

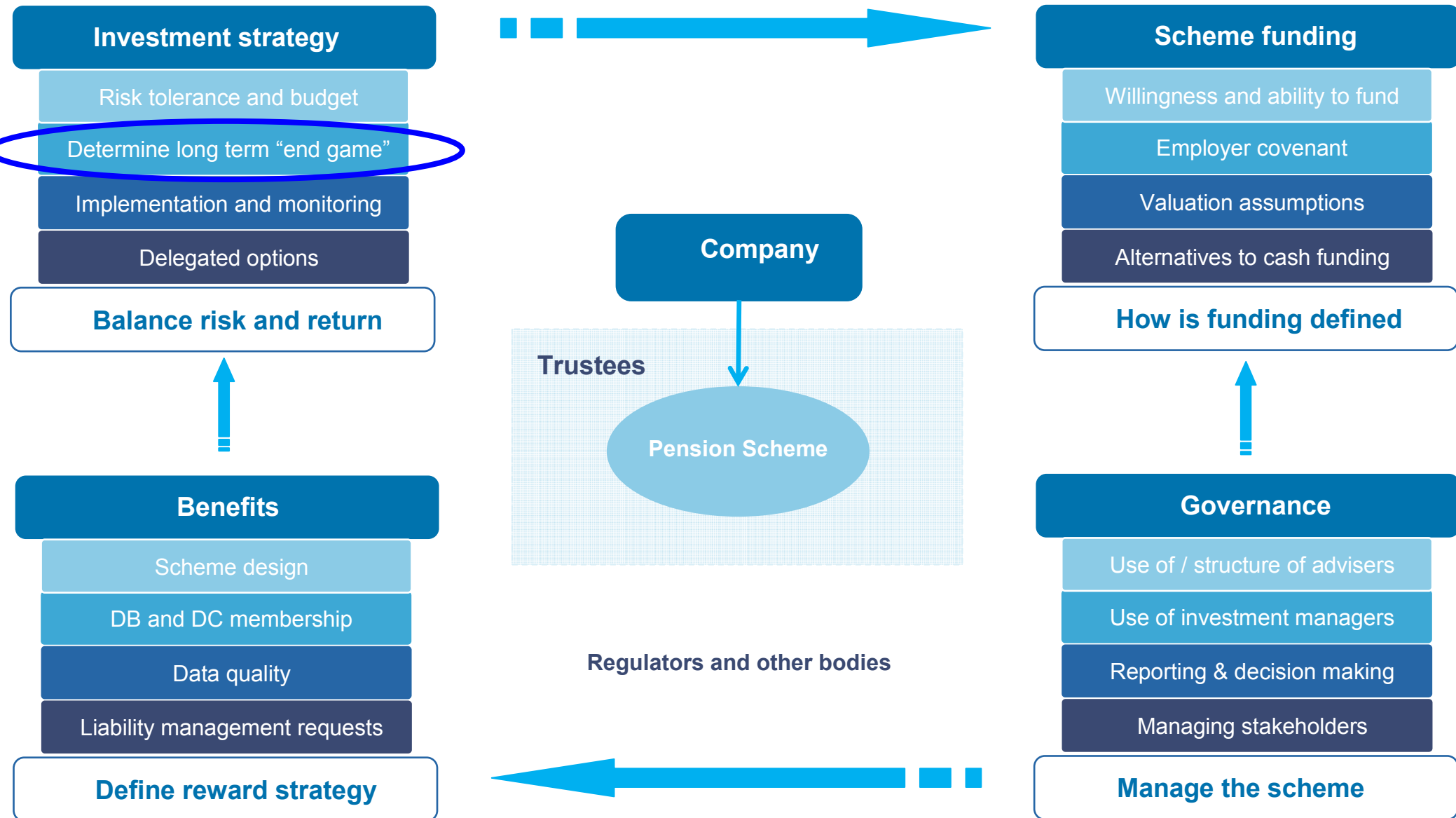
# LDI Case Study – A Consultant’s Perspective

