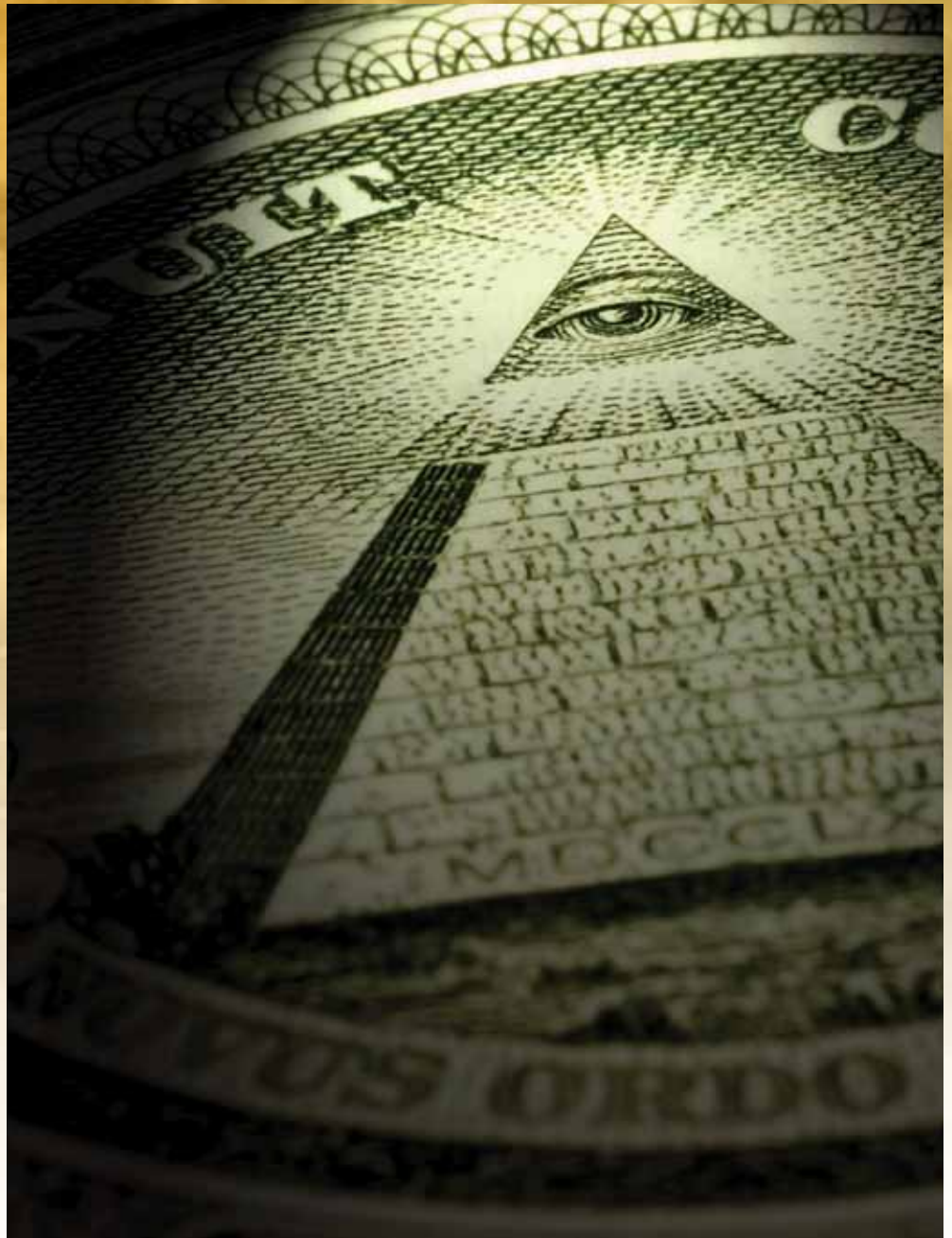


The Fixed Income Summit

Meeting the Challenges of Bond Investing in 2011



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The Fixed Income Summit Contents

The State of the Fixed-Income World **4**

Plan sponsors face myriad concerns: rising interest rates, punishing return targets, liquidity issues and sovereign risk. But bond investments remain the successful backbone of most pension portfolios BY SONYA RUSHTON

The International Opportunity **8**

Like the move to international equities in decades past, U.S. plan sponsors are heeding the siren song of global and emerging market debt

The Long End **12**

With many plan sponsors hoping to increase their allocations to long-duration bonds, will there be enough supply?



