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Russell Investments Communiqué

Our perspective on current and emerging investment issues

Best practices for target date funds and managed accounts

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FALL 2017

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Relationships matter. The "human element" we define as the relationship between the client and the provider. While the human element is not easily quantifiable--it's important not to overlook it. This article discusses the three operation levels of our client relationships and how communication and a healthy relationship between the in–house team and the outsource provider is fundamental to success.

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EXECUTIVE VIEW

Nifty nifty – look who's fifty

By: Rachel Carroll, CFA, Managing Director, Consulting

Welcome to the latest issue of *Russell Investments Communiqué* – the fiftieth.

In the first issue, we grandly promised that "we'll tell you what we see in clear, concise, and objective terms. And we'll find out what it means to you. We're simply not doing our job if we stand by and watch."

Not only has much changed since that first issue, but the pace of change has accelerated. Today's investment world is more diverse and more complex than ever. And there is a growing suspicion that the exceptionally low market volatility of the past 18 months may prove to be a lull before a storm.

In this issue, we look at some of the key issues faced by plan sponsors in these uncertain times. Our first article describes a simple diagnostic tool that allows pension plans to gauge their interest rate hedge ratio; the second looks at best practices in target date funds (TDFs); our "opinion" column is devoted the human side of outsourcing (a growing trend among large investors); and the Q&A looks at the current tight credit spread from the perspective of portfolio implementation. The closing *Great Moment in Financial History* is October 27, 1986 and the "Big Bang" deregulation of the UK's financials markets.

We hope that these topics provide not merely food for thought, but also ideas for action: today, as before, we're not doing our job if we stand by and watch.

Thank you for reading,

Rachel Carroll,
Managing Director, Consulting

Rachel Carroll

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INVESTMENT FOCUS

An interest rate hedging diagnostic

By: Bob Collie, FIA, Chief Research Strategist, Americas Institutional and Justin Owens, FSA, CFA, EA, Director, Client Strategy & Research

Bob Collie

Justin Owens

> Choosing an interest rate hedge ratio is much trickier for some plans than it is for others.

One of the biggest strategic decisions faced by defined benefit (DB) pension plans is that of choosing an interest rate hedge ratio; i.e., deciding how much interest rate exposure should be built into the asset portfolio to offset the interest rate exposure in the liabilities. This is never a totally straightforward decision, since it involves a tradeoff between competing objectives. The decision is, however, much trickier for some plans than it is for others.

In this article, we describe a broad diagnostic that helps to identify some of the key pressure points. It's a high-level tool that provides a general assessment rather than a definitive answer; each plan's circumstances are, of course, unique and the final hedging decision should be based on comprehensive asset-liability analysis, not just the high-level framework built into this tool. The diagnostic sets the stage by highlighting what are likely to be the most important considerations given a particular plan's situation.

FOUR KEY CONSIDERATIONS

The diagnostic is based on four key areas of consideration: risk tolerance; funding and accruals; current commitment to liability-driven investment (LDI); and expectations regarding future interest rate movements. These topics are regularly raised in conversations with our clients and are important discussion points for any investment committee to consider.

Let us consider these in turn:

1. Sponsor's ability/willingness to take on risk in the plan

The typical plan sponsor today is somewhat risk-aware; they are able to handle some fluctuation in the funded status of the pension plan, but only up to a point. Not everyone is in the same boat, however. In some cases, pension plan risk is a particularly acute problem. If the plan is, for example, unusually large relative to the sponsoring corporation, then any unwelcome developments in the plan's situation could potentially translate into a significant hit to the sponsor's balance sheet or contribution requirements. In other cases, the sponsor may be relatively well placed to cope with fluctuations in the plan's fortunes, and the potential downside is manageable.

This step in the diagnostic should take into account not only the sponsor's ability to bear interest rate risk in the pension plan, but also their willingness to do so.

