LCP INSIGHT CLARITY ADVICE

APRIL 2017 **LCP EXPLAINS**

Keeping on top of your LDI portfolio

Are you aware of the latest market developments and regulations?

Liability-driven Investment ("LDI") is one of the most complex areas of investment strategy, particularly following the recent introduction of new regulation. In this short document, we summarise the key issues that trustees should be aware of to ensure good governance of their LDI portfolio.

TEST YOURSELF

Are you prepared for cash calls?

What is roll-risk?

Did you know the cost of repurchase agreements is higher than usual?

Are you Central Clearing ready?

Do you know what your hedge ratio is?

How often should you review your LDI portfolio?

Are you prepared for cash calls?

We've all become accustomed to the seemingly one-way, downward movements in yields. This has led to leveraged LDI strategies (ie one where £1 invested provides more than £1 worth of protection against changes in interest rates / inflation expectations) typically releasing cash no longer required to maintain the desired level of leverage.

However, it works both ways. Towards the end of last year, yields were on an upward trend and as a result some managers called for cash. Should that rise in yields resume this year, LDI managers could call for an injection of cash in order to maintain the same level of hedging within a given LDI strategy.

Cash calls may come at short notice. If you haven't already, we strongly advise that you put in place a process to meet such calls in the future. You may have assets sitting in cash for this purpose or you may have earmarked an allocation that can be used to meet these calls.

It is just as important to consider the logistics; for example, who could be around to sign and send instructions to the investment managers in the event of a sudden cash call.

What is roll-risk?

A leveraged, gilts-based LDI strategy usually involves the use of what are known as gilt total return swaps ("TRS") and / or "repos" (more on repos here). Whilst a swap is typically a long-dated agreement (eg 20 years), gilt TRS and repos are much shorter in term, typically 12 months or less. Consequently a leveraged, gilts-based hedge has to be re-instated, or "rolled", on a frequent basis as and when these contracts end.

It is possible that market conditions may make it very expensive, or impossible, to roll a gilts-based hedge when it expires. This risk is minimised by your LDI manager by spreading the roll dates of the contracts used across a range of dates and a range of counterparties.

Did you know the cost of repurchase agreements is higher than usual?

What is a repurchase agreement?

A repurchase agreement, or “repo”, is effectively a loan arrangement where an LDI manager borrows cash from, say, an investment bank. The LDI manager will typically deposit gilts it already holds as security against that loan, resulting in a relatively low borrowing rate. With the borrowed cash, the LDI manager might buy more gilts to increase the liability hedge. When the loan matures, the LDI manager either rolls the contract or pays back the loan plus interest to the bank. In effect, over the period of the loan, the bank has received interest similar to a cash return while the LDI manager has received the return on its deposited gilts, plus the return on any gilts it bought in the interim (less the interest paid on the repo).

What do higher costs mean for your scheme?

The interest rate charged on the loan is known as the “repo rate”. This rate is typically higher than historical averages following the introduction of new bank capital rules and regulation. Currently, using a repo generally still results in a higher yield than entering into a swap. This is because gilts typically offer a materially higher yield than swaps which offsets any “drag” associated with the repo rate. However, this may not always be the case. It is necessary therefore to keep repo costs under review, and monitor whether there are other, more cost effective ways to achieve the hedge exposure in future (eg using leverage in other parts of your investment strategy).

Are you Central Clearing ready?

What is Central Clearing?

Central Clearing is a process under which, for certain types of swap contracts, an LDI fund and an investment bank are counterparties to contracts via a low-risk clearing house, rather than directly with one another. Central Clearing is currently expected be mandatory for pension schemes by late 2018.

What does this mean for your scheme?

Where swaps are held with a clearing house, profits and losses – resulting from the change in the value of the swap – need to be settled daily between the LDI fund and the clearing house, using cash only. Previously, there was more flexibility as to which assets could be used for settlement purposes – gilts were typically used instead of cash. Central Clearing is likely to increase the amount of readily accessible cash needed to support a leveraged LDI strategy. All of our buy-rated LDI managers expect to be "Central Clearing ready" well before the mandatory deadline.

Do you know what your hedge ratio is?

You can't hedge all your liability bases at once. For example, a 100% hedge of the technical provisions will not be a 100% hedge of your scheme's buyout liabilities, or the IAS19 liabilities. Make sure you know what you are hedging.

Did you know that your hedge ratio will change over time?

It is not possible to buy instruments that perfectly match a pension scheme's liabilities. In addition, these liabilities will change over time due to membership experience and other demographic changes. Thus a scheme's hedge ratio will fluctuate and possibly deviate from what is being targeted. You should ask your consultant for a regular update on your hedge ratio to ensure you are still on track.

How often should you review your LDI portfolio?

We recommend that a health check is performed annually, or after a significant market event (such as a marked change in inflation expectations). A more thorough review should be carried out at least once every three years following the actuarial valuation.

LCP INSIGHT CLARITY ADVICE

Contact us

If you would like more information please contact your usual LCP adviser or one our LDI specialists.

James Fermont

Partner

James.Fermont@lcp.uk.com

+44 (0)20 7432 6762

Gavin Orpin

Partner

Gavin.Orpin@lcp.uk.com

+44 (0)20 7432 3778

Hannah Ni Riain

Analyst

Hannah.NiRiain@lcp.uk.com

+44 (0)20 7432 6788

At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and employee benefits.

Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands B.V.
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com

All rights to this document are reserved to Lane Clark & Peacock LLP ("LCP"). This document may be reproduced in whole or in part, provided prominent acknowledgement of the source is given. We accept no liability to anyone to whom this document has been provided (with or without our consent). Lane Clark & Peacock LLP is a limited liability partnership registered in England and Wales with registered number OC301436. LCP is a registered trademark in the UK (Regd. TM No 2315442) and in the EU (Regd. TM No 002935583). All partners are members of Lane Clark & Peacock LLP. A list of members' names is available for inspection at 95 Wigmore Street, London W1U 1DQ, the firm's principal place of business and registered office. The firm is regulated by the Institute and Faculty of Actuaries in respect of a range of investment business activities. The firm is not authorised under the Financial Services and Markets Act 2000 but we are able in certain circumstances to offer a limited range of investment services to clients because we are licensed by the Institute and Faculty of Actuaries. We can provide these investment services if they are an incidental part of the professional services we have been engaged to provide. 4 April 2017

© Lane Clark & Peacock LLP 2017