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The State of the Fixed-Income World

Plan sponsors face myriad concerns: rising interest rates, punishing return targets, liquidity issues and sovereign risk. But bond investments remain the successful backbone of most pension portfolios

BY SONYA RUSHTON

Since the financial markets crash in 2008, fixed-income investing has been a beacon of light for most pension plan investors. Even in the times of greatest gloom, opportunities were available to pocket returns and mitigate some of the pain. Yet the market turmoil also highlighted some serious issues, such as the risks associated with evaporating liquidity and active management that fell short of expectations.

Many plan sponsors have spent time considering the risks associated with their fixed-income portfolios — alongside all their other allocations. But now some other concerns are rising to the fore. “The greatest concern is the current interest rate environment,” says David R. Wilson, Managing Director, Liability Driven Investing, at Cutwater Asset Management. “While it is true that rates are low, the yield curve is also historically steep. Given unprecedented stimulus, a ballooning budget deficit and increased economic activity, we are positioning for a ‘bear-flattening scenario.’ In this scenario short and intermediate rates rise more than long rates.”

More pension plans are considering their assets in the context of their liabilities. “Most of our clients are looking to reduce the surplus volatility of the pension plan by adding more fixed income to the asset mix,” says Nanette Abuhoff, Vice President and Director, Fixed Income Product Management, Wellington Management Company. “But they are also focused on performance. Since many plans are still judged on the performance of their assets, higher rates are a concern. We hear many people saying they want to explore LDI, but are afraid of when rates go higher. They are looking for a better entry point. We say it is very difficult to time this decision. We had the same conversation in early 2010 and what happened? Rates headed down until November!”

The move to lower the equity component of pension portfolios is on the minds of many plan sponsors as they consider very carefully the huge proportion of overall risk associated with large equity portfolios. “If rates are going up and you are trying to de-risk, the timing of the rebalancing in order to lock in the most attractive yields is important — and difficult to accomplish. They are deferring the decision to shift the equity allocation into fixed income,” says Gordon

Ross, Director and Senior Portfolio Manager at DB Advisors.

Equity investors rattled

Although memories are short in the investing world, they aren’t that short. “The volatility of equities during the past few years, as well as a lost decade of returns for equity investors has forced many plans to rethink their dependence on stocks,” says Cutwater’s Wilson. “Think about the past 10 years: the tech bust of 2000, the corporate governance crisis of 2002, two recessions (including the Great Recession), combined with increased geopolitical events and increased regulation — all have been bad for equity investors. All of the above have left equity investors rattled. Many plans now see the value of a lower-volatility approach by increasing their allocations to fixed income.”

Balancing the need for returns, particularly when funding gaps still exist, against the need to reduce risk perplexes most pension plan sponsors. “The search for income and return is difficult when 10-year bonds are paying 3½%,” says Wellington’s Abuhoff. “Corporate plans are more liability driven, to the extent that their funding gaps have improved. Typical funded levels are 75% to 80% at the moment. But for public plans, it’s more complicated. They are facing budget gaps and are still facing return targets of 8% in a 3½% fixed income world. If they lower the discount rate, their liabilities will go up and they still need to earn outside returns to close the funding gaps.”

