Liability-driven investment – the only framework in today's pension environment

18 April 2012

You don't have to spend a great deal of time researching global pension issues to establish that threats like longevity and adverse equity and interest rate environments have contributed to the near-demise of Defined Benefit (DB) plans. As a result, the risk of not having enough money in retirement now falls firmly on the individual member instead of the company. However, regardless of where the risk lies or the type of scheme, the SA retirement fund industry has recognised that liability-driven investment, or LDI, is the only framework to use to formulate an investment strategy.

A successful LDI strategy targets a customised benchmark defined by your expected liabilities, as opposed to a peer-based or market-related benchmark. Liabilities might be the pension obligations of a DB plan, or the need to provide an 'acceptable' level of retirement benefits to members of a Defined Contribution (DC) plan over time. Irrespective of how you think about liabilities, formulating your strategy with an LDI approach gives you peace of mind, because your assets track your future liability commitments.

Reg 28 and LDI

The old Reg 28 of the Pension Fund's Act prescribed a set of asset class restrictions, without considering how you should formulate your investment approach. A fund could follow a strategy that complied with the guidelines, but didn't factor in its own objectives. This misplaced focus has contributed to the downfall of many a fund, especially in recent years where we've seen global funds devastated by an equity market collapse on the one hand, and increased liabilities due to depressed interest rates on the other.

In a recent memorandum, the FSB noted that the "investment of the assets of the fund is one of the most critical of all the management functions carried out by the trustees. Particularly now that most members belong to Defined Contribution funds in which the investment risk is carried by members, most members will experience, directly, any losses suffered, or lower than average returns earned, by the fund." In line with this, the amendment to Reg 28 requires funds to pursue a strategy that is "suitable for the fund's specific member profile, liquidity needs and liabilities."

While Reg 28 goes a long way to correcting a systemic problem in the pension fund industry, it's still critical that funds and their consultants carefully consider the implementation of this framework. This will ensure they're able to choose a risk budget that is suitable for the specific needs of the fund and take advantage of shorter term market opportunities.

LDI provides a solid foundation

DB funds that correctly formulate an LDI strategy in accordance with the new Reg 28 guidelines are likely to have fewer concerns about issues such as the need to minimise funding level volatility, make allowance for future pension increases and manage longevity risk. Similarly, DC funds that follow these guidelines would be far better positioned to satisfy member expectations. With this solid foundation in place, the South African retirement industry will find itself better equipped to ensure that future asset growth is translated into a sustainable benefit for the retiree.

For more information on Regulation 28, **click here**.

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