2. Strength of funding, adjusted for accruals

The average funded status of pension plans sponsored by U.S.-listed corporations – as of the 2016 financial year end – was roughly 80-85%. As with risk tolerance, however, there is a fair amount of variation around this average number. Some 5-10% of plans are at least 100% funded, while a similar number are below the 70%.

The strength of funding affects interest rate hedging strategy because it is an indicator of the extent to which a plan needs to emphasize the generation of returns (as opposed to the management of risk) in order to achieve its goals. For an underfunded plan, every dollar of return earned represents a dollar less for the sponsor to contribute. But additional returns generated in an already well-funded plan can become trapped there[1], so the attraction of a return-oriented strategy weakens as funded status rises.

For the purposes of our diagnostic, an adjustment should be made for new benefit accruals. That's because the financing of new benefit accruals is another use for investment gains. Therefore, plans with participants accruing new benefits would be less interested in portfolios that decrease expected returns, such as liability-hedging strategies. It's only when all future benefit accruals (as well as past accruals) are fully funded that capital becomes trapped in the plan.

3. Current commitment to LDI

Most DB plans have made some move toward LDI in recent years, either by allocating additional assets to, or increasing the duration of, their bond portfolios. A typical interest rate hedge ratio is now around 40-45%. That is to say, for every $100 increase in liabilities that would occur if interest rates were to fall, there would be a corresponding increase in the value of the fixed income portfolio of around $40 to $45.

Here, too, however, not every plan is typical. Hedge ratios, in practice, can lie anywhere along the spectrum.

4. Expected change in interest rates

The fourth consideration that goes into the diagnostic is an expectation regarding future interest rate movements. A neutral view on interest rate movements is that they will gradually increase over time in line with the forward curve.[2]

The degree of conviction in the view is a relevant factor here. Historically, interest rate movements have been very difficult to consistently forecast with any degree of success. So investors need to weigh not only what they consider the most likely scenario to be, but also the extent to which they wish to embed that view into the strategic hedge ratio decision.

Most DB plans have made some move toward LDI in recent years, either by allocating additional assets to, or increasing the duration of, their bond portfolios.

[1] This is because the return of surplus assets from a pension plan to the sponsor is a complicated process that generally involves a tax penalty.

[2] The reason that rates staying the same is not the neutral position is explained in Collie (2015) "The effect of the term premium in a rising rate environment" Russell Investments Practice Note. As of July 31, 2017, for example, the forward curve implied that the 10-year Treasury yield would increase from 2.30% to 2.48% over the following 12 months, and to 2.77% over a three year period. This is the rate of increase that is, in effect, already priced into the market.

APPLYING THE DIAGNOSTIC

For plans that are approximately "typical" on all four considerations above, there is no obvious need for an immediate change in strategy. Clearly, there are other factors that may lead to a different conclusion, but, for these plans, the diagnostic does not identify any clear pressure points.

To ensure that the strategy remains on track in the future, a liability-responsive asset allocation strategy[3] may be appropriate (i.e., a de-risking glide path that increases the hedge ratio as funded status improves). But what if a plan is not typical in one or more regards?

But what if a plan is not typical in one or more regards?

For plans that fall to the left on one or more of the considerations above, an increase in the interest rate hedge ratio may be appropriate. These are plans that are less able than others to take interest rate risk, have less need to do so, have a larger mismatch between assets and liabilities and/or do not anticipate earning a positive return from taking interest rate risk. That points to a need to close the gap between the interest rate exposure in the assets and the liabilities.

Similarly, plans that fall to the right might consider reducing their hedge ratios. However, the application of the diagnostic is not symmetrical, and it takes more to justify a reduction in hedge ratio than to justify an increase. That's because a moderate or low interest rate hedge ratio already represents a large position, a significant bet that interest rates will rise faster than implied by the forward curve. A high hedge ratio, in contrast, is merely the absence of a bet that interest rates will rise and not (unless the hedge ratio is above 100%) a bet that they will fall.

MORE COMPLEX SITUATIONS

The situation is more complicated when a plan falls to the left side of the chart on one or more considerations, and to the right on others.