Trying to solve the risk-return paradox in fixed income has sent many plan sponsors squarely into the passive investment camp. It’s not surprising in one sense, as many plans experienced bad performance during 2008 and 2009 from their active managers. This realignment, however, is taking several forms. “Low rates and low prospective returns concern people,” says Christopher Gagnier, Head of U.S. Fixed Income at Aberdeen Asset Management. “In trying to be more creative with their bond portfolios, we see plan sponsors considering a couple of divergent trends. Some plans are being reactive. After seeing poor performance in 2007 and 2008, they are converting their core or core-plus mandates to passive indexes. Others are making changes as well, but mov-

ing in the other direction to more of a core-satellite approach. This approach, they feel, allows them to gain a better handle on the overall risk of the portfolio.”

Not all observers think the move to passive will accomplish what plan sponsors expect. “In the past few years, plan sponsors have migrated into passive portfolios,” says Gibson Smith, Co-Chief Investment Officer and Co-Portfolio Manager at Janus. “We would like to raise a big question about the risk metrics associated with being passive, as we see a number of unintended consequences. The first revolves around the construction of the index. Because of the changes in the market, the index is constructed from more securities — agencies and mortgages — that have a high sensitivity to interest rates. The duration of the index has also extended. The Barclays Capital U.S. Aggregate Bond Index has moved from a duration of 3.7 years in the past 12 months to 4.8 years. We are not at all sure that investors understand these changes.”

Less credit-sensitive

Some managers advocate a more selective approach to the passive vs. active debate, and evidence suggests it reflects the reality for most plan sponsors. “One approach to fixed-income investing involves disaggregation of the index, where plan sponsors are becoming much more specific in thinking about managers and picking experts in asset classes,” says Wellington’s Abuhoff. “A plan that might have had a core-plus strategy that picked up high yield and emerging markets through a generalist manager is now moving to hire specialists. Now they will leave basic governments and mortgage-backed securities — those that are less credit-sensitive — to generalist managers.”

The idea can extend across the investment spectrum. “We are seeing plans wanting specialist managers even for investment-grade credit because of the ability to sector allocate,” says Janus’ Smith. “As a manager is seeking to manage the position around and against the direction of interest rates, security selection becomes ever more important and a key driver of returns.”

Also gaining traction are the ideas of absolute or total-return investing. Capital protection resonates with plan sponsors. “There was a big move in 2008 away from benchmark-based investing to absolute or total-return performance,” says DB Advisors’ Ross. “This focus comes from the fact that if your manager beat the benchmark in a year when the index was down 12%, you still lost money.”

But like most investing approaches, it pays to do your due diligence. “Absolute return is a mindset shift,” says Wellington’s Abuhoff. “You need to know if it truly performs in all markets and therefore is better than just beta. For plan sponsors, the key is to invest in absolute-return strategies that are truly absolute return.”

“We also see plan sponsors adjusting mandates to allow managers to go long and short,” says DB Advisors’ Ross. “This is an area they need to consider

more seriously in a time of low rates. What it means is, don’t lose money. Plan sponsors are adopting long-short mandates in both relative and absolute-return terms and allowing specialist managers to make tactical decisions. The success of those mandates will teach plan sponsors a lot.”

More discretion

Plan sponsors are also taking a more opportunistic approach to writing fixed-income mandates. “As liquidity dried up during the financial turmoil, the fixed income market suffered the most and that affected pricing,” says Brian Birnbaum, Partner at Mercer. “Those in core and core plus strategies were somewhat constrained. Those with more flexible mandates were able to adjust and take more advantage of the situation. The breaking down of restrictions around core-plus mandates is continuing, as plan sponsors are allowing managers more discretion to move away from the index.”

In times of market turmoil, however, passive management can shine. “We do see a general expansion in unconstrained, go-anywhere mandates to capture the return opportunities in fixed income while limiting duration in the current environment,” says Aberdeen’s Gagnier.

