Liability Driven Investment

Irish Institute of Pensions Management

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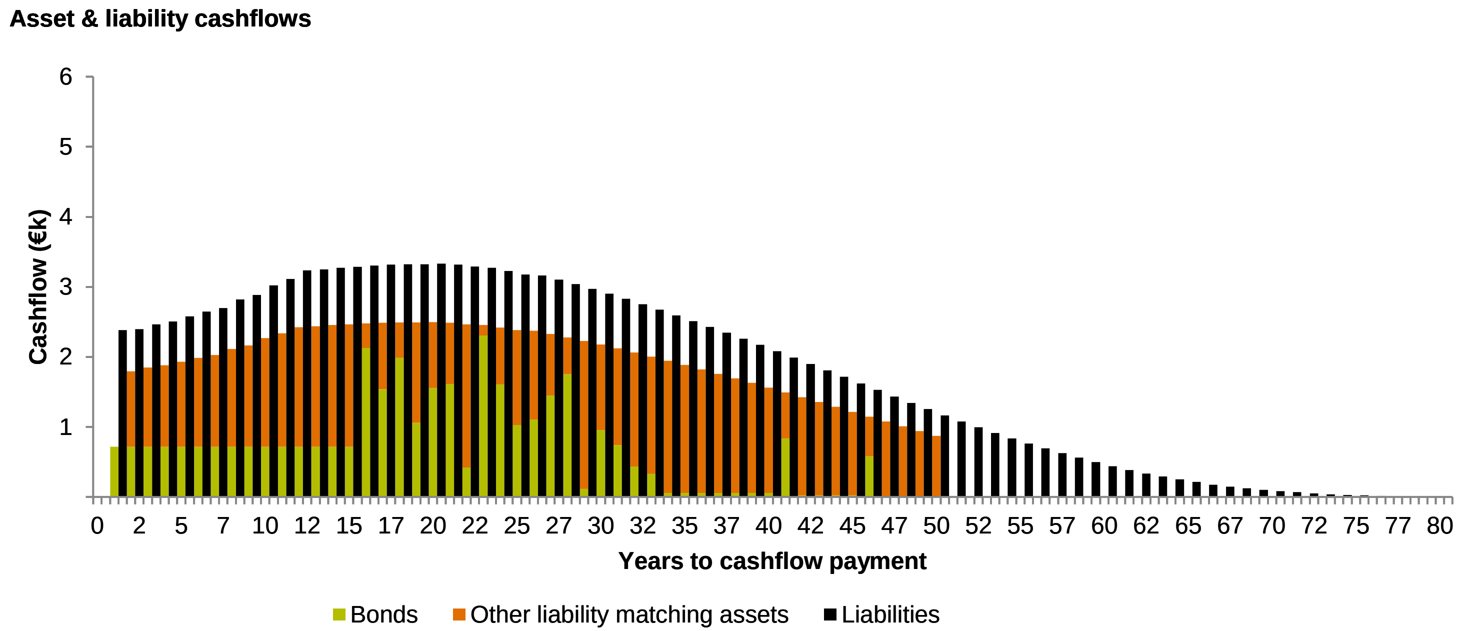
Willis Towers Watson

What do we mean by Liability Driven Investment?

- A DB pension scheme is a commitment to make annual pension payments to its members



- Liability Driven Investment (LDI) is the purchase of bonds and other assets (e.g. interest rate swaps) to more closely match those liability payments

