The Evolution of Asset Liability Investment Management

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Trends in Liability Driven Investing (LDI) continue to evolve as Canadian plan sponsors of all sizes put LDI strategies into place. Implementing them has never been a simple exercise, as there are many factors to consider, including competing priorities. Regardless, as plan sponsors faced two major economic downturns in one decade and the harsh realities of large pension costs, historically low interest rates, ongoing market volatility and slower economic growth, LDI quickly evolved from a marketing buzzword to a new normal framework in institutional investing for defined benefit pension plans.

But has the pendulum swung too far with too much emphasis being given to precisely matching assets and liabilities in a narrow framework of prescribed rules? And what will happen as the next round of changes to solvency and accounting rules becomes a reality?

We think the next generation of LDI requires a long-term perspective; whereby risk is no longer, or not only, defined by regulations and accounting rules for measuring, paying for and expensing pension obligations. Does this mean abandoning past LDI strategies? We say no, but with a caveat — for plans with long time horizons, the next generation should include consideration of the true long-term economic costs within the larger context of the enterprise’s financial objectives and appetite for risks. Forward-thinking consultants and asset managers can facilitate discussions to define these objectives, identify risks and potential challenges, and offer a variety of progressive solutions to help plans succeed with the next generation of LDI.

The Evolution of LDI

The evolution of LDI fundamentally shifted the roles of, and the conversations between, plan sponsors, their consultants and their asset management partners. Historically, the consultants’ rigorous asset liability modelling produced a requisite rate of return derived from an efficient frontier analysis based on modern portfolio theory. The rate of return target was expressed in the form of an asset mix or a mix of market benchmarks or indices. The asset manager’s objective was to either efficiently and cost effectively deliver a benchmark rate of return passively, or actively generate excess returns (alpha) relative to a given market
benchmark. The asset manager’s performance measure was either the tracking error or the value added relative to the appropriate market index —“Here is your Beta, now please go and meet it or beat it.” Conversations were not focused on the relevance of the referenced benchmarks to the behaviour of the obligations, and there was limited discussion about the risks embedded in the construction of the index or the securities included in it, either on an absolute basis or relative to the plan’s obligations.

A decade of volatile and predominantly sideways equity market returns combined with declining interest rates and corresponding rising liability obligations made it apparent that the traditional policy mix was too far from the minimum risk portfolio. This led to a greater focus on risk budgeting and LDI.

In the early days of LDI implementation, many sponsors came to the same conclusion – the traditional 60% equity/40% universe bond portfolio had too much money invested in risky return-seeking assets. Even their fixed income assets, which they thought were their liability hedge, had too much uncompensated risk. The first step in reducing these risks was to better align the fixed income allocation to that of the obligations.

A step towards risk mitigation

The most simplified approach meant shifting the fixed income allocation to longer duration bonds through strategies aligned with the industry benchmarks, like the DEX Long Bond Index. This was often referred to as “duration matching” and served to improve the overall hedge ratio relative to the obligations, thereby reducing interest rate risk. In the early days of duration matching, there was limited discussion of the actual bonds within the benchmark or the resulting altered corporate credit profile of longer duration fixed income portfolios.

As duration matching evolved, focus shifted to creating increasingly customized fixed income portfolios designed to more closely align with obligations. These structured solutions may have been either key rate duration matched, or more precisely cash flow matched, with income from bonds replicating the pattern of payout obligations.

This concept continued to evolve to include much discussion about creating highly precise fixed income allocations designed to very closely align with how pension plans are required to measure the present value of solvency and accounting obligations. In essence, the goal was to hedge the liability based on how regulators or accounting professionals prescribed obligations be measured.

This strategy may be appropriate for fully funded and closed plans with highly predictable and fixed obligations and 100% allocation to fixed income. However, for many plans with a remaining significant allocation to equities, the attention to high precision in the fixed income allocation alone was less warranted and may have introduced unnecessary costs. This was
somewhat akin to a firefighter wearing the highest quality fire retardant pants topped by only a t-shirt. In addition, the focus on precision carried with it a false perception of accuracy, because how liabilities are measured, paid for and expensed is a moving target

Today’s tactics

Today, some of the most creative LDI solutions use derivatives in the fixed income allocations. Initially, their primary purpose was to cost-effectively add significantly more bond duration, which hedged interest rate risk relative to mark-to-market liability measures (i.e., solvency, accounting, etc.). The synthetic bond overlay allocation was typically paired with other fixed income strategies to achieve a customized duration and interest rate hedge ratio target. Many plans used this tool because it allowed them to add bond duration in a capital efficient manner, raising the total portfolio hedge ratio while leaving capital available for return-seeking strategies.

