



# LDI Roundtable

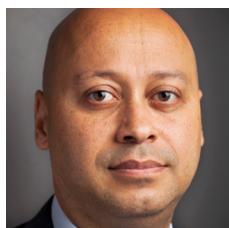
## TRIGGER HAPPY

Will fully funded Canadian plans finally pull the LDI switch?

Slowly but surely, they're coming back. By most measures, Canada's defined benefit (DB) plans have managed to climb back up since the dark days of 2008, when the average funded status for Canadian plans hit an all-time low. But as more plans reach — and surpass — the fully funded mark, liability-driven investing (LDI) is now a viable option for those who want off of the rollercoaster of volatile returns. At the same time, LDI is now a possible path to de-risking as more plans seek to get out of the DB pension space

altogether. Experts at our roundtable spent a few hours in August talking about the state of LDI in Canada and why they think Canadian plan sponsors lag behind their global peers when it comes to implementing these strategies. As Canadian pension funds get healthy again, they're getting clearer on what LDI means, how best to implement a strategy, and why it's wrong to let worries over interest rates prevent plan sponsors from starting down an LDI path.

## EXPERT PANEL:



**MICHAEL AUGUSTINE**

**Vice-President & Director**

TD Asset Management



**ÉTIENNE DUBÉ**

**Vice-President**

Phillips, Hager & North  
Investment Management



**AUBREY BASDEO**

**Managing Director,  
Head of Canadian Fixed Income**

BlackRock Asset Management  
Canada Limited



**STEVE MORRIS**

**Managing Director,  
Liability Driven Investments**

Sun Life Investment Management



**JIM COLE**

**Vice-President**

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**PAUL PURCELL**

**Managing Director,  
Institutional Client Business**

BlackRock Asset Management  
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**RACHNA DE KONING**

**Vice-President & Director**

TD Asset Management



**BRENT SIMMONS**

**Senior Managing Director,  
Defined Benefit Solutions**

Sun Life Investment Management

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**You hear the term “LDI” used all the time and in different contexts — but do you think plan sponsors really understand what it is? And how do each of you define it?**  
.....

**RACHNA DE KONING**

People tend to talk about LDI at the same time that they’re talking about de-risking — as a result, the two concepts are becoming synonymous in people’s minds. While LDI is an approach that can help with de-risking, it’s really a framework for making investment decisions, and isn’t really about just de-risking or one asset class. LDI represents a fundamental shift for plan sponsors from simply tracking the market to actively managing relative to their liabilities. That’s a real mindset change.

**PAUL PURCELL**

I agree — it requires a change in mindset. Plan sponsors need to understand that, within an LDI context, if your assets are down by 3%, it’s a good year if your liabilities are also down by 5%. Many pension committees don’t look at their assets relative to their liabilities, but they should.

**BRENT SIMMONS**

In the U.K., the LDI discussion is a lot further ahead than it is in Canada. We’ve seen a 20% shift in U.K. asset mixes over the last seven years from return-seeking assets to hedging assets. UK plan sponsors now understand that they don’t need to be economists

and predict where equity markets and interest rates are going to go. They know that the pension plan should be about benefit security, as opposed to chasing excess returns.

**MICHAEL AUGUSTINE**

I cut my teeth in the insurance world — when it came to managing an insurance company’s assets, we never talked about LDI. It was just what you did every day. Since the beginning, however, the LDI discussion with pension plan sponsors has evolved from a conversation about bonds or interest rates into one about the risks inherent in the liabilities. People now think about LDI much like the banks or insurance companies do — it’s become a more holistic conversation about how their plan fits into their entire enterprise.

.....  
**Let’s look at the funded status of the typical Canadian DB plan today. Can they expect to maintain the ground they’ve gained during the last few years of positive equity returns?**  
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**STEVE MORRIS**

The Mercer Pension Health Index stood at 105% as of June 30. But, if you look at the funded status of plans, there has been a lot of volatility over the span of 10 years. Pension plan sponsors who are 105% funded but have lived through that decade of volatility are now having informed discussions about its impact. More and more, at the board



“.....organizations are focused on doing what they do best, and the pension committees meet quarterly. There isn’t a fast decision-making process for pension fiduciaries. So, setting up triggers allows them to make decisions on a timely basis and overcome the committee inertia or time-lag that can exist.  
  