LDI – What it is and what it isn't

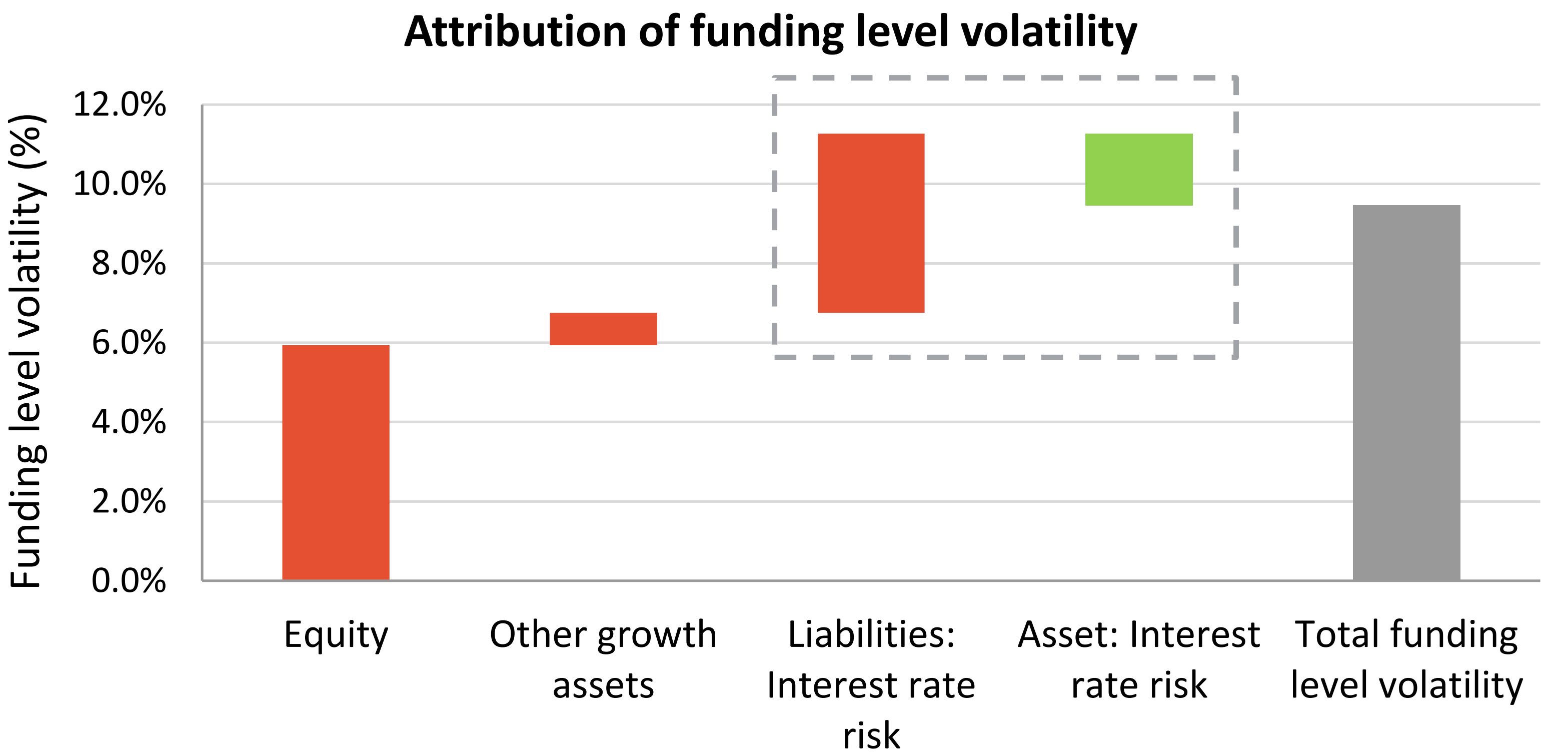
What it is…

- LDI is about better risk management
- Hedging interest rate & inflation risk
- Improving investment efficiency (improving return per unit risk)

