What’s next for LDI? Preparing for the End Game

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Schemes are increasingly focused on the end game

Increasing focus on certainty of assets matching liability cashflows

DB pension journey

END GAME

Buy-in / Buy-out 27%

Self-sufficiency 49%

…..and primarily looking to de-risk towards buy-out or self-sufficiency

LDI is not a one size fits all strategy

Source: Aon Hewitt Global Pension Risk Survey 2015
Self-sufficiency – the Good Life?

- Trustees have an expectation of meeting cashflows as they fall due
- Without the need for further sponsor contributions
- With an acceptable risk of failure

Like an insurer?
Buy-out – time to sell out?

- Buy-in all or part of the liabilities with an insurance company
- Remove longevity and market risk
- Ultimate goal of a full scheme buy-out

How to get there?
What’s next for LDI?

1. Corporate bonds are going to be more important than you think
2. LDI is not a set and forget strategy, it needs management over time
3. Liability benchmarks will include a corporate bond based discount rate

Where are we heading?

Source: L&G and Engaged Investor 2015 report on Derisking Journeys of Large Pension Schemes
How do insurers invest? Annuity books

- Diversified portfolio of (predominantly) fixed income assets
- Largely a hold to maturity philosophy
- Asset income streams closely matched to anticipated benefit payments
- Fully interest rate and inflation hedged

Other assets (bond like): assets in the fixed income bracket, including loans backed by mortgages, social housing loans, commercial real estate debt, equity release mortgages

Source: End 2013 FSA Returns and L&G Reports and Accounts
Theoretical approach to self-sufficiency investing

- ‘Lowest risk’ approach would be to match all cashflows with swaps or gilts

- If the credit spread were truly a ‘free lunch’, the cost of pension provision could be reduced with no additional risk, by matching a portion of all future cashflows with corporate bonds

- Corporate bonds do still contain some default risk. If prepared to accept investment risk, it is more efficient to diversify that risk. Scope to hold other diversified growth assets (with LDI overlay).

- Need to consider how the asset allocation would be expected to evolve over time.

Gilts + 0.75% pa portfolio
45% LDI, 45% credit, 10% other diversified growth assets

Theory is nice, but…
In practice, this is not possible...

- There are few very long duration corporate bonds
- To hold corporate bonds for the duration of the liabilities would expose the scheme to reinvestment risk
- There is still benefit in holding shorter-duration corporates
- Wider factors will influence decision to buy more credit in future (journey plan, return requirement, risk tolerance)

Implied cashflows in 20 years...

Credit assets geared towards paying pensions
Paying pensions: Buy and maintain credit

- **Better diversification**: Access to global markets; avoid index pitfalls
- **Liability-aware**: Focus on bonds which will help you pay pensions
- **Avoid unnecessary costs**: Low turnover; scale/access matters

**From….**

**To…**

Typical market-value weighted index sector allocation

Typical Buy and Maintain fund sector allocation

LGIM’s fund is managed similarly to £40bn annuity book

Source: LGIM
Buy-out: what really matters?

1. Improve buy-out funding level
   ...by investing in credit assets to generate an expected yield above the evolution of the buy-out price

2. Minimise buy-out funding level volatility
   ...by investing in assets that reflect the primary drivers of buy-out pricing 100% hedged for rates/inflation

3. Minimise buy-out transition costs
   ...by investing in assets which can be transferred efficiently at low cost to the life insurer

Be prepared!
Investing in gilts only?

Better options for funding level and volatility…

Source: L&G Retirement
Liability benchmarks allowing for corporate bonds

- Historical bond price volatility has been greater than downgrades and realised defaults

Source: LGIM analysis.
What should a buy-out aware portfolio look like?

**KEY INPUTS**

- Annuity pricing from range of insurers
- Insurance industry regulatory and investment constraints
- Corporate bond and gilts market data

**BUY-OUT AWARE PORTFOLIO**

- Liability matching 25%
- Buy and Maintain Credit 30%
- Buy-out Aware Credit 45%

...buy-out aware portfolio to provide return over liabilities

Source: LGIM – for illustrative purposes
Closing the gap to buy-out over time

Representative buy-out price (50% RPI with duration of 15 years, 50% fixed with duration of 12 years)

...combined with liability benchmarks allowing for credit

Source: LGIM; Note: Using model points that are provided by L&G to various consultants we have approximated the evolution of the L&G buy-out price since May 2013, together with an estimate of the historical monthly performance of the proposed strategy compared to the current strategy; to give a non-subjective back-test we assumed that the proposed allocation was not adjusted through time whereas in practice this would not be the case. We note that part of the above outperformance is due to buy-out pricing improvements over the last 12-18 months due to non market factors, including the impact of the UK Budget in March 2014.
Keeping your options open

What level of certainty do you have that you will actually be able to buy-out in [10] years?

Illustrative funding level projection
Buy-out basis

- Increasing certainty of buy-out

Buy-out considerations
- Managing risk/reward of asset value vs. buy-out cost
- Assets to reflect drivers of pricing and likely to be acceptable to insurer
- Shorter term cash flow needs to meet pension payments in interim

Self-sufficiency considerations
- Sufficient asset cash flows to outlast liabilities over long term
- Focus on cash flow generation qualities of assets and risks around those

What might best of both worlds look like?

Source: LGIM
Best of both worlds?

Objective: be ready for buy-out in \([x]\) years

Prior to expected buy-out date there is a reduced requirement for insurer “friendly” assets as cash flows paid to members

Focus on matching early year pension payments, reducing need to be a forced seller in distressed market condition

Initial cash flow matching portfolio has run off and growth de-risked into longer term matching assets

Careful planning can save costs
LDI is not a set and forget strategy

- Changes in cash flow, interest rate and inflation matching need to be managed

Matching portfolios need to be managed too
Don’t miss the boat!

- Get plumbing in place to be ready to capture opportunities
- Focus on long-term strategy rather than short-term tactics
- Have a Plan B for when things don’t go according to Plan A
- Combination of (related) trigger options commonly used by clients:
  - Market level
  - Funding level
  - Timing

Source: LGIM
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LGIM as at July 2014