

PENSION MANAGEMENT RESEARCH PANEL

Liability Driven Investing: The Global Truth On Use of These Strategies

EXECUTIVE SUMMARY

The **Pension Management Research Panel** recently conducted a global Quick Poll of pension executives from four countries - Canada, Netherlands, United Kingdom and United States. The poll was completed by a total of 226 executives overseeing pensions ranging from US \$30 million to over US \$5 billion in assets. The questions were designed to gain insight into how organizations around the world are defining Liability Driven Investing (LDI), whether or not LDI strategies are being implemented, and some of the factors driving these decisions.

Globally, many countries have implemented new funding rules requiring the improvement, maintenance, and transparency of pension funding levels. In response, Liability Driven Investing (LDI) has become more than a common “buzz” phrase around the world when discussing strategies for managing the pension’s assets in coordination with pension liabilities. However, with LDI’s popularity there has come a lot of criticism and scrutiny even as pension executives agree there that is a need for a fundamental shift in investment strategies.

Objectives of LDI Are Clear

More than three-quarters agreed that the primary objective of implementing an LDI approach should be to control year-to-year volatility of the pension’s funded status. In addition, executives feel an LDI approach should control contribution and/or pension expense levels as well as optimize the impact on corporate liquidity and cash flow.

Definition of LDI Questioned

Participants did not agree on what defines an LDI strategy. Some felt it was to match duration of pension assets to duration of pension’s liabilities. Others felt it should be to create a portfolio designed to be risk managed with respect to liabilities. Lastly, some believe the approach should involve consideration of the liability pool and/or costs in setting asset allocation strategy.

Many Considering LDI While Trying to Understand the Flexibility It Provides

Although less than 20% are currently employing what they would call an LDI approach, almost 50% are considering it. Only about a third said they are NOT considering an LDI approach at all. Almost three quarters of the respondents said that absolute return was NOT the primary benchmark of success for pension investments as they want the asset pool to provide some level of support to the liabilities.

Pension Management Continues to Change

Over 40% of the respondents have already closed the pension to new entrants and a significant portion of that group has taken the additional step of freezing participant accruals. Almost a quarter polled said that plan design changes would be a factor in changes to its asset allocation policy

LDI Advice Slow to Come

One of the reasons for the lack of LDI implementation appears to be a lack of advisor recommendations. Half said recommendations drive their asset allocation changes, yet almost half reported that it has been more than three years since an asset allocation change was made.

Variety of Investment Products Considered

Many are already using or considering investment products tied to LDI strategies. More than 50% use long duration bonds or short duration cash products while more than 20% are considering interest rate derivatives or portable alpha.

POLL RESULTS

What Do Pension Sponsors Believe Should Be the Primary Goals of an LDI Approach?

When asked to identify the primary goals behind employing an LDI approach, those polled responded:

- To control year-to-year volatility of funded status (79%)
- To control contribution and/or pension expense (46%)
- Minimize or maximize impact on corporate liquidity/cash flow (31%)
- Improve funding levels (19%)
- Avoid the minimum funding liability (14%)

GLOBAL NOTES: Participants in all four countries agreed on the first two goals, but there were differing responses to the third. In the United Kingdom, 25% of the respondents felt the primary goal should be to “progress the plan toward termination”. In the Netherlands, “avoiding the minimum funding liability” was a concern as 29% felt it should be the primary goal of LDI.

How Do Organizations Best Define an LDI Approach for Managing Pension Assets?

One of the ongoing public debates around the term “LDI” is whether it is a specific defined strategy or if it is a broader context under which a number of different strategies would qualify. Those participating in this poll appear to validate that LDI is widely considered a variety of strategies customized for the organization and its goals. When asked to best define an LDI approach to pension investments, participants had a variety of strategies they considered:

- Matching duration of assets to duration of liabilities (41%)
- A portfolio designed to be risk managed with respect to liabilities (38%)
- Consideration of liability pool and/or costs in setting asset allocation strategy (12%)
- Forcing asset performance to mimic liability performance (4%)
- Immunizing the plan’s liabilities with fixed income securities (2%)
- Use of asset classes with reduced volatility (2%)

GLOBAL NOTES: The Netherlands was the only country that did not rate “matching duration of assets to duration of liabilities” as the best definition of LDI. Instead, over two-thirds (64%) of the Netherlands respondents felt LDI was best defined as “a portfolio designed to be risk managed with respect to liabilities”.

How Many Pensions Are Actually Implementing an LDI Approach?

