The synergy of CDI and LDI

Jon Exley and Mike Burdett reveal how to unlock greater certainty with a unified investment approach

Introduction

As pension schemes strive to manage risks and plan for endgame, investment strategies like Cashflow-Driven Investment (CDI) and Liability-Driven Investment (LDI) have gained prominence. While CDI focuses on delivering sufficient funds to meet liability cashflows, LDI protects against risks like interest rate and inflation expectations, currency fluctuations, and reinvestment risk. This article explores the crucial interplay between CDI and LDI, emphasising the importance of integrating both strategies. Furthermore, it highlights the benefits of employing a single investment manager to oversee both CDI and LDI, particularly in the context of liquidity management post the Autumn 2022 gilts crisis.

Understanding CDI and LDI

CDI is an investment strategy focused on generating predictable cashflows to meet future pension scheme liabilities. CDI involves investing in mostly high-quality fixed-income assets, such as corporate bonds, that align with a scheme's expected cash flow and return requirements. By delivering returns through high-quality, predictable assets, CDI aims to increase the certainty of a scheme being able to meet their objectives. However, it is not usually possible, or desirable, to perfectly match the liability cashflows of a scheme, and the assets in a CDI portfolio typically have limited inflation linkage, meaning there will usually be a significant level of "unhedged" interest rate and inflation risk. This is where LDI comes into play.

LDI is an investment strategy aimed at mitigating the interest rate and inflation risk inherent in pension scheme liabilities. This is achieved by investing in physical assets and derivatives that mirror the scheme's liability profile, thereby reducing the impact of interest rate movements and inflation on funding levels.

How do CDI and LDI overlap

The overlap between CDI and LDI is important to understand, before considering the most efficient way to construct a solution. There are three factors to consider:

1. Fully-integrated liability risk management: Corporate bonds and other assets with a long duration will provide a significant amount of implicit interest rate hedging. This is beneficial for portfolio efficiency as these assets serve multiple purposes, from return generation to liability hedging. As such, constructing an LDI solution where a scheme adopts a CDI approach means ensuring the CDI assets are taken into account, and the LDI portfolio builds around the CDI assets.

2. Mitigation of broader risks: A CDI strategy will often invest in both Sterling and non-Sterling assets, to ensure sufficient diversification within the strategy. Whilst this makes sense from an investment perspective, it does introduce potentially unwanted risks, such as currency risk and non-Sterling interest rate risk. Hedging these risks is important in delivering certainty of outcome. Much like in LDI, these risks will be managed using derivatives to remove any unwanted exposures.

3. Liquidity management: Meeting pension payments and ensuring total portfolio liquidity are important factors to consider. A CDI portfolio will typically deliver income and over time redemption payments that can be used to pay pension payments. Ensuring there is sufficient liquidity in the broader portfolio to pay pensions and retain sufficient collateral to comfortably support the hedging arrangements remains a key consideration.

An efficient solution demands a fully-integrated approach

The operational and cost efficiencies of using a single manager to deliver an integrated solution outweighs the benefits of having different components with different managers.

1. Total Portfolio Risk Management: With a single investment manager overseeing both CDI and LDI, there is enhanced coordination and integration of risk management activities. This allows for a comprehensive assessment of risks, ensuring that investment decisions consider a scheme's overall objectives and constraints.

2. Cost Efficiency: A unified investment approach can lead to cost efficiencies by streamlining operations and reducing duplication. Consolidating investment management activities reduces administrative complexities, transaction costs, and the need for multiple service providers. This cost-effectiveness enhances the scheme's financial position in the long run.

3. Consistency and Alignment: A single investment manager ensures consistency and alignment of investment decisions. This means a coherent and unified investment strategy across the entire portfolio.

4. Enhanced Reporting and Communication: A single investment manager can deliver consolidated total portfolio reporting. Trustees gain a holistic view of their whole investment strategy, enabling better-informed decision-making.

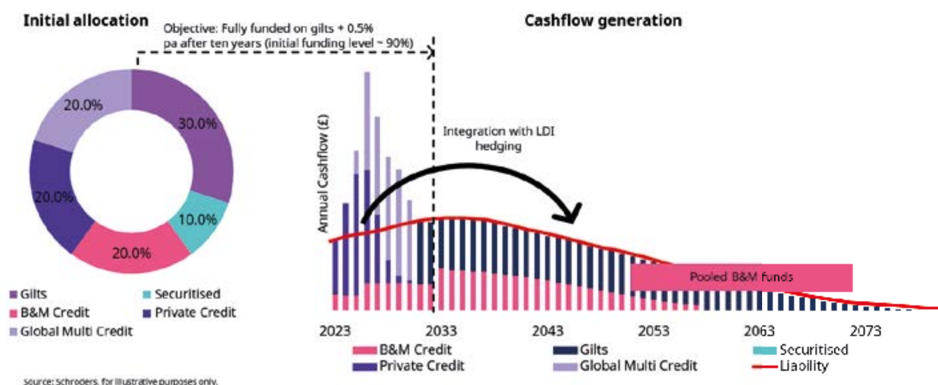
Post gilts crisis

The gilts crisis of Autumn 2022 highlighted the importance of liquidity management for pension schemes. Ensuring sufficient liquidity to meet collateral calls from the LDI portfolio to maintain liability hedging positions became crucial. The need for operational access to liquid assets led to the recognition of the benefits of managing LDI and collateral assets "under one roof."

Having a single investment manager overseeing both CDI and LDI assets offers several advantages in the post-gilts crisis era. It enables easy liquidity management by selling liquid assets and transferring the proceeds to an LDI arrangement managed by the same investment manager by a simple instruction. CDI assets like corporate bonds can also be used to enhance collateral through corporate repurchase agreements with counterparty banks, reducing the need to sell assets in times of market stress.

Considerations for CDI implementation

CDI is most suitable for well-funded pension schemes. A strong funding-level ensures that a suitably diversified portfolio of credit and government bond assets can generate sufficient returns to meet all liability cashflows. For pension schemes with lower funding levels, alternative strategies such as a well-diversified return-seeking portfolio may be more appropriate. However, gradual implementation of a CDI strategy is still possible for schemes, as their funding position improves over time.



Size considerations: Small vs. large pension schemes

Initially, CDI implementation was primarily feasible for larger pension schemes through bespoke, segregated portfolios. However, the availability of pooled vehicles has made CDI more accessible for smaller schemes. Long-dated global investment-grade bond funds, managed on a 'buy and maintain' basis, and pooled LDI funds that provide effective hedges for interest rate and inflation exposures are readily available. These pooled funds, combined strategically, offer CDI solutions for smaller pension schemes.

Conclusion

In conclusion, the synergy of CDI and LDI, coupled with a unified investment approach and a single investment manager, provides pension schemes with the tools to achieve greater certainty, manage risks effectively, and navigate the complexities of the investment landscape. By embracing this integrated approach, trustees can deliver a more robust strategy, focussed on providing security for members in retirement.

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