Asset liability matching for fixed income allocations continues to evolve and is now more obligation focussed and holistic in nature, with the overall asset mix being taken into consideration. Rather than simply asking a manager to meet or beat a benchmark outcome, this approach involves collaborative dialogues earlier in the design process, requires specific solutions to meet the unique circumstances and priority of objectives for the plan, and includes not just a solution prescription but also an implementation strategy.

While traditional fixed income benchmarks may be useful guideposts in the construction and measurement of a liability-driven solution, the benchmarks alone are not meaningful measures of a plan’s risks.

The Next Generation of LDI

Recent changes to solvency funding rules and accounting standards present an opportunity to challenge ourselves to think about LDI strategies and implementation in the context of the long-term costs of the plan and risks that need to be hedged. For example, multi-employer pension plans are already exempt from solvency funding rules and this trend is continuing, with certain jurisdictions also exempting some public sector plans.

LDI is still important for these plan sponsors, but with more flexibility in the rules they need to determine the right trade-off between the perfect hedge and the opportunity to take some risk to reduce expected costs.

While LDI has evolved with a focus on hedging the shorter term mark-to-market measures of the obligation, we believe the next generation will also include a longer-term view. In this
context, it will be equally important to consider income generation and the search for return in a low yield environment. Where we expect to see varying degrees of importance is in the areas of solvency, windup and accounting metrics, as these are highly dependent upon the plan sponsor.

As perspectives change, we see the next generation investment portfolio including physical fixed income allocations, synthetic bond overlays, tactical opportunities to add yield, and equity strategies with a focus on reduced volatility and capital preservation.

**Physical fixed income allocations** will be designed to better match the obligations of the plan. For most plans, that means a continued focus on longer dated bonds. But we expect that the next generation of LDI will look beyond just duration matching based on DEX benchmarks and will take a closer look at how the index is constructed, especially with respect to how and where on the maturity spectrum the corporate credit exposure should be taken.

**Synthetic bond overlays** evolved as an important tool in LDI because of their ability to significantly increase the duration match to mark-to-market measures like solvency of accounting. Not as well understood, but beneficial, is the consideration that bond overlay strategies can also provide a very good source of predictable income via coupon payments from the referenced securities.

Synthetic Bond overlay strategies increase the overall yield of the fixed income portfolio, because the larger notional exposure earns a yield that is higher than both the underlying reference benchmark, and the financing cost (often referred to as the "positive carry"). In fact, some plans may use a higher going concern discount rate assumption to reflect this higher yield, which results in an immediate reduction in the current service cost and going concern liabilities.

**Tactical opportunities to add yield and enhance return** will come from a broad spectrum of assets, including corporate investment- or non-investment-grade bonds, global bonds, emerging market sovereign debt and inflation linked securities. In an LDI context, these sources of income provide a relatively stable overall return stream, which could result in lower overall volatility when compared to other options, like common shares. High yield bonds rank higher in the capital structure than common equity, an important consideration in LDI strategies focussed on long-term capital preservation.

**Equity strategies focussed on reduced volatility and capital preservation** will include investment in high quality companies. To the extent that funds are allocated to return-seeking assets, like equities, we see less emphasis on traditional capitalization weighted indices. Success will not be measured solely on the outcome relative to typical benchmarks,
instead it will also be measured relative to the plan’s ultimate objective, namely reducing ongoing funded status volatility.

In an LDI context, the focus will be on innovative strategies that deliver obligation relevant returns in a risk-controlled fashion. They might bear limited resemblance to cap-weight market indices, but will deliver a more predictable and comfortable outcome for the plan sponsor.

In order to navigate the increasingly complex and uncertain future of plan risks, sponsors will need partners who understand their businesses intimately and who are able to translate that understanding into financial implications for their benefit plans – on both the liability and investment fronts. With a deep analytic capability, a broad skill set, and a diverse suite of cost effective solutions, the next generation asset manager will be that partner. For some, the next generation may be closer than they think!

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