Summary
- LDI and CDI strategies are complementary, not binary.
- The majority of DB schemes are now implementing LDI strategies, with CDI use growing.
- Increased inflation should not be a huge issue for well-hedged schemes.

Complementing, not contrasting

Pete Carvill explores how pension schemes can use a mix of LDI and CDI strategies

The challenge for defined benefit (DB) schemes is not to make as much money for their pensionholders as they can, but to ensure that what goes out meets and matches expectations. It is a balance and an aim that takes expertise, knowledge, and experience in order to get right.

Two strategies by which funds have tried to achieve this aim in recent years have been liability-driven investment (LDI) and cashflow-driven investment (CDI).

First, some definitions. Abrdn says of LDI strategies: "These seek to invest in assets that will mirror the interest rate and inflation exposure within the liabilities. They therefore act as a hedge against movements in the liabilities."

Meanwhile, the same company defines its counterpart thus: "A CDI strategy selects assets that provide contractual income to match, as far as possible, the future expected cashflow requirements of the pension scheme. By matching cashflows, the assets are intended to be held to maturity and so provide a greater level of certainty over return."

Who is using these strategies?

Assessing the popularity of both strategies is difficult, but there are some indications as to how they are used across the UK's DB schemes. A recent report from Mercer called *Investing in the Future*, published in 2021, found that the majority of pension schemes in the UK used LDI strategies to hedge liability risk. Mercer found, through its survey of around 460 schemes, that more than 80 per cent of funds with between €50 million and €2.5 billion in assets were using LDI strategies.

This proportion, however, dropped among the smaller schemes. Just over two-thirds of those with fewer than €50 million in assets reported that they implemented LDI strategies. Going up in increments (€50-€100 million, €100-€250 million, €250-€500 million, €500 million-€1 billion, €1-€2.5 billion, and over €2.5 billion of AUM), Mercer found that the percentage of schemes implementing LDI strategies peaked and troughed, going from 67 per cent, to 89 per cent, to 84 per cent, and to 96 per cent between <€50 million and €250-€500 million of AUM, before falling to 86 per cent and 81 per cent, gradually dropping to 72 per cent at the far end of the spectrum.

Legal & General Investment Management (LGIM) reports similar statistics attesting to the popularity of LDI strategies. The company's senior solutions strategy manager, Robert Pace, says: "The average LGIM LDI client was around 80 per cent hedged at 30 September 2021, which is a 3 per cent increase since the end of 2020. Whilst some schemes will still need to play catch up, the majority have made the hard yards already."

He adds: "At the same time, 2021 has been an incredible year for funding levels. LGIM's Funding Level Tracker showed a gain of 84 per cent to 93 per cent over the same time period and that is consistent with industry data from the Pension Protection Fund. This has caused a step change in the demand for CDI strategies, as schemes look to de-risk further by ensuring they hold sufficient contractual cashflow generating assets to pay their liabilities."

Against this, the make up of the country's DB schemes is shifting. Mercer's *Investing in the Future* reports that over three-quarters (76 per cent) of respondents saying that their plans were cashflow negative, meaning that they were paying out more in benefits than was being paid in. This was an increase of 10 percentage points from the previous year. And, as Mercer points out, "of the cashflow-positive schemes, the proportion (93 per cent) expecting to become cashflow negative within the next 10 years has also increased compared to last year".

This is a trend that others have noted. Insight Investment head of solution design, Jos Vermeulen, says that many funds are moving towards CDI strategies due to the wins and gains they have made in their investments in recent years.

Vermeulen says: "More and more are able to lock down the cashflows risk by investing in CDI strategies. That's because of the funding improvement that we've seen over the past few years."

The above may make it sound as if LDI and CDI strategies are a binary in that having one precludes a fund from using another. But those speaking to *Pensions Age* often use the word 'complementary' when describing the pair.

These include Russell Investments head of strategic client solutions, David Rae. He says that it was not a case of choosing one or the other, adding: "They complement each other. LDI, from its beginning about 15 years ago, was about serving as a facilitator to allow pension schemes to hedge interest rate and inflation risks in the right place. It meant that they could go and invest the portfolio in things like equities, corporate bonds and private assets in order to get the returns that needed. It was this kind of balance that has really worked well."

Rae adds: "The way I approach it is to think about what the objective is that you are trying to meet. The typical assets that you'll see in a CDI strategy are things like high-quality corporate bonds and maybe some secure income assets. Those things have interest and inflation sensitivity, which means that they can help support an LDI strategy."

Rising inflation

Recent months have seen inflation surge around the world. While the rule of thumb with most central banks is that inflation should be kept at or near to 2 per cent, reports in recent weeks have seen inflation within the US and Germany rise to 6.8 per cent and 5.2 per cent. And the beginning of December 2021 saw the Bank of England's monetary policy chief, Ben Broadbent, say that he expected inflation within the UK to 'comfortably' top 5 per cent in the first quarter of the year.

Other organisations and figures are warier about prospect of increased inflation. Alpha Real Capital, in November 2021, put out a paper called *Will Inflation Take Off? How Can this Risk Be Managed?*

In this, Alpha Risk Capital wrote: "[…] a significant proportion of pension fund investors (over 70 per cent) see a moderate or high risk that higher levels of inflation may persist in the longer term. Over half of the respondents also said they planned to increase their level of inflation hedging."

Increased inflation has a direct effect on pension funds, whose benefits are often predicated on increases in inflation. "In the UK, a lot of liabilities have inflation protection embedded into them, and it's a concern for schemes that they can ensure that their assets can deliver in times of increased inflation," Rae says.

LGIM head of solutions portfolio management, Guy Whitby-Smith, offers a more detailed take. He says: "For lower-hedged schemes, the recent surge in inflation has highlighted the need to have a strategy that protects against inflation increases. We have seen schemes increasing hedge ratios as a result."

He adds: "But even for the well-hedged schemes, what might previously have been considered to be second-order risks are increasing in comparative importance as funding levels improve. For example, our clients are being much more dynamic with inflation hedging when they look at pension increases linked to Limited Price Indexation. This can actually offer the opportunity to lock in gains by selling hedges when inflation rises and buying them back when inflation reduces."

Vermeulen says that the average pension scheme, having a high hedge ratio, will not have too much of a problem with increased inflation. The pensions industry, getting to this point and to this level of de-risking should, he says, give itself a pat on the back. "If they hadn't de-risked like this," he says, "then this rising inflation would have been a much bigger issue. But that's not been the case because they are so well hedged."

He concludes: "To the extent that inflation and the expectations around it have gone up, their assets have also increased because through LDI strategies, the industry has essentially bought for itself inflation exposure."

Written by Pete Carvill, a freelance journalist