Consider, for example, the situation where there is a strong view that interest rates will rise, but the plan is to the left with regard to, for example, strength of funding. In this case, increasing the bet on interest rates most likely *does* not make sense, since the upside from being to the right is constrained by the possibility of trapped capital. If, on the other hand, there is a strong view that interest rates are likely to fall, then it most likely does make sense to consider increasing the interest rate hedge ratio, even if, for example, the plan is significantly underfunded. This is an example of the asymmetry mentioned above.

And other combinations of characteristics may make the decision even more involved. Some combinations allow considerable flexibility in selecting a preferred approach. Others are more problematic. For example, in the case of a poorly funded plan whose sponsor is very sensitive to risk in the pension plan, a point may be reached where it becomes unrealistic to rely on investment strategy alone to achieve the desired result.

In summary, even though the above diagnostic is just a high-level tool, it offers useful pointers as to the key considerations that are likely to drive a plan's choice of interest rate hedge ratio.

[3] See Gannon and Collie (2017) "Liability-responsive asset allocation: Defining the de-risking glide path for defined benefit pension plans" *Russell Investments Viewpoint*.

CLIENT FOCUS

Best practices for target date funds and managed accounts

By: Holly Verdeyen, CEBS, Senior Director, Defined Contribution Strategy and Andrew Scherer, Senior Director, Defined Contribution

Defined contribution (DC) plans are the primary retirement planning vehicle for many American workers, and target date funds (TDFs) are often popular for DC participants who want to leave the management and monitoring of their portfolios to a professional investment manager. This article is designed to help plan sponsors who want to understand the best practices for evaluating and managing target date funds and managed accounts, in order to offer the most beneficial DC plan possible to their employees.

Holly Verdeyen

Andrew Scherer

ALL TARGET DATE FUNDS (TDFs) ARE NOT THE SAME

The passage of the Pension Protection Act in 2006 led to safe harbor status for four types of default investment options in defined contribution plans: target date funds, managed accounts, balanced funds, and capital preservation products. Since then, TDFs have become the dominant qualified default investment alternative (QDIA).[4]

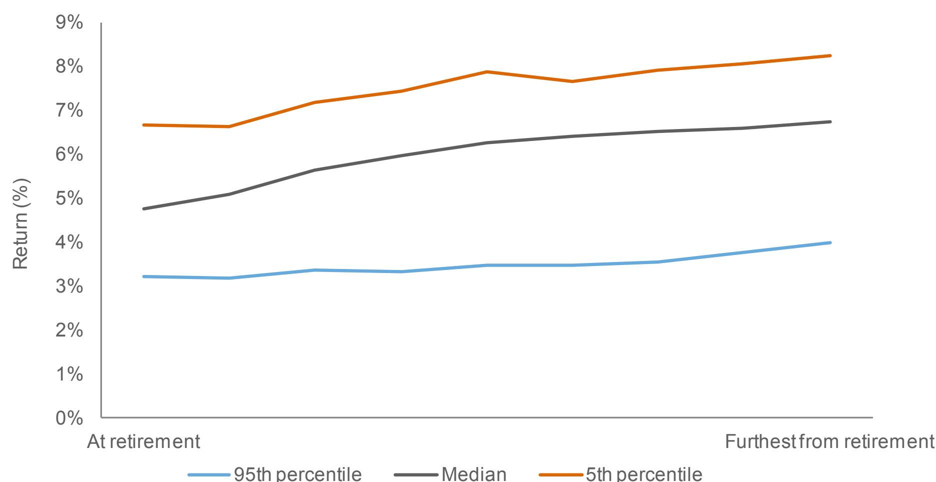
TDFs are popular for participants who want to leave the management and monitoring of their portfolios to a professional investment manager, but all TDFs are not the same. The percentage of growth assets vs. capital preservation assets changes markedly over the life of a TDF in what is known as "the glide path," and glide paths vary widely across TDF providers.

