THREE STEPS to measure your LDI SUCCESS

How do you calculate and report on the success of your liability-driven investment (LDI) program? As an industry, we’ve traditionally used active manager performance to judge success, measuring excess return versus the best available market-based benchmark. Such benchmarks are valuable as portfolio management tools (hence our recent work with Barclays to create the Barclays-Russell LDI indexes), but the true test of the success of an LDI program is how well a portfolio has matched or exceeded the plan’s actual liabilities.

There are a number of hurdles to clear in creating a true measure of LDI success. We see these three steps as being key to the process.

1 CREATE THE RIGHT BENCHMARK

We consider the right benchmark to be a liability benchmark, which we define as the return of high quality corporate bonds used by a specific plan to discount its actual pension liabilities. Liability benchmarks are comprised of two elements:

1. Interest cost—the impact of passage of time (analogous to a coupon payment of a bond).
2. Impact of discount rate changes—the price change due to change in yield (this can be further decomposed between Treasury and credit spread components).

Taken together, these two elements create a target for your LDI portfolio.

2 CALCULATE RELATIVE PERFORMANCE

With a plan-specific benchmark identified, you are in a position to calculate the excess LDI return versus your plan’s liability benchmark, and monitor the success of your LDI program in terms of tracking error versus your specific liability benchmark.

Sometimes, the LDI portfolio will underperform liabilities in a falling interest rate environment, because the sponsor is only partially hedging interest rate risk, but the key is that this impact is an intentional outcome of the portfolio management process.

A well constructed LDI portfolio will also be a good representation of the liabilities it is designed to hedge—most often, an LDI portfolio with lower tracking error versus the liability benchmark would be considered a more “successful” LDI portfolio.

3 ATTRIBUTE PERFORMANCE

A closer look into excess returns versus liability benchmarks reveals valuable information on the success of LDI portfolio management decisions. To properly attribute these decisions, one must first remove the component of the liability return that is typically outside the control of the LDI portfolio manager—we call this component “uninvestability.”

The main driver of this uninvestable component is that discount rates measured under many actuarially accepted standards are not subject to downgrade and default risk, but fixed income portfolios are. Russell’s test of a sample plan, fully funded with 100% in fixed income and invested passively from 1996 to the end of 2012, resulted in a cumulative loss of almost 20% in funded status—almost 1% per annum on average. To strip this effect out, we calculate the difference of the market-based benchmark vs. the liability benchmark. Next, we decompose the LDI portfolio between active manager positioning (often LDI allocations are managed by multiple sub-advisors) and portfolio construction positioning where the overall LDI program is managed versus liability-hedging targets by a single provider. Some in the industry have labeled this discretionary role the “LDI quarterback.”

Notice the ordering of the investment management process indicated by the arrows in the chart above, that the LDI quarterback is ultimately responsible for the duration exposure of the overall LDI program versus liabilities. Performance of each of these components combines to result in the excess return vs. the liability benchmark.

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To learn more about our LDI research, visit www.russell.com/ldi or call 800-426-8506.