How pension plans can improve on approaches to LDI

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In recent years, pension plans increasingly have embraced approaches and solutions offered by the liability driven investing model, wherein investment choices are in large part a function of the term of the liabilities. The need to bolster returns amid fixed income yield compression has led to an expansion of the strategy, away from pure debt with potential liquidity and valuation trade-offs. Embedded in these choices are human resource decisions involving internal vs. outsourced investment talent.

Are there other approaches that plans should consider, including the potential benefits of 'strategic risk intermediation' and alternative processes?

Pension plans' defensible approach to investing

Is this heavy reliance on LDI by some pension plans prudent? This strategy is expected to safeguard the assets of the plan and deliver the needed return. Current investment thinking resets the traditional approach to LDI into a high-beta large bet on economic growth as represented by debt, real estate, infrastructure and private equity, since these are the assets that provide the needed term and assumed return. On the surface, economic growth of 1% to 2% plus interest rates of 2% to3% does not suffice, necessitating assumption of credit risk and sector/geography selection component to boost returns.

The original LDI model emphasized a fixed income approach founded on certainty of coupon payment and principal return. The new version makes assumptions that returns will provide for liabilities, but has resulted in a bidding up of marginal assets and opportunities in illiquid, hard- to-value investments.

The premise that one always gets paid for long term illiquidity should be critically examined in light of the unknown unknowns, and unanticipated technology-driven business disruption in retail, real estate, energy, entertainment and transportation, as well as the large number of alternative, more active approaches available. Pension plans can participate in a variety of business models that have a higher liquidity aspect, high expected return and don't wait for long periods to realize value.

What is the attraction of LDI?
Simplicity in implementation, execution and smoother valuations have attracted pension plans to adopt this liability-driven approach. While not "fire and forget," this model generally requires only tweaks with no major course changes once deployed. While liquid equity indices continually and automatically throw out losers/disrupted businesses and re-allocate to winners and successful businesses, LDI investments, once deployed are fairly static.

While LDI has become an established orthodoxy, many investors have developed a nuanced approach to LDI. Some investors have turned to the banking model wherein one benchmarks and baselines the liability via an LDI approach, but then engages in the shorter term and sometimes more liquid market, rather than term matching of assets with liabilities. Some have looked at diversified long-term earnings/dividend persistence as an alternative to a fixed income approach.

Cash-efficient risk-taking opportunities
Pension plans that have adopted the LDI approach might consider spending more of their internal resources and capital in a complementary cash-efficient risk-taking approach rather than adding credit risk and business risk to a long-term, somewhat illiquid beta approach. The full-on LDI solution locks up cash for a long time and leaves plans with few resources (cash and internal talent) to evaluate and exploit idiosyncratic opportunities that seem to present themselves with stunning regularity. How many times have plans been unable to participate when the market or a sector is depressed and selling at a huge discount? That is one reason why Warren Buffett keeps tremendous cash on hand.

The opportunities available to return-seeking plans have never been greater. In the past, pension plans were passive participants in capital markets and were fed what the large financial institutions did not want to eat. This landscape has undergone a seismic shift. Knowledgeable plans now have the capital and talent to deal directly with opportunities while banks and dealers have been forced by regulation to become deal intermediaries. Pension plans are expected to take intelligent risk to meet pension obligations and banks are explicitly discouraged from risk-taking via significant internal capital charges and the microscopic oversight by armies of investment analysts and regulators. A smart plan or group of plans with a global capital markets network can be a provider of liquidity when it suits their risk profile and be paid very well for it.

Early Adopters
The combination of an LDI style approach plus the use of a cash-efficient risk-taking and intermediation has been embraced in varying degrees by some Canadian public pension plans and is worth considering.

Canadian public plans were established with an independent governance model, traced back to the founding of Ontario Teachers' Pension Plan in the early1990s. The contrast with many U.S. pension plan investment models is startling. The largest Canadian plan, Canada Public Pension Investment Board (CPPIB), was created in with an independent structure and staffed with experienced investment professionals who would not default to outside influence or surrender control and authority over assets, even informally, to third parties. Independent thinking led Ontario Teachers' to be an early adopter of derivatives and futures to alter their risk profile. Consider this question: "What would have been the result if a retired Paul Volker had recommended that U.S. public pension plans be independent entities and free to set salary levels and investment strategies with a requirement to be 100% funded?"

The C$70 billion (US$54 billion) Healthcare of Ontario Pension Plan, which is 122% funded, uses cash efficient instruments to generate complementary and risk-offsetting return drivers by taking advantage of market anomalies that periodically present themselves. The intelligent plan will be a provider of liquidity and capital.

Jim Keohane, HOOPP's CEO and President told me earlier this year that the plan's "approach is grounded on the idea that one never wants to slip into underfunded status. An over-emphasis on a particular sector /strategy can have significant consequences. The key is to understand your risks and wait for opportunities. The most important attribute is that plans can outwait every other investor and are not a hostage to today's mark-to-market valuation and second guessing."

Where do we go from here?

LDI has been likened to the foundation of a building: a necessary first step that anchors the liabilities and gets a base return. Much of the skill and value is created above the ground: the return-seeking aspect of the portfolio. Rather than taking significant beta risk with an all-in LDI approach, the larger plans can diversify by participation in capital markets risk intermediation for profit while at the same time have a diversified, fairly liquid portfolio.

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