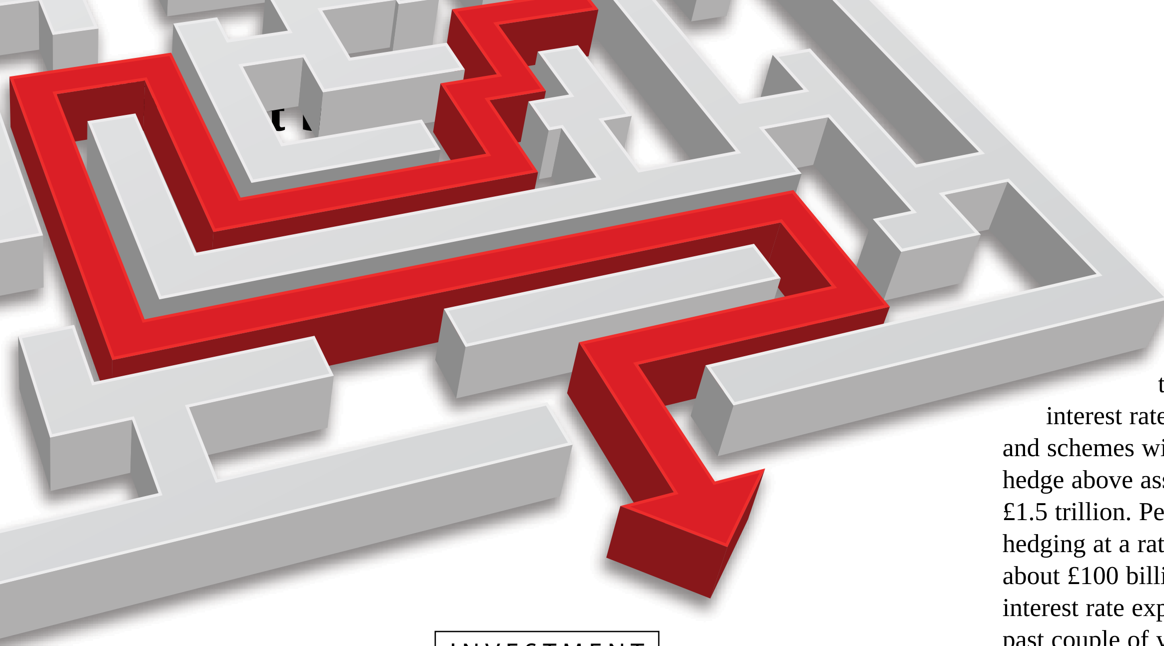

INVESTMENT

LDI – a new direction

Louise Farrand questions whether LDI has become a victim of its own success, as DB schemes become fully hedged in the years ahead

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Smart beta, also referred to as factor investing, is a term that covers a range of investment strategies. Instead of making investment decisions based on the way in which separate asset classes or individual securities behave, a smart beta strategy takes into account the underlying factors that might affect performance.

Pension schemes across the UK and parts of Europe have been swept up in a wave of liability-driven investment (LDI) over the past 20 years. The all-conquering investment philosophy has been especially popular in the UK and Dutch pension fund markets, with KPMG calculating that £908 billion of liabilities had been hedged by 1,808 pension schemes by the end of 2016.

LDI first became popular when regulation changed in the late 1980s and early 1990s to make defined benefit (DB) pension scheme liabilities more contractual and less discretionary, recalls Schroders solutions manager Jon Exley, who is one of LDI's pioneers.

"Schemes also started recognising that matching assets were bonds, not equities. They started hedging the movement of the assets relative to the cost of liabilities. That was what LDI was," explains Exley.

Since then, schemes that have taken up LDI have done very well, says Exley. "LDI was not only theoretically correct in my view but it has benefitted from being hugely rewarding for anyone who followed the strategy. Interest rates fell dramatically in that period and so schemes who had done LDI did very well and schemes that hadn't found they significantly underperformed."

However, in recent years, parts of the pensions industry have questioned whether LDI could become a victim of its own success. A note by consultancy Hymans Robertson predicted that, at the rate they are currently hedging, UK DB schemes are likely to be fully hedged up to their asset level by 2021.

The note reads: "About £1.2 trillion of notional interest rate risk is hedged today and schemes will not materially hedge above assets levels of about £1.5 trillion. Pension funds are hedging at a rate that has added about £100 billion of notional interest rate exposure a year for the past couple of years. At this pace they are likely to be fully hedged up to their asset level by 2021."

Evolution or revolution

Could we have reached a peak in LDI? Its proponents think that LDI is more likely to evolve to meet changing demand. "We have offered LDI in the UK for 20 years and it has always changed, it has never been one size fits all or a single strategy that hasn't adapted over the years. We just see that continuing," says BlackRock's head of EMEA LDI, Richard Wood.