— Paul Purcell

level, we are finding plan sponsors focusing on benefit security as a risk parameter for the plan.

**RACHNA DE KONING**

Canadian pension plans are still further behind than their European, U.K. and U.S. counterparts as far as the number who have implemented LDI. A lot of the funded status gains Canadian DB plans experienced are due to the fact that they’ve kept the asset-liability mismatch. But, if they want to maintain those gains without riding the roller coaster again and again, they’re going to have to do something



different. Unfortunately, while there has been a lot of interest in LDI in Canada, implementation rates are lower, compared to plans on a global basis.

### ÉTIENNE DUBÉ

My fear is that there's going to be another market correction. It is impossible to say when — it could be in three months, six months or two years — but it will happen. When it does happen, plans that have maintained an allocation of 40% fixed income and



The question plan sponsors are asking is, “If rates are going to rise, then why lock in the loss today?” The temptation to forego implementing LDI today is significant, given perceptions about the asymmetric profile of interest rates. But the consensus has had a very poor track record forecasting the direction of rates for the past three decades.

— *Aubrey Basdeo*

60% equity (which is still typical for a Canadian pension plan) are going to be in trouble again. In fact, plans with such an asset mix can experience a drop of up to 20% in their funding status during a market downturn. That means, if they do nothing today, then their funded statuses could revert to the 70%-80% level very quickly. The first thing they need to do is really understand and measure the downside risk being carried in the portfolio, and then decide if they want to continue tolerating it.

### JIM COLE

On the corporate sector side, many plans have been closed for some time, so the cost of providing DB pension benefits for active members is going down. Consequently, they are in a good position to de-risk and keep the gains they've realized. This is what we are starting to see with greater frequency. However, there are still challenges in the public sector, where funding rules are sometimes different and the cost of funding benefits encourages ongoing risk-taking because the assets become a mechanism for subsidizing the economic cost. This will probably result in less de-risking, so public plans will likely continue to have higher risk exposures that could leave them susceptible to losses if markets turn.

### Do you think more plans in Canada are looking seriously at LDI — and what are the top questions you're being asked?

### JIM COLE

Over the last three or four years, the big challenge has been to define LDI as a policy at the overall plan level and not just at the investment level. We've been working to build an understanding of LDI from a holistic standpoint, including the plan's governance framework for the investment strategy, funding strategy, and so on. But there has been reluctance on the part of many plan sponsors to take a more refined or granular approach to risk management, and to move away from talking only about LDI in the context of the asset allocation.

### ÉTIENNE DUBÉ

Absolutely, more plans are looking at LDI. Some of the main questions people frequently ask are: “What's the trade-off if I go the LDI route?” or “What's going to happen to my expected return — and how can I keep that expected return at a decent level, even if I'm engaging in LDI?” The shift from “managing return” to “managing risk” is still not evident for every investor, and changing a pre-existing mindset can take time.

### MICHAEL AUGUSTINE

I agree with Étienne. At the same time, clients all seem to be centred around where we are in terms of interest rates. We see it in the markets with the demand for credit, new issues and oversubscriptions in those new issues. People are going out further along the risk spectrum, whether they're in an LDI framework or not, and one of the questions people ask is, “How do I get more yield?”

### Michael brings up a good question about interest rates — with rates set to rise at some point, is now a good time to be going the LDI route?

### BRENT SIMMONS

We've been hearing this question for the last twenty years — but it's the wrong question to be asking. Plan sponsors should not be trying to be economists and forecast interest rates. I was at a conference a month or so ago, and I heard a U.S. plan sponsor explaining their de-risking strategy. They talked about this change in philosophy they had gone through, where they were no longer just focused on asset returns. The most satisfying part for them was educating their board and their senior management that the pension plan wasn't a place where you were playing to win; it was a place where you were playing not to lose.

