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Taking Back Control:
Transparent LDI for UK Pensions

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Building a suitable hedge for a UK pension liability can be challenging. That's why many pension investors have chosen to outsource to liability driven investment (LDI) managers who provide a full hedging programme in a single mandate. This idea may initially seem attractive—an expert offers a rigorous solution to a hard problem and allows clients to avoid the heavy lifting—but packaged solutions are a mistake.

Packaged LDI solutions provide rigor but offer little transparency and less control. They are often black-box programmes built according to basic parameters using generic models. They offer almost no way to understand the massive array of liability modelling, gilts, linkers, inflation caps, credit, repo, return seeking swaps, completion swaps, and view-based tactical positioning that drives the outcome. Without transparency, it can be hard to know if the programme is working and even harder to know what risks may lurk around the corner.

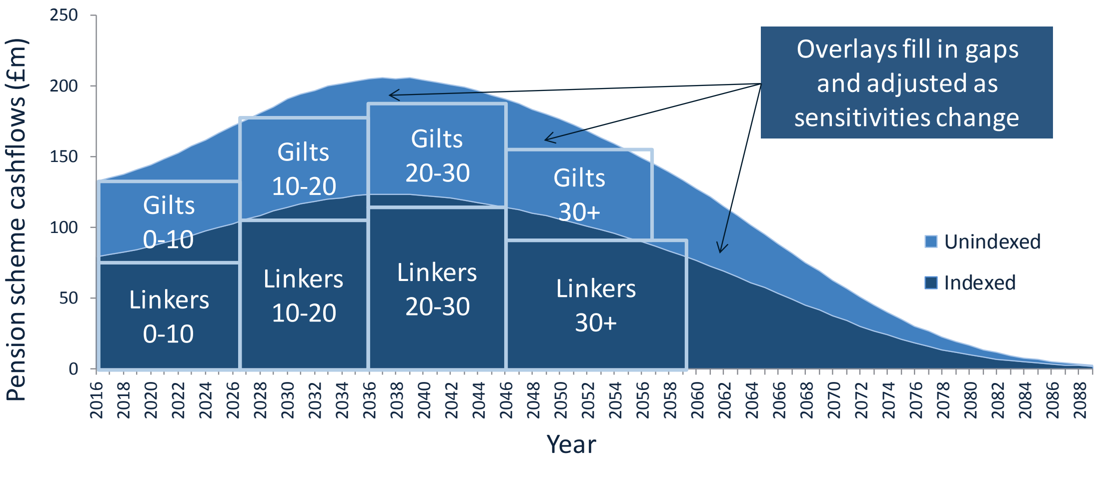
Reducing rigor in the name of simplicity and transparency is no better. A sloppy hedging programme at high hedge ratios can easily lead to over-hedging that increases total scheme risk. Investors should not need to settle – rigor, control, and simplicity can be achieved in unison. Done correctly, LDI can be precise and fully transparent.

A Customised and Transparent LDI Framework

It's possible for investors to match the precision of a packaged solution, while staying fully informed and in the driver's seat. This result can be achieved with just two simple components:

1. Traditional investment mandates managed against transparent market benchmarks
2. A rules-based completion overlay

Correctly applying a building block approach that separates passive hedging from active management will enable investors to seamlessly fit these components into a rigorous hedge. Gilts, linkers, and credit can provide the bulk of the hedging in traditional delegated mandates, and a rules-based overlay can bring things together as illustrated below:



"LDI can be precise and fully transparent"

Market-Based Gilts and Linkers

Investors have long relied on transparent market benchmarks to govern delegated managers and matching gilt programmes do not need to be an exception. Having a clear market benchmark eliminates ambiguity about manager performance and ensures agreement about targets. Market benchmarks may not match the scheme liability perfectly but loss in precision is easily offset with the overlay.

An investor can consider up to eight market benchmarks across the yield curve (four gilts and four linkers) and apply flexible weights to align them (as closely as possible) to the liability. To the extent that market benchmarks create a mismatch versus the liability, overlay fills in the gap.

