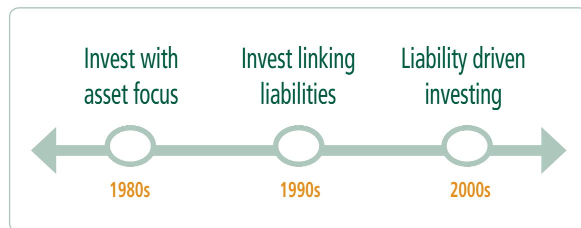
LIABILITY DRIVEN INVESTING

Good process, good outcomes: Liability driven investing (LDI) is often associated with reducing risk. The lower risk does not have to be at the expense of increased operating costs of a defined benefit (DB) plan. The key is to consider a range of risk management options and then determine the approach, or combination of approaches, that delivers the best risk/reward outcome for you. This note highlights the range of options for managing risk.

CHANGE IS SLOW

Changes in the defined benefit (DB) investment world are very slow. We have, however, seen a gradual shift from an asset focus when DB assets were generally small, to a greater link with the liabilities as some plan sponsors moved to better matching bond portfolios, to the current discussion and focus on LDI.



WHAT IS LDI?

LDI is a process and not an investment strategy. LDI means focusing on the liabilities as a starting point for developing investment strategy. At an extreme, this can involve establishing a portfolio that closely matches the expected cash flows arising from the liabilities. In most cases, however, it involves establishing a specific liability benchmark for a DB plan, and then assessing the risk/reward implications of departures from the liability benchmark to determine the asset mix.

LDI Characteristics

Focus on liabilities	Starting point to develop investment strategy
Using a liability benchmark	Based on either cash flow or combination of indices
To determine asset mix	Assess risk and reward preferences relative to the liability benchmark

There is a lot of discussion on LDI, but not as much action. The barriers to plan sponsors' embracing LDI have been a combination of there being no incentive, not being ready to consider such approaches and not easily being able to grasp some of the concepts that often form part of LDI solutions.

Key Barriers

No incentive	To reduce bias to more volatile equity assets
Not ready	To adopt as no formal plan for de-risking
Not able	Due to governance challenges with little or no committee expertise on derivatives

FREE LUNCH?

Another plan sponsor concern with LDI is that with lower risk comes lower return, which will increase the cost in supporting a DB plan. This does not have to be the case so long as a plan sponsor can gain comfort with strategies that allow for an increase to the fixed income allocation through an overlay strategy.

Overlay strategies allow risk to be reduced by cutting back equity investment, but not sacrificing the long-term expected return due to the benefit of the higher fixed income allocation. The catch – overlay strategies are associated with derivative-based investments, which require the oversight committee for the DB plan to gain an understanding of and confidence in these types of investments.

Derivative-based solutions are associated with a "risk optimization" approach. However, there are a range of options available to plan sponsors that vary from both a governance and investment perspective in terms of how easy or hard they are to implement.

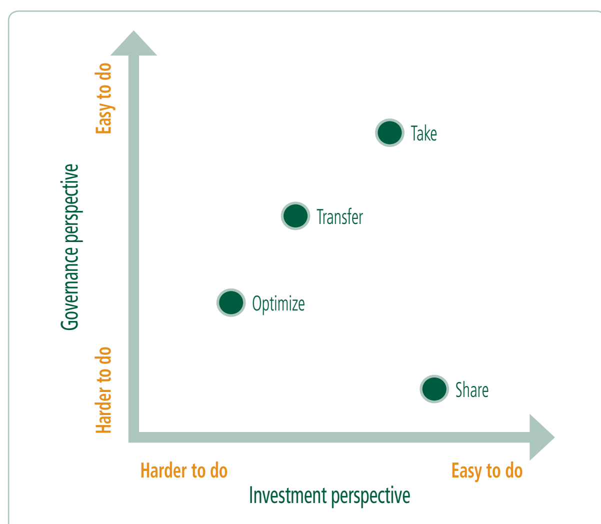
RISK MANAGEMENT OPTIONS

Four risk management options for plan sponsors are, take risk, share risk, optimize risk and transfer risk.

Key Options

Take risk	Maintain pension fund equity bias
Share risk	Higher member contributions, or benefit reductions
Optimize risk	Use overlay strategies and non-traditional investments
Transfer risk	To a third party, such as an insurance companys

The chart below summarizes our view of how the four different options compare from a governance and investment perspective.



RISK OPTIMIZATION

Some of the approaches under the risk optimization category include extending duration and using overlay strategies. The benefits and challenges of these approaches are highlighted below.

Approach	Benefits	Challenges
Extend duration	Simplest to implement	Limited impact to risk profile?
Bond overlay	Can reduce risk without reducing return	Requires comfort with non-traditional investments
Alpha and bond overlay	Biggest potential impact to improving risk and return profile	Requires comfort with non-traditional investments

RISK TRANSFER

The approaches under the risk transfer category include: buy-out, buy-in and longevity hedge.

Transfer Options

Buy-out	Annuity contract that transfers DB plan liabilities to an insurance company
Buy-in	Similar to buy-out, but annuity contract retained as a DB plan investment
Longevity hedge	Reduce the cost of plan members living longer by swapping a fixed payment stream for a variable stream

The benefits and challenges of the risk transfer approaches are highlighted below.

Approach	Benefits	Challenges
Buy-out	Transfers pension obligation (except in Quebec) Reduces investment and longevity risk	Top up contribution if in deficit
Buy-in	No top up contribution since plan investment reduces investment and longevity risk	Partial risk transfer since the plan retains assets and liabilities
Longevity hedge	No large lump sump payment (that applies for an annuity) Reduces longevity risk	Likely limited capacity in Canada

The need to better manage total pension fund risk is at the forefront of plan sponsors' minds. There is a range of risk management options to choose from. Be sure to assess each one.

For further discussion on how you can progress your risk management goals contact.

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