The Actuarial Profession
making financial sense of the future

LDI and Return Solutions

MLIM – Equity Manager Perspective

LDI is coming your way – and will have an impact to remember!

But what is it……………..?

LDI at MLIM: Range of existing clients

	Clients	AUM (£m)
Duration Matched	11	1,920
Cashflow Matched & Swap Overlay	7	7,235
Absolute/Target Return	16	1,223
Unconstrained Equity	14	697
Total	48	11,075

Source: MLIM, as at 31 December 2005

Whose definitions of LDI?

- What are ‘Target Return’ and ‘Unconstrained equity’
- Why are they on a slide talking about LDI?

A common objective?

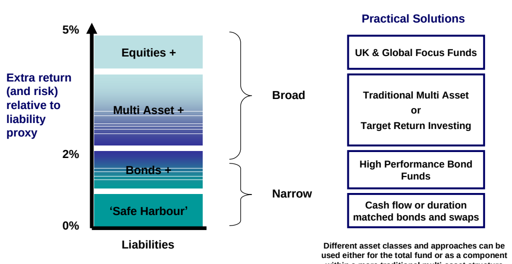
ASSETS to exceed **LIABILITIES**

LIABILITY VALUES driven by **BONDS**

INVESTMENT RETURNS to exceed **BOND RETURNS**

Single objective of bond returns +

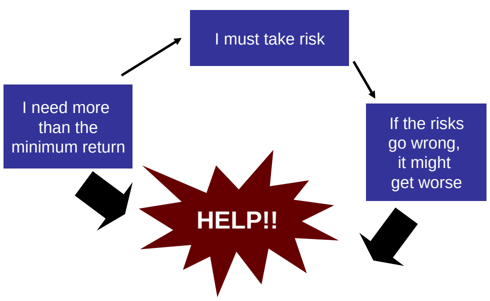
Liability-Led Solutions – A Framework



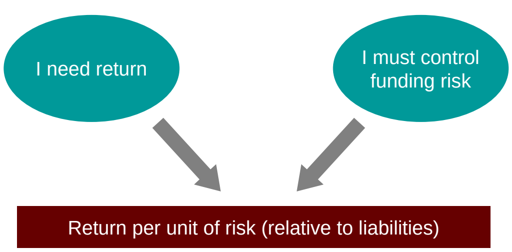
Some happily matched clients

But what about deficits…………….?

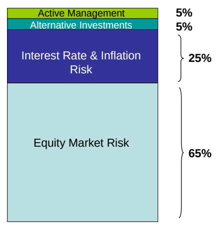
The deficit dilemma



Key measure



Typical risk profile

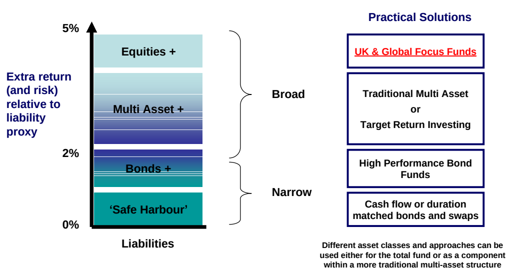


- Total risk relative to liabilities c.14% pa
- 2 major components:
  - Equity market risk = rewarded
  - Interest rate / inflation risk = unrewarded
- No diversification of rewarded risk
- Complete exposure to equity market cycle
- No attempt at short-term risk management

- Expected return per unit of risk : ~0.25

Source: MLIM Internal

Liability-Led Solutions



Traditional active relative management

Is this compromising return?

With the benefit of hindsight ..!

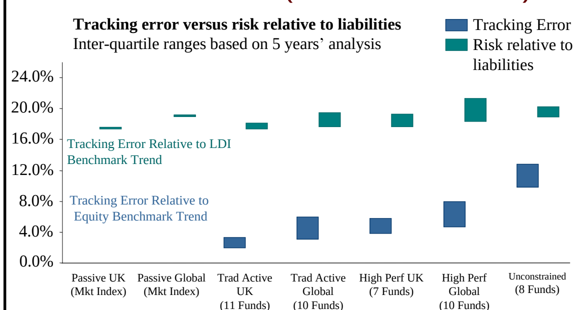
Year	2000	2001	2002	2003
FTSE 350 Return	-6.5%	-13.2%	-22.5%	20.3%
No. of shares making a return greater than 8%	166	121	64	179
% of shares making a return greater or equal to 8%	47%	34%	18%	52%

Doesn't it make sense to just put money into stocks you like?