Truly opportunistic investment mandates reflect a reality that became apparent during the last financial crisis. A pension plan investment committee consisting of individuals with limited time to devote to pension issues and that meets quarterly simply can’t keep up with today’s volatile investment markets. “Some pension plans are asking investment managers for their best ideas,” says Cutwater’s Wilson. “This is a reflection of the underfunded status of many plans and the

MANY PLANS NOW SEE THE VALUE OF A LOWER-VOLATILITY APPROACH BY INCREASING THEIR ALLOCATIONS TO FIXED INCOME

need to generate higher returns. Plan sponsors are giving managers more flexibility with their investment decisions with the hope they can be more nimble and take advantage of market opportunities.”

An opportunistic mandate can raise governance issues for plan sponsors, and because these can take time to resolve, larger, first-mover type plans have been more likely to go down this road. “More sophisticated plans often have the governance wherewithal, experience and ability to manage many relationships

continued on page 6

continued from page 5

that allow them more freedom to choose and flexibility to move quickly. This kind of a structure allows them to invest in a wide variety of fixed-income areas," says DB Advisors' Ross.

Risk management across the investment portfolio and specifically in fixed income is a high priority for plans. "We are seeing clients re-evaluating the way that they allocate capital, assessing their risk tolerances and rewriting parameters and guidelines," says Janus' Smith. "One of the key elements to understand is the basic inefficiency of indexes and therefore developing agnostic mandates."

Tail risk management

"Since 2008 investors have been questioning the risk-management capability of asset managers to focus on downside protection," says Janus' Smith. "There's been a drive toward yield and a lack of variation in returns. What plan sponsors need to do, rather than

are focusing on downside risk management and tail risk management," says Wellington's Abuhoff. "After two horrendous equity downturns in 10 years, there's a recognition that this will probably happen again at some point. Plans are drawing up a tail-risk profile and looking to buy an insurance policy. We have clients looking to buy protection by buying CDS on companies in the S&P500, instead of simply buying protection on the S&P500 directly."

Alongside rising rates lurks the risk of inflation spiking up. "Plan sponsors are more sensitive to real returns, though probably less in the U.S., at least for those plans that don't have any inflation indexing," says DB Advisors' Ross. "But nevertheless a decade of unexpected inflation will dilute the real returns."

It's interesting, though, that inflation seems to be provoking all talk and no action. "We hear a lot of conversation about inflation protection strategies," says Mercer's Birnbaum. "With unemployment at 9% it is unlikely that inflation will be a problem in intermediate term. So there's not much implementation of any inflation protection strategies. That said, many institutions see that they have implicit inflation protection from their investments in equity markets and real estate."

"We are seeing people considering inflation protection," says Janus' Smith. "TIPS are not a universal solution because of their inherent interest-rate sensitivity. But plans are using a number of different approaches including emerging-market debt and emerging local debt, short-duration instruments, real estate and commodities. It depends on the situation of the sponsor."


For those that do want inflation protection for whatever reason, the solutions are available.

"We see more plans implementing strategies synthetically where there is not a perfect physical match, particularly inflation-protection strategies — as, say, an inflation swap overlay," says DB Advisors' Ross.

Credit plays have been a bright area of the bond market in the last few years, but some think the trend's days are numbered. "Credit will continue to be an area of opportunity," says DB Advisors' Ross. "Although credit spreads aren't where they were, 2008 showed how volatile credits can be. The correct approach is for plan sponsors to embrace this volatility because it gives positive risk-adjusted returns."

The opportunity extends down the credit spectrum. "Many people think the high-yield trade is over," says Wellington's Abuhoff. "We don't. We are having interesting conversations with people about using high yield as a substitute for equity. It provides equity-like returns with more downside protection. It's a another way of thinking about fixed income as a diversifier."

And for the biggest question on investor's minds? "What happens if now is the end of the bull market for bonds?" says DB Advisors' Ross. "You need to shorten duration, give your managers more leeway and consider your risk reporting strategy." ■



WHAT HAPPENS IF NOW IS THE END OF THE BULL MARKET FOR BONDS? YOU NEED TO SHORTEN DURATION, GIVE YOUR MANAGERS MORE LEEWAY AND CONSIDER YOUR RISK REPORTING STRATEGY

react by moving into a passive mode, is to understand what the active fixed-income manager is doing, what their risk-management system is, recognize when the manager is deviating from its process."