TDFs can be designed for maximum accumulation, downside protection or income replacement in retirement. Depending on the outcome desired, the glide path may maintain a static asset allocation after retirement (remain flat) or continue to de-risk. According to Russell Investments' analysis of 2016 data from Morningstar, the allocation of growth assets at retirement varies by 45 percentage points across TDF providers. The differences in asset allocations can lead to very different outcomes for participants.

The allocation of growth assets at retirement varies by 45 percentage points across TDF providers.

[4] In 2015, TDFs accounted for 97% of QDIA assets. *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data*, Vanguard, 2016. Available online at vanguard.com.

Exhibit 1: Distribution of Morningstar Target Date Universe returns



Source: Morningstar Direct and Russell Investments analysis. Reflects the one-year return of the Morningstar Universe as of 6/30/16. Results not adjusted for survivorship bias.

Regulators made the point that non-proprietary and custom solutions may be viable options for some plans and should be explored.

It is important for plan sponsors to understand plan participant demographics and behaviors and how they compare to glide path assumptions. If plan sponsors determine the levels of risk that make sense for participants at each life stage, then they can answer one of the most important questions about the glide path: How much equity exposure should participants have at the point of retirement?

There is also more to selecting a target date fund than just choosing a glide path. Plan sponsors should review the underlying asset classes and the investment manager's skill and track-record in each, be comfortable with target-date fund's overall objective, and assess the total costs in light of the portfolio construction and investment strategy employed.

FOLLOW THE DOL ROAD

The Department of Labor (DOL) has provided a framework for selecting and monitoring target date funds. In February 2013, the DOL released "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries".[5] Chief among the suggestions from the DOL was that fiduciaries need to understand how target date funds work, and establish a process for evaluating their fit for a specific plan. Recognizing that the target date fund universe is as varied as the American workforce, regulators made the point that non-proprietary and custom solutions may be viable options for some plans and should be explored. The DOL suggested six steps for plan sponsors:

1. Explore: *Inquire* about whether a custom or non-proprietary solution would be a better fit.
2. Process: *Establish* a process for comparing and selecting funds. *Document* it.
3. Research: *Understand* the investments and how they change over time.
4. Calculate: *Review* the fees and expenses.
5. Communicate: *Develop* effective employee communications.
6. Manage and Monitor: *Evaluate* the target date fund and recommendations you received.

[5] Available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fsTDF.pdf

Some plan sponsors find that these responsibilities exceed their in-house capabilities, and decide to outsource certain fiduciary duties. Outsourcing can take many forms, from limited scope duties such as investment manager selection and monitoring to full plan management and administration. To evaluate providers, it helps to understand the history and perspective of the three types of firms that generally provide outsourcing services – consulting firms, investment managers, and multi-managers.

Some consulting firms have built the infrastructure and expertise required to offer new outsourcing services and products. It is important to ask consultants about their track record in outsourcing and their willingness to provide fiduciary services beyond advice. Since consultants have not traditionally focused on investment implementation, their experience and capabilities in this area cannot be taken for granted, especially the ability to rapidly adjust client portfolios in response to changing market conditions.

Investment managers have experience making investment decisions and providing investment-related services, but their focus is not necessarily on an entire portfolio. Accordingly, it is important to determine the breadth of an asset manager's experience and their willingness to customize a solution for the plan sponsor. This includes managing risk across asset classes and managing the entire portfolio towards measurable goals that matter to clients. Since plan sponsors may have relied on consultants or in-house staff for manager research, they should query investment managers about this capability. Investment managers should be able to show that their "buy list" has historically had high probability of outperforming the relevant index.

Multi-managers seek to provide small-to-medium sized plans with greater diversification and access to money managers typically available only to large plans. They generally focus on manager selection for the overall exposures in the portfolio rather than narrow security selection within specific asset classes. As a result, it is important to ask multi-managers about their willingness to provide fiduciary services beyond manager selection oversight, and their ability to provide a broad set of investment options backed by strong manager research and consulting experience.

