

How LDI Strategies Are Evolving to Meet New Goals

Liability-driven investing strategies aren't just for shuttering corporate defined benefit plans any more. The use of these strategies has been evolving as a means for DB pension plans to meet their liability requirements. The derisking aspects of LDI can also protect against the effects of market volatility and future financial crises — both of which apply to all kinds of pension plans, whether closed, frozen or open. And principles of LDI can be applied beyond DB plans to include defined contribution plans and individual investors. This *Pensions & Investments* roundtable with Gary Veerman, head of LDI solutions at Capital Group; Serge Lapierre, global head of LDI research at Manulife Asset Management; and Craig Stapleton, head of asset liability management and quantitative strategies at Securian Asset Management, dives into the evolution and expanding uses of LDI.

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Pensions & Investments: What's been driving LDI growth over the past year or two? Are those factors still in place or are they changing?

CRAIG STAPLETON: I think the largest contributing factors in LDI have been the increase in [Pension Benefit Guaranty Corp.] premiums, strong equity market returns and a rapid growth in the pension risk transfer market. More companies realize that the cost of maintaining their plans' status quo has increased dramatically. With modestly higher interest rates, they're seeing a chance to take risk off the table and move out of equities and immunize a larger portion of their liability block. I think it will continue because the pension risk transfer market has increased dramatically, it's getting more news and you're getting more LDI conversations.

SERGE LAPIERRE: We've been in one of the longest bull markets, if not the longest bull market, in history. There hasn't been any significant crisis since the global financial crisis in 2008. I think it might be a wake-up call for certain people down the road, because we believe a crisis is going to occur again at some point. I think for those who haven't adopted an LDI strategy, they should consider doing so, because they don't want to act when the next crisis is here. They want to take action beforehand.

P&I: Is LDI a strategy that any plan sponsor can or should consider regardless of their funded status?

GARY VEERMAN: Every corporate plan sponsor should be implementing LDI. It's really [a question of] to what magnitude. I think from a sweet-spot perspective, what gets super-interesting is when a plan starts to reach the 90% to 100% funded-status level. Particularly at 100% funded, there's significant funded status asymmetry. Any upside gains in funded status have decreasing marginal benefit, but increasing pain as funded status



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falls. Falling below full funding will result in higher PBGC premiums, contributions and other implicit costs at an increasing rate. When you get to that fully funded range, we think that's where aggressive derisking really should be your primary objective versus, say, return generation.

LAPIERRE: LDI is not just about immunization. I think there's a misconception that going full LDI means going 100% bonds and hedging 100% of your duration. LDI is really a framework for managing the assets and the liabilities of the pension plan holistically. I don't think there is any question that this is something that needs to be done by every pension fund. It's really a matter of how willing you are to hedge your liabilities and your ability to withstand the risk you are facing in terms of additional cost, additional PBGC contributions and/or the volatility of your balance sheet or your income statement.

STAPLETON: LDI was a solution that was designed for a multibillion-dollar plan to start, but it has gone down market. There have been limitations for those small plans to reach truly customized solutions that match their duration, key rate duration and cash-flow profiles. There are some pooled solutions, but they have

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— GARY VEERMAN
Capital Group

not [been widely] available or promoted to smaller plans. We've developed them because we know that they're looking for the same sort of risk management and they need to have access to it. The only way to do it in a cost-effective way is through these pooling vehicles.

P&I: Can LDI be applied to sponsors that do not expect to terminate their defined benefit plans?

STAPLETON: That's absolutely true. With a recent

pension client, one that plans on remaining active, we have done an in-portfolio pension risk transfer, to say it one way. We're totally immunizing a portion of retirees, and we're looking at immunizing emerging retirees as they come through, but also generating the returns that help support the active participants.

LAPIERRE: It's also about the LDI solution specialist's ability to show the trade-offs present in designing a particular glidepath, and any particular exposure to growth and hedging. Some plans might be willing to take on a little bit more risk because they have more cash or the ability to withstand more volatility, whereas others may be more cash-strapped and might want to

play it safer but still get out at some point or resolve their funded status problem. It's all about finding the right balance between these different components of risk.

P&I: Can alternative investments fit in an LDI strategy?

