



Investment comment

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The month's guest columnist is Simon Jagger of Jagger & Associates. Simon raises the topical issue of increasingly ubiquitous liability-driven investment (LDI) strategies, which are continuing their inexorable rise in popularity as trustees seek to remove exposure to 'unrewarded risks'. But are these risks real, and is now the best time to be removing them?

Jagger writes: The tide of mandates going into LDI products can create a herd instinct of trustees thinking, 'surely it must be the thing to do?' 'Of course it is', say some consultants and investment bank product salesmen, some of whom stand to do very nicely in fees out of it all. But is it really the right thing to do, and should the LDI tide reverse?

I'm not arguing that trustees should ignore the liability profile of the institution in constructing an investment strategy - I first built a tailored gilt portfolio to fit a scheme's detailed cash flow requirements 14 years ago, the plainest version of LDI that you can get. However, there is something perverse in people introducing swaps programmes at what may be seen to be a very expensive time.

The key pro-LDI argument seems to be that almost any yearly volatility arising from variation in long-term interest rate and inflation is bad. Now, if real yields started at 2% or more, and then fell to, say, 1% and stayed there, then that move could be painful for some mismatched schemes' funding. Yet real yields on index-linked gilts are already pretty much as low as they have ever been. Similarly, swaps' retail price index (RPI) inflation pricing is strongly above the Bank of England target (even allowing for consumer price index/RPI effects), so it is not obvious that you want to lock in on any of those market conditions. (Just consider what happens to real yields if the UK government continues to issue a lot of long-term index-linked debt as part of its bid for survival.)

Many LDI approaches do not eliminate risks, they simply move them to other areas - for example, the swap route typically requires a return of London interbank offered rate of +3% from the invested assets but, as recent data for several absolute return mandates has shown, this is not always the walk in the park that the salesmen portray. Also, counterparty risk should be watched closely.

So, for those sitting on 'conventional' structures and being encouraged to jump to LDI ones, have a think - can you not improve the house you are in, rather than move to a whole new one?

