Why the move to liability-driven investment?

25 April 2012

The 'old school' approach to setting a pension fund’s investment strategy has usually been to set a target return and then structure the assets to try to match the actual performance with the targeted performance. This approach didn't fully recognise the importance of meeting the fund's future pension obligations. The success of the investment strategy was only measured on whether the portfolio outperformed some market benchmark and not a liability benchmark based on the present value of the pension fund’s obligations or liabilities as they change through time.

The shortcomings of 'old school'

The problem with this approach was exposed when global financial markets took huge knocks during the early 2000's and again in late 2008. Markets performed poorly, interest rates dropped, and as a result, liability values rose substantially, resulting in widespread deficits and decreased funding levels. This 'double whammy' had a very negative impact on the financial health of many pension funds, as expressed by their funding status. Milliman, a global consulting and actuarial firm, reported that their 100 Pension Funding Index, an index tracking the funding level of the 100 largest U.S. corporate pension plans, dropped to a 10-year low of 70.1% at the end of August 2010, the lowest level since 31 May 2003 when the solvency ratio was 70.5%. More recently the index has shown an improvement and at the end of March, the funding level was 85.1%, still short of the required 100%.

As many Defined Benefit (DB) pension funds had corporate sponsors backing them, this drop in funding level not only impacted the pension fund, but also the sponsor’s balance sheet. This is precisely what happened to British Airways. The downturn in global markets not only impacted their pension funds, but also affected British Airways as a company. It had to take on a pension fund deficit of £3.7 billion on its balance sheet after the March 2009 valuation of their Airways Pension Scheme (APS) and New Airways Pension Scheme (NAPS). As a result, British Airways and their pension funds have often humorously been referred to as “a pension fund deficit with wings” and “a large pension fund with a small airline company on the side”.

Looking ahead

The growing recognition by pension fund managers of the importance of structuring their investments around their liabilities, rather than a market benchmark, was the key catalyst for the move towards LDI. An LDI approach is also very applicable to Defined Contribution (DC) schemes where the true liability is the present value of the expectations that members have of their level of pension income when they retire.

It has always been our view that LDI techniques originally developed for DB funds have a very logical and necessary application to DC funds. This was recently echoed by the UK's Minister for Pensions, Steve Webb, when he was quoted in the Financial Times saying that he believes DC funds should focus on what members receive after retirement and should aim to pay a pension linked to members' expectations. He called these 'Defined Ambition' funds instead of Defined Contribution funds. All we can say is: Welcome, Mr Webb, to the world of LDI!

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

Close window