Plan sponsors also need to understand their own risk tolerance and goals in order to work effectively with managers. "The experience in 2008 made plan sponsors want to know what the risks really are," says DB Advisors' Ross. "Although fixed income is at the lower-risk end of the spectrum, it was still volatile and liquidity did dry up, so plan sponsors want to know where the risks are. Plan sponsors are looking for advisors and managers that have the ability, the size, the investment process to maintain very tight control over indigenous risks. But at the outset, you need to know what the plan sponsor wants so you can be sure to do it. Is the goal cash flow or duration matching?"

Plan sponsors remain gun-shy. The move toward absolute-return strategies reflects a desire not to lose money. Asset managers are developing strategies that address this risk directly. "Plan sponsors

The International Opportunity

Like the move to international equities in decades past, U.S. plan sponsors are heeding the siren song of global and emerging market debt

It seems that in the great search for bond performance, U.S. pension plan investors have nowhere to go except international. And not just to the developed markets outside the borders, but into the challenging world of global and emerging market debt. It's not all plans that feel comfortable making the move. "There is a division between those plans that will go global and invest in currency, and those that stay in the U.S.," says Gordon Ross, Director and Senior Portfolio Manager at DB Advisors. "What is attractive internationally is that interest rates are rising at different times in different countries, which provides some protection."

Even for those plans that might have been loath to consider this asset class in the past, the arguments are becoming more compelling. "Typically, mature plans end up in fixed income, considering it a conservative asset class," Ross says. "We would suggest looking at the asset class more creatively by making space for unhedged international fixed income investments and active currency management. We can prove statistically that emerging market debt provides diversification with lower volatility and higher alpha."

The experience that plans have garnered from the international component of larger mandates is paying off. "We are seeing an increased acceptance of global bonds on a stand-alone basis, not just as the 10% to 15% of a core-plus mandate," says Brian Birnbaum, Partner at Mercer Investment Consulting. "Dedicated mandates in emerging markets offer a better credit story and opportunity set."

New school

It still isn't a widespread phenomenon, though. "The more sophisticated the plan, the more likely they are to have a significant allocation to international bonds," says DB Advisors' Ross. "Some Silicon Valley companies are very adventurous, for instance. So there is a bit of old school, new school."

In terms of trends and movements of money, more mandates are being written for international and emerging market bonds because of the capacity for enhanced returns and a perceived lowering of risk, at least in comparison to other markets. Managers see a high degree of interest in emerging market bonds as a source of yield enhancement, lower correlations and diversification vs. developed market debt.

The growth argument, long understood in relation to equities, is also a powerful incentive. "We see a shift from broad market U.S. core and core-plus to global fixed income," says Nanette Abuhoff, Vice President and Director, Fixed Income Product Management, at Wellington Management Company LLP. "I think it's not unlike the shift to international equity.

We are seeing more interest in emerging markets because of the belief that the engine of future growth is there for the next 10 to 20 years."

At least neutral

But emerging market debt isn't your risk-free asset class. "There are risks in emerging-market bonds," says Kevin Daly, Portfolio Manager, Emerging Market Debt, at Aberdeen Asset Management. "If U.S. Treasury yields rise, this will erode the return on emerging-market debt. It is an area for long-term investment. Investors should have exposure, though, at least on a neutral basis, and more likely on an overweight basis."

The last few years have seen a reconsideration of the relative riskiness of sovereign borrowers. As demonstrated by the experience of several European Union countries in the past year, creditworthiness cannot be taken as a given. "What we've seen recently is that sovereign borrowers are in fact no different than credit borrowers and should be analyzed as such," says DB Advisors' Ross. "There is a value/price balance, which, provided this is analyzed correctly, should mean that the value is reflected in the price."

