

CFO Summary (April 2009):

## Liability Driven Investing (LDI) – Three Reasons For Caution in Today’s Implementation

One of the primary goals of an LDI strategy has been to try to control year-to-year volatility of the pension plan’s funded status by providing a return on assets that was aligned with the return on overall liabilities of the plan. Historically, some of the more popular tools used in LDI portfolios have been increased allocation of fixed income, use of long-duration bonds, and use of interest-rate swaps. Long-duration bond strategies continue to be viable options in the current market environment because bond and liability values are similarly sensitive to interest rates and move in tandem. However, given the market environment, the implementation of these strategies including the use of interest rate swaps, may not currently be as effective as they have been in the past. As financial executives consider LDI strategies as a possible response to a volatile market environment, here are three considerations as to why the timing requires a judicious approach:

### 1. INTEREST RATE LDI STRATEGIES WILL LOCK IN SIGNIFICANT EXPENSES

Because most pensions are under-funded at this time, many plan sponsors cannot afford to lock-in the losses on pension assets suffered during recent months. A recent SEI survey showed that 78 percent of US pension plans lost at least 20 percent of pension assets in 2008. As assets declined, at least half of those surveyed saw a decrease in funded level of 20 percent or more. If a pension’s funded status went from 90 percent to 70 percent, then an LDI strategy increasing allocations to fixed income could lock-in that decrease, meaning the plan sponsors would need to make up the difference through contributions over the next seven years. For many organizations, those contributions are large relative to the sponsor’s business and given decreased revenues and subsequent cash flows, they simply cannot afford to accept that cost.

### 2. HEDGING INTEREST RATES FORFEITS BENEFITS OF POSITIVE MARKET CHANGES

Assuming an LDI strategy that would hedge interest rate risk while reducing equity exposure; plans would in-fact lower volatility but would also subsequently relinquish potential upside. The higher contributions mentioned above would result in a high opportunity cost if long term interest rates rise and equity markets recover. While plan sponsors are looking for ways to invest in a controlled and risk-efficient manner, they cannot afford to forfeit the benefits of a

rising interest rate environment and/or a resurgence of equity markets. If those two things happen simultaneously, the benefits of not implementing certain LDI strategies at this time will lead to improvements in funded status.

### 3. DISLOCATION OF CREDIT MARKETS MAKES MANY LDI STRATEGIES LESS EFFECTIVE

Many plan sponsors that chose not to implement LDI strategies did so because their risk tolerance allowed for shorter-term uncertainty in exchange for longer-term asset appreciation. Despite dislocated credit markets last year, organizations implementing an LDI strategy using treasury bonds or interest rate swaps benefited as the value of those investments increased as the liabilities they were hedging against were relatively level at year end. Those same strategies are expected to be negatively impacted this year as Treasury rates, which currently remain low, may be expected to rise in the future. The upheaval in the credit markets has made these tools inefficient to match assets and liabilities requiring plan sponsors to reconsider the implementation of their LDI strategies.

## CONCLUSION

Plan sponsors should work with their investment management providers to fully understand LDI strategies and whether or not they can help them accomplish their pension related goals. In the current environment, organizations can potentially still benefit from LDI strategies using long-duration bonds, but these should be considered within the context of the individual organization's overall needs. While recent industry news suggests a potential increase in implementation of LDI strategies using interest rate swaps or increased allocations to fixed income, this might not be the optimal time to implement such strategies. As plan sponsors are determining investment strategies for managing the pension plan moving forward, LDI strategies are one alternative. Before implementing strategies, plan sponsors should consider the entire investment management model in a broad risk management framework, confirm the structure and timing of interest rate hedging strategies, and consider all alternatives for plan management.

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