Paul Watson

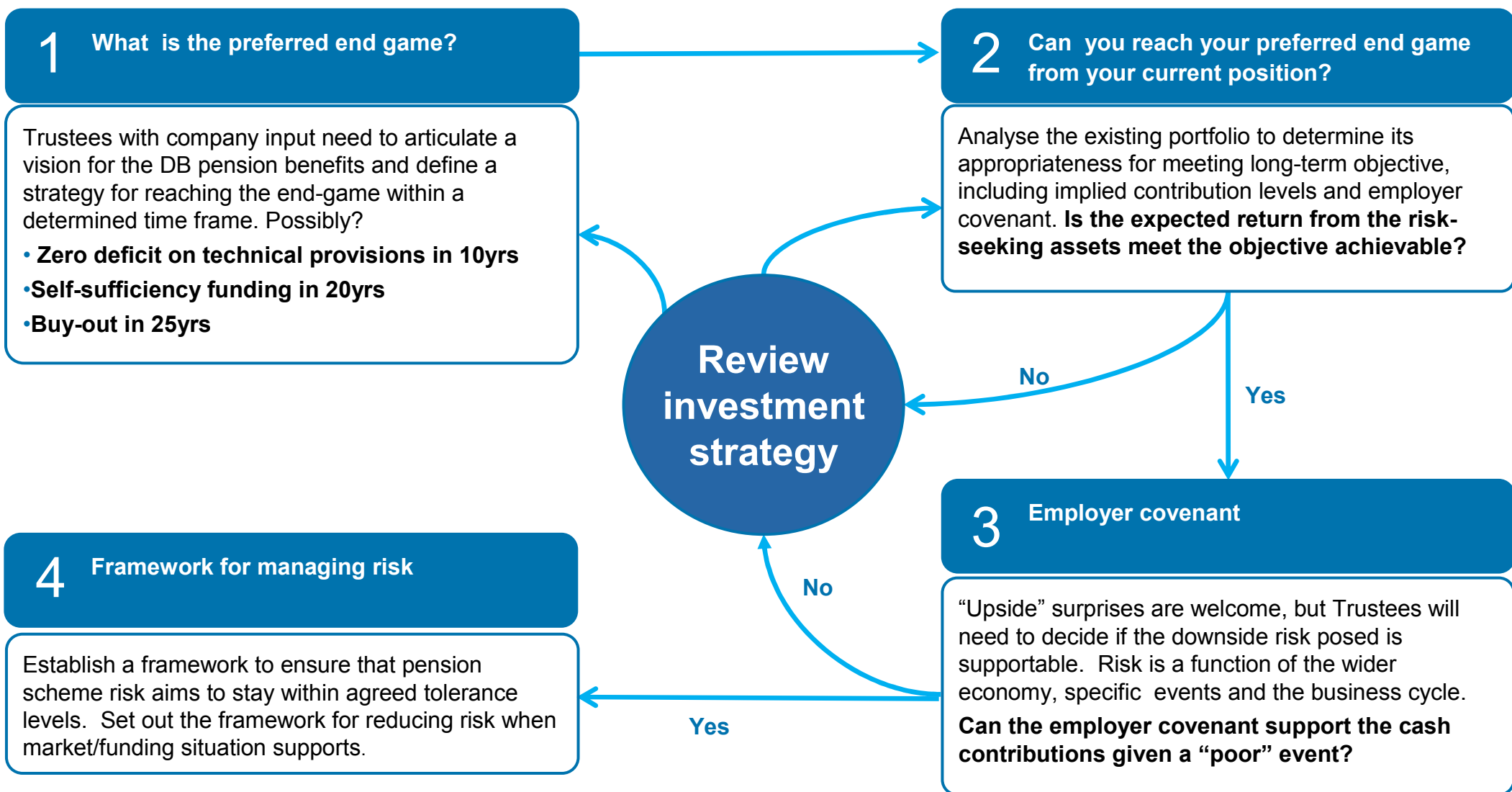
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# Its not just about investment... set yourself a business plan



# Roadmap to an end-game position?



# What are the main risks faced by pension schemes?

## Investment Related

Interest Rates

Inflation

Equity Risk

Currency

Credit

Counterparty

Reinvestment

Liquidity

## Non-Investment

Longevity

Covenant  
(deficit is an “investment” in the company)

Legislation Changes

Demographic

Funding Basis/Objectives

Operational Risk

Data Quality

# Managing risk – the levers



- *Potential closure to new members and accrual (company drives change)*

- At its simplest sell equities to buy bonds
- Alternative assets in place of some equities
- Recognise short-term need for performance in recovery plan