"Pension plans are concerned that sovereign risk is the next subprime crisis," says Wellington's Abuhoff. "This fear ebbs and flows. It was at its height in May 2010 when Greece was downgraded and again in November 2010 when Ireland required a bailout. These fears have now subsided. But the jury is still out. Funding rates are high. There are worries about the contagion effect if there is another issue. Investors are waiting for the EU summit at the end of March and expecting some new calming measures."

An underweight

The shakiness of some developed economies has energized the argument for emerging market debt. Investors have long had a toe in the water here, investing primarily in hard-currency denominated sovereign debt. But investors are seeing success in local currency-denominated debt as well, and in corporate - not just government - bonds. "U.S. investors are underweight emerging market debt in their fixed income portfolios," says Aberdeen's Daly. "According to a recent study, public and private pension funds in the U.S. have \$6 trillion of market value in bonds, with only 1% of that in emerging-market debt. Emerging-market bonds make up 6% of government bonds worldwide. So by any standard, that's an underweight."

Changes in market structure, the underlying economics and political stability also play roles in the attractiveness of the sector. "Local-currency emerging

continued on page 10



continued from page 8

market debt no longer looks as risky as it did," says Mercer's Birnbaum. "Emerging markets have better demographics and a better GDP story than the U.S. and Europe. Historically these economies were marked by runaway inflation and closed markets, but now we are seeing something of a global rebalancing. Active managers are seeking more discretion to move into these emerging markets."

The argument between hard currency and local currency emerging market debt is swinging toward local currency. "Emerging local debt performs better than external dollar-denominated emerging market debt, and it's becoming more popular because it is less interest-rate sensitive," says Wellington's Abuhoff.

Not created equal

But it pays to hire a manager with experience for any international exposure. "We are seeing a lot of interest in emerging market debt," says Jesse L. Fogarty, Managing Director at Cutwater Asset Management. "Market participants are seeing relative value in the developing world vs. developed countries. In addition to yield pickup, investors are comforted with the additional benefits of diversification and low correlation compared to their existing portfolios. While we do see value in emerging market debt, we caution investors to approach this market carefully, meaning it is paramount that pension plans work with asset managers with extensive experience and a strong track record in the emerging market space. Cutwater has partnered with an emerging market specialist, Tandem Global Partners to launch a strategy that will combine a dynamically managed portfolio of emerging market debt and core plus."

Knowledge of international markets is paramount. "Not all emerging markets are created equal," says Aberdeen's Daly. "Many are closing in on investment grade, such as Turkey and Indonesia, where 100% of the local currency index will be investment grade within 12 to 15 months."

"In an inflationary environment, investors need to reduce duration exposure to minimize the impact of rising rates," says Aberdeen's Daly. "Another risk for investors in local currency debt is central banks falling behind the curve, which resulted in a big sell-off in Indonesia in January. But Indonesian bonds posted strong gains when the central bank raised rates 25 basis points in February."

"Hard currency emerging market debt is not dead," says Aberdeen's Daly. "Pension funds are using either a 50/50 hard currency/local currency benchmark or an all local currency benchmark. There's a higher yield in local currency if you look at the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM). It has a 7% yield, which is 1% higher than the hard currency J.P. Morgan Emerging Bond Index (EMBI). In local currency, investors reap the benefits of medium- to longer-term currency appreciation, growth and demographic factors. For those pension plans denominated in dollars, the risk of a potential dollar event could be offset with a posi-

tion in emerging currencies."

Emerging markets are interesting, but not without risk. "Inflation could hurt in the short term and could definitely cause a hiccup in those markets," says Wellington's Abuhoff. "The currencies will need to appreciate as well. In their search for return, clients are looking for more flexibility and the interest in emerging market debt has shifted to local currency debt for the rate exposure, the currency exposure and even corporate emerging market debt."

Emerging market corporate debt is another area that is opening up as issuance grows. "We have seen strong performance in emerging-market debt over the last 10 years," says Gibson Smith, Co-Chief Investment Officer and Co-Portfolio Manager at Janus. "The risk premia in emerging market debt are now tighter than in U.S. corporate debt, though, so there's some re-evaluation taking place. We will see more focus on emerging-market corporate debt in the next few years."