AVOID FALSE CHOICES

The percentage of DC plans with a managed account option has been rising such that the majority participants are now offered this choice.[6] Managed accounts are also increasingly being designated as qualified default investment alternatives (QDIAs), but many plan sponsors feel they can choose only one of the designated safe harbor categories (i.e. a TDF, balanced fund, or a managed account). On the other hand, offering just one of these QDIAs may not be optimal for workers of all ages or retirees.

Plan sponsors have another choice—the hybrid QDIA. Hybrids include an asset allocation fund, like a target date fund or balanced fund, and then transition into a professionally managed portfolio when many participants need it most—as they get closer to retirement and their financial situations may become increasingly complex. Hybrids have the potential to improve outcomes, compared to a TDF-only QDIA, because professionally managed accounts can build a more personalized and precise glide path for each participant that can be adjusted based on progress toward a retirement income goal.

Despite the potential benefits of hybrids, plan sponsors are rightfully concerned about participant behavior vis-à-vis managed accounts. By some estimates, half of participants who use a professionally managed account today do not provide the information needed to customize

The percentage of DC plans with a managed account option has been rising such that the majority participants are now offered this choice.

[6] In 2015, 57% of participants were being offered a managed account option, up from 38% in 2009. *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data*, Vanguard, 2016. Available online at vanguard.com.

their portfolios.[7] The good news is that plan sponsors no longer have to choose between utilization and the benefits of managed accounts. New QDIAs have been developed that automatically collect participant information from the recordkeeping system, so that they can provide a customized asset allocation similar to a traditional managed account, but without requiring extensive input from participants.

Managed accounts can be implemented as an "opt in" or as a default for new participants. Existing participants can also be defaulted into a managed account through re-enrollment, in order to refine their asset allocations. Just as with TDFs, sponsors who choose managed accounts for their DC plans need to make sure the investment methodology is sound and consistent with the sponsor's investment beliefs. Examples of different philosophies are target retirement income versus mean/variance portfolios at different risk levels.

If the managed account will be a QDIA, it should be built for that purpose, not as an opt-in.

If the managed account will be a QDIA, it should be built for that purpose, not as an opt-in. Some other important issues to cover with potential managed account providers include the following:

- Is the provider willing to take fiduciary responsibility for the asset allocation?
- Is the provider willing to use the full plan menu for asset allocation?
- Will participants have a high degree of customization?
- Are the interactive tools intuitive enough to help participants make better investment decisions?
- Will the reporting and communications help the plan sponsor understand participants better and help target campaigns to assist participants who are behind?

BEWARE THE RULE OF THUMB

DC plan excellence goes beyond picking investments and meeting with managers. It means following a disciplined process, creating frameworks for understanding, prioritizing the workload and communicating with participants in a way that helps them make good investment decisions. It is a lot to look after, but plan sponsors who take many small steps in the right direction can improve participants' lives in retirement. That is an outcome worth the extra care and diligence to move a DC plan from average to excellent.

This is an abridged version of an article "Best Practices for TDFs and Managed Accounts" which will appear in Q1 2018 of *Benefits Quarterly Magazine.*

[7] Lee Barney, "Half of Managed Account Users Do No Provide Requisite Information," *PlanAdviser*, October 14, 2016. Available at http://www.planadviser.com/Half-of-Managed-Account-Users-Do-Not-Provide-Requisite-Information/

OPINION

The human element of OCIO

By: Bruce Clarke, CFA, Managing Director, Institutional Investment Solutions

Any plan sponsor, CFO, or treasurer who has run an RFP process to find an OCIO provider knows how much work that process can be. You need to look closely at investment capabilities, reference clients, track records, and pricing, just for starters. And then there's the relationship between the client and the provider—what we might call the human element. Although it's not easy to quantify, don't underestimate the importance of the human element in the plan's success.