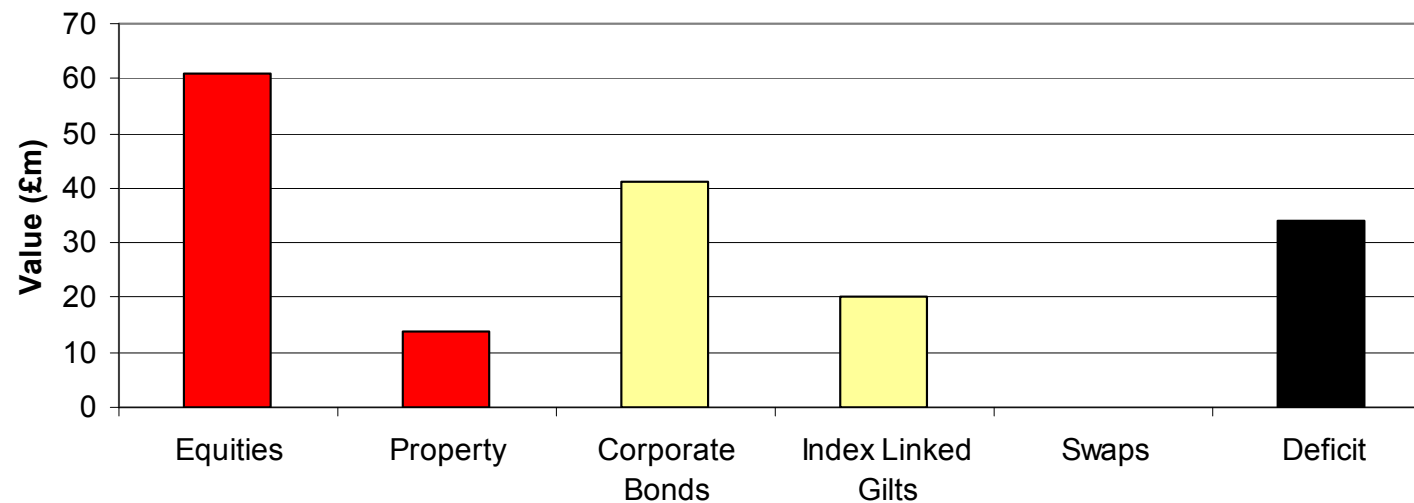
- Consider term and nature of liabilities (fixed / inflation)
- Preferred combination of physical bonds and swaps
- Decide on implementation timescale; Immediately? Or staggered based on market or funding levels?

- Deficit reduction contributions often rely on growth assets
- Mechanism for recognising and capturing funding gains, reducing risk
- Desire to move to a more prudent funding basis?

- Potential for longevity swaps / reinsurance to reduce or remove mortality risk
- Financial de-risk plus mortality de-risk is akin to “synthetic” buy-out

- Long-term possibility of purchasing annuities to perfectly hedge liabilities / pass them across to third party.

## Reminder of case study



“Liabilities of £170m, the majority of which are linked to inflation (87%) with an overall duration of 18 years”

# Issues to consider in appointing an LDI manager

Having considered the end-game for the scheme (the need for growth assets to help fill the deficit and capacity of the employer to tolerate risk) the Trustees can then consider the needs of a LDI manager / mandate.

- Complexity / **Flexibility** / Speed of implementation
- Portability
- Pooled / Segregated solution
- **Client service**
- Proposed solution; look for some suggestions for how you'll work together
- Counterparty risk
- Legal contracts
- Ongoing fees; **implementation costs and evidence of best execution**
- **Ability to stagger implementation based on market views/funding**
- **LIBOR generation / Gilts versus Swaps / Credit exposure**
- Consultant Rating
- Interaction with Scheme Actuary on cashflow changes and **basis risk**

**Swap execution is a commodity – value add is in best execution/flexibility/client service**

# Staggered or Immediate implementation?

A **sliding scale** of triggers increases the amount of hedging as

- rates rise towards “fair value”
- or the funding level improves and thereby locks in improvement