### RACHNA DE KONING

I agree with Brent. And, back in 2011 and 2012, plan sponsors were more willing to see the market in that exact way — as a place where you are playing



LDI represents a fundamental shift for plan sponsors from simply tracking the market to actively managing relative to their liabilities. That's a real mindset change.

— *Rachna de Koning*

not to lose. But now that the funded status has improved for many plan sponsors, the question becomes, “How much upside do you really need?” Equities helped plans a lot — but maybe the conversation should be about how much upside you’re looking for, as opposed to how much downside protection you need on your bonds in a rising interest rate environment.

**AUBREY BASDEO**

The question plan sponsors are asking is, “If rates are going to rise, then why lock in the loss today?” The temptation to forego implementing LDI today is significant, given perceptions about the asymmetric profile of interest rates. But the consensus has had a very poor track record forecasting the direction of rates for the past three decades. Given that record, the decision to hedge a plan’s rate risk at any time should be based less on loss aversion and more on funded status and the reduction in surplus risk.

**JIM COLE**

It’s always a good time to be engaged in LDI if you are a pension plan. The question is more about the timing of certain LDI-related decisions, such as reducing interest rate risk. It can be a touchy discussion to have with clients, but I think it’s absolutely appropriate to express a view on interest rates.

Being exposed to interest rate risk is one way that a plan can try and outperform its liabilities, especially if rates are expected to rise. However, as with any risk factor, it’s really important to understand and measure the size of the risk budget that’s allocated to an interest rate mismatch. The reality is that, even if most plans were to simply extend the duration of their existing fixed income component, they would still be exposed to a considerable degree of interest rate risk and benefit from a rising rate environment. However, they would also be better positioned from a downside risk perspective, should interest rates not move as expected. In many cases, there could be benefits to diversifying the plan’s risk budget away from interest rate risk and into better rewarded opportunities that support the long-term economic cost of the plan.

**When it comes to glide paths and triggers, how should they be established in the context of LDI? What types of trigger mechanisms or indicators do you recommend?**

**PAUL PURCELL**

Let’s start with asking why pension committees need triggers. While all of us are watching the market on a daily basis, pension committees aren’t. Their organizations are focused on doing what they do best, and the pension committees meet quarterly. There isn’t a fast decision-making process for pension fiduciaries. So, setting up triggers allows them to make decisions on a timely basis and overcome the committee inertia or time-lag that can exist.

In the future, I think we will see more triggers based on interest rate levels or funded ratios. Conceptually funded ratios make sense, but they rely on having an essentially mark-to-market view of your plan’s funded status. In practice, what we’ve seen so far are mostly triggers around calendar dates — plans will shift a certain amount of their asset mix from risky assets into less risky assets, like longer duration fixed income, bit by bit over time. It’s simple and remarkably effective.

**ÉTIENNE DUBÉ**

I don’t think there is one good or bad set of triggers — we’re seeing a lot of different types out there and they all have their pros and cons. The triggers a plan uses depends on what they are trying to achieve. As an example, if the objective of the glide path is to take risk off the table once the funded status improves, then triggers should be based on funded status. If you only



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— *Michael Augustine*



My fear is that there's going to be another market correction. It is impossible to say when — it could be in three months, six months or two years — but it will happen. When it does happen, plans that have maintained an allocation of 40% fixed income and 60% equity (which is still typical for a Canadian pension plan) are going to be in trouble again.

— Étienne Dubé

use interest rate movements as a trigger and your equities score a goal, your funding status will improve but you will not take risk off the table because your glide path triggers will not have been activated. As a result, you're possibly going to continue taking risk that perhaps is no longer needed, and that you don't even want to take.

If the goal is to increase the interest rate hedge in order to closely match your liability profile, then it could make

sense to use interest rate triggers for a glide path. Time triggers are also good to use as a safety net in such a situation. If rates are not increasing as expected, duration will still be extended based on time triggers, and so the portfolio will suffer less from the usual negative carry of shorter bonds versus longer bonds.

A combination of triggers (e.g., rates and funding status) could also be very efficient in some cases.