Source: Factset

IoA 01.06 (8698)

Risk vs Liabilities (Source – Hewitt's)



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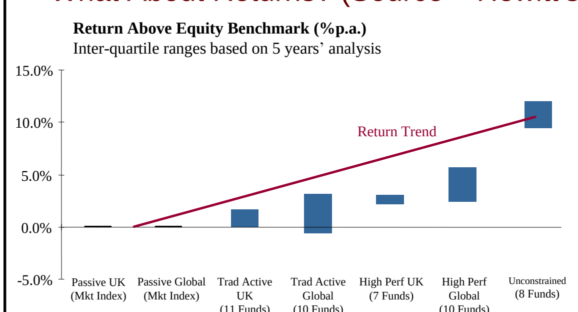
What About Returns? (Source – Hewitt's)



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Introducing the focus approach

- Equities are already risky relative to liabilities
- Active management adds little risk versus liabilities
- Increasing concerns about index concentration
- Belief in ‘true’ active fund management
- A better expression of investment manager skill
  - “Best ideas”
  - No benchmark hugging

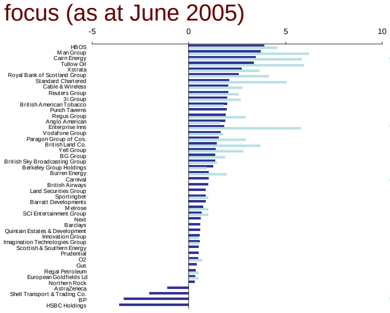
A better way to use your risk budget for equities

Focus approach - investment process

- Detailed research should identify good investments, i.e. those which are at least 20% below estimated fair value
- Investments will be made with a long term view whilst allied to a strong buy and sell discipline
- Positions reflect conviction, upside/downside risk, and liquidity

Investing in companies not markets

An illustration: A comparison of holdings: standard specialist v. focus (as at June 2005)



Active Positions illustrate greater conviction

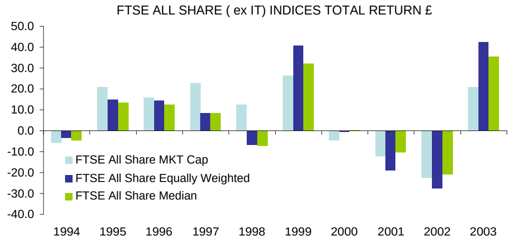
Increase “focus” in some sectors

Lower conviction ideas eliminated

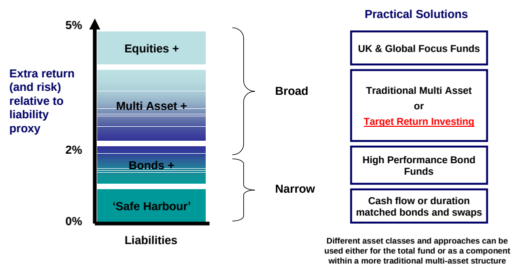
Selection of Mid/small cap ideas retained

“Risk Dampeners” no longer required

Alternative equity benchmarks – median and equal weight



Liability-Led Solutions



Why Bother Re-inventing 'Balanced Management'?

- Balance between tactics and strategy is changing
- Missed opportunities
- Responsibility for the final outcome is unclear
- Diversification has benefits
- Specialist structures are more expensive
- Balanced management could offer a holistic solution

Target Return or 'New Balanced' - Summary

- Not about maximising returns
- Focus on target, volatility and capital protection
- Typically cash + or RPI + targets
- Dynamic asset allocation as opposed to classic 'fixed' benchmark
- Aim for diverse opportunity set including 'portable alpha'

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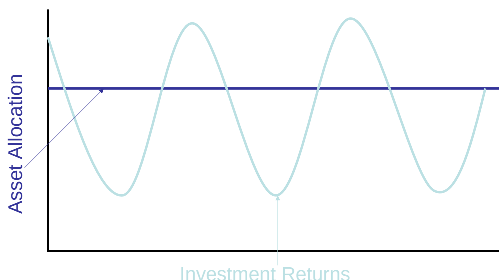
Relative Return



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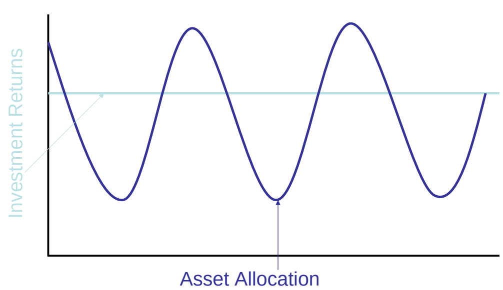
Target Return



