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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Liability Driven Investment Strategies (continued)

Liability Driven Investment (LDI) is becoming a global theme for defined benefit pension funds. Major pension funds in Europe are embracing the LDI concept and implementing significant changes to asset allocation policy. In the United States there is growing recognition that the future viability of public and corporate pension plans requires that assets and liabilities be managed in a consistent integrated fashion. There is clear evidence of increased allocations to fixed income securities and the use of interest rate swaps as a part of LDI risk mitigation strategies.

In the United Kingdom and Europe, the implementation of new accounting standards for defined benefit pension plans (FRS 17 and IAS 19) is having the effect of raising the awareness of pension plan sponsors and corporate financial executives to the importance of the inherent risks of mismatched pension assets and liabilities. In the United States, the Securities and Exchange Commission recently submitted a report to Congress recommending that pension fund asset values be marked to market. If adopted, this recommendation would lead to an increased emphasis on LDI. The US Financial Accounting Standards Board and the International Accounting Standards Board have begun a joint project to develop unified global pension accounting standards. Global convergence of pension accounting standards would almost certainly mean the abandonment of US Financial Accounting Standard 87, the current accounting standard with its controversial features that include smoothing of asset values.

An important first step in implementing LDI is the choice of a benchmark against which to monitor performance. The traditional approach of establishing asset class benchmarks is being challenged as being inappropriate for the LDI environment; the new thinking is to establish a Custom Liability Index as the proper benchmark for asset management. Pension plan sponsors are changing the way in which they assess the merits of investment managers. Instead of selecting, monitoring and rewarding asset managers for outperforming an asset class benchmark with an exclusive focus on rate of return and the alpha measure of outperformance, the emphasis now is on how an investment manager's strategy will complement the management of pension liabilities. In practical terms this new approach has resulted in increases to pension funds' fixed income allocations and a focus on the assets that correspond to the long duration of pension liabilities. As a result, long duration bonds and, in certain circumstances, inflation linked bonds, have become the logical choice for consideration in the realignment of asset class allocations. This trend is having an effect on the bond market. Demand for long duration bonds is producing two notable responses; the prices of long bonds are being bid up in the market and new long bonds are being issued to meet the increased demand. In Europe, France has issued a 50-year bond for the first time. Spain, Netherlands, Poland and Greece have all recently issued 30-year bonds. The United States has agreed to restore the issuance of the 30-year Treasury bond that had been discontinued over recent years.

As defined benefit pension plan assets seek out long duration investments, the economic effect of this demand-push on the fixed income markets is reflected in the level of interest rates, the shape of the yield curve, sector spreads, and in the volatility of rates. As the Federal Reserve has moved up interest rates at the shorter durations, there have been significant non-parallel shifts in the shape of the yield curve, resulting in its flattening as long, intermediate and short yields move closer together. Some observers, including Federal Reserve Chairman Alan Greenspan have remarked on the anomalous situation whereby long bond yields have not risen to levels consistent with changes in yields at intermediate durations. This anomaly may be partly explained by pension funds creating a strong demand-push effect on prices of the limited available supply of long bonds in the market.

The Pension Benefit Guaranty Corporation (PBGC) is realigning the allocation of funds that it holds against the liabilities of terminated pension plans that it has taken over. It has adopted an LDI strategy and is in the process of increasing its bond allocation towards 85 percent. However, a serious problem looms in the private sector with pension plans that are at risk of being transferred to PBGC trusteeship at some point in the future. There are several large pension plans with substantial unfunded liabilities that do not adopt the concept of prudent asset-liability management and instead seek out riskier strategies, referred to as "all offense and no defense" in the pursuit of higher absolute returns on assets. This creates a moral hazard as this policy of "desperately seeking alpha" entails risks that may result in failure and the consequent transfer of unfunded liabilities to the PBGC whose costs will be borne by increased levies on healthy pension plans insured by the PBGC.

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