Bruce Clarke

RELATIONSHIPS MATTER

Those who, like me, naturally focus on numbers can be tempted to overlook something as squishy as a relationship. But an OCIO mandate covers many responsibilities—and even though the industry calls this process *outsourced chief investment officer*, most clients do not give their OCIO provider full discretion: duties are split between the in–house team and the outsourcer. For example, while portfolio management is typically outsourced, major asset allocation decisions usually still happen on the inside.

This sharing of duties means success is dependent on communication between the in–house team and the outsource provider and a healthy relationship is fundamental to keeping things on track. That relationship typically operates at three levels: we call these the client executive, the account executive and the client investment analyst.

> Success is dependent on communication between the in–house team and the outsource provider.

THE CLIENT EXECUTIVE

The client executive should take a proactive approach to communication, reaching out to clients with actionable market insights that could affect asset allocation decisions. For example, at Russell Investments, our client execs may have recently spoken directly to U.S. clients about our market outlook. Or they may have shared projections on emerging markets or currencies. Markets don't follow a quarterly cycle and a proactive client executive doesn't wait for quarterly meetings to contact clients.

Since every OCIO client is unique, valuable client interaction requires an understanding of the client's goals, preferences and constraints. It's also dependent on understanding the personality of each client—how they prefer to be communicated with, whether they prefer a formal or informal approach, or how much information they may require to make strategic decisions. *The human element*.

This type of deep understanding calls for a relatively small number of clients. And the willingness of a client to seriously consider the advice requires something that's too often the exception instead of the rule in the modern financial services industry: trust.

From the institutional investor's perspective, that trust begins with the client executive—are they seen as investment professionals or as salespeople? Do they have meaningful credentials, such as CFA designations or long tenure in the industry? Do they proactively bring the firm's best thinking to their clients? Do they consistently act in the best interest of clients?

The human element is not easily quantifiable, but it's worth trying. I've mentioned the number of clients per client executive as one measure of the human element. Another is average client longevity: How long do clients stay with the provider? And then there may be client satisfaction surveys: What do independent third–party survey results say about the overall client experience?

While the client executive interacts at a strategic level, the account executive focuses on implementing that strategy.

A BROADER RELATIONSHIP

While the client executive interacts at a strategic level, the account executive focuses on implementing that strategy within the context of the client's other goals, regulatory requirements, and operational consideration. Account executives should serve as the client's primary partner for daily orchestration, both with their own staff and with their other key service providers such as trustee/custodians, paying agents, recordkeepers, and auditors. An experienced and skilled account executive ensures the administrative side of the relationship runs smoothly—not the highest profile of roles, but critical nonetheless.

Further support is provided by the client investment analyst. Analysts bring the investment performance, analytical, and reporting capabilities that are needed for purposeful analysis. This can involve not just the investment portfolio, but also pension liability analysis, market outlook positioning, and peer relative comparisons. Access to investment analysts expands the analytical tools and resources available to time–and resource–constrained CFOs and investment committees.

So there you have it: The human element. It matters, maybe more than ever. In this number–centric industry of ours, keep relationships in mind, because no one succeeds on their own.

Q&A

The practical implications of tight credit spreads

With: Greg Nordquist, CFA, Director, Overlay Strategies and
Travis Bagley, CFA, Director, Transition Management

