now come to encompass a whole series of mechanisms that have pushed the boundaries on what fund managers can achieve.

Once the premise of forward-looking Scandinavian and Dutch pension funds, it is now established in the UK, is rapidly being taken up in the US and is branching out beyond pension fund investing. Decommissioned mines and power stations in Europe have been cited as some of the newer clients of the approach that have sought to gain a steady flow of income from a fixed pile of cash with no unpleasant surprises.

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A good definition of LDI is hampered by the way its practice has evolved. In the UK until relatively recently, applying LDI simply meant switching to bonds.

Independent pensions adviser Ros Altmann says: "Trustees were told their liabilities were bond-like, so they started to switch into bonds. This was totally misguided thinking: they may have been bond-like, but they weren't actually bonds.

"Nowadays trustees are encouraged to look at the shape of their liabilities and the factors that affect them, and to ensure that at least part of their assets will move in line with their liabilities."

Trustees have used swaps and derivatives to insure their scheme against unexpected changes in inflation and interest rates, something their counterparts in Scandinavia and the Netherlands have been doing for some time.

The extent to which schemes can embrace sophisticated LDI strategies is partly dictated by cost. Smaller funds that lack both the spare cash and the governance to follow such approaches have the option of using pooled LDI funds, which allow schemes to purchase investments that reflect their interest rate risks.

A bespoke LDI approach can involve using a range of swaps, derivatives and a monthly analysis of actuarial liabilities on a segregated basis. Joe Moody, head of LDI at State Street Global Advisers, gives an example of how this has worked under ideal conditions over the past 12 months.

"Pension funds that have swap positions and have seen the market fall and their liabilities rise have taken out tens of millions of pounds of profits from those swaps. They have then gone into the market and bought a government index-linked bond and then swapped that bond again for Libor plus 100 basis points for the next 25 years and they have locked that in."

This approach uses the concept of funding ratio mandates that seize market opportunities on a monthly basis to transfer risky assets into more stable ones that better reflect long-term liabilities.

The use of swaps and derivatives has been one of the most controversial areas of LDI. Many pension funds have been wary of these approaches and many felt vindicated for rejecting LDI when Lehman Brothers collapsed last September.

However, such perceptions have proved exasperating for proponents of LDI, who insist the Lehman collapse proved that LDI worked.

Rob Gardner, partner and co-founder of Redington Partners, says: "Lehman's collapse proved that LDI as a framework works – there were none of the systemic shocks that the cynics predicted. You only have to look at the difference between say, Shell and Philips. Philips has done a lot of LDI and its cover ratio fell by only 6 per cent in 2008. Shell, heavily invested in equities, saw its investment portfolio decline by 40 per cent in 2008."

This word is starting to spread. Companies using the approach in the Netherlands or the UK that have first-hand experience of LDI have chosen to export its principles overseas. Vivendi, the games manufacturer, operates an LDI strategy in the UK and exported the approach to its

US office, which ultimately led the US plan to the point where it could instigate a buy-in.

Growth in LDI has also been driven by regulatory change. Strict solvency requirements in Scandinavia and the Netherlands prompted pension funds to begin to treat their schemes more like insurance companies and to pay strict attention to imbalances between assets and liabilities.

The possibility of stricter international accounting standards for pensions, proposed by the UK Accounting Standards Board, is likely to spread LDI even further.

This is bad news for companies in the US, where pension schemes have been able to use a fudged yield curve to value liabilities rather than the AA corporate bond rate required by international accounting standard methodology. A more prudent valuation method, as used in the Netherlands and Scandinavia, would have resulted in enormous liability numbers, produced huge deficits in the pension schemes of companies like GM, Ford and Chrysler, and wreaked havoc on these companies' balance sheets.

However, Carl Hess, global head of investment consulting at Watson Wyatt, says the application of LDI often differs globally depending on what end of the complexity spectrum the relevant country operates in. "Many Canadian funds have inflation- indexed liabilities for example, but there's not yet much availability of derivatives that hedge Canadian inflation." He adds that regions where governance levels are higher are likely to witness more complex hedging strategies, he adds.

There are some countries not ready for LDI, such as Japan. Tarik Ben-Saud, head of LDI at Barclays Global Investors, says there is notional interest in Japan but no key driver to get it off the ground. Similarly, southern Europe continues to employ the pay-as-you-go strategy for pensions, and is unlikely to move into LDI any time soon.

One likely development in LDI is the use of futures. BGI, for example, is talking to clients about using futures to obtain equity exposure rather than a stock portfolio.

"By doing this we can release the cash from that equity portfolio to buy, say government bonds," says Mr Ben-Saud. "This way we're still in equities, because we haven't moved out of them, we've just used the physical assets to buy high yield bonds and swaps."