



## INDEPENDENT TRUSTEE

### LDI – will the love affair break our hearts?

For the last few years, liability driven investing (LDI) has been all the rage. As a trustee, I have sat in many trustee meetings where the investment consultant has delivered performance reports showing stellar returns for LDI funds, whilst giving themselves a metaphorical pat on the back for advising to invest in this asset class. Better still, as gilt yields have fallen, the investment managers have been posting capital back to the scheme and the trustees have nodded sagely at the wisdom of their investment decisions. After all, LDI funds have returned 30% pa or more over the last couple of years and, where else can you get incredible returns like those?

Quite a number of my trustee appointments are for schemes with material deficits and a weak employer. So, if the scheme had been investing elsewhere instead of in LDI, then the deficit may have been even bigger and it may well have become untenable. In many cases the LDI funds have propped up the scheme returns.

It is important to remember why we invest in LDI funds. It is not to achieve high returns. It is to protect the funding position. And that means that LDI funds protect the funding level from falling and protect the funding level from rising. That's their job and over the last couple of years, they have done their job well as the gilts yields have fallen. Funding levels would be a lot lower if schemes had not invested in LDI funds. But now we need to consider what will happen if and when gilts yields rise. Of course LDI funds will do their job again, but what will this mean for the schemes' assets, the members and trustees?

As gilt yields rise then pension scheme liabilities will fall and funding levels will rise (all other things being equal) if the liabilities are not hedged. Those schemes invested in LDI funds will see the value of those funds decrease in sympathy with the movement in gilt yields. The investment managers will seek a cash call from their investors and our pension schemes will need to pay over assets to the LDI investment managers. It is this scenario which makes me feel a little uncomfortable.

I accept that gilt yields may need to rise significantly before LDI managers are making cash calls from pension schemes. But who knows how gilt yields will move over the next few years? With rising inflation, BREXIT negotiations and various other

global macro-economic and political events, I am not about to predict where gilt yields will go next. However, if the outcome is "up, up, up" then pension schemes will be posting their members' assets as collateral rather than holding the assets as investment in another asset class.

And that is my concern with LDI. Not that it does not do its job properly, because it does. However, when returns are negative and possibly, very big and negative, then how will trustees and members react? My fear is that emotion will suddenly take over. The trustees could come under pressure from the employer and members to come out of LDI investments altogether. But this forgets the reason why we invest in LDI in the first place – it is not to make money but to protect the funding level (up and down). If yields rise, will trustees and their advisors have the courage of their own convictions and hold on to their LDI funds? I hope so.

Of course, there is another very significant problem with the cash call scenario above. When the investment manager comes looking for money they want it in cash and they want it (relatively) quickly. The trustees may have to sell assets to realise the cash to pay the investment manager. And then the question becomes even more tricky – sell equities or bonds or other assets and are those asset values high or low? Will the trustees still hold on to their investment strategy? A worst case scenario could be trustees needing to sell assets at a depressed price to post collateral and maintain their hedge ratios. In this case, emotions will definitely run high and then the decisions trustees make, may be sub-optimal.

I hope I am wrong but one day we may all fall out of love with LDI funds. ■



Vassos Vassou  
Senior Trustee  
Representative  
Dalriada Trustees

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