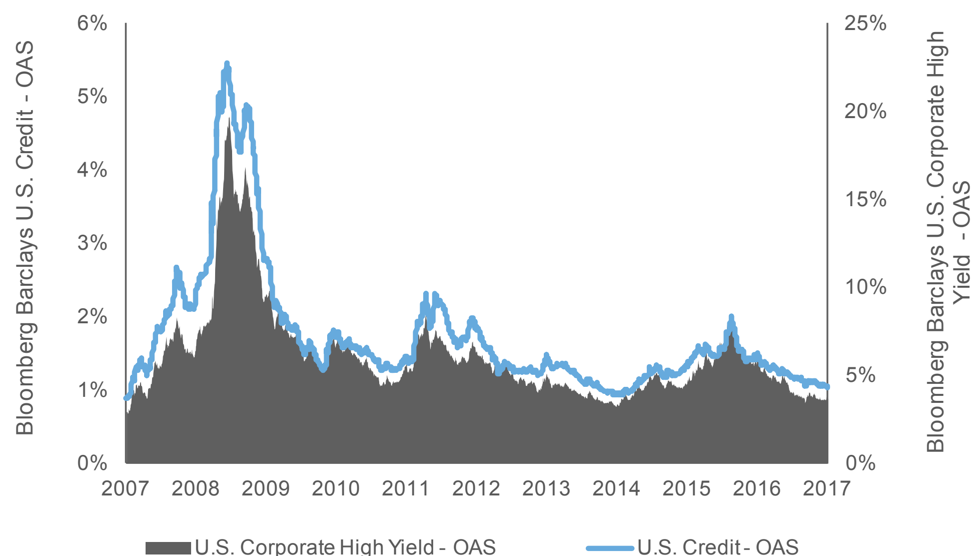
Q: GLOBAL CORPORATE CREDIT CONDITIONS HAVE BEEN ON A POSITIVE TREND. CAN THIS TREND CONTINUE?

A (Nordquist): Corporate credit spreads are unquestionably tight compared to history (see Exhibit 1). This is not an easy measure to forecast, but it's difficult to envision many scenarios where spreads tighten significantly from here.

There are several known risks that could have a significant impact on the economy and, specifically, on credit markets. These include things like U.S. Federal Reserve activity around its inflation and employment goals as well as actions by other central banks across the globe. Then we have the civic and geopolitical environment, which is in some ways unlike anything we've seen before. There's no way to foresee with certainty how that might eventually impact global capital markets.

In theory, this uncertainty is priced into today's credit market. But with spreads as low as they are, it becomes less and less clear how to make a convincing case that credit markets will continue to strengthen.

Exhibit 1: Bloomberg Barclays Indices Option Adjusted Spread (OAS)



Source: Bloomberg Barclays June 2007 – June 2017

Greg Nordquist

Travis Bagley

In theory, this uncertainty is priced into today's credit market.

Q: WHAT CHALLENGES CAN TIGHT CREDIT SPREADS CREATE FOR INVESTORS?

A (Bagley): Meeting long term return goals is more difficult, given the lower return expectations from all markets right now. For bond investors, this tight credit spread market also creates implementation challenges when trying to transact in credit securities. Finding reasonably priced credit securities is tougher in this environment, so building a credit portfolio is more challenging and takes longer.

These liquidity challenges can feed on themselves, as investors have less incentive to sell desirable credits. Many would rather hold the securities and continue to receive healthy yields. The larger the portfolio, the bigger the challenge can be. And liquidity is especially tight for longer duration securities.

Q: WILL NATURAL SUPPLY AND DEMAND FORCES HAVE AN EFFECT AND ALLEVIATE SOME OF THESE CHALLENGES?

A (Nordquist): That would be the hope, but that's a long-term impact. Meanwhile, in the near term we see the imbalance in supply and demand growing rather than shrinking. Although corporate issuance has been strong over the past several years, demand has been even stronger. Many defined benefit plans are de-risking, typically selling equities and shorter term fixed income to buy long-dated credits, which better hedge their liabilities. This de-risking demand will most likely weigh on credit spreads at the long end of the yield curve for the foreseeable future, unless credit conditions and/or supply change considerably. There is also speculation that bond issuance will be further reduced if a change in corporate taxes eliminates the tax deductibility of bond interest. That has the potential to drive spreads even lower.

> Some liability-driven investing (LDI) strategies lend themselves to more effective implementation than others.

Q: WHAT CAN CREDIT INVESTORS DO TO MITIGATE THESE IMPLEMENTATION ISSUES?

A (Bagley): Some liability-driven investing (LDI) strategies lend themselves to more effective implementation than others. For example, many plans have adopted de-risking glide paths[8], which tie asset allocation to funded status and therefore re-allocates into a portfolio of long credit and government securities over time. This breaks the de-risking transition into multiple stages, rather than requiring a single transition for the entire plan all at once. Reducing the size of credit trade makes the event less costly and easier to implement.

