

Wise to think outside the swaps box

LIABILITY DRIVEN INVESTMENT

Swaps offer an efficient alternative to bonds, but the multi-asset route is best for returns, says Pádraig Floyd

To many, the activity that has surrounded the development of liability driven investment in the UK has been somewhat overplayed. LDI is, after all, about prudent investment within an acceptable risk budget with the future liabilities of the pension scheme in mind. As far as many pension scheme managers, trustees and advisers are concerned, this was the approach they had always taken.

Yet, by the end of 2002, most schemes were in the red with no apparent exit strategy, and they had to come up with new ideas.

The most obvious way out of the hole was to match assets more closely to liabilities and so move into bonds in a big way. Such an approach, often referred to as a "narrow" LDI strategy, would use traditional bonds to match the scheme's future cashflow requirements.

Insufficient supply has greatly reduced yields, particularly on the longest dated bonds, and these increased bond allocations

also do nothing to protect the scheme from the vagaries of inflation or interest rates.

An alternative approach uses derivatives to insulate liabilities from interest rate and inflation risk.

Phil Irvine, director of advisory services at Liability Solutions, says: "Over the past five years the depth and sophistication of the derivatives market has increased dramatically. This means certain risks can be hedged more efficiently now through the use of interest rate and inflation swaps."

But while swaps have become synonymous with LDI, they are not the complete answer. Swaps are not a cheap solution, nor are they straightforward, and many schemes and their advisers have complained of their expense and lack of transparency.

Although using swaps may help to protect a scheme from the worst of interest rate and inflation risks, compliance has to be extremely rigorous due to the additional risks involved in entering derivatives contracts. The scheme must consider whether what it expends in compliance is worth the expected return.

Swaps also fail to offer protection against the risk of rising longevity.

Although JPMorgan has launched a mortality index that may kick-start a market in

longevity instruments funds can use to hedge their exposure, longevity risk remains the weakest link. So returns must be the answer, says Richard Graham, head of institutional business development at Barings Asset Management.

"Even if you are fully funded but think you may not be, you need to grow your assets and you are not going to do that with bonds."

For Mr Graham, this means a multi-asset approach, seeking to generate returns from a combination of market exposures and active management of the underlying asset classes.

This should not be confused with the now out-of-favour balanced managed portfolio, he says. "This approach means that fund managers must say they have to manage on an absolute return basis and not own any asset unless they believe it is going to contribute to growth or control the risk."

Antigone Theodorou, director of investment solutions at Axa Investment Managers, says: "Different schemes will choose different means to plug the pension gap. Some will prefer a higher proportion of index risk to active management risk. Others might prefer to target a diverse blend of return seeking assets."

This has led to increased demand for Libor plus portfolios, says Mr Irvine of Liability Solutions, with the result being

an increased familiarity with and use of hedge funds by institutions. It has also led to a blurring of the approaches between long-only fund managers and hedge funds, a trend he expects to continue.

He says the search for a broader, more diversified portfolio represents something of a back to basics approach, when equities were a smaller proportion of the asset allocation policy: "The move of late to investment companies offering more multi-asset class portfolios, including private equity, hedge funds, commodities and infrastructure, is certainly reminiscent of the previous approach."

"However, the development of the derivatives markets has meant there is a genuinely extended range of options that can be used to better manage certain of the risks that the scheme faces."

Greater freedom is also being given to fund managers to use their skill to generate alpha in the shape of unconstrained mandates or the use of portable alpha portfolios. However, not all schemes can afford such an approach, says Mr Theodorou. "For many smaller schemes, pooled funds are the only way to access LDI solutions. The main alternative - a segregated approach - is too costly and time consuming for the majority of small schemes."