

PENSION MANAGEMENT RESEARCH PANEL

## Liability Driven Investing: What Has Changed Over the Past Year?

### EXECUTIVE SUMMARY

The **Pension Management Research Panel** recently conducted a global Quick Poll of pension executives from five markets - Canada, Hong Kong, Netherlands, United Kingdom and United States. The poll was completed by a total of 160 executives overseeing pensions ranging from US \$30 million to over US \$5 billion in assets. This global poll is a follow-up to a similar poll conducted in 2007 in which 226 executives participated. The aim of these two polls is to examine how feelings around liability driven investing strategies have changed over the past year.

#### A Look Back to 2007

Last year, many countries had recently implemented new funding rules requiring the improvement, maintenance, and transparency of pension funding levels. Liability Driven Investing (LDI) had become a new and common “buzz” phrase around the world when discussing strategies for managing the pension’s assets and liabilities. However, LDI also carried some criticism as many felt this was not a well understood strategy and actual implementation was low.

#### 2008: LDI Implementation is Underway

The implementation of LDI strategies appears to be taking place as the percentage of poll participants already implementing these strategies doubled between 2007 and 2008. Furthermore, the poll results showed a decrease over last year in the number of pensions not considering LDI.

#### Definition of LDI Becoming Clear

The most popular definition of LDI changed over the course of the past year as “matching duration of assets to duration of liabilities” no longer ranked the highest. Instead, most pension executives define LDI as “a portfolio designed to be risk managed with

respect to liabilities.” This suggests a stronger understanding around the broader implementation of LDI.

#### Goals of an LDI Approach Similar to 2007

Overall opinions regarding the primary goals of LDI did not drastically change when compared to last year. More than three-quarters of those polled still feel a goal should be to control year-to-year volatility of funded status. Almost half feel that a goal should be to control contribution and/or pension expense.

#### New Measures for Investment Success

In 2007, poll participants identified absolute return of the portfolio as the most common measurement for pension investment success. This year, the most common measurement of success was improved funded status.

#### Plan Design Changes Continue

Almost half of the poll participants noted that they are considering plan design changes. This increased significantly over last year when just over a quarter said this was the case.

## POLL RESULTS

### Increase in Implementation of LDI Strategies

The number of pensions implementing an LDI strategy increased drastically from 2007 to 2008, almost doubling from 20% to 37%. In addition, the number of global pensions not considering an LDI approach at this time decreased from 33% last year to 26% this year. Here is a breakdown by market:

- **CANADA**
  - 27% currently employing LDI
  - 37% considering LDI
  - 34% not considering LDI at this time
- **HONG KONG**
  - 28% currently employing LDI
  - 12% considering LDI
  - 27% not considering LDI at this time
- **NETHERLANDS**
  - 62% currently employing LDI
  - 21% considering LDI
  - 17% not considering LDI at this time
- **UNITED KINGDOM**
  - 43% currently employing LDI
  - 29% considering LDI
  - 28% not considering LDI at this time
- **UNITED STATES**
  - 36% currently employing LDI
  - 38% considering LDI
  - 26% not considering LDI at this time

**GLOBAL NOTES:** The United Kingdom and the United States each saw the percentage of pensions already implementing LDI strategies double from last year to this year. The UK saw an increase from 19% to 43% and the US saw an increase from 17% to 36%. The Netherlands continues to be at the forefront of implementation with 62% of respondents currently using strategies (vs. 43% last year). Canada (from 21% to 27%) saw a moderate increase.

### How Is LDI Being Defined?

Last year, poll participants validated that LDI is widely considered the customization for the organization and its goals of a variety of strategies. However, the opinion around how LDI is best defined changed between last year and this year, suggesting a more detailed understanding. In 2007, the most popular definition was “matching duration of assets to duration of liabilities” with 41% of the respondents. In 2008, the most popular definition was “a portfolio designed to be risk managed with respect to liabilities” as 34% chose that definition.

How the poll respondents chose to define liability driven investing is listed below:

- A portfolio designed to be risk managed with respect to liabilities (34% vs 38% in 2007)
- Matching duration of assets to duration of liabilities (30% vs. 41%)
- Consideration of liability pool and/or costs in setting asset allocation strategy (14% vs. 12%)
- Forcing asset performance to mimic liability performance (6% vs. 4%)
- Immunizing the plan’s liabilities with fixed income securities (6% vs. 2%)

**GLOBAL NOTES:** Unlike last year, the best definition of LDI varied from country to country. In the United Kingdom and Canada, “a portfolio designed to be risk managed with respect to liabilities” received the most responses. In the US, Netherlands and Hong Kong the most popular choice was “matching duration of assets to duration of liabilities.”

### Primary Goals of an LDI Approach Differ

When asked to identify the primary goals behind employing an LDI approach, overall opinions did not drastically change when compared to last year:

- 79% to control year-to-year volatility of funded status (79% in 2007)
- 45% to control contribution and/or pension expense (46%)
- 30% to minimize or maximize impact on corporate liquidity/cash flow (31%)
- 14% improve funding levels (19%)
- 13% avoid the minimum funding liability (14%)

**GLOBAL NOTES:** Unlike 2007, participants across the countries did not agree on the second goal. While “controlling year-to-year volatility of funded status” was the top choice in all countries, “controlling contribution and/or pension expense” was only the second highest in the United States, Canada and Hong Kong. In the United Kingdom, 50% of the poll participants (vs. only 15% in 2007) felt the primary goal should be to “minimize impact on corporate liquidity/ cash flow.” In the Netherlands, 44% of those polled felt “meeting FTK requirements” should be a primary goal of LDI.