Depending on where a plan is in the pension lifecycle and what its objectives are, these components can be managed passively or actively, with or without repo, and by one or multiple managers. As liabilities, indexation profiles or other holdings change, the programme can be reweighted to maintain alignment.

Swap Overlay

The overlay provides the bridge between simplicity and precision. While the bond components provide most of the hedging in relatively broad terms, the swap overlay is used to fill in hedging gaps with more precision and course-correct as things evolve. Using a simple overlay eliminates the need to use one-off, opaque bond targets and the overlay targets can be calculated with full transparency.

Swap overlay targets are set to fill the gap between the weighted bond benchmarks and the liability at a range of maturity points. Implementation requires regular monitoring of the liability and hedge programme targets. Systematic tools and the right advisor or overlay manager can help.

Credit and Other Return Enhancing Components

Other hedging components are incorporated into the framework with a similar distinction between passive hedging and excess return strategies. For example, with credit hedges, investors can carefully measure the gilt-like hedge contribution and consider that another bond benchmark. This also applies to return-oriented derivatives like total return and credit default swaps.

Applying the Framework

The building block approach creates transparency and control, but to fully reap the benefits, investors should apply the framework with the following three goals in mind:

1. **Hedge programme should target the actuarial liability**: The scheme actuary's liability valuation is what matters. Many LDI providers use their own liability models and therefore often hedge to irrelevant targets.

2. **Baseline hedge should be clearly stated in advance**: Investors should define a clear benchmark that aligns as closely as practical with the liability and is stated in simple terms of weights on bond components and overlay instruments. The hedge programme is working if the baseline hedge matches the liability before any active management.

3. **Value added through active management should be obvious**: By clearly defining the passive baseline, investors can easily measure active performance. Managers who add value outperform their benchmarks while poor performers lag. Nothing should be lost in the tangled web of components.

Summary

Truly sophisticated LDI does not require giving up control. By separating bond management from completion overlay, everyone can specialise in what they do best—bond managers find the best bonds, implementation experts align performance with the liability, and scheme managers ensure the package achieves their goals. Below is a simple outline of how plans can take control of their LDI allocations and create and implement a programme that is both rigorous and transparent.

Actuarial Liability
Hedging starts with a single measure of the liability to eliminate confusion and links every step in clear and transparent succession

Investment Risk Model
We work with the client's actuary to ensure the hedge programme model accurately predicts changes in the actuarial liability as markets change

Passive Hedge Targets
We specify a practical, achievable mix of hedge components that matches the liability sensitivities -- maintained as a hedge baseline

Manager and Overlay Benchmarks
Delegated managers are given clear mandates against market-driven benchmarks that collectively match the total passive hedge target. Overlays fill in any gaps

Portfolio Implementation
Implementation should be consistent with benchmarks and the chosen level of active latitude

About SECOR Asset Management

SECOR Asset Management is a boutique global asset management firm with offices in New York, Palo Alto and London. SECOR provides comprehensive and customised solutions to a wide array of institutional clients, ranging from multi-national U.S. and European corporate pensions to endowments and foundations.

SECOR is comprised of thought leaders and experienced professionals with a rich heritage in multi-asset and quantitative investing. The firm specialises in providing customised solutions that meet the unique return and risk profile of each of our clients – from liability-driven investing, portfolio completion, multi-asset solutions and alternative investment solutions, to hedging and risk-management techniques.

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About the Author

Scott is the Head of Strategy and Risk for the advisory and solutions business at SECOR. He leads the firm's efforts in investment policy and hedging strategy design for multi-asset clients. In addition, Scott is instrumental in the development and ongoing improvement of SECOR's portfolio construction, asset-liability management, and multi-asset risk analytics. He has over 10 years of investment management industry experience, including time at General Motors Asset Management where he created its first complete set of strategy and plan-level risk management capabilities and helped build a successful third-party advisory business. Scott holds a B.A. with distinction in economics from the University of Rochester and an M.B.A in analytical finance from Northwestern University's Kellogg School of Management.