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Enhanced Service LDI portfolios

Holistically managing the liability-matching portfolio while aiming to reduce the trustee governance burden

LGIM

The challenges of managing your LDI portfolio

Many pension schemes have put liability-driven investment (LDI) portfolios in place to reduce their interest rate and inflation risks. In recent years these portfolios were perceived as relatively easy for trustees to manage as the level of hedging undertaken by schemes has been relatively low and interest rates and inflation were relatively stable. In an environment of rising interest rates and inflation as well as increased financial market volatility, however, the ongoing maintenance of schemes' interest rate and inflation hedges as well as the management of recapitalisation events have significantly increased the governance burden on trustees. At the same time as funding levels improve the management of interest rate and inflation risk becomes even more important.

As one of the UK's fist LDI providers, LGIM has an unrivalled scale and experience, and is here to help. Through our Enhanced Service LDI, you set the overall objectives, then responsibility for practical portfolio implementation and ongoing management is delegated to LGIM. This can reduce both your governance burden and the implementation risk, with the goal of increasing the certainty of outcomes.

How LGIM's Enhanced Service can help

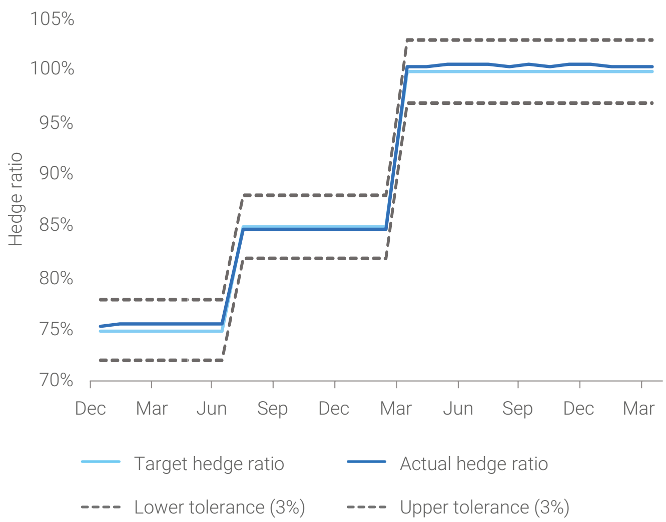
Our Enhanced Service LDI is designed, in conjunction with your investment advisor, to holistically manage the entire matching portfolio, thereby aiming to reduce the governance burden associated with managing rebalancing events. The service also has a range of other features as described below:

Delegated LDI portfolio management

You set the overall objectives for your LDI portfolio, for example, the level of interest rate and inflation protection you want to target. The responsibility for practical portfolio implementation and ongoing management, including rebalancing events, is then delegated to LGIM.

The LDI portfolio is managed against a client-provided fixed and real liability cashflow profile to target interest rate and inflation hedge ratios, and defined overall and tenor point tolerance limits. Due to market movements, self-managed LDI portfolios in particular may not always achieve or remain at their target hedge ratios. Small deviations from the target hedge ratio can potentially cause large hedging profits or losses. For example a ±5 percentage point deviation in the hedge ratio from target can lead to a profit or loss of £20,000 for every £10 million in liabilities hedged.[1]

Figure 1: Achieving and maintaining your target hedge ratios*



The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

[1] Source: LGIM, for illustrative purposes only.

Reducing funding costs and minimising cash drag

Under the Enhanced Service, we take responsibility for reallocating capital within the portfolio to meet any capital calls or distributions, due to rebalancing events for the LDI pooled funds, for example, while maintaining your LDI hedge. By adjusting the split between leveraged and unleveraged assets on an ongoing basis we can reduce funding costs by minimising any cash drag.

Figure 2 shows a 2x leveraged LDI portfolio backed by a 40% investment in the LGIM Sterling Liquidity Fund (SLF). This is the typical minimum percentage clients have to back their leveraged execution-only LDI investments. With Enhanced Service, the SLF holding could be used to reduce the leverage of the LDI portfolio and save on funding costs. his could be a saving of around 0.05% as a percentage of LDI assets.[2]

Aim to increase expected returns

Reallocating assets within the LDI portfolio, while maintaining your hedge, will potentially increase the market moves that would need to occur before reaching outside of the LDI portfolio for additional assets, as can be seen in Figure 3.

