Working together: Absolute returns and LDI

Jonathan Smith explores the options for additional returns alongside LDI

'Absolute return' investing encompasses a wide range of strategies and there are many potential roles they can play with a view to delivering a defined outcome. In this article, we take a closer look at their potential application alongside Liability Driven Investment (LDI) and argue that an appropriately managed absolute return bond fund may offer scope for additional returns whilst meeting other important considerations.

Options for released cash

A key benefit of LDI is the ability to achieve more than £1 of coverage per £1 invested. This presents trustees with a nice problem to have: what to do with the released cash? Trustees have three options:

1) Keep the cash as an additional buffer to meet future LDI rebalancing calls
2) Use the cash to support more LDI coverage
3) Invest the cash in a strategy to increase expected return (illustrated below)

For option 3) the strategy selected to enhance returns should meet two criteria: firstly, it should offer an attractive return over cash. Secondly, and crucially, the strategy selected should not compromise the main objective of the matching strategy – to manage funding level risk. This means not introducing unwanted funding level volatility in the search for additional returns. The strategy will also need to be a suitable source of cash for when the LDI requires rebalancing. This means it should be sufficiently liquid and, ideally, have a low correlation with the LDI strategy to avoid the risk of buying high or selling low.

Volatility and liquidity considerations

Based on these criteria, equity based strategies are likely to be ruled out on the basis of introducing too much volatility. Many alternative asset strategies are also likely to be unsuitable due to their lack of liquidity. However, credit and alpha (strategies that seek to generate returns through manager skill) are potentially suitable sources of return. These can typically be found in absolute return bond (ARB) funds.

The ARB strategy selected should be suitably constructed to fit alongside an LDI strategy. Firstly, trustees should ideally look for an ARB strategy with a low duration. The LDI strategy will generally provide the duration that the trustees require. Adding a strategy with material corporate bond duration may mean needing to reduce the LDI allocation in order to maintain the desired level of coverage, whilst at the same time introducing unwanted credit spread duration. Credit spread volatility can be significant and can, in some cases, outweigh the risk reduction benefits of the LDI strategy. This is more likely with longer maturity credit portfolios.

Alpha will generally complement credit in strategies used alongside LDI. Alpha strategies can reduce market cyclicality and improve diversification. They can also reduce the correlation of the strategy with the LDI strategy to reduce market timing risk when rebalancing the LDI portfolio. However the strategy should be diversified and risk controlled. The range of opportunities in fixed income markets (FX, Duration, Issuer/Sector) make fixed income alpha a natural fit for matching strategies, provided the ARB fund is taking full advantage of the opportunity set.

Finally, the ARB strategy selected should have sufficient dealing frequency in order to facilitate timely LDI rebalancing. Selecting an ARB strategy managed by the same provider as the LDI strategy can have governance advantages as the fund manager may be able to manage the LDI rebalancing on the trustees' behalf.

ARB funds are often suitable sources of additional return alongside LDI strategies. However trustees should check that the strategy selected is consistent with the risk management objectives of their LDI strategy. An ARB fund consisting of short duration, diversified global credit, supplemented with diversified fixed income alpha strategies may be such a suitable strategy.

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