This sliding scale of triggers might depend on

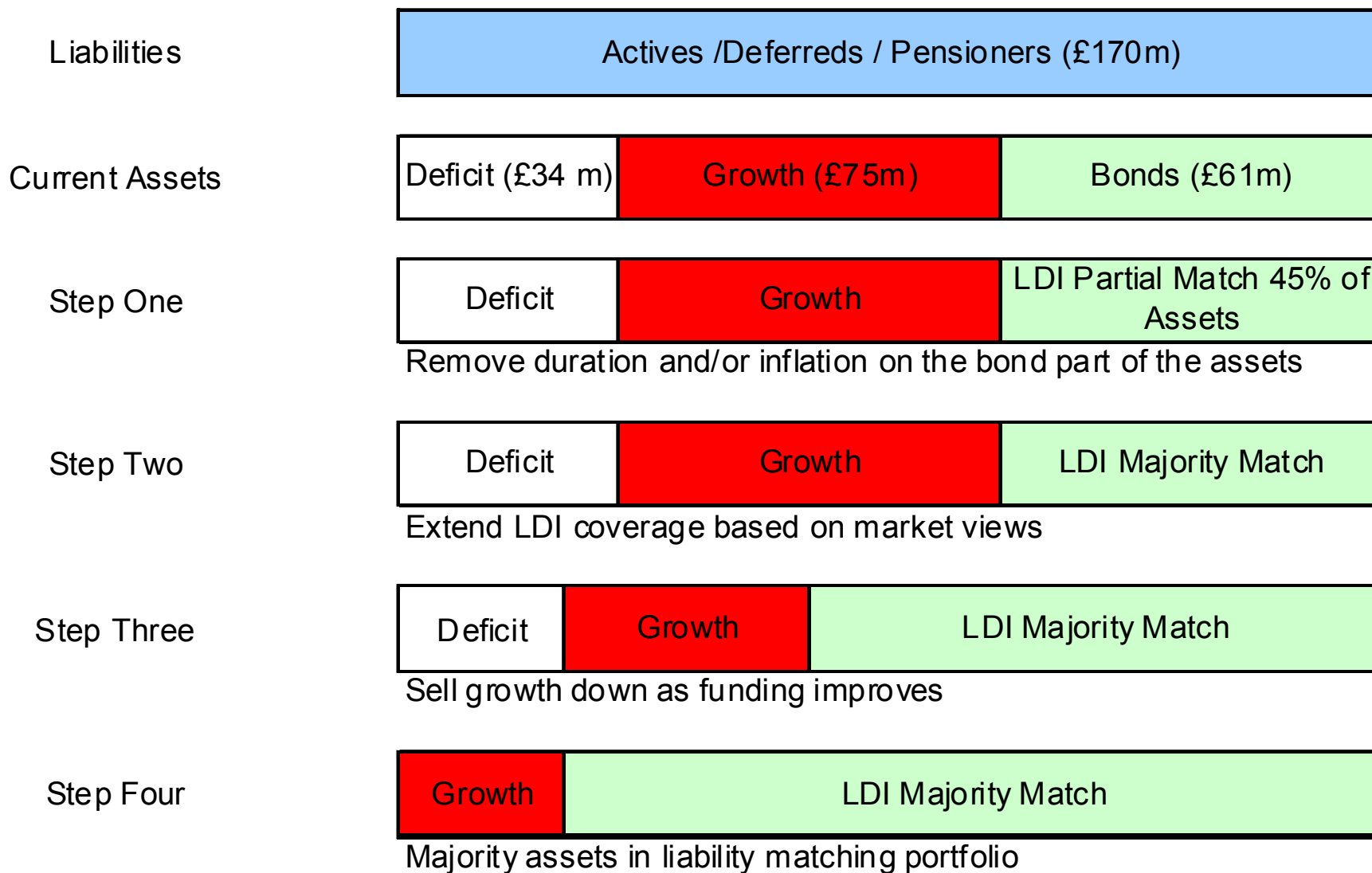
- Level of conviction in the fair value levels. *Are we at an historic low?*
- Time horizon: the relative importance of short and long-term risk. *Can you afford to be wrong?*
- Scope for divergence in real and nominal rates, or inflation, relative to fair value
- Supply/demand imbalances; many buyers of yield weakness. *Will markets remain low?*

Warren Buffett said “Markets can remain irrational longer than you can remain solvent”

Is there logic to **full hedging** before “fair value”?

- “Fair value” estimates are necessarily subjective
- “Fair value” assumption is too high, missed opportunity to hedge at current rates
- As rates rise, the risk/return trade-off from not hedging changes
  - Potential for further liability-relative gains reduces?
  - Potential downside increases?

# What might the solution look like?



# Summary

LDI not a magic bullet BUT it is a critical tool in the de-risking glide path – set your goals and objectives. Whilst LDI is lower risk – but does carry its own different risks, make sure you understand these

There is significant flexibility / many options which can be overwhelming. Client service is critical with your preferred manager.

The “investible” benchmark is the projected liabilities discounted back on a swaps based discount rate – this creates a basis risk for many schemes which are on a gilts/gilts+ basis.

Why wouldn't any trustee want to remove interest rate and inflation risk given it is an unrewarded risk? Given the constraints of physical bonds, an LDI solution allows the investment portfolio to be better matched to the nature and term of the liabilities

The issue often then becomes education and timing of implementation.

# Paul Watson



## Paul Watson

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