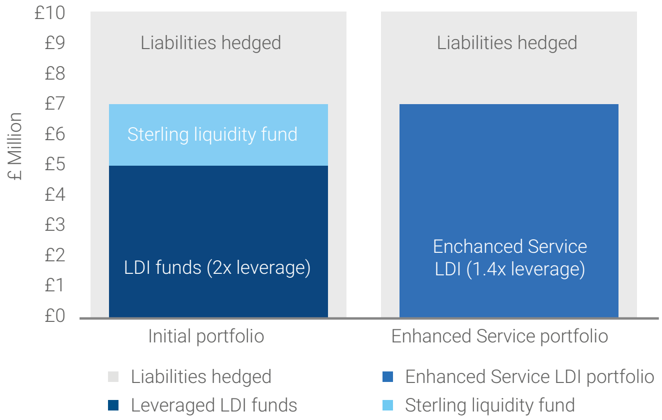
The matrix shows how each 0.5% move in interest rates (horizontal) and inflation (vertical) corresponds to the collateral required to top up LDI funds. The dark blue area is the percentage move in interest rates and inflation before the Enhanced Service portfolio would need to call in collateral. The light blue area shows the execution-only model. It can therefore be seen that Enhanced Service clients have significant excess collateral headroom.

As your LDI portfolio would require top-up assets less frequently, that capital can be reallocated to higher-returning assets, depending on the views of your advisor. These assets can also be incorporated into the matching solution and managed holistically.

Figure 2: Reducing funding costs with smarter use of LDI capital

Enhanced Service portfolio management can be used to reduce cash drag by 0.05% points as a percentage of assets.*

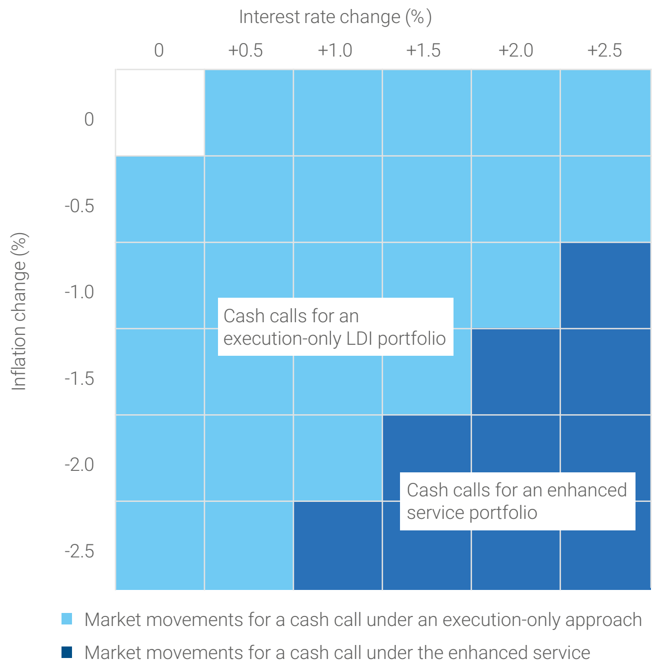
Example matching asset allocation:



DIY LDI portfolios are often structured as leveraged LDI funds backed by a holding in the Sterling Liquidity fund

Under the Enhanced Service, we reallocate assets between leveraged and unleveraged funds to minimise cash drag and reduce funding costs