Another noteworthy de-risking approach is a hedge long first[9] strategy, which hedges the longest duration liabilities first. This approach relies mainly on treasury strips to hedge these very long duration liabilities, thus is unaffected by the state of liquidity in credit markets.

Even if you're not following a hedge long first approach, it's worth addressing the question of whether current credit spreads offer enough return over government bonds to be worthwhile. In an extreme environment, some plans may choose to hedge only the interest rate exposure – the largest risk exposure versus the liability value – and not, for the time being, the credit exposure. For plans with a meaningful allocation to return seeking assets, the interaction between the credit premium and the equity risk premium can be a factor in that decision, too.

For shorter maturity portfolios, there is an array of ETFs and derivatives that allow investors to obtain credit exposure at very reasonable costs with good liquidity. These instruments are blunt; however, in many cases, they provide the needed exposure for a short period of time or for an extended investment horizon.

[8] See Gannon, J. and Collie, R (2017). "Liability-responsive asset allocation: Defining the de-risking glide path for defined benefit pension plans". *Russell Investments Viewpoint*.

[9] See Phillips, D., Gannon, J., Sylvanus, M., and Collie, R. (2015). "Hedge long first: An alternative approach to LDI". *Russell Investments Viewpoint.*

GREAT MOMENTS IN FINANCIAL HISTORY

1986: Britain's Big Bang

By: Lisa Cavallari, CAIA, FRM, Director, Fixed Income Derivatives & Commodities

Lisa Cavallari

Monday October 27, 1986 ushered in a new era in global finance with London's "Big Bang." Fixed brokerage commissions had been abolished in the United States on May 1, 1975, an event widely referred to as "May Day" (for obvious reasons). Although not necessarily perceived as a revolution at the time, within a few years it had become clear that the United States' change had fundamentally altered the dynamics of trading. It also helped position New York City as a competitive global financial center.

Recognizing the need to be more competitive, the package of financial deregulation championed by then Prime Minister Margaret Thatcher did not involve gradual, incremental changes. There were a number of initiatives designed to fit a broader framework of financial deregulation. The decision was made to introduce the reforms all on the same day. London's "Big Bang" brought to fruition three key reforms:

1. Abolition of fixed commissions on trades
2. Elimination of the distinction between brokers (who advised individuals) and market makers (who conducted trades)
3. Removal of the prohibition on foreign firms owning U.K. brokerages

That historic Monday saw a most inauspicious start plagued with problems. The simultaneous electronification of the trading floor so overwhelmed computer servers, traders reverted to open outcry in the pit. Fortunately, the challenges were short lived and the city quickly attracted international interest from foreign banks. For years, London had been losing market share to New York but, with the "Big Bang" changes, the financial landscape and the geography of the city was forever changed. U.S., European and Japanese banks moved quickly to purchase U.K. clearing banks.

One of the interesting consequences of changes from the "Big Bang" was an end to the requirement that London's banks be within 10 minutes' walking distance of the office of the governor of the Bank of England.[1] Among the ads in the *Financial Times* on the day of the "Big Bang" was an announcement of a new financial center to be built three miles to the east at Canary Wharf, a sign that London's financial industry was breaking literal, as well as metaphorical, new ground.

London's financial industry was breaking literal, as well as metaphorical, new ground.

There is little doubt that "Big Bang" events propelled London back onto the global financial stage, breathing new life into one of the world's great financial centers.

[1] Robertson, J. (2016, October 27). "How the Big Bang changed the City of London for ever. *BBC News*. Retrieved from http://www.bbc.com/news/business-37751599

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U.S. contact

Eric Macy
Managing Director
U.S. Institutional

212-702-7941
emacy@russellinvestments.com

Canadian contact

Andrew Kitchen
Managing Director,
Institutional Canada

416-640-2482
akitchen@russellinvestments.com

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