

Some commentators have been a little sceptical of the role of liability hedging within pension fund management. We suggest that liability hedging can have a role for most DB pension funds today if instituted in a way consistent with the governance level of those funds.

A photograph of two people sitting at a long table in a modern office, looking out a large window. The scene is dimly lit, with the primary light source being the bright window, creating silhouettes of the individuals. The office has a clean, minimalist aesthetic with a dark floor and recessed ceiling lights.

# Liability hedging

**Why are funds pursuing it?**



### **Liability hedging – a quick reminder**

Liability hedging is the implementation of a strategy with the purpose of explicitly recognising the liabilities in some way. This primarily relates to inflation and interest rate risk, but could be extended into other areas such as mortality risk if suitable markets develop. Liability hedging has a narrower definition than is often applied to the term liability-driven investing (LDI), but the one which we believe to be most useful.

There is currently a spectrum of liability hedging approaches and matching products in the marketplace, from the simple and cheap to implement, to the complex and expensive. At the simple end, clients can adjust the duration of their bond portfolios to be more in line with their liabilities, thus reducing interest rate risk. We then move through tailored bond and swap portfolios targeting particular interest rate or inflation risks. At the complex end, clients can institute full cash flow matching of the liabilities.

### **Upside potential**

The greater availability of long-dated bonds and swaps and more flexibility to use leverage have been key developments in making liability hedging more attractive. Leverage allows fiduciaries to hedge out a large proportion of interest rate and inflation liability-related risks whilst still retaining the exposure to non-matching,

return-seeking assets. More sophisticated matching instruments can often be leveraged, meaning that fiduciaries do not have to allocate all of their assets to such matching arrangements for meaningful matching of these risks to occur. This differs from the past when fiduciaries typically had to choose between matching and value creation. As a result, even funds with a reasonably significant exposure to return-seeking assets may still find matching attractive.

### **Following a liability hedging strategy**

We believe that all clients have the ability to implement liability hedging in some form. There is, however, probably scope for a fund with advanced governance to add more value, in terms of reducing risk at the right price, in this area. This relates to its potential to adopt more precise matching products that are priced attractively.

A number of factors are important for the decision-making process in this regard:

#### **Time horizon of liabilities**

If a fund's liabilities are so far into the future that hedging them is considered simply too expensive or difficult, limited matching and the retention of a high exposure to return-seeking assets may well merit some consideration. A weak covenant or full funding may make limited matching unsuitable even under these circumstances,

however. In addition, if a sponsor chooses not to match, it would need to be aware of the potential balance sheet implications given trends to mark-to-market measurement of liabilities in corporate accounts.

Given that a large proportion of funds are now closed to new members, it seems unlikely that an option that contains no hedging at all will retain much merit into the long term for this reason alone. This is especially the case now that the concept of leverage allows clients both to match and to aim for value creation.

#### **Financial economics**

Financial economics notes that, in risk-adjusted terms at least, an investment in equity cannot create extra value of itself. Any additional return comes packaged with additional risk if instruments are priced efficiently.

This school of thought is reflected in changes taken and taking place in pension accounting and in the corporate funding rules in the US as well. In the US corporate funding rules, liabilities are now assessed using bond rates, removing the prior equity bias of using an expected rate of return without adjusting for risk.

Under this assumption, equity investments within a pension fund create no added value for shareholders. The implication of this view is that pension funds should match their liabilities with bonds. This is also supported by

tax-arbitrage arguments of financial economics.

However, many object to this belief on theoretical grounds; they do not believe that all asset classes, including equities, are efficiently priced all of the time. In turn they believe that a fund's risk-adjusted returns can potentially be enhanced by investing in return-seeking assets. This is often supported by the view that both equities and pension funds share a long time horizon.

#### **The price of hedging instruments**

If all pension funds chose to fully match today, the current issuance of matching securities would substantially undershoot any demand. This would make the price of hedging instruments rise. Arguably the present imbalance between supply and demand has already made hedging assets relatively expensive.

The evidence indicates that this could be a real problem in practice. For example, research has suggested that if all UK pension funds sought to transfer their equity holdings into sterling long-dated fixed income, the likely requirement would be around £515 billion against an outstanding total today of around £300 billion (approximately US\$1,000 billion and US\$600 billion respectively). A subset of these supply/demand issues is the non-availability of matching assets at particular points of the maturity spectrum.

In the US, where accrued pension liabilities are generally not linked with inflation, there is less of a concern. There is a relatively larger market plus it is more likely that any increased demand for matching assets could be met by an increase in supply.

#### **Opportunities for funds**

We believe that funds should explore the array of matching opportunities available to improve investment efficiency at the total fund level. We note that, over time, the supply of fixed income and index-linked securities may well become more tailored to pension fund portfolios. Under these circumstances, the attractiveness of hedging instruments would increase for an even greater number of investors.

