

PENSION MANAGEMENT RESEARCH PANEL

Third Annual Liability Driven Investing (LDI) Poll: Globally, LDI Has Entered the Mainstream

The **Pension Management Research Panel** recently conducted the 3rd Annual Global Quick Poll on Liability Driven Investing (LDI). The poll was completed by 150 pension executives from Canada, Netherlands, United Kingdom and the United States. The executives oversee pensions ranging from UK £10 million to more than UK £2 billion in assets. The aim of this poll and this summary is to examine how feelings around LDI strategies have changed over the past three years. Additionally, the poll sought to understand what impact the recent economic environment has had on LDI strategies.

The State of Liability Driven Investing – Global Themes

- Adoption of LDI strategies has increased steadily and significantly during the past three years

In 2007, 20 percent of polled organisations said they were employing an LDI strategy within pension investments. In 2008, more than one-third (37 percent) employed LDI strategies and in 2009 more than half (54 percent) utilised LDI strategies.

- Many LDI strategies recently implemented

More than one-third (37 percent) of organisations polled currently using an LDI strategy said they implemented this tactic within the past twelve months.

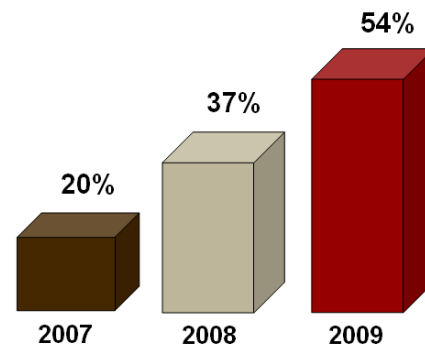
- Recent market volatility increases value of LDI

Nearly three quarters of those polled (70 percent) agreed that the market volatility over the past year has increased the benefits of an LDI approach when it comes to pension management.

- Not many moving away from LDI

Of the poll participants that are *not* currently employing an LDI approach, 90 percent have never done so in the past.

Percentage of pensions employing a Liability Driven Investing (LDI) strategy



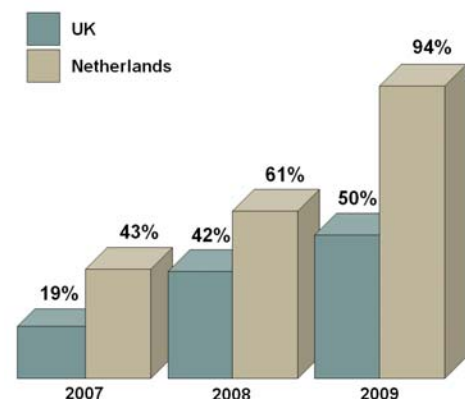
UK / Netherlands Highlights

Dramatic Increase over 3 year period:

Netherlands leading the way

- 94 percent of Dutch respondents currently employ an LDI approach.
- Half (50%) of UK poll participants said they are currently implementing an LDI strategy.
- Of those currently utilising LDI, 37% of UK and 44% of Dutch respondents have implemented the approach in the last 12 months.
- In 2007 less than a quarter (19%) in the UK and under half in the Netherlands (43%) were utilising an LDI strategy. In 2008 this figure increased to 42% in the UK and 61% in the Netherlands and in 2009 the figures reveal that the increase is even higher.

Percentage of UK and Dutch pensions employing a Liability Driven Investing (LDI) strategy



UK / Netherlands Highlights

Market volatility driving demand in both UK and Netherlands

In both markets the poll results show that market volatility is driving demand. Fifty percent of those surveyed in the UK and 88% in the Netherlands stated that they believed that the recent market volatility had increased the value of an LDI approach.

- **What are the objectives of LDI? – Global Themes**

The market turmoil of late 2008 and early 2009 has caused funding-level volatility because assets depreciated and have had a bumpy path toward recovery. In addition, interest rates have pushed towards record levels at both the highs and the lows, adding to the havoc with funding levels. As a result, many pensions have increased their consideration and adoption of LDI strategies.