VEERMAN: From our perspective, we think that in the LDI portfolio, it's interest rate risk and it's credit spread risk, and you want to match that with mark-to-market risks. If you want to reach for return through alternative strategies, we believe you do it in the



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return-seeking portfolio. Just make sure you weight the trade-offs between illiquidity and how much any excess return derived from these strategies can help you achieve your objectives.

LAPIERRE: Other people see alternatives belonging in the return-seeking portion. The thing is, there are some alternative asset classes that can be integrated within the liability-income-hedging component. We call that an LDI-plus approach, where we look at the revenue that can be generated from these asset classes. I'm thinking about commercial mortgages, real estate, timber and agriculture, and also some absolute-return strategies that can be embedded within the LDI strategy or the liability-hedging strategy and can be maintained over time as you derisk. It means you don't necessarily have to sell out of your private assets in order to continue adding a good hedging strategy. If you include asset classes that have some interesting liability-hedging properties embedded within your liability-hedging strategy, you don't necessarily have to sell them if you're going to hibernate your plan in the long term or if you want to keep them for the really long term.

STAPLETON: We are in the pension risk transfer business, and it is true that most insurance companies don't want to receive alternative assets, specifically illiquid alternative assets. Therefore, you have to transfer in cash and transfer out the alternatives or take a haircut on those alternative asset prices. So if you're looking to do a pension risk transfer transaction, you need to be very cognizant of that fact.

P&I: Let's talk about capacity and issuance issues related to corporate bonds. What strategies can be used to replicate long-duration bonds as liability hedges?

STAPLETON: There are only so many names you might want to own in a long corporate universe, and we don't want to go down in credit on some of the long names. As one solution, you can use long Treasury futures or long interest rate swaps and marry those with shorter-duration, seven-year or 10-year cash bonds that maybe dip down in credit. By add-

ing that strategy, plans dramatically increase the universe that's available to invest in and hit their long-duration bogey.

VEERMAN: In the short term, we don't really see capacity challenges in the investment-grade long-credit space. Even if plans move 10% of equities into long corporate bonds today, that translates to about \$300 billion of flows or 15% of the long corporate bond market. And that's assuming all that money goes into corporates. We know Treasuries, Treasury STRIPS and interest rate derivatives are also utilized in LDI programs. And then by definition, Economics 101, supply will meet demand. The question is, Does that result in implicit or explicit costs that come through tighter spreads? Potentially, but there are a lot of other factors driving this dynamic.

But we're also seeing a lot of plans migrate down to the intermediate market part of the curve when they think about curve-matching as they increase their LDI allocation. It really comes down to when you start to tighten the screws, you're now accessing a market that's multiple times bigger than just a long-duration corporate bond market.

LAPIERRE: Eventually, supply and demand in the long end becomes an issue for corporate bonds. That's the case in the U.S. and across the world. At some point, we won't be able to actually buy those corporate bonds and we need to find an alternative to mimic the behavior or the liabilities that are valued using these spreads. I think the quickest way is maybe to look at global credit, where there may be some opportunities as they weather the currency risk. It's really about building a return engine that has a zero beta relative to the liabilities and integrating that within your liability-engine component.

P&I: What problems are posed by equity-drawdown risk in the return-seeking portion of an LDI asset portfolio?

STAPLETON: Equity market volatility is the most underappreciated risk to funded status — volatility in particular. There's been a tremendous amount of focus on interest rate risk within the fixed-income portfolio but not a ton of discussion about managing the very large funded-status volatility related to equity drawdowns and the return-generating portion of the portfolio. We think plans should spend just as much time — if not more — thinking about how they control or manage that volatility risk, specifically in the equity portfolio.

VEERMAN: I completely agree. For many plans, equity risk continues to be the largest driver of funded status volatility. You know, focusing on equity diversification is arguably a free lunch if you can allocate among non-correlated assets. Let's not forget that corporate bonds and equities are the same companies at different parts of the capital structure. So we know that in periods of stress, they perform in the same direction, and that's usually not a good direction. And you know, that's why we hold Treasuries and that's why we love

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With LDI strategies, it's really about changing the mindset from an asset-return-only perspective to an asset liability, trying to achieve an objective over the long term.