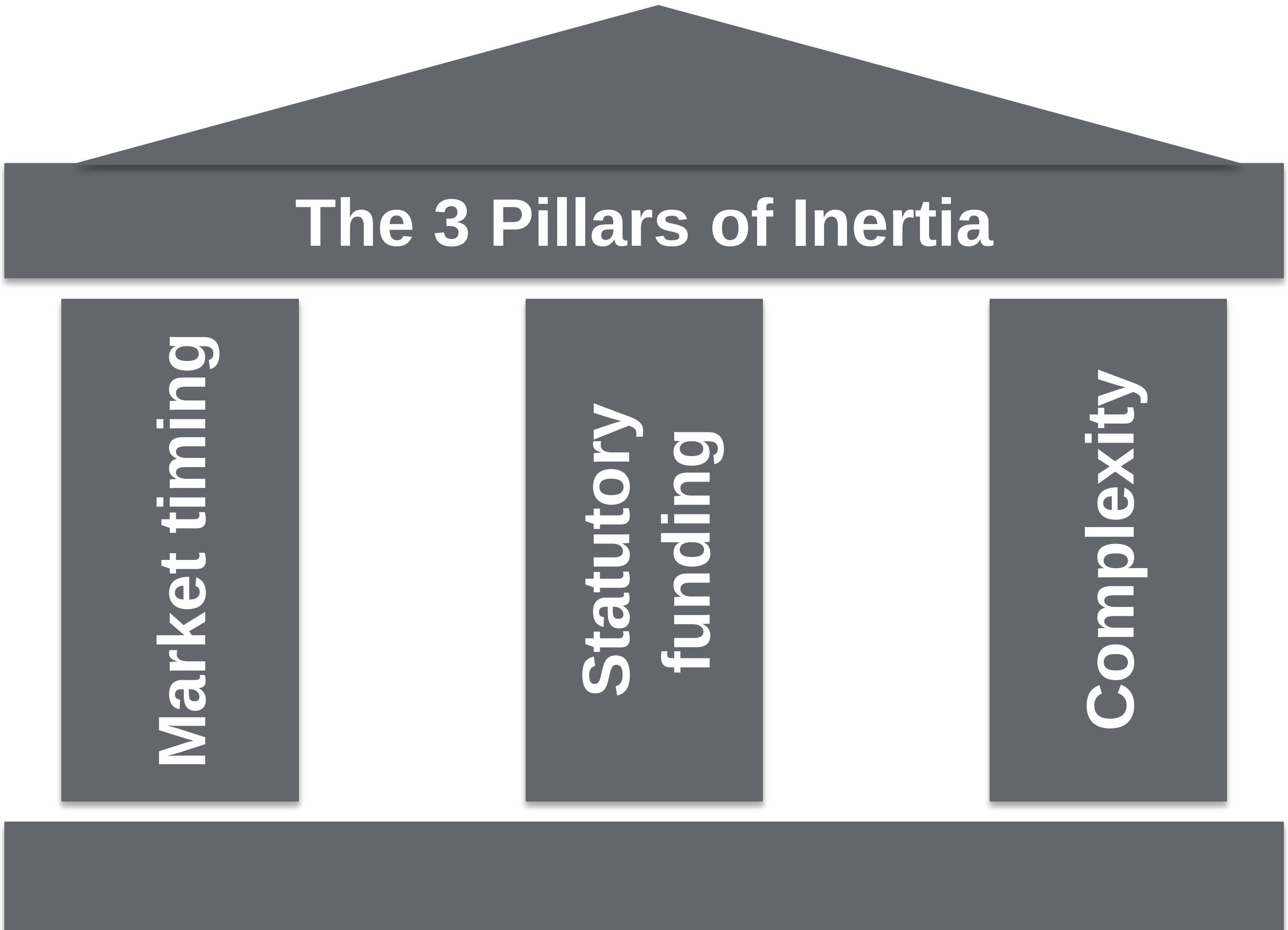
What it's not (at least not always)…

- Increasing the allocation to bonds
- Bad for expected returns

Pension scheme risk