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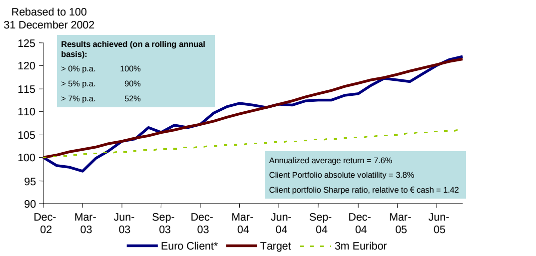
Historic asset allocation (existing Euro client)

	Mar-03 %	Jun-03 %	Sep-03 %	Dec-03 %	Mar-04 %	Jun-04 %	Sep-04 %	Dec-04 %	Mar-05 %	Jun-05 %	Sep-05 %
Equity:	**40.8**	**42.4**	**37.6**	**38.6**	**18.3**	**24.9**	**21.5**	**36.9**	**23.6**	**33.6**	**28.0**
North America	18.9	17.4	13.4	6.6	2.4	2.4	2.5	4.9	1.7	3.1	0.0
Europe	14.5	14.9	12.4	21.9	11.8	11.5	9.2	13.5	9.5	13.4	11.5
Japan	3.9	2.7	3.2	2.5	2.1	2.0	3.9	0.0	5.3	7.0	6.5
Pacific ex Japan	1.2	3.5	5.0	4.1	1.6	6.9	5.9	9.2	2.5	3.3	3.3
Emerging Markets	0.5	0.5	1.2	0.9	0.0	0.0	0.0	2.8	0.0	5.3	4.2
Sector Funds	1.8	3.4	2.4	2.6	0.4	2.1	0.0	6.5	4.6	1.5	1.7
Hedge Funds	**0.0**	**0.0**	**8.7**	**8.6**	**8.6**	**8.7**	**8.6**	**8.4**	**8.5**	**7.4**	**7.4**
Bonds	**54.1**	**51.3**	**49.2**	**49.5**	**45.8**	**45.6**	**43.9**	**44.3**	**48.2**	**44.5**	**49.7**
Cash	**5.1**	**6.3**	**4.5**	**3.3**	**27.3**	**20.8**	**26.0**	**10.4**	**19.7**	**14.5**	**15.7**
	100.0	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Highlights denote material allocation decisions
Note: Bonds includes currency and credit allocations
Source: MLIM

What do we hope it looks like? Performance track record (existing Euro client)



*Client of MLIM for 6 years but Target Return mandate managed by SIG since start 2003.
Source: MLIM, based on existing Euro-denominated account, with all calculations gross of fees, as at 31 August 2005.

Case Study Solution: Swap overlay to manage interest rate risk

- Return portfolio aims for cash+ X – greater freedom to seek returns
- Swap provides interest rate sensitivity tailored to liability position

	Return Portfolio	+	Swap	=	Client Portfolio
Economic Goal:	*Cash* + *X*		*Liabilities* - *Cash*		*Liabilities* + *X*

Swap manages duration risk and 'frees up' return portfolio

Investing Cash Plus

True Cash Plus Assets

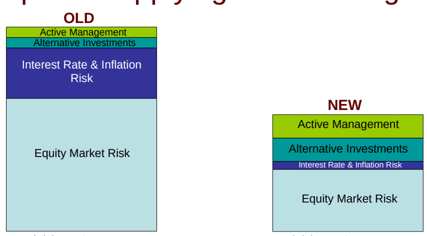
- Hedge Funds
- Target Return Process
- Portable Alpha
- Structured Products
- CPPI and Dynamic Strategies

Traditional Assets used in this context

- Index Unconstrained Equity
- Short Duration Bonds and High Yield
- Diversified Balanced Management

Portfolio of assets optimised to deliver target above cash

Impact of applying new thinking



- Total risk c.15%
- Expected return +3.5%
- Expected return per unit of risk ~0.25
- Full exposure to equity market cycle

- Total risk c.7.5%
- Expected return +5.0%
- Expected return per unit of risk ~0.7
- Greater management of short-term risks

Source: MLIM Internal

Concluding Thoughts

- LDI is a framework not a product
- Risk relative to liabilities is key
- Deficits mean that returns are required
- Sources of returns (Alpha and Beta) should be diversified
- Equities still have a role to play
- Cash + products can be tailored through use of swaps
- Solutions will continue to evolve