— SERGE LAPIERRE
Manulife Asset Management

Treasury STRIPS and things that should hold up and provide flight-to-quality protection.

P&I: What nontraditional LDI investment strategies (i.e., anything other than long-duration corporates) are being developed?

LAPIERRE: I think we need to go further than just diversifying equity in the growth component. There are all sorts of asset classes that you can put within your growth component. They're going to help to significantly reduce the overall volatility of your funded status and get the same kind of expected returns over the long term. It's something that also needs to be considered in designing your LDI strategy — getting better diversification of the growth component by adding not only equities but also alternatives and perhaps some bona fide protection within the equity component. It's about integrating alternatives and absolute-return strategies within the hedging component of your LDI assets in order to help generate returns while maintaining good matching capabilities.

VEERMAN: I think the further you stray from the major risk factors, the higher probability you have of experiencing unexpected or potentially negative outcomes. If you do add nontraditional investments, we say do those in very modest amounts. And really, I'd ask the question if you're thinking about these, do you need any of these nontraditional LDI strategies

to achieve your LDI objective? Not a perfect analogy, but you go back to absolute-return strategies on top of the S&P and you know, absolute return wasn't absolute return. It was highly correlated with the S&P. In theory, it made a lot of sense, but in practice, it turned a 40% drawdown into a 60% drawdown. So those downside risks really need to be thought of as the primary variable and the question of whether the risks are worth it, for maybe 100 basis points on 10% of the portfolio, needs to be asked.

STAPLETON: We think that the private markets provide a great plethora of diversification benefits but also excess spreads, yields and illiquidity premiums. As an example, we really like the commercial loan and real estate debt that we originate. These markets are harder to access, so you get additional yield in a significant way versus public bonds with similar credit risks. Many real estate debt instruments also amortize over time, so they match the cash flows of retiree blocks of individuals very nicely. The problem with any of these private-credit transactions is that they're less liquid. So again, we go back to that alternative question, What is your timeline, Do your derisking glidepath and desired end state allow for that reduced liquidity?

P&I: Are there other applications of LDI for institutional asset owners that do not involve defined benefit plan endgames?

LAPIERRE: There's a new name for this — goal-based investing. It's about establishing the time frames, the amounts you will need at some point in time. It can be applied to retirement saving, but it could also be applied to funding for education or your own various goals. The idea is to determine the obligations that you want to meet, similar to a pension liability, and creating a fixed-income matching strategy for that component. You can then combine that with a growth component in order to generate excess returns to increase the chances of achieving your objective.

STAPLETON: There's a lot of opportunity to use the same tools that we've utilized, that have been utilized by defined benefit plans, for other institutions and individuals. If you think about a defined benefit plan, it's basically just a collection of individuals proceeding toward retirement or being paid in retirement. Glidepaths that plans are using are a lot like the target-date approach within 401(k) plans. If you think about LDI, it's about defeating the known or projected cash flows from the needs of the individuals that the plan is or will be paying out. Obviously, you can reverse-engineer this whole structure and create lifetime-income products. So instead of just talking about accruing more in your 401(k) plan, how do you turn it into a pension plan for individuals? I think that will emerge eventually as the regulations and ease of transferability come forth. Generally, once you start looking at everything through an asset-liability-management lens, every

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Generally, once you start looking at everything through an asset-liability-management lens, every decision becomes more educated and thoughtful, and you generally have smoother and more stable outcomes.

— CRAIG STAPLETON

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VEERMAN: At the end of the day, all investors have some liability. I think the biggest challenge applying LDI is [that] we really think of things in present-value terms and many of these other investors are thinking about future value. So that's a big hurdle. But at the end of the day, all this is just an asset allocation exercise. So stick whatever liability you want in there, have an objective, and I think many of the same concepts should apply.

P&I: What are the most common questions or issues that potential or existing LDI clients have?