Low adoption of LDI in Ireland



Yield levels / market timing

- D … ment
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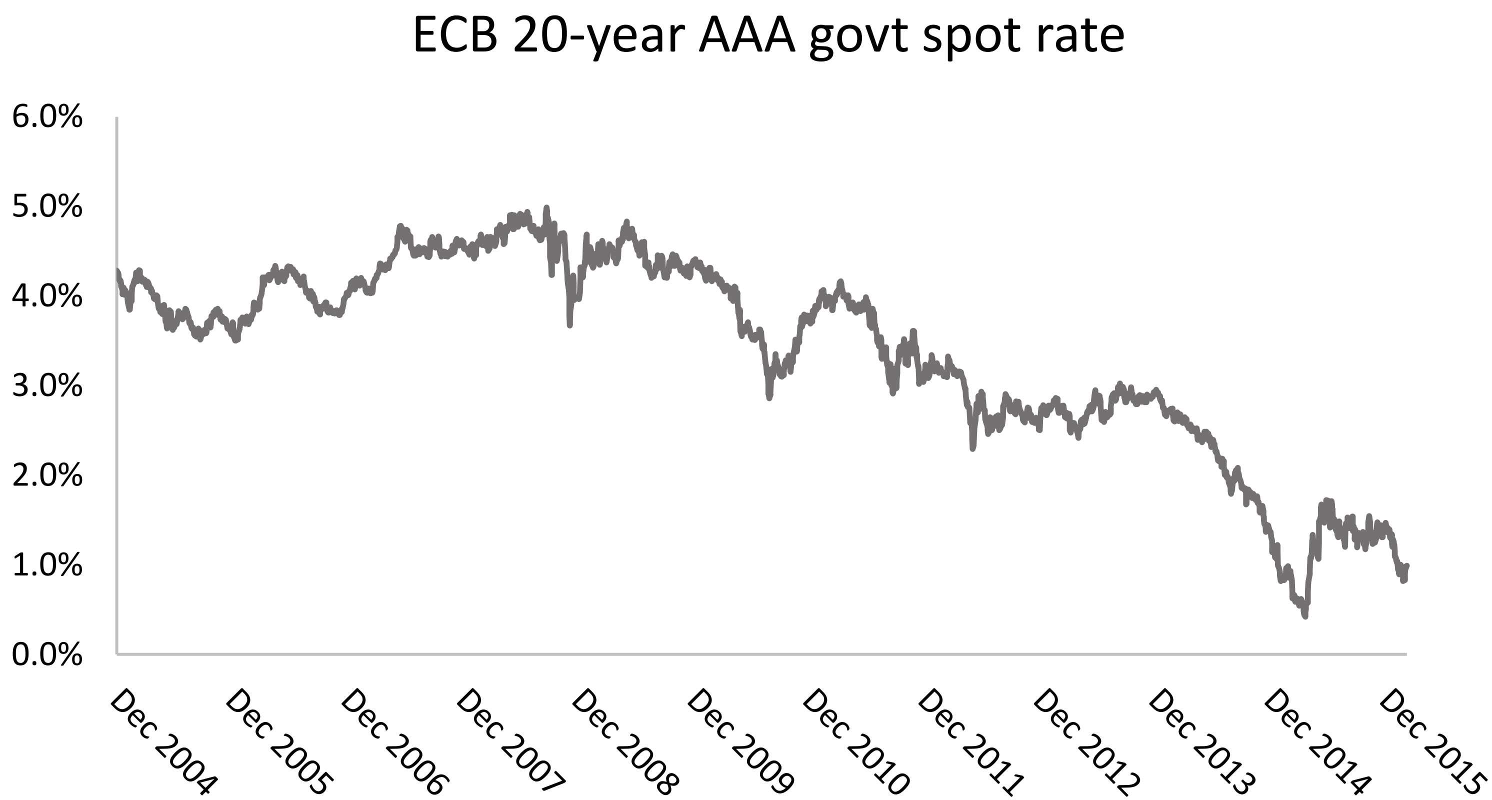


