

# The hidden costs

**GAVIN ORPIN** of Lane Clark & Peacock looks into the hidden costs of liability-driven investment and finds out how trustees can make the best judgement when implementing this strategy

**P**ROBABLY the biggest investment topic at the moment is liability-driven investment (LDI). Fund managers and banks are heavily promoting their LDI solutions to pension schemes and the press is full of articles discussing their merits. The availability of this option is a very positive development, since until recently, removing these risks was not a practical option for many schemes.

However, there is an issue that is well known within the industry, but not widely discussed and trustees should know about it. Not only are the costs of implementing LDI high, they are potentially up to double what you might expect, and could result in an immediate reduction in the value of the assets hedged of around 1.5pc.

LDI solutions generally utilise interest rate and inflation swaps to remove any unwanted interest rate and inflation risks. The beauty of using swaps is that they enable interest rate and inflation risks to be hedged away while still allowing some assets to remain invested in performance seeking asset classes, although doing so introduces other risks which must be considered carefully. In practice, however, these swaps must be obtained directly or indirectly from an investment bank and this is where the majority of the costs arise.

Inflation swaps are a relatively new product and, as such, the banks are able to charge high margins. The long duration of pension scheme liabilities requires long duration swaps, which multiplies these margins many times; hence why banks are keen to sell to pension schemes.

To illustrate this, suppose a pension scheme wished to hedge out its 30-year real interest rate exposure. Using a combination of interest rate and inflation swaps, the pension scheme can effectively lock-in to the prevailing 30-year real yield, which is currently around 1.35pc. However, the bank charges a margin for these swaps. This is typically around two basis points (or 0.02pc) and so the scheme locks-in to a slightly lower real yield of 1.33pc. This does not sound much, but since the swaps are over 30 years, and the bank takes its entire fee up front, the margin needs to be multiplied by 30. This means that the scheme will in fact suffer an immediate 0.6pc reduction in the value of assets hedged.

By comparison, to buy a long dated index-linked gilt might cost around 0.1pc. Worse still, if the scheme were later to decide to unwind this swap, the bank would charge another similar fee again!

Swaps are not often implemented directly between pension schemes and banks. Usually a fund manager is appointed by the scheme to ensure that the swaps are implemented cost effectively. As part of this process the manager gives an indication of the margin charged by the bank so that the impact on the scheme's assets can be estimated.



Unfortunately, there is an additional "hidden" cost to the scheme that is not always identified and can increase significantly – perhaps double – the overall impact. This cost results from the almost inevitable adverse market impact that accompanies a swap implementation. An example LDI trade is shown in the graph below.

In this instance, the scheme is hedging its 30 year real interest rate risk and it does this at prevailing real yields. The trade takes place at 12pm and standard practice usually means the bank is aware of the trade at the start of the day to enable it to adjust its position to take account of the risk it will be taking on. It does this by buying a mix of securities, predominantly index-linked gilts of similar duration to the swap being sold.

From the pension scheme's perspective, this buying has a negative market impact such that by the time of the swap trade the real yield has fallen by 0.03pc. Following the trade, yields return to their previous levels. While this is a simplistic example, the pattern illustrated is not unusual and many pension scheme trades implemented recently have shown broadly similar market impacts on the day of the trade.

In our example above, the bank has hedged out its own risk at yields 0.03pc higher than the pension scheme. This results in further profits for the bank,

(and hence a cost to the scheme), and this is in addition to the explicit margin of 0.02pc discussed previously that the bank charges. The real yield the scheme actually achieves is 1.30pc – this is a total difference of 0.05pc to the yield at which the bank hedged. Taking into account the 30-year duration, the total immediate reduction in the value of assets hedged is 1.5pc!

Fund managers do aim to reduce both the bank's explicit margin and the market impact, but very often the client is left in the dark about the full cost. Also, some managers have substantially more experience and ability than others in executing these trades efficiently, but it is not easy for trustees to evaluate this.

Therefore, consultants should play a key role in informing trustees of the full costs of implementing a particular LDI strategy and selecting a fund manager who is well equipped to achieve both the best execution and minimisation of costs. This is critical given that costs are incurred on day one.

This is a new area for managers, consultants and trustees; for trustees to be able to make a sound judgement on LDI they need to be fully informed of all costs – both explicit and hidden ones.

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