SEAL COVE FINANCIAL
Strategies for the Institutional Investment Management Community

Liability Driven Investing: A De-Risking strategy for managing your OPEBs

Liability Driven Investing (LDI) is an approach that matches the investment strategy for the assets to the liability stream. For long-lived liabilities, like defined benefit pension plans or other post-employment (health care) benefits (OPEBs), the closer the match of assets to liabilities, the better management of the funded ratio, making budgeting of contributions more predictable.

Small public funds are facing a new liability in their OPEBs. With the disclosure of their post-retirement liabilities, finance directors need to determine how to manage the assets that will meet that obligation and mitigate the negative impact of volatile funding status on budgeting for contributions. With the recent market decline, newer strategies for managing the volatility of the funded status of defined benefit (DB) plans are needed as well. Many issues need to be considered when developing the investment strategy for managing their DB or OPEB obligation:

- What is the funded status of the OPEB or DB plan? If underfunded, what is the time frame to become fully funded?
- Is managing the funded ratio volatility in order to help stabilize contributions a goal?
- Are the plan sponsor's financial resources adequate for large catch-up contributions?
- Is there a maximum catch-up contribution that the sponsor can tolerate?
- Are there certain populations or demographic groups in the liability stream that can be isolated and matched to a fixed income strategy?

The appropriate investment strategy depends on the financial resources of the plan sponsor, such as its level of overall debt and ability to pay higher contributions, as well as tolerance for changes in risk exposure. Finance Directors can adopt some LDI principles by developing a dynamic investment policy to manage their DB and OPEB funds, so that the funded status volatility will be minimized and contributions will be more predictable.

Scenario 1: Funded Status below 85%

It is important for underfunded plans to maximize return per unit of risk, so a higher equity allocation portfolio, such as 60% - 70% equity/30% - 40% fixed income, makes sense. In some cases, the plan sponsor might add catch-up contributions to get the funded status improvement jump-started. If not, regular contributions and the higher expected returns from an equity-based investment strategy will close the gap over time.

Scenario 2: Funded Status is closer to fully funded.

As the plan moves closer to fully funded status, re-allocating equity exposure to liability-matching fixed income securities will take some risk off the table: the higher the funded ratio, the lower the equity exposure should be. Trigger points can be identified to prompt de-risking activities. For example, the Investment Policy Statement (IPS) can require that equity allocations be reduced by some amount for various levels of improvement in funded status. Consistent, regular monitoring of the funded status will let the plan fiduciaries know when a trigger level has been reached, forcing a re-allocation or de-risking of the portfolio. At certain triggers, new contributions can be dedicated to fixed income investments only. A dynamic strategy like this one means that the IPS must provide the flexibility to adjust the asset allocation when certain trigger levels are achieved. The IPS needs this latitude written into it ahead of time, balancing the short term goal of stabilizing the funding ratio with meeting the long term requirement of investing into perpetuity.

Scenario 3: Fully Funded Status

Once fully funded status is reached, a goal of maintaining it can be achieved through a closer match of assets and liabilities, using additional LDI strategies. Matching the duration of the asset stream to the duration of the liability stream helps to minimize the effect of changing interest rates on the funded status. Because OPEBs are long-lived liabilities, extending the maturities and duration of the fixed income portfolio will improve the match and reduce volatility in funded status. A typical liability stream may have a duration of 15 years. Since the Barclay's Capital Bond Aggregate has a duration of only 4 years, adding a component of the US Long Credit Index, which has a duration of 11 years can improve the duration matching and provide a higher return that more closely matches the discount rate on the liabilities. Funded status will be less affected if interest rates change when both sides of the asset/liability equation are close in terms of duration and expected returns.

Certain populations or demographic groups in a liability stream can be isolated and matched to a fixed income strategy. Retired lives would track a shorter duration than active lives, for example, allowing a de-risking by subsets. Frozen defined benefit plans can use these LDI concepts (reducing equity exposure, lengthening maturities, increasing corporate bond exposure) effectively to build a closely matching asset/liability portfolio.

Summary

Liability Driven Investing provides a strategic framework for a dynamic policy that de-risks the asset base as the funded status nears or exceeds 100%. A dynamic strategy using LDI concepts that seeks to minimize volatility in funding status will allow the sponsor to plan and budget for more stable, predictable contributions.

October, 2009 **By Lauryn Agnew**

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LDI strategies can help minimize funded status volatility and make contributions more predictable.

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Dynamic strategies need flexible Investment Policies