#### **RACHNA DE KONING**

I like the concept of funded ratio triggers as well. It takes into account market movements and what's happening in your growth assets, especially if you still have a significant allocation to those assets. If you're writing cheques to fund your pension obligations, funded status triggers also take into account how quickly you're funding those arrangements. So a funded status trigger captures more of what's going on with your plan.

#### **What are the challenges from a governance perspective — and how does LDI change the relationships between fiduciaries, investment managers and consultants?**

#### **MICHAEL AUGUSTINE**

LDI is a collaborative effort between the plan sponsor, consultants and asset managers. Part of setting up the governance structure for LDI involves resourcing. If you're a big plan, you might have in-house talent that's looking at everything more frequently. But, if you're a smaller plan, you might choose to delegate some of those responsibilities either to your consultant or to your asset manager. The governance structure starts with understanding who you are, who the parties are at the table, what needs to get done and how those responsibilities should be divided up amongst the different parties.

#### **PAUL PURCELL**

LDI requires a shift in mindset and a holistic view of the plan. Traditionally, pension committees have their actuary

come in and talk about the liabilities, and the asset managers come in and talk about the assets. But that's problematic. For example, back when I worked as a consulting actuary, the bond manager came when interest rates were down and talked about what a great year they'd had because their assets were up 11%. I had to remind the pension committee that this was a bad thing from the total plan perspective! Reporting in an LDI context has to be holistic — assets and liabilities must be reported on together to see the plan's funded status overall.

#### **RACHNA DE KONING**

A lot of this is just basic good governance for any plan — but it can be difficult to implement. One of the big challenges in adopting LDI is making sure that the Board sticks with the decision for the long-term — will the Board come back in three years and ask, "Why did you do this?" Some pension decision makers aren't confident that they're going to make this stick for the long-term and, if that's the case, what are the really big changes that need to be made in how you are going to measure success?

#### **BRENT SIMMONS**

Trigger points are very helpful in this regard. If your pension committee isn't meeting every day or every month, or even every quarter, having those pre-determined triggers in places is absolutely important; you can't wait until the next pension committee meeting to make a decision on this stuff.

#### **RACHNA DE KONING**

There are still some internal silos in organizations, where you have teams that work on the liabilities and you have other teams that work on the assets. But, if you're really going to actively manage your total portfolio to your liabilities, your liability teams and your asset teams have to come together. That's another big challenge with the governance structure in organizations.

#### **ÉTIENNE DUBÉ**

I would say that communication is one of the biggest challenges when going the LDI route. Fixing objectives, designing the mandate, implementing and monitoring all require good communication and coordination



between the stakeholders involved (i.e., pension and investment committees, investment managers and consultants).

However, many organizations are not adequately staffed and don't have the time (or are not taking the time!) to go through a rigorous process. For example, we have seen situations where there is a pension committee meeting once every six months with seventeen items on the agenda. The last item on the agenda is risk management, and the bulk of the committee discussion ends up focusing on the value added of their Canadian equity managers, so the risk management topic just gets deferred.

If you go the LDI route, you need to understand that it's going to change many things: benchmarking, peer comparison, objectives setting, monitoring and so on. It all starts with a good understanding and communication of what you're doing. I'm concerned that some pension plans are doing LDI but not spending enough time on understanding the decision framework and associated subtleties that can have a big impact on the outcome.

**Whether it's a mindset shift or a governance overhaul, how challenging is LDI from a trustee education standpoint?**

**BRENT SIMMONS**

Ideally, LDI is simpler than the status quo, because you can see your assets

and liabilities moving together. It's what large financial institutions — banks and insurance companies — have always done. Think of all the additional time pension committees have spent over the last five or 10 years discussing their underfunded status and the need to put in extra contributions. If LDI had been adopted early on, then they could have avoided those conversations — a much simpler outcome from a trustee's perspective.

**PAUL PURCELL**

It's hard to change conventional thinking. I'm sure all of us have experienced a new pension committee member who comes from a completely non-pension environment. They bring a fresh perspective and they look at the conventional thinking and ask, "What is this? This doesn't make any sense." And you realize how the conventional perspective is actually flawed.