Figure 3: Example increase in portfolio headroom



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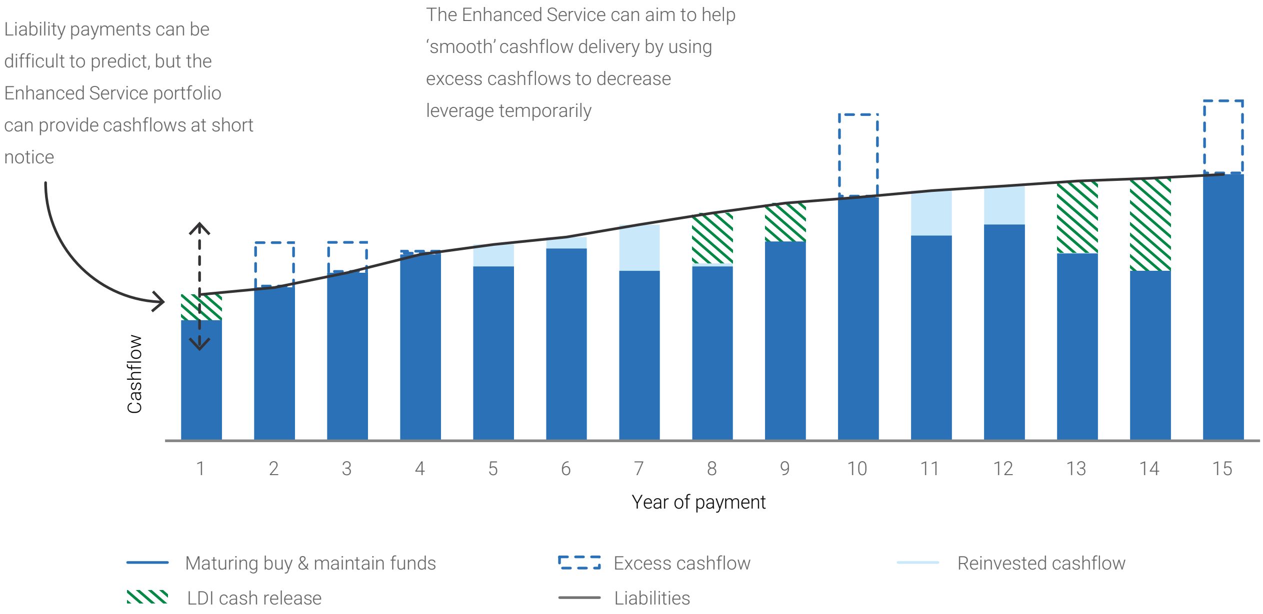
[2] LGIM, for illustration purposes only as at 31 January 2023. Initial portfolio hedges £10m liabilities using £5m in c. 2x leveraged LDI funds, backed by £2.0m in the Sterling Liquidity Fund (SLF) which corresponds to 40% of the LDI investment. Under the Enhanced Service the SLF holding would be reduced to c£0.3m, therefore funding costs could be reduced by c£3.4k [=c20bps * £1.7m] or 5bps as a percentage of the £7.0m LDI allocation.

Figure 4: Paying pensions, using a holistic matching portfolio:



Source: LGIM, for illustrative purposes only

Cashflow management

As schemes mature and become cashflow negative, paying pensions while meeting your other objectives can become more challenging. We believe enhanced Service LDI can be used to help smooth and simplify cashflow delivery. By directing all income and outgoings via the LDI portfolio, the cashflow can be managed holistically and leverage in the LDI portfolio can be used to temporarily meet any cashflow needs.

For example, LGIM's Maturing Buy and Maintain funds aim to provide a high degree of cashflow generation and can be customised to a scheme's liability profile. Any interest rate or inflation hedging provided by these matching assets can be incorporated into the total scheme hedge ratio by the Enhanced Service portfolio.

Future-proof approach

As schemes get better funded the management of interest rate and inflation risks becomes even more important; as well as ensuring ongoing pensioner cashflows are met. Whatever your long-term objective is, be that buyout or self sufficiency; we can help partner with you for the entire journey of your pension scheme.

Under the Enhanced Service we can flexibly tailor your portfolio to better match scheme cashflows as discussed above, in line with your risk appetite. Alternatively, if buyout is the aim, we can incorporate assets as directed by your investment advisor to assist with buyout pricing, move quickly to a price-lock portfolio and support any transition to an insurer. Our insurance expertise combined with the holistic management of your matching portfolio seeks to future-proof your approach.

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Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Contact us

For further information about LGIM, please visit lgim.com or email SolutionsDistribution@lgim.com

Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. Liability-driven investment strategies are driven by the sum of your current and future liabilities. An example would be a defined benefit pension scheme that must make future pension payments to scheme members over their expected lifetimes. A pension scheme following an LDI strategy focuses on the pension-scheme assets in the context of the promises made to employees and pensioners (liabilities). This is in contrast to an approach which focuses purely on the asset side of the pension scheme balance sheet. Typical LDI strategies involve hedging, in whole or in part, the pension scheme's exposure to changes in interest rates and inflation. These risks can eat into a pension scheme's ability to keep their promises to members. Historically, bonds were used as a partial hedge for these interest rate risks but the recent growth in LDI has focused on using swaps and other derivatives. These various approaches offer significant additional flexibility and capital efficiency compared to bonds, but also raises issues of added complexity, especially when the rebalancing of an LDI portfolio following changes in interest rates is considered. Counter intuitively the hedging portfolios are designed to gain value where interest and inflation rates increase the value of future liabilities, but more importantly the hedging portfolio is designed to lose value where those same future liabilities diminish. LDI strategies will also involve significant use of leverage, particularly where the pension scheme is seeking to free up assets in order to pursue an additional non-hedging investment strategy that is seeking to close any funding gap that the pension scheme may be experiencing.

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