



## **An LDI Approach to Funded Status and Contributions**

Interview with David R. Wilson, CFA

Cutwater Asset Management

**The goal of a LDI strategy is to minimize funded ratio volatility and contribution volatility while achieving the objective of meeting all plan obligations. David R. Wilson, CFA at Cutwater Asset Management joins Finance IQ to discuss how an LDI approach provides stability and predictability, what approach corporate and public plans should take, and how to blend this approach with an existing growth strategy.**

**Finance IQ: Define for us how an LDI approach provides stability and predictability to funded status and contributions**

David Wilson: The goal of a LDI strategy is to minimize funded ratio volatility and contribution volatility while achieving the objective of meeting all plan obligations. A LDI portfolio is generally comprised of fixed income securities that seek to cash flow match asset maturities with liability payments, as well as liability duration on an overall and partial basis (i.e. at all points on the yield curve). The portfolio is heavily weighted to the corporate sector to be better correlated with corporate plan discounting practices. The portfolio also invests in very high quality structured assets on the short end of the curve to maintain diversification and provide a better cash flow match against the liabilities. Generally, we recommend a portfolio that is high-quality and minimizes credit risk and cash flow prepayment / extension risk.

There has been much discussion over when and how to implement a LDI strategy. We strongly recommend developing a “milestone plan” that is designed to transition the portfolio from a highly volatile growth strategy to a low-volatility fixed income approach over time in a disciplined fashion. One way to accomplish this is based on funded ratio milestones. The milestones should be customized for each plan and can be quantified by running stochastic simulations to determine an efficient de-risking path based upon the plan’s ultimate risk tolerance and objectives.

**Finance IQ: What are the differences between how corporate and public plans should take an LDI approach.**

David Wilson: For corporate plans, we recommend a more traditional LDI approach, where the portfolio is almost completely allocated to fixed income securities that seek to cash flow and duration match the liabilities. This will most likely result in a long

duration, corporate-centric allocation that will serve as a hedge to the liability discounting methodology. Despite not having the same mandated liability discounting methodology as corporate plans, LDI is still relevant for public plans because they must still invest capital to meet future liabilities.

However, given that many public plans across the country are significantly underfunded, and a “traditional” LDI strategy effectively guarantees an extremely high level of contributions, we developed an alternative approach, the Cutwater Rolling Immunization Strategy. The Cutwater Rolling Immunization Strategy is designed to immunize a defined horizon of plan payments on a rolling basis with a high-quality, cash matched fixed income portfolio. The strategy and time horizon should be customized based on the unique circumstances of each plan. For example, a plan would initially invest in a fixed income portfolio sufficient to meet the next five years of plan payments. As each year passes, the plan would immunize the fifth year to ensure that the subsequent five years of plan obligations are covered at all times. This strategy offers significant benefits to public plan sponsors, mainly by extending the plan’s time horizon to be able to withstand near-term volatility that may come with equity and alternative growth strategies and allowing time for these strategies to produce the returns required to improve the plan’s funded ratio.

**Finance IQ: Why are growth strategies particularly dangerous right now, and can LDI blend into an existing growth strategy**

David Wilson: Defined benefit plan are exposed to significant funded ratio and contribution volatility using a traditional equity-centric allocation. Equities have exhibited periods of extremely high volatility over the past 20 years, most notably during the recession of the early 1990’s, the Russian default and LTCM collapse in 1998, the tech bubble bursting in 2000, the terrorist attacks and recession in 2001, the corporate governance crisis in 2002, the global financial crisis and resulting Great Recession in 2008 - 2009, and most recently, the U.S. debt crisis of 2011.

**Finance IQ: Talk about the differences in regulatory considerations and how discount liabilities factor in**

David Wilson: The Pension Protection Act of 1996 requires corporate plans to use a double-A corporate curve to discount their liabilities. This discounting methodology has caused many plans to rebalance the investment portfolio to long duration corporate bonds in order to increase the correlation between the asset and liability valuations, therefore reducing funded status and contribution volatility.

Public plans use an assumed rate of return for discounting their liabilities (about 8% on average), which is the subject of much debate. The current practice of using an assumed rate of return on investments to discount future plan payments is misguided for several reasons, such as there is no recent historical support to justify an 8% discount rate. In

fact, the average public plan investment portfolio has returned just over 6% over the past 20 years. Additionally, applying an assumed rate of return on investments is inappropriate for the portion of the liabilities that are unfunded. Many have argued for reform on this topic, but the solutions seem to be all over the map and most recently GASB has proposed legislation that discounting the funded portion of the liabilities at an assumed rate of return on the investment portfolio and discounting the unfunded portion of the liabilities using a double-A rated municipal curve.

*David is a speaker at the upcoming IQPC Pension Risk Management Forum, October 31 to November 2, 2011 in New York City. For more information or to register, visit [www.pensionplansummit.com](http://www.pensionplansummit.com) or email [info@iqpc.com](mailto:info@iqpc.com).*