**When it comes to LDI, what kinds of asset classes are being used and why?**

**AUBREY BASDEO**

Long bonds are key to an LDI approach and we are beginning to see segmentation within the long end of the market. Long provincials, long government bonds, 20+ strips, et cetera, are being used as building blocks to better achieve a tailored solution. Sometimes, an alpha engine is embedded within these building blocks to help deliver a higher return. We've

also seen some willingness to have a discussion about leverage in order to achieve better capital-efficiency within the fixed income allocation.

Beyond that, you're looking for investments that act like fixed income — infrastructure and private debt provide an attractive illiquidity risk premium. Even when de-risking, you still need to consider return seeking assets as a part of the solution. Alternative assets (i.e., absolute return strategies) satisfy this need.

**RACHNA DE KONING**

We've had clients that have implemented LDI through derivatives. Between 2007 and 2012, when interest rates were going down, they were getting mostly mark-to-market gains on their derivatives positions — those were easy discussions to have with the board —



There's a spectrum of approaches for an LDI benchmark. You can just take blended market indices, or you could get into more of a custom LDI benchmark, which builds in the sponsor's preferences.

— Steve Morris



Think of all the additional time pension committees have spent over the last five or 10 years discussing their underfunded status and the need to put in extra contributions. If LDI had been adopted early on, then they could have avoided those conversations — a much simpler outcome from a trustee’s perspective.

— Brent Simmons

pension liabilities were going up and the benefit of using derivatives for LDI was clear. But then last year, when long interest rates went up a bit, attention turned to the mark-to-market losses on their derivatives — that was harder to explain. Boards had to be reminded that liabilities had also gone down, the funded status was less volatile, and in an LDI context the derivative strategy, in our opinion, had worked.

#### ÉTIENNE DUBÉ

We’re seeing more and more appetite for absolute return strategies or enhanced cash strategies used jointly

with fixed income derivatives. These types of portable alpha strategies were aggressively promoted a decade ago, but I don’t think many pension plans went that route. Now it looks like there is more appetite. One difference is that the alpha engine, typically hedge funds, is now running at version 2.0 or 3.0: more liquid, greater transparency and lower fees. I do not think that all pension funds are going to go in that direction, but we definitely see increased appetite.

#### BRENT SIMMONS

We’ve been spending a lot of time educating folks on how alternative asset classes can supercharge LDI mandates — private debt, infrastructure and commercial mortgages, for example. Plan sponsors still want to see yield, so we do an illustration where the plan goes from a 60/40 equity/bond mix to a 20/80 equity/bond mix. The expected rate of return is virtually the same because we put in alternatives with a nice yield pick-up, but we’ve reduced the plan’s equity exposure and interest rate exposure to a third of what it was before. So, for those pension plans that understand risk budgeting and want to match their assets and their liabilities, you can have the best of both worlds. I think our challenge is in educating folks and helping them understand that these different products and solutions exist.

#### AUBREY BASDEO

The one potential challenge we’re anticipating in the fixed income market is shrinking supply, at least on the U.S. Treasury side, as a result of a significant improvement in the federal deficit. We don’t think markets have factored in the ramifications of diminishing supply and, when they do, that’s going to have an impact on how high rates could potentially go on the long end of the bond market. In Canada, the supply of government bonds will be constrained as the federal government is trying to run a balanced budget.

At the provincial level, Ontario and Québec are the only two provinces that will need to fund a fairly significant deficit — but we should consider that both these provinces typically use foreign markets to meet their overall needs. In both the U.S. and Canada,

corporate issuance is also down significantly, relative to last year.

And so, in terms of implementation for an LDI strategy, this supply trend has implications for both the level of long-end rates and the cost of implementing a plan stemming from reduced liquidity.

### Benchmarks. We’ve talked a lot about comparison points; how should we be measuring setbacks and success with an LDI program?