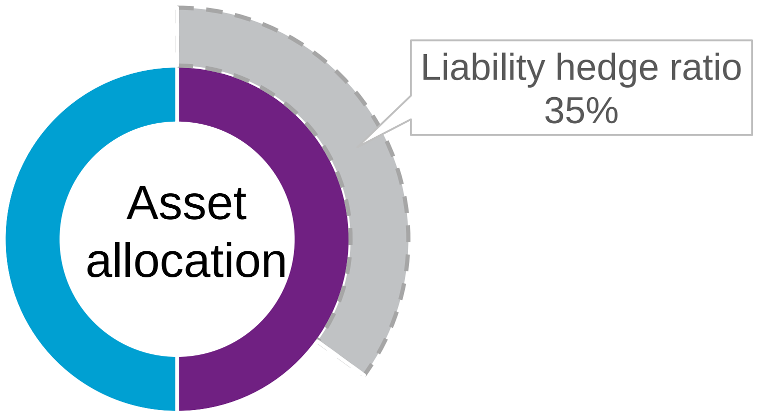
Source: Willis Towers Watson

Positive

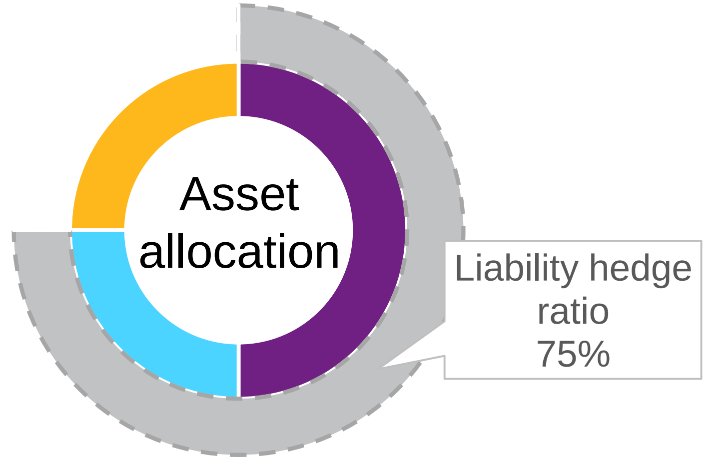
Low

Affordability

Traditional equity bond portfolio

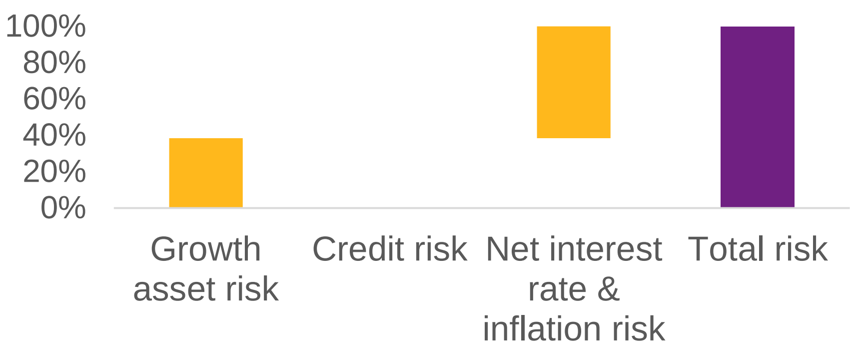


Portfolio with LDI

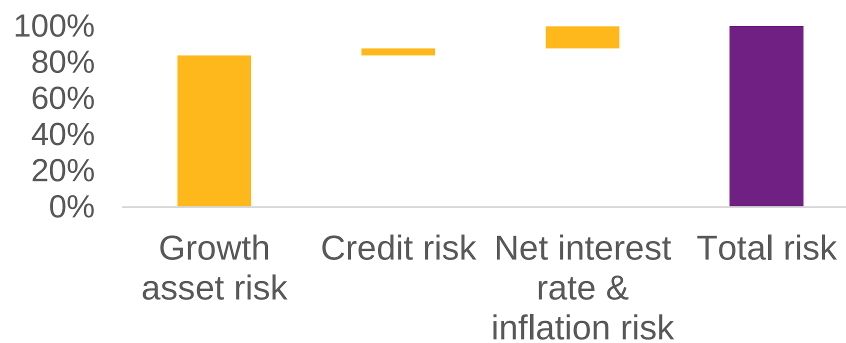


■ Growth assets ■ Government bonds ■ Credit assets ■ LDI ■ Liability hedge ratio

Funding level volatility = 11.3%



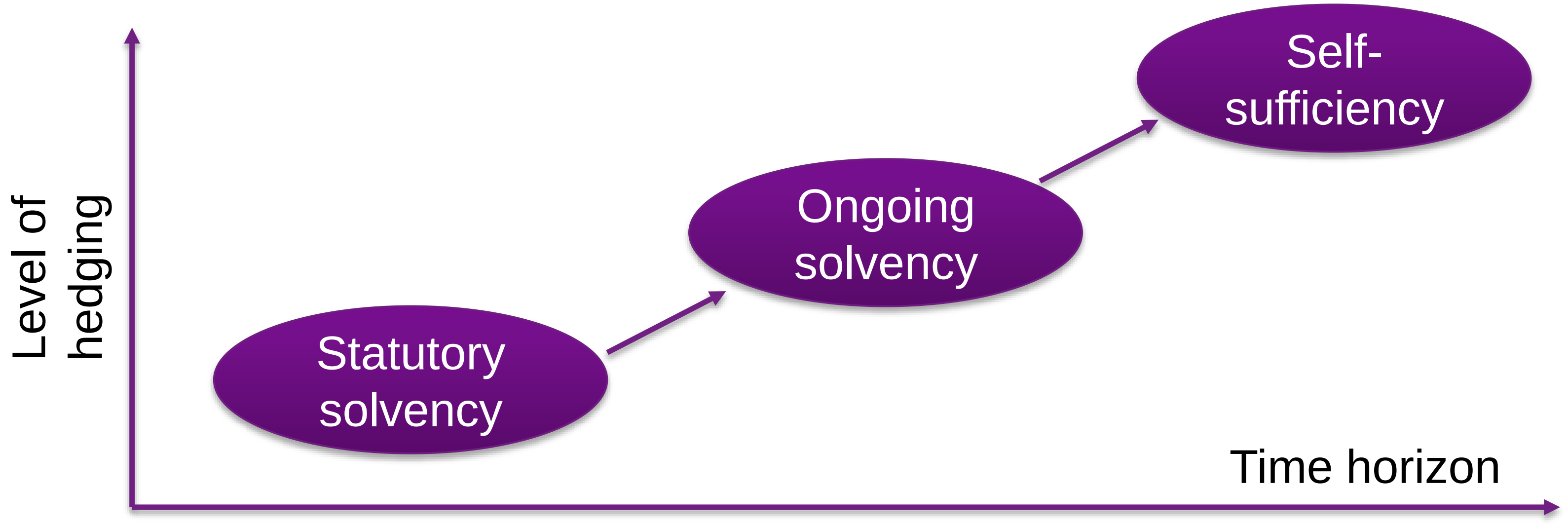
Funding level volatility = 7.7%



Managing risk on multiple liability measures (1)

Typical Irish scheme

- Still focused on meeting the MFS / FSR
- Hedging 60-100% of MFS interest rate risk
- Hedging 10-40% of long-term interest rate risk
- On a journey to better funding and more hedging



Managing risk on multiple liability measures (2)

- LDI is just as important for schemes focused on statutory funding
- Path dependency / risk management
- Making assets work harder
- Building risk management infrastructure for the future

"It's too complex"

Central clearing

Leverage

Yield reversion

Minimum Funding Standard

Expected return?

Collateralisation

Instrument selection

Inflation basis risk

Counterparty risk management

- Trustees already accept & outsource complexity
- Simple approaches capture much of the benefit
- Focus on the key characteristics not the minutiae

Conclusions

- Risk management is critical
- LDI is a powerful & under utilised tool
- Current market conditions and complexities are not insurmountable