## Pension Investment Success Measures are Changing

The investment volatility over the past year seems to have changed how organizations view the benchmark for success of pension investments. Last year, the most noted benchmark was “absolute return of the portfolio,” but in 2008 the highest ranking benchmark was “to improve funded status.” This year’s poll also saw an increase in the number of participants choosing “protect current funded status” “maintain funded status in all markets” and “minimize or control pension expense.”

Benchmark for success of pension investments:

- **22%** improve funded status (vs. 23% in 2007)
- **20%** absolute return of the portfolio (28%)
- **19%** protect current funded status (17%)
- **16%** maintain funded status in all markets (11%)
- **7%** minimize or control contribution requirements (15%)
- **7%** minimize or control pension expense (6%)

**GLOBAL NOTES:** Last year, almost half of the respondents in the UK (48%) participants said their most important benchmark was to “improve funded status,” but this year that number fell to 23% likely because of the large increase in “protect current funded status.” Respondents in the Netherlands were consistent year-to-year as the same percentage (50%) said their most important benchmark was to “improve funded status.” Canadian plan sponsors remain focused on “absolute return” as 30% reported this as their most important benchmark. In the US, there was a stark contrast between last year and this year. In 2007, the most popular benchmark was “absolute return” chosen by a third (33%) of the poll participants, but this year that percentage dropped to (18%). Taking over in 2008 as the most popular benchmark in the US is “minimize or control contribution requirements” chosen by 24%.

## Asset Allocation Changes Confirm New Investment Strategies Being Implemented

The significant increase in implementation of LDI strategies is supported by ongoing asset allocation changes. In last year’s poll, more than half (57%) of the poll participants said they made asset allocation changes at some point in the previous twelve months. Since so many pensions had made changes that recently, the expectation might be for that number to drop in 2008. Yet again, more than

half (51%) said they had made asset allocation changes in the past twelve months.

In fact, only 8% of all poll participants have not made asset allocation changes within the past three years.

## What Factors Are Driving Asset Allocation Changes?

Another indicator that LDI is starting to gain momentum is that “poor investment performance” is clearly not driving changes in asset allocation. In 2007, it ranked as the fourth most popular choice at 23%. That number dropped to 14% in 2008 and four other reasons for asset allocation changes ranked higher:

- **38%** consultant recommendation
- **28%** recommendation from internal board or committee
- **16%** need to better control pension expense
- **15%** plan design changes

## Flexibility of LDI Strategies Has Increased Interest in Numerous Investment Products

In each both poll (2007 and 2008), at least 40% of all participants said the primary benchmark for success of pension investments was to improve or protect funded status. As part of this process, pension executives are no longer just evaluating but are implementing new strategies. Usage or consideration of the following investment products increased in 2008:

- **44%** are using or considering private equity investments (vs. 28% in 2007)
- **39%** are using or considering high-yield products (vs. 34%)

Furthermore, there continues to be high interest in a number of other investments. Here are the percentages of poll participants already using or considering the following:

- **71%** long duration bonds
- **34%** short-duration cash products
- **37%** interest rate derivatives
- **26%** portable alpha strategies

**GLOBAL NOTES:** In last year’s poll, it was noted that Canada could see a significant increase in pension sponsors using portable alpha as only 9% were currently using this strategy but another 28%

were considering it. Usage of portable alpha in Canada jumped to 16% in 2008. For the second straight year, the highest percentage of respondents already using interest rate derivatives came from the Netherlands (76%).

### Plan Design Changes Continue

The number of poll participants considering plan design changes increased significantly over the past year going from 27% to 41%.

**GLOBAL NOTES:** The trend of pensions being closed to new entrants continues to be the greatest in the United Kingdom where 72% of those polled (up from 67% last year) said their organization has taken that step. In addition, the United Kingdom is the only country that had a notable percentage (28%) of participants considering the “buy out” route as the next plan design change.

Almost half (46%) of the poll participants in the United States have closed the plan to new entrants. The US also had the highest percentage of plans that have already frozen accruals (14%). However, 83% of US participants said the current state of the pension plan will remain its state for the foreseeable future.

In Canada, the overall percentage of pension sponsors not planning any plan design changes decreased from last year, going from 84% to 70%. These numbers remain high and sponsors appear to continue to be committed to keeping pensions open as 72% said the plans are currently active and open to new entrants.

Almost all (94%) poll participants from the Netherlands represented pensions that were active and open to new participants. However, the ways these plans are being managed could change as 17% said they are considering hiring a fiduciary manager, 12% said they are considering creating a new defined contribution plan and 11% said they are considering reducing or changing benefits.

### CONCLUSION

The results of this Quick Poll suggest that organizations around the world are proactively making changes to the way they are managing pension investments. The overall attention has shifted from absolute returns to focus more on the liabilities in the plan and how they impact the organization.

The biggest change over the past year appears to be that pension sponsors are no longer in the “understanding phase” when it comes to LDI and are now entering the “implementation stage.”

Financial executives are being very proactive when it comes to asset allocation changes and use of new investment products. As funding rules and accounting changes continue to evolve, these executives will continue to be challenged with finding the best ways to manage this liability.



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