Matching Current Assets to Future Liabilities

While low interest rates and market underperformance have hurt pension plans' funded status in recent months, LDI strategies continue to help meet overall objectives, even with a slowdown in glide path de-risking. **By Howard Moore**

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RENE MARTEL, PIMCO

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AMY MORSE, WELLINGTON MANAGEMENT

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SUNY PARK, JANUS CAPITAL GROUP

LDI (liability-driven investing) is a framework used to manage current investment assets in order to meet future liabilities and is implemented by about 75 percent of defined-benefit pension plans. Since the financial crisis in 2008, plans have been challenged by low interest rates and volatility in equity markets. Overall, their funded status ratio, the percentage of future liabilities they are able to cover, has dropped from 105.3 percent in 2007 to an average in the low-80s at yearend 2015.

A typical implementation will separate a plan's assets into return-seeking and liability-hedging allocations and will follow a glide path, triggered by achieving levels of funded status, to de-risk the portfolio—moving portions of the return-seeking assets, usually equities, into the liability-hedging allocation, usually fixed-income instruments. "In the last year or so, de-risking activity has been somewhat slower than expected," says Rene Martel, head of pension solutions at PIMCO, as rates have continued to stay low and pension plans have not hit the triggers.

Funding ratio deficits are covered by rates rising, growth in equity markets and direct contributions. "Some companies have made contributions year to date, despite a series of legislative changes that have loosened funding rules," says Amy Morse, director of U.S. pension strategies at Wellington Management. The Balanced Budget Act of 2015 extended the use of a discount rate based on a 25-year historical average. Even though many plans are underfunded using market rates, the higher historical basis makes them appear better funded, reducing or even exempting them from mandatory funding requirements.

Spreads on long-dated credit securities are helping. "Rates might be low but corporate spreads at the long end of the curve have become very wide," says Martel. This has led a number of plan sponsors to make allocations to long-dated credit. "The idea of locking in that attractive level of spread has garnered some attention from a number of sponsors," he says.

More and more plan sponsors are looking for more creative ways to improve the funded status by generating higher returns through opportunistic investments in dislocated areas of the market, like high yield bonds and bank loans. Some plans are waiting until they hit their next trigger, while some have an interest in re-risking. "Even though LDI has a structured, systematic approach, it does require a certain amount of active management to generate a certain level of return," says Park.

Other plans are maintaining their investment strategy until they hit their next de-risking trigger point, while some have an interest in re-risking, especially if they think the potential asymmetry in interest rates provides them cover to shorten duration. "Lower beta equity strategies, income oriented strategies, and fixed income credit strategies can serve this role as a bridge investment," says Morse. Another way to seek to enhance returns without adding equity beta is to combine synthetic long-bond beta exposure, to match liabilities, with a market-neutral absolute-return portfolio.

Another debate is whether LDI should be managed actively or passively. "There was an initial argument for passive in the early days of LDI implementation in the US," says Martel. At that time, proponents of passive approaches questioned why one would incorporate some amount of active risk that would distract from the objective of matching liabilities. However, as investors gained a better understanding of discount rate methodologies, active LDI became the preferred approach. "Discount rate methodologies implicitly presume that you manage your LDI portfolio actively by assuming you avoid downgrades," he says. "In fact, they assume you are very good at it and that you avoid everyone." ■