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A CLOSED WORLD

LIABILITY-DRIVEN INVESTING may seem like the answer to all a pensions consultant's problems, but we should step back a bit first and look at what we're trying to do for pension funds. Liability-driven investing (LDI) is just part of a package of solutions, although it's about to have its turn in the spotlight.

The reason for this is that we are now entering the world of closed schemes. Over the last five years, the majority of the £800bn (€1,174bn) of UK pensions have decided to close.

When, at Lane Clark & Peacock, we realised this shift was under way, we decided to take a look at the implications. The question we asked was whether there is any real difference in the pension fund between one day when it was open and the next day when it was closed.

Smoothing risk

In fact, there is a huge difference: you lose the ability to smooth risk over the generations. With an open fund, the risks of one generation are offset by the next, but with a closed fund, there is only one generation.

That's why LDI is a good idea – you need to maximise the chances of getting it right. One generation is bearing all the risk, and if that goes wrong, there's only one way out – that's for the sponsor company to stump up an awful lot of money.

LDI seems very appealing. With a closed scheme, you can know precisely how much money there is in the fund, how much the company is committed to paying in, and even the name of every single person in the fund. You can work out exactly what investment return you need; you just have to balance all the variables, and the last balancing item is the investment return you need.

You normally end up with two numbers: one is an outperformance target (for example, LIBOR + 4) and the other is a period of time, such as 20 years. That seems to lead precisely to LDI.

Four or five years ago, various consultants – myself included – went around to asset managers, discussing what they should do.

BGI put together something called a 'SILC' (a synthetic index-linked corporate bond). This looks like a normal index-linked bond, but with some credit risk on top, so that it offers some outperformance.

IT'S HUMAN BEHAVIOUR THAT HAS THE REAL IMPACT, NOT MIS-SPECIFIED BENCHMARKS

However, the complications occur when you start to apply this common-sense principle to the real world.

The first problem is 'benchmark bleeding'. You can try to specify the best possible benchmark, but it's impossible to reproduce the liabilities perfectly. In one case, for example, within two years, the benchmark had drifted from the liabilities by 15%.

There are two reasons why the real-life situation is very hard to match.

Firstly, regulatory issues in the UK mean that deferred pensions are often linked to a limited price index (LPI), and there aren't really any LPI-linked assets.

The second reason is that it may simply not be possible to create a benchmark that mirrors the liabilities. Not only are the benefits very complex, but there is a discontinuity between when the beneficiary is working (even though they may no longer be working for the scheme sponsor) and when they retire.

Benchmark bleeding occurs because, although the benchmark may be based on the liabilities, these are not assessed on a daily basis. The actuary only sits down and revalues them perhaps every two or three years.

Doomed to failure

Theoretically, it should be possible to use a dynamic liability benchmark that is constantly revalued.

It would be great if managers would use liability benchmarks, but even then this is probably doomed to failure because it's still based on actuarial assumptions, and these may change.

There's also be the issue of cost – the product would be so complicated that it would have very high running costs.

However, if the difficulty of defining the benchmark was the only problem, it would probably be solvable.

The real reason that liabilities are changing so much is not benchmark bleeding, but the big things that happen in the real world. If a scheme allows for a brand new mortality table – something that happens regularly – this has a huge impact on the liabilities.

It's human behaviour that has the real impact, not mis-specified benchmarks. Demographic changes or big company events such as redundancies induce massive changes in the liabilities.

So, the message is that you shouldn't fiddle while Rome burns. It's important to warn clients that LDI is not the end of the story – it's a strategy based on emerging liabilities, so it must keep up with their development. fe

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