#### BRENT SIMMONS

It goes back to this mindset change we were talking about before. The whole point of LDI is to match your assets and your liabilities, so your benchmark has to be your liabilities; you want those two things to move in the same direction at the same rate. Of course, the liabilities that we’re trying to match in Canada are somewhat arbitrary, especially the accounting ones. So, you need an LDI benchmark or a couple of different LDI benchmarks to help people understand how well the manager has done versus what they were supposed to do. It allows plans to answer questions like, “Was there some tracking error just because the liability itself moved in an unpredictable fashion?” and “How much tracking error is manager value-add and how much is investment management constraints?”

In the end, it comes back to this: you can’t really look at how the person down the street did. You have to look at how your assets did relative to your own liabilities — and that’s a huge departure from most Canadian pension plans’ current thinking.

#### STEVE MORRIS

There’s a spectrum of approaches for an LDI benchmark. You can just take blended market indices, or you could get into more of a custom LDI benchmark, which builds in the sponsor’s preferences. For example, they may have certain sector preferences, single name limits, credit components — spending time on those

discussions for LDI benchmarking is very important. At the governance level, there's a need for measuring your manager, so it's important to construct a benchmark that the board members have confidence in, is based on a very rigorous methodology and is very transparent and measurable.

You need to go through that process of building a solid custom benchmark, and then finalize the process with very detailed attribution.

### ÉTIENNE DUBÉ

I think everybody should have a liability-based benchmark, even if you are not LDI investors. I think most investors should at least understand their liabilities (not necessarily manage against them, but understand them) and be able to measure their basis risk (i.e., the risk between their policy benchmark and their liability benchmark). If you are not an LDI investor and you do this, the chance that you will become an LDI investor in the next few years is ten times greater!



Over the last three or four years, the big challenge has been to define LDI as a policy at the overall plan level and not just at the investment level. We've been working to build an understanding of LDI from a holistic standpoint including the plan's governance framework for the investment strategy, funding strategy and so on.

— Jim Cole



### PAUL PURCELL

We're in a fascinating time, actually, because I think we're near the turning point from using asset class benchmarks to a time where plans are adopting true liability benchmarks that are in line with their cash flows. Reconvene this group three years from now and I'm sure it will be much more common. We'll have seen some really clever approaches.

### What are some of the main implementation challenges in adopting LDI?

### STEVE MORRIS

What's important is constant communication during the implementation process, because as new committee members come on board, the strategies need to be reinforced along the way. At the same time, your reporting provides very in-depth attribution relative to your liabilities, your benchmark and your asset performance. You don't go straight from reporting your liability to your asset portfolio; you have to look at that attribution between your liability and your benchmark performance, and then your benchmark performance to your asset portfolio.

I think when you explain that to trustees, you can see the light bulb go on; they go, "Oh, that makes sense." It's very measurable — people have more confidence in implementing the strategy when they have very holistic step-by-step processes.

### ÉTIENNE DUBÉ

When going the LDI route, the involvement of both the consultant and the investment manager typically increase compared to a traditional mandate. In fact, in many situations, the role of the consultant is so important that if he or she is not comfortable with LDI, then it likely will not happen. Years ago, many consultants were not comfortable with LDI investing for a variety of different good reasons, and I think it was an obstacle to the growth of LDI as an investment strategy.

Now things are different; LDI is better known and promoted. The number of investors adopting an LDI approach is growing and will probably continue to grow over the next few years, especially if interest rates increase in the meantime!

### PAUL PURCELL

One particular challenge is that the Canadian fixed income market is just much thinner than the U.S. and other markets. So, once you come up with a strategy, especially if you're a larger plan, you can't just go out and implement it in one day or one week; you need to do it very carefully. Timing becomes very important, and the transaction costs in fixed income markets are far from trivial. Plan sponsors that are used to putting on positions in the equity markets are used to a certain level of transaction costs. But, if you try to put on positions in long fixed income, especially long credit, the costs are going to be much higher. Costs now become an integral part of the implementation strategy, not just a consequence of the strategy. ●

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While there is no one-size-fits-all LDI portfolio, the purpose behind our LDI framework is to help deliver confidence to our clients in achieving their funding goals with better control of their plan.