For the third consecutive year, poll participants were asked to identify what they felt were the primary objectives of an LDI strategy and for the third year straight, the most popular response was to “control year-to-year volatility of funded status.” While this remains the main objective, it is important to recognise how this response has grown over recent years. In 2007 and 2008, slightly more than three-quarters (79 percent) said controlling year-to-year volatility of funded status was the key concern. In 2009, that percentage jumped to 90 percent. In fact, of the five objectives of an LDI strategy, four saw increased percentages. The only objective that decreased was avoiding the minimum funding liability.

Here is a breakdown of what poll participants felt were the primary objectives of an LDI strategy by year:

	TREND	2009	2008	2007
To control year-to-year volatility of funded status	↑↑	90%	79%	79%
To control contribution and/or pension expense	↑	51%	45%	46%
Minimize or maximize impact on corporate liquidity/cash flow	↑	35%	30%	31%
Improve funding levels	↑	24%	14%	19%
Avoid the minimum funding liability	↓	9%	13%	14%

- **How do pension executives define LDI? – Global Themes**

When the first LDI poll was conducted in 2007, one of the ongoing public debates about LDI was whether it is a specific strategy or if it is a broader context under which a number of different strategies would qualify. Each year, poll participants continue to validate that LDI is widely considered a variety of strategies customised to a specific organisation and its goals. However, it is important to recognise that a definition of “addressing interest rate risk” has moved significantly ahead of other definitions. Here is a breakdown of the popularity of these definitions with the highest-ranking definition each year highlighted in orange:

	TREND	2009	2008	2007
Matching duration of assets to duration of liabilities	↔	40%	30%	41%
A portfolio designed to be risk managed with respect to liabilities	↓	32%	34%	38%
Consideration of liability pool and/or costs in setting asset allocation strategy	↓	7%	14%	12%
Forcing asset performance to mimic liability performance	↑	8%	6%	4%
Immunizing the plan's liabilities with fixed income securities	↔	5%	6%	2%
Use of asset classes with reduced volatility	↓	1%	1%	2%

UK/Netherlands Highlights:

In the UK the most popular answer as to how LDI should be defined was 'A portfolio designed to be risk managed with respect to liabilities' (36%), closely followed by 'Matching duration of assets to duration of liabilities' (31%). Interestingly, when compared with last year's poll, less respondents (4%-2009 vs. 10%-2008) felt the definition should be 'Use of derivative instruments such as interest rate swaps'. This perhaps reflects the growing understanding of LDI as a holistic approach to pension fund management rather than an off the shelf product.

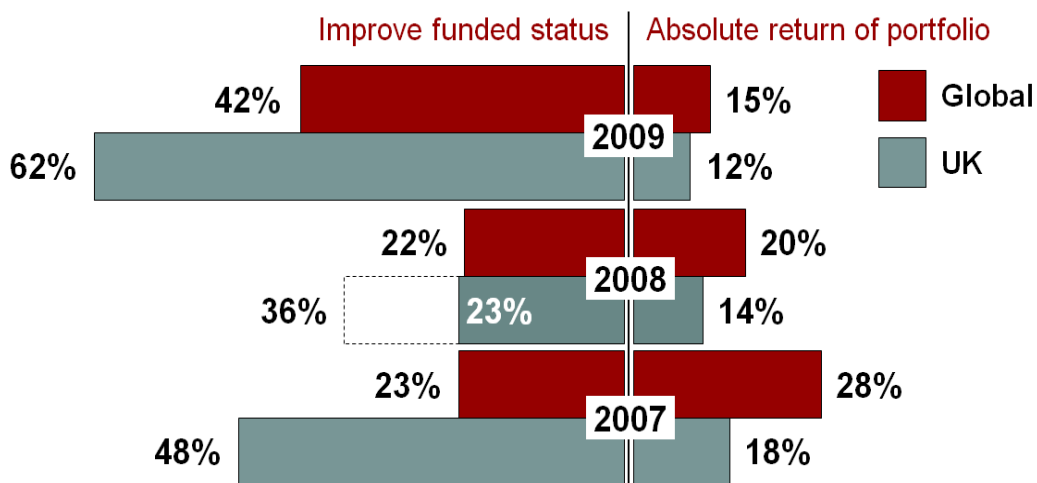
In the Netherlands definitions of LDI have been more consistent over time reflecting the advanced nature of the market in utilising LDI approaches to manage risk in respect to liabilities. Over a third of Dutch respondents in 2009 (35%) and slightly less in 2008 (22%) felt that LDI should be defined as a portfolio to be risk managed with respect to liabilities.

