Manulife Investment Management

POST-CONFERENCE BRIEF

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A Personalized LDI Plan

Liability-driven investing has become a hot topic as defined benefit plan sponsors move pension risk off their balance sheets. And LDI is also evolving, as the industry works to figure out how to take the LDI structure and apply it to defined contribution plans.

The timing is good, since DC plan sponsors, along with their service providers — such as record keepers, managers and consultants — are struggling with decumulation and trying to keep retiree assets in plan once they stop working.

"The idea of applying LDI to DC plans is essentially that it used to be your corporation that offered you the ability to match or to build retirement income," said Serge Lapierre, global head of liability-driven investments research and senior managing director of quantitative management at Manulife Asset Management, who was interviewed on the sidelines of *Pensions & Investments'* DC East conference. "So we decided to apply the same kind of methodology to the DC space for individuals."

Manulife has built what Lapierre called a "personalized DB plan for an individual." Technically, it's called dynamic LDI.

The idea is to use the DB concept of LDI for defined contributions, before and after retirement. LDI asset allocations for DB are designed to ensure income distribution over a specified period of time, and adjusted for that allocation if, and as, needed over time. When crafting it in a DC context, participants are responsible for building their own retirement fund and spending it down in retirement without running it to zero.

"Participants want to make sure they're able to have a minimum level of income. So we build a base of bonds to match the floor of income they want for their retirement," Lapierre explained. "But at the same time, they want some upside potential to make sure they don't outlive their assets."

To do that, the dynamic LDI has two parts: An LDI component to match a fixed stream of income and a growth component to build the capital base.

"The way the fund is managed is that when we capture gains in the growth strategy, we lock in those gains and secure more income," Lapierre said. "That's built into the investment strategy so the individual participant doesn't have to worry about locking in those gains or changing their asset mix."

SOLVING 'TO VS. THROUGH'

The dynamic LDI attempts to solve a couple problems. First, employees in defined contribution plans accumulate assets through their working years, only to retire with little understanding of how to spend those assets over the balance of their lives. That includes, importantly, how much to spend each year. Common guideposts, like the so-called 4% rule, remain hotly debated.

Second, these employees also need to ensure that some percentage of their assets remain in return-seeking assets so they don't run out of money.

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Those pieces of information can go a long way toward helping plan participants better secure their retirement, especially since they bear all the responsibility.

"With the dynamic LDI strategy, we're able to say, 'This is the exact amount you're going to get on the first day you retire because we've got some bonds maturing on your retirement date that are going to pay you this amount of money,'" Lapierre said. "And by adding that sense of how much they can get out of their assets, it's a way also of getting some financial advice as to whether it's actually the right time to retire or not. So by having a sense of how much they can get, participants are able to say, 'Maybe I need to postpone my retirement a little bit. Maybe I need to save a little bit more.'"

The dynamic LDI strategy can also solve the "to versus through" problem that many plan sponsors face when offering target-date funds, according to Lapierre.

"There are a lot of people coming into retirement with target-date funds that are maturing up to their retirement date, and they don't know what to do with their assets," he said, adding that the options are basically to take a lump-sum distribution or buy an annuity.

"People generally don't know what to do with all that money, and annuities can be costly," he said. "Now, when the target-date funds mature, they can roll those assets into a dynamic LDI that will give them retirement income they can rely on, a base retirement income that will grow over time with their diversified growth assets on top of it."

Plan sponsors, however, may also offer the strategy to employees who are still years away from retirement. According to Lapierre, plan sponsors can offer this dynamic LDI as an option on their DC investment lineup and might even be able to use it as a default option. The company plans to add a 25-year payout period for U.S. participants. Lapierre said that would cover about 80% of the population.

THE DYNAMIC PART

Lapierre warned that the dynamic LDI is not a set-it-and-forget-it strategy because it can be adjusted if and when a participant's situation changes post-retirement.

"Let's say you get sick and your life expectancy drops by five years. You might say, 'Well, I don't need that money to last as long as I thought, and so I'm going to take more today so I can pay for my medical bills,'" he said.

It could work the other way around as well.

"If you're completely healthy and you get to age 75, you might say, 'Maybe I'm going to need to reduce my expenses a bit.' So you can readjust your income over time, and the investment strategy will adjust as well," he said.

Here is where an advice component is critical. In addition to helping participants figure out the right initial level of income, an adviser can also help participants make adjustments along the way.

Lapierre said the reception among plan sponsors has been warm, but they do have a common concern.

"The main concern is the fact that we're not specifically hedging the longevity risk," he said. "But the fact is that the strategy is liquid and can be readjusted over time to account for changes in a participant's health status or other issues."

In addition, he said, gains generated from the growth component can be used to cover for longer cash flows that a participant might need.

"Having the flexibility to take those gains out, to take that excess income and reinvest it forward into later years, allows us to cover for that longevity," he said. •

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