

# Introduction to Liability Driven Investment

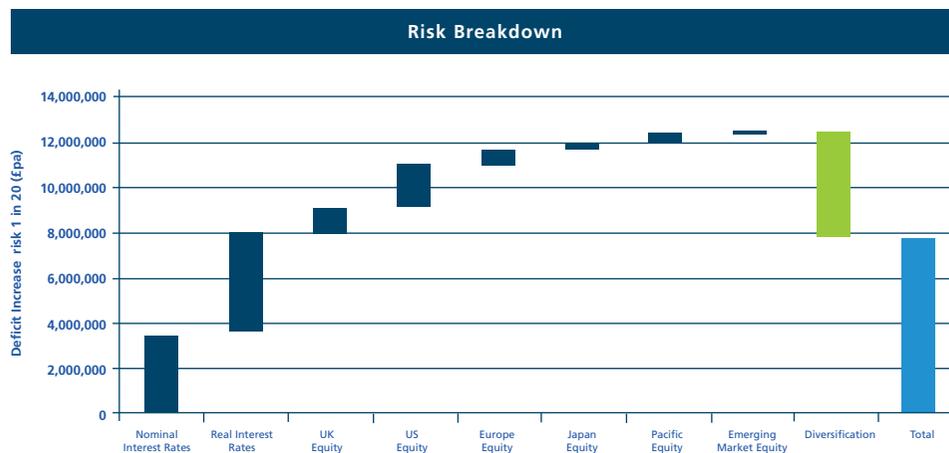
A short introduction to Liability Driven Investment (LDI) for trustees of defined benefit pension schemes

## What is LDI?

In its broadest sense, LDI is an approach to investment in which all or part of the strategy is designed to match a scheme's liabilities. Within this context, LDI is also used as a specific term to describe a range of investment approaches that are designed to help schemes reduce the volatility of their funding level by addressing interest rate and inflation risks. LDI can therefore be considered as another tool within the range of investment options that are available to schemes which may be useful depending on the objectives that have been set.

## What problem is LDI trying to solve?

Scheme funding positions are often volatile and subject to large changes over short periods of time. This can cause significant uncertainty for trustees (in relation to security of benefits) and employers (in relation to contribution levels). Before we consider how to address this volatility, it is important to understand what factors are driving the movements in funding position. This graph illustrates the main risks for a typical scheme, by considering what factors might cause the funding position to worsen based on possible future experience.



The size of the bars illustrates the extent of different risks and illustrates that for a typical scheme, the biggest sources of short term funding level volatility are interest rates as the value placed on the liabilities is very sensitive to changes in long term interest rates. This is because the length of time over which pension benefits are paid is very long and therefore small changes in interest rates can cause a large change in the value placed on benefits. Typically real interest rates are the biggest concern because the majority of liabilities tend to be for inflation-linked benefits.

In recent years, pension schemes have seen this risk play out, with falling gilt yields causing significant deteriorations in funding positions. As a result, schemes are increasingly looking at ways to address this problem.

Schemes can address this risk by investing part of their assets in bonds which have a similar sensitivity to changes in long term interest rates. However, most schemes cannot afford to invest all of their assets in bonds and so a large mismatch between assets and liabilities remains. LDI is an approach that seeks to offer a solution to this problem.

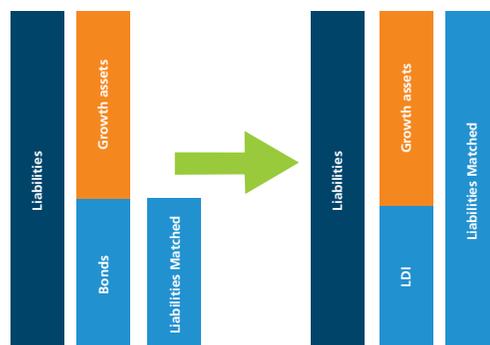


## How does LDI work?

An LDI approach allows a scheme to increase the exposure of its assets to changes in long term interest rates, and thus better match the interest rate and inflation characteristics of the scheme's liabilities.

This is done through the use of financial instruments that are especially sensitive to changes in long term interest rates.

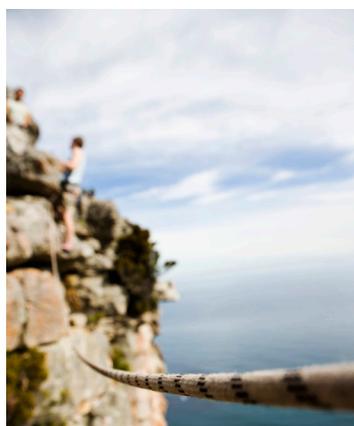
This allows a scheme to increase the exposure of its assets to changes in interest rates, without committing all of the scheme's assets, as would be required if using bonds. We have illustrated this idea in the diagram above. In recent years, pooled LDI funds have become available that make this sort of approach accessible to all schemes.



## What are the main advantages and disadvantages?

LDI is an effective way of reducing the short term volatility of a scheme's funding level. It helps control the main unrewarded investment risk that the majority of schemes are exposed to. On the other hand, an LDI approach is relatively complicated and is likely to incur additional costs and governance requirements compared to a more traditional investment strategy.

Over the long term, an LDI approach is not expected to enhance a scheme's funding position. Its objective is to provide a smoother path towards full funding and therefore to provide more certainty over employer contribution levels.



## Is LDI appropriate for your scheme?

In deciding whether or not an LDI approach is appropriate, it is essential to consider how important it is to reduce the volatility of your scheme's funding position. This is likely to depend on three key factors:

<b>Attitude to risk</b>	How concerned are you about short term funding level volatility? Controlling volatility means a smoother ride, however, the end result is the same assuming the employer covenant is sufficiently strong.
<b>Employer covenant</b>	The strength of the employer covenant is important when considering how much investment risk can be tolerated; if investment experience is worse than expected, the employer would be required to make up the shortfall.
<b>Employer's views</b>	The employer may favour taking steps to reduce short term volatility or be more focused on controlling the long term cost of the scheme.

## How can Barnett Waddingham help?

We have considerable experience in advising clients on whether LDI is appropriate for their circumstances and in assisting them with implementing LDI strategies.

We believe our biggest strength in this area is our ability to take complex concepts and explain them clearly. This enables our clients to effectively determine what role LDI should play in their strategy.

Please contact us if you would like us to provide training or advice or if you would like further information about any of our investment consulting services.

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### Important Information

This presentation is not intended to provide, and must not be construed as regulated investment advice. Returns are not guaranteed and the value of investments may go down as well as up. The information in this guide is based on our understanding of current taxation law, proposed legislation and HM Revenue & Customs practice, which may be subject to future variation. Barnett Waddingham LLP is a limited liability partnership registered in England and Wales. Registered Number 0C307678. Registered Office: Cheapside House, 138 Cheapside, London, EC2V 6BW. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries for a range of investment business activities.

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