Emerging Strategies for Liability Driven Investments

Over the last five years, the Liability Driven Investment (LDI) framework and related Long Duration Fixed Income strategies have grown in popularity with U.S. multi-employer plan sponsors. This framework is the cornerstone of sound risk management for pension and insurance structures for several decades worldwide.

The growing global emphasis on ensuring the primary purpose of pension plans is achieved (i.e., to grow assets faster than liabilities as a compliment to relative return vis-a-vis asset-only peer manager or published benchmarks), has led to fundamental changes in how investors view their portfolio allocations. Funds that are able to tackle the issues of uncertainty in today's market - volatility and low interest rates - and abandon traditional asset allocation frameworks to embrace outcome oriented portfolios will have a competitive advantage going forward.

In our continuing series of articles, we will take a close look at the strategic LDI framework and Long Duration Fixed Income strategies with an emphasis on the if, how and when decision process and practical implementation.

Thanks & Kind Regards,

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There's widespread concern about the ongoing viability of Defined Benefit (DB) pension plans. Why? What went wrong?

Yes, inferior investment performance, reduced hours and increased longevity are part of the story. But the big problem has been a mismatch between assets and liabilities. The steady decline in interest rates has driven up liability valuations in a way that generally was not offset by "traditional" (e.g., 65/35) asset allocation strategies.

The same thing has happened with other programs (like retiree medical) that promise a guaranteed future benefit. Interest rate declines have dramatically increased the cost of funding, and sponsors have had to recognize large losses and significantly increase contributions. That's all happened even though there have been few benefit increases, and it's happened even for those plans in which assets performed reasonably well.

Sizing the Squeeze

How bad is it? Say you've promised to pay a $1,000 lump-sum benefit to a participant 30 years from now. In 1985 it would have cost you $38 to fund that benefit. That is, in 1985 you could have invested $38 in a 30-year Treasury and in 30 years you would have the $1,000 to meet your obligation. Today it costs more than 10 times as much --$422 -- to fund the same $1,000 benefit. The following table charts what has happened to interest rates and funding costs since 1985.
As you can see, there have been only brief pauses in the steady decline in interest rates and the steady increase in the cost of benefits.

Are multiemployer plans "exempt" from this interest rate squeeze? A lot of professionals will tell you that they are. The typical long-term actuarial plan valuation rate is around 7.5%. If you budget using that rate, and the plan can earn 7.5% on average, then it only "costs" you $110 to fund that $1,000 benefit due 30 years from now.

But if interest rates at current levels persist, at some point they will have to be reflected in multiemployer plan valuations. And using a 7.5% "bogey" -- when current yields are half that -- sets an unrealistic return goal, while ignoring the main underlying cost driver: the impact of interest rates on your liabilities.

**The Primary Purpose of a Pension Plan**

In the end, regulatory conventions, like ERISA minimum funding standards, serve only one purpose: to make sure there's enough money to pay benefits when they come due in the future. To meet that goal, trustees only need keep in mind one rule: assets must keep pace with or grow faster than liabilities. It's just that simple!

And when structuring a real world portfolio, you have to make decisions based on real world facts and the actual risks a plan faces. To that end, here's the message current interest rates are sending: it's going to cost a lot more to collateralize these benefit promises than it has in the past.
We believe there are sound reasons for multiemployer plan trustees to consider the impact on liabilities of changing interest rates, when they are evaluating the cost of new benefits and, most importantly, when they are structuring (or restructuring) their asset portfolio. Doing so will reduce risk and, ultimately, total cost, and it will methodically and systematically get their plans back on sound financial footing.

In this series of articles we're going to discuss how you can do that -- while enhancing portfolio performance and reducing risk.