▪ GLOBALLY

- 20% currently employing LDI
- 12% not currently but will in 2007
- 35% not currently but will consider some time beyond 2007
- 33% not considering LDI at this time

Here is a breakdown by country:

▪ CANADA:

- 21% currently employing LDI
- 7% not currently but will in 2007
- 28% not currently but will consider some time beyond 2007
- 44% not considering LDI at this time

▪ NETHERLANDS

- 43% currently employing LDI
- 21% not currently but will in 2007
- 7% not currently but will consider some time beyond 2007
- 29% not considering LDI at this time

▪ UNITED KINGDOM

- 19% currently employing LDI
- 11% not currently but will in 2007
- 37% not currently but will consider some time beyond 2007
- 30% not considering LDI at this time
- 4% not currently using LDI but have in the past

▪ UNITED STATES

- 17% currently employing LDI
- 13% not currently but will in 2007
- 30% not currently but will consider some time beyond 2007
- 40% not considering LDI at this time

How Are Organizations Measuring the Success of Pension Investments?

When asked for their organization's benchmark for success of pension investments, almost three-quarters (72%) of all respondents indicated they wanted the asset pool to provide some level of support to the liabilities of the pension.

Benchmark for success of pension investments:

- 28% absolute return of the portfolio
- 23% improve funded status
- 17% protect current funded status
- 15% minimize or control contribution requirements
- 11% maintain funded status in all markets
- 6% minimize or control pension expense

GLOBAL NOTES: The four countries were split in terms of their most important benchmark for success of pension investments. Almost half of the respondents in the Netherlands (50%) and United Kingdom (48%) said their most important benchmark was to "improve funded status", while a third in Canada (30%) and the United States (33%) reported their most important benchmark was "absolute return".

Actions Have Not Necessarily Been Aligned with Measures for Success

While globally the highest percentage of participants indicated that absolute return was the measure of success, surprisingly, failure in that area is not driving asset allocation changes. When asked to identify which factors drove decisions to make changes to asset allocation policies, only 23% said "poor investment performance", ranking as the fourth most popular choice.

Also, despite 72% wanting assets to provide some level of support to the liabilities of the pension, 42% have not made a change to asset allocation policy in more than three years. Almost a fifth (18%) of those polled have not made a change in over five years.

Executives Acknowledge Need to Change in Response to a Changing Environment

Globally, organizations with pensions continue to make changes in response to a pension environment that continues to evolve. More than a third (36%) of all participants said new funding

and/or accounting requirements are a driver for making asset allocation changes. More than a fifth (22%) said plan design changes have caused their organizations to change asset allocation. In addition:

- 57% of all participants said their organization made a change to their asset allocation policy within the past year (30% in the past six months)
- 43% of all of the pensions polled have already closed the plan to new entrants and 22% of that group have taken the additional step of freezing participant accruals
- 27% of all polled said their organization is considering a change to the pension's current design

GLOBAL NOTES: Pensions are being closed to new entrants in the United Kingdom faster than in any other country polled as 67% said their organization has taken that step. The Netherlands had the highest portion (93%) of pensions open to new entrants. The United States had the highest percentage of plans that have already frozen accruals (13%) and just under half (45%) of the participants had already closed the pension to new entrants. Canada seems very committed to pensions as 65% are currently active and open to new entrants and 84% are not planning any pension design changes in the immediate future.

Organizations Poised to Reevaluate Asset Allocation Strategies As They Work to Understand the Flexibility of LDI Strategies

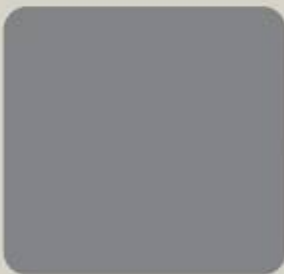
As 40% of all participants said the primary benchmark for success of pension investments was to improve or protect funded status, executives are evaluating new strategies. Almost half (43%) of those polled said that it has been more than a year since their organization changed asset allocation, yet they are using or considering numerous new investment products:

- 76% are either currently using or considering long duration bonds (61% currently)
- 50% are using short-duration cash products
- 28% are using private equity investments
- 37% are either using or considering interest rate derivatives
- 34% have high-yield products in their portfolio
- 36% either currently have or are considering portable alpha strategies in their portfolios

GLOBAL NOTES: Canada could see a significant increase in pension sponsors using portable alpha as only 9% are currently using this strategy but another 28% are considering it. A significant number of plan sponsors in the United States appear to be poised to make use of interest rate derivatives (42%) and emerging market debt (49%). Given the high number of closed plans, it is not surprising that almost all plans in the United Kingdom (89%) are in long duration bonds. With strict funding requirements, the Netherlands is far ahead of the other three countries when it comes to considering investment products tied to liability driven strategies. Almost three-quarters of those polled in the Netherlands were already using interest rate derivatives (71%), emerging market debt (64%) and high-yield bonds (64%).

CONCLUSION

The results of this Quick Poll suggest that organizations around the world are in the early stages of understanding the flexibility that liability driven investing strategies can provide. Many organizations are doing their best to determine how to build investment strategies that provide the necessary return on assets while protecting the overall funded status of the pension. This challenge continues to become more complex as many countries are reviewing or changing the funding rules and organizations must find more effective ways to improve funding status. For companies offering pension plans, the shift towards more liability driven investing strategies is underway, however they are prioritizing the creation of a comprehensive plan management model that optimizes the oversight of new complexities and ongoing challenges.



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