Wood adds: "The main observation with the UK, relative to other markets, is that much more hedging has been done in the UK market now. Much more of the core first principle around client-side liability hedging was to control their interest rate and inflation risk. Ultimately, the UK has got that hedging to a level that clients are more comfortable with and now we are talking about the next step. The conversations we have with clients are about their objectives for their liability-driven portfolios."

Elsewhere in Europe, the popularity of LDI varies. It all depends on where schemes are on their de-risking journey, as well as the regulatory situation. For instance, with its consistent focus on risk management, the Netherlands has a well-established LDI market of a similar maturity to the UK's.

"Back in 2001, one of our first clients was one of the large Dutch pension schemes," recalls Legal & General Investment Management's head of strategic partnerships, Mike Walsh. "They have a really sophisticated pensions market in terms of understanding managing risk." Walsh also reports an uptick in interest in LDI in Germany and Ireland.

New frontiers

Increasingly well-funded UK DB schemes are thinking about the next step in their de-risking journey. LDI managers are looking to introduce new asset classes to meet their changing demand. "It goes back to the key point around the broadening of objectives. When everything was risk focused, derivatives or highly liquid government bonds were the primary assets used in liability hedging in the UK. As we see those objectives broadening out and people thinking about cashflows and return objectives, that requires a broadening of the asset set," says Wood.

He adds: "We are seeing a lot of conversations around incorporating more credit assets into solutions and using those credit allocations to tie into specific cashflow objectives. We are also seeing it further down the fixed income spectrum and are thinking about all sorts of assets that have contractual cashflows. Those assets can each play a role in how you achieve a combination of risk, cashflow and return objectives. It's early days but we expect that to continue."

Cashflow-driven investment (CDI) is the new industry watchword, both in the UK and increasingly Europe, says Walsh. He defines CDI as: "Trying to line up cashflows from your assets to meet liabilities when they fall due. [CDI] has been driven by two things. With yields being so low, people in Europe haven't been outright hedging interest rate risk; they have been trying to buy assets with higher yields but remain cognisant of when the cashflows from those assets become due as well."

Walsh adds: "We are seeing a lot of demand for real assets both in the UK and across continental Europe, the UK probably more inflation-linked, in Europe more fixed in nature. That has effectively been the next generation of LDI, where people are trying to make their assets work harder and give themselves interest rate protection, but also a higher yield, than they are able to get from traditional bonds."

In the UK, the introduction of freedom and choice in 2014 has led to a sharp uptick in people transferring their DB pensions into defined contribution (DC), to allow them to access the new flexibilities. The trend has fuelled schemes' increasing focus on their cashflows, says Wood. "Schemes have had to deal with this issue immediately and it hasn't been as predictable as they may have thought. Equity markets have generally been reasonably buoyant – but that doesn't mean it will always be the case. If anything, it has helped bring focus onto cashflows more generally."

Old problems

Of course, perennial challenges remain true. With the outcome of Brexit looking uncertain and populism still causing waves across Europe, political uncertainty continues to be a real risk for investors. Walsh says: "LDI is about knowing the risk you have exposure to and trying to reduce that down in a sensible manner despite low rates. You don't want to do it overnight but if you have other risks in the portfolio which may be a bit harder to manage, you may want to manage your overall risk so that it is at a level you are tolerant of."

Walsh emphasises the importance of looking to the long term, managing risk through taking diversified positions, and looking at the scheme's holistic risk management picture.

Regulatory risk is another spectre. In KPMG's 2017 survey, 82 per cent of LDI managers said that regulatory risk was the biggest challenge facing pension schemes over the year. Of course, Brexit could have regulatory implications, especially for the UK pensions industry; these remain a complete unknown.

In addition, regulation continues to trickle through in reaction to the financial crisis, as European legislators try to manage systemic risk by tightening up solvency requirements, risk management, and supervisory frameworks. LDI managers needed to make some changes to their approaches to derivatives in response to the European Market Infrastructure Regulation (EMIR), for instance.

Walsh welcomes EMIR as a good thing. "We were very proactive in talking to clients and moving our portfolios because as an LDI manager you have to manage things for clients, but also look on the horizon and see what's coming. We were able to invest quite heavily and make sure we cleared all those positions. You don't want to end up in a situation where you can't clear and then have to restructure."

All in all, LDI looks unlikely to lose favour any time soon. As LDI managers point out, the strategy is evolving to meet pension schemes' needs as their funding positions improve. We may be hearing more about CDI, but LDI is here to stay. ■