Aberdeen's Daly concurs: "Emerging-market corporate debt is also looking favorable. Issuance is rising: in 2010 there was \$150 billion of corporate issuance and \$36 billion in January alone. Over the past five years, there has been \$500 million of emerging-market corporate debt, which is twice the rate of issuance of government debt in this sector. This area has a dedicated investor base as well, benchmarked to the J.P. Morgan Corporate Emerging-Market Bond Index (CEMBI). Investors are gaining exposure to a higher growth, lower leverage part of the market."

Scope and space

"Spreads in emerging-markets corporate bonds are attractive relative to U.S. corporate and high-yield bonds and very attractive when compared to emerging market sovereign bonds," says Aberdeen's Daly. "We expect to see more opportunities in this area in the future as sectors develop."

Alongside interest in corporate emerging market debt, explorers in the international debt arena are considering the possibility of investing in the related currency as a separate asset class. "Internationally, we've seen plans investing in emerging market debt, both local and hard currency debt," says DB Advisors' Ross. "It's an underutilized asset class. There is scope and space to allocate additional assets to emerging market debt. Why? It provides diversification. Because of the growth prospects, investors are likely to get absolute returns. And some investors are treating currency as a separate asset class, after a long time of just investing in emerging market debt when fully hedged."

"We are also seeing more interest in currencies as an asset class, as a feature of this global rebalancing. Emerging market currencies are appreciating relative to developed market currencies," says Mercer's Birnbaum. "Because of the low level of rates in developed markets, low growth, fiscal problems and a likely period of inflation in at least the medium term, investors are looking outside to non-dollar denominated currencies for return." ■



INVESTORS ARE COMFORTED WITH THE ADDITIONAL BENEFITS OF DIVERSIFICATION AND LOW CORRELATION IN EMERGING MARKET DEBT

The Long End

With many plan sponsors hoping to increase their allocations to long-duration bonds, will there be enough supply?

In the pension plan world, liability driven investing (LDI) has become the accepted route to plan security. So it's no wonder that plan sponsors are looking for ways to enter into liability matching strategies, embracing longer duration fixed income portfolios and generally raising their overall allocations to fixed income.

But thanks to a confluence of factors, the move to LDI hasn't always been smooth. Understanding the principles behind LDI, working with the investment committee to buy into the strategy, and analyzing the liabilities to understand what to do with the assets – many plans have accomplished these steps. But few plans have actually implemented the longer duration portfolio that matches liabilities, which is the goal of the exercise.

to add alpha in long-duration bonds and a problem in risk concentration in terms of issuers. The long end doesn't have mortgages, asset-backed or commercial mortgages, and there's a lot less sectoral diversification. Even in the corporate sector, there's less individual diversification. It's mainly chunky large issuers."

Less supply

But pension investors are still looking at the cash markets. "Net credit supply is going down," says Nanette Abuhoff, Vice President and Director, Fixed Income Product Management at Wellington Management Company. "It's about one-quarter of what it was in 2006. That said, our investors are looking at the primary markets as their best source of liquidity for im-



The reason? Low interest rates, poor equity performance at times and underfunding all contribute to the lack of progress. But, interestingly, another issue may become more troublesome: the lack of supply at the long end of the yield curve.

Implementation of LDI ground to halt during the financial crisis and has been somewhat anemic since, with rates staying low. But that seems to be changing. "We have recently seen interest in longer duration mandates pick up, partly because long rates backed up," says Christopher Gagnier, Head of U.S. Fixed Income at Aberdeen Asset Management. "It's fits and starts. Only 11% of plan sponsors have durations in their bond portfolios out beyond 10 years, so there is room to move. There are problems though – not enough supply, and the cash benchmarks are chunky and not very efficient. There can be a limited ability

plementing credit-related strategies such as LDI and using a mixture of cash, swaps and futures to get the duration our clients need. We haven't seen a big shift to swaps or synthetics. In fact, many clients have actually moved to more physicals given that long-dated swap rates got so expensive last year. We are still funding LDI mandates in the cash markets."