LAPIERRE: I think a lot of plan sponsors want the best of both worlds. They want to be able to hedge their risks at the lowest cost possible, which is normal. But given that rates are so low, they're looking for ways to enhance the performance of their fixed-income risk, or they're not even willing to invest in fixed income. So they prefer not to hedge their risks because they feel that the costs are too high and instead, they're taking on other risks. We address this by going back to the basics and educating people as to why they're doing LDI — they're doing this because they've got this big liability that's taking a lot of risk. Their liabilities are valued right now, so it's really a matter of how much of your liabilities you want to get off of your balance sheet, essentially through a hedging strategy. And again, how much risk are you willing to take over and above that?

VEERMAN: Certainly, the level of rates comes up a lot. What we say is that interest rate risk for a corporate DB plan is an uncompensated risk; so, arguably, a plan sponsor should be agnostic on the level of rates. At a minimum, when you look at your risk budget, consider taking more risk in equities than in rates, which often means utilizing strategies such as high-quality corporate bonds, long government bonds, STRIPS and potentially interest rate derivatives. The expected return-on-assets dilemma, when moving from equities to fixed income,

certainly at the [chief financial officer] level, is a significant headwind. We are the world's largest active equity manager, and our analysts often factor in pension risks when making decisions about companies they invest in.

People shouldn't stop their derisking because of the short-term implications on earnings, so that's a common discussion.

Maybe people don't ask this enough, but how do they appropriately communicate overall LDI program success? We know it's not looking at your 3% allocation to your emerging equity manager and seeing that they're 30 basis points under [benchmark] and talking about whether you should keep them or fire them for the next 45 minutes of a committee meeting. It's really about what drove your funding outcomes. How hedged were you, and did the hedge do its job? And then not doing an asset-liability study every committee meeting, but having risk metrics to evaluate if you're still comfortable with the amount of potential downside risk you're taking as an organization. An LDI program is only as good as your ability to communicate it.

STAPLETON: Most of the conversations that we have revolve around the conflicting desires of mitigating your funded status volatility while maximizing your return. Obviously, you can't do both. So what you have to do is really establish a strong glidepath strategy, and that includes all those risk metrics that we were just talking about. It's not just about returns and how much you have in fixed income, but what is your key rate duration mismatch, what is your equity volatility drawdown exposure and having that be front and center, so everybody understands what's on the table. If you don't have everybody educated, it's going to be very difficult to get buy-in and support on a continuous basis because you're going to have short periods of underperformance versus benchmarks, and that's not what materially matters. It's all about risk management and matching as an [asset-and-liability management] problem. That's what everybody should have as a goal. It's more [focused on] long-term investment and risk management.

P&I: What are the main friction points when implementing an LDI strategy? Are there things plan sponsors can do to alleviate those? In other words, what work ahead of time should plan sponsors be undertaking?

STAPLETON: It's really about knowing what your exposures are. If you don't know what your exposures are, you don't really know how important it is to use LDI. Because as we were saying, there's not a lot of upside in taking interest rate risk on the LDI side of the portfolio, so why would you take the mismatch? It took us a while to get our head around it because many plans looked at it from a perspective of returns versus benchmarks as if they only cared about the asset side. Then once every year, they look at their present asset value. Now they're looking at future cash flows and how they change through time. If they're more

sophisticated, they're getting smarter about how they manage that mismatch.

VEERMAN: An ad hoc LDI strategy does not typically work. In our view, getting back to your strategy is only as good as your ability to communicate it as it relates to the risk you face at any point in time and your exposures across your portfolio. You should be able to summarize those pretty simply in three to five pages to investment committee members, so every quarter they know exactly what they're looking at, where to look and understanding what drove the impact on the portfolio. LDI is pretty darn sophisticated, but we don't need to make it sophisticated in terms of how we communicate it.

LAPIERRE: A lot of times, you're going to see the investment committee talking about expected return,

value-added objectives and things like that, but the real objective of managing a pension fund is not to reach a certain level of expected returns. If the investment committees or sponsors define their objectives in a clear and understandable manner — for example, we want to get to a 110% funded ratio within the next 10 years — that probably changes the way you look at the investment strategy. You're not just there to make money, you're there to manage a pension fund. You have a goal to get to that funded status at some point in time. And you need to establish a strategy that will deliver on that goal, and one you can follow to make sure that the strategy is in line with your actual objective. With LDI strategies, it's really about changing the mindset from an asset-return-only perspective to an asset liability, trying to achieve an objective over the long term. •



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