- **Pension benchmarks are shifting**

Critical to the implementation of an LDI strategy, or any investment strategy, is the success benchmark to which the pension is measured. Two years ago, in 2007, "absolute return" was the highest ranked benchmark with 28 percent of poll participants and last year that dropped to 20 percent. This year, only 15 percent of the poll participants identified "absolute return of the portfolio" as the primary success metric marking the second straight year this has decreased.

When asked to identify the primary benchmark for success of the pension investments this year, 85 percent of respondents indicated their benchmark was tied to whether or not the asset pool provided some level of support to the liabilities. The most popular benchmark for pension success identified in this year's poll was "improved funded status," chosen by nearly half (42 percent) of the poll participants. The graphic below illustrates the contrast over the past three years between the percent of participants saying "absolute return" was the primary benchmark versus those saying it is "improved funded status." As the chart indicates, there is a clear shift towards the latter as the measure of success for pension investments:

Which best describes your organisation's benchmark for the success of the pension investments?



*Percent of respondents stating that protecting funding status is the benchmark for success of the pension investments

UK/Netherlands Highlights:

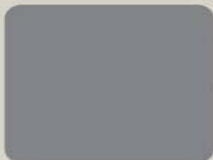
In the UK, the results for this question were dramatic in terms of their difference from the global view. 61.9% of UK respondents felt improved funded status was the benchmark for success which was higher than in any other country. It is interesting to note that this has changed from last year where the most popular benchmark to be selected was 'Protect current funded status' at 36% followed by 'Improve funded status' at 23%. This emphasis on improved funding status in 2009 not only reflects the impact of the market conditions of the last year but also the failure of the pensions management model to achieve the objectives of pension funds in protecting assets. The fact that funding level is the most important benchmark for UK funds clearly reflects the need for a model, such as Fiduciary Management, which focuses on managing the individual funding level for a pension fund rather than a model which focuses on absolute returns.

In the Netherlands, where Fiduciary Management is already well established, it is interesting to note that the trend towards using a funding level benchmark has existed for some time. In both 2008 and 2009 the most popular response to the question about benchmarks was 'improved funding status' with 50% in 2008 and 53% in 2009 stating that this was the benchmark by which they measure success.

Conclusion

It is clear from the poll that the use of Liability Driven Investing (LDI), particularly in the UK and Netherlands, is on the increase as pension funds seek to find ways to address the pain of rising deficits and pressure from their company sponsors. Over the last three years understanding of the benefits of a liability driven approach has improved with many pension funds recognising that it is not a 'product' but an overall approach to the management of the pension fund which focuses on integrating the management of assets and liabilities.

Importantly, as the research reveals, pension funds are also changing the way that they measure success in a move away from absolute returns to using funding level as a benchmark. Both objectives are addressed through the Fiduciary Management approach, which focuses on managing the growth of assets whilst neutralising the effects of liability movements, in order to increase the potential of meeting funding goals. Therefore, it can be argued that the survey supports the case for trustee delegation models such as Fiduciary Management. This is borne out by evidence in the Netherlands, where according to the results of this survey the use of LDI is at its highest globally with a large percentage of pension funds utilising a Fiduciary Management approach.



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