The question of implementation has several facets. "There is certainly a finite supply of cash bonds with which to extend duration," says Brian Birnbaum, Partner at Mercer Investment Consulting. "But there aren't the restrictions on the use of derivatives that there were 10 years ago. However, implementing a longer duration bond strategy synthetically provides its own challenges. So the supply issue in the cash market can present problems for folks."

continued on page 14

continued from page 12

“There will be enough supply for LDI, but not necessarily in cash instruments,” says Gordon Ross, Director and Senior Portfolio Manager at DB Advisors. “When thinking about implementing these strategies synthetically, you need to consider the quality and liquidity of the counterparty. The swap market is becoming more regulated, and I would make the argument that it is less risky than the debt of Ireland and Greece. There is demand for different synthetic solutions from managers, particularly those that are able to educate plan sponsors and their investment committees.”


“It is possible to lengthen duration synthetically, but there is significant basis risk with long swaps relative to a high quality corporate discount rate,” says Aberdeen’s Gagnier. “Swaps based strategies outperformed significantly in 2008, and plan sponsors have been trending back to a cash benchmark for long duration. It’s a big challenge.”

Milestone plan

Other challenges to LDI implementation center on timing. “The Cutwater LDI team recommends that its pension clients and prospective clients adopt a mile-

extent offset the loss in long-duration bonds. But they are still thinking about how to handle the potential rise in long-term rates.”

Managers are developing methods to help plan sponsors with this issue. “The technical picture for both the intermediate and long end for investment-grade spread product will be supported by demand from traditional investors and be further pressured as plan sponsors increase allocations to fixed income,” says Jesse L. Fogarty, Managing Director at Cutwater. “Intermediate corporates are seeing increased buying as a result of negative net supply in structured products (MBS, ABS, CMBS & CLOs). While we do not foresee asset-backed issuance returning to the record issuance of the 2006-2007 boom, we do see an eventual increase in supply as the markets continue to recover and the shadow banking system reinvents itself. This should alleviate some of the pressure on corporates brought in from the crossover buyer base. The long end of the curve has always been challenging and has gotten more difficult over the years as the universe of high-quality issuers has become smaller. During 2009-2010, Cutwater was able to take advantage of the Build America Bond (BAB) program, where we were able to leverage our



WE’VE ALWAYS ADDED MUNICIPAL BONDS TO LONG CREDIT AS A WAY TO REDUCE RISK AND INCREASE RETURN. IT DOES INCREASE TRACKING ERROR, BUT HELPS PLANS ACCESS MORE DIVERSITY

stone plan that will take effect over several years,” says David R. Wilson, Managing Director, Liability Driven Investing at Cutwater Asset Management. “As funded status improves and contributions are made over time, we recommend that pension plans allocate more to long duration fixed income investments that are correlated to the way liabilities are discounted. The fact that this milestone plan would be executed over several years mitigates the risk of allocation to fixed income in one-rate environment.”

Rising rates remain the thorniest issue for plan sponsors. “The greatest concern for plan sponsors is the future direction of rates in the U.S.,” says Mercer’s Birnbaum. “Most corporate plans have embraced LDI and are now invested farther out the yield curve. Rising rates will mean lower liabilities, which will to some

municipal credit expertise and further diversify our LDI portfolios.”

Diversification can be difficult at the long end, but it is not impossible. “One solution is to look to the municipal sector,” says Aberdeen’s Gagnier. “We’ve always added munis to long credit as a way to reduce credit risk and increase return. Although it does increase tracking error for pension plans that are looking at a high-quality corporate benchmark, it helps plans access a larger opportunity set while maintaining high credit quality. Of course, careful issuer selection based on fundamental credit research is very important in the municipal market. We’ve also been looking at ways to limit the downside risk, including constraining issuer size and requiring a certain level of diversification.” ■

