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Shaken, not stirred

Shalin Bhagwan explains how Liability Driven Investment (LDI) strategies are coping with these challenging times

While investing in more risky assets may be rewarded over time, conventional wisdom says that there is no upside for pension fund trustees when it comes to movements in long-term interest rates and long-term inflation expectations.

As a result, a variety of strategies and instruments have been developed to hedge 'unrewarded risks', allowing pension funds to focus on taking risk elsewhere in their investment strategy.

There are a variety of instruments available for hedging interest rate and inflation risk. Broadly, it comes down to a decision between bonds and swaps. However, bond investors have the choice between not only categories of Sterling versus Non-Sterling and fixed interest versus inflation-linked bonds, but also between government and corporate bonds.

Relative value

In choosing between various hedging instruments, market standard methodologies help investors assess the relative value offered by each instrument. One common methodology is to compare the excess yield offered on a bond or swap with yields offered by a comparable investment in the government bond market.

Traditionally, the yield available on a corporate bond has been higher than that on a swap, which in turn has been higher than that on a government bond. These relationships reflected the premium demanded in each type of instrument as compensation for their perceived credit risk. Swaps have inherent credit risk related to the credit worthiness of their manufacturers (the banks) and so are expected to yield more than a government bond. In addition, the banking sector has traditionally displayed lower credit risk than other sectors and so the swap yield premium over government bonds is typically lower than that of 'non-bank' corporate bonds.

Sign of the times

However, many of these conventional relationships have broken down following the fall-out from the banking crisis, forcing pension fund trustees to revisit old paradigms regarding the choice of hedging instrument.

In the latter part of 2008, the yield available in the swap market versus the government bond market turned negative, creating a conundrum for LDI investors.

Ordinarily, this relationship might imply that LDI investors should shun the use of swaps in favour of government bonds. However, trustees should be aware that the use of swaps allows greater flexibility when investing the scheme's underlying assets. Coupled with the perceived cheapness of other asset classes, this means that despite the yield-drag versus government bonds, some trustees continue to hedge using swaps. This allows the opportunity to earn a higher return by investing their underlying assets in high yielding assets – such as corporate bonds.

Corporate bonds and swaps

Long-term buy and hold swap investors have an opportunity to invest the assets underlying their swap hedging programmes in corporate bonds, to earn a return of at least three per cent p.a. above the return locked into on their swap portfolio. Historically, this excess yield has been closer to half a per cent p.a.

Government bonds and swaps

Of course, risk averse investors may not be keen on taking additional credit risk by investing in corporate bonds. In addition, early embracers of LDI strategies, having already executed their swaps and locked into swap yields, are also looking to benefit from the cheapness of government bonds.

For these investors, buying government bonds affords the opportunity to enhance the swap yield already locked into. However, having already matched the duration of their liabilities using swaps, the challenge is one of purchasing the government bond to lock in the yield enhancement above swaps without at the same time being exposed to the liability matching characteristics (the duration) of that bond. In fact, it is possible to buy government bonds with the duration characteristics stripped out. For overseas bonds, it has been possible for clients to lock into the yield enhancement while eliminating both the duration and the currency risk.

Risk premia have never been higher and pension funds are well-placed to take advantage of these market dislocations. Segregated investors have the greatest flexibility in implementing these strategies. That said, some LDI providers offer pooled funds which package the benefits of swaps with those of corporate bonds, making some of these opportunities accessible to smaller investors.

Shalin Bhagwan is derivative structurer at Legal & General Investment Management (LGIM)