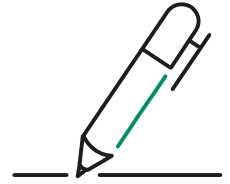


TALKING HEADS PODCAST



By **Andrew Craig**, Co-head Investment Insights Centre | **Sergey Pergamentsev**, Head of Institutional Structured Management

WHAT IS HAPPENING IN LIABILITY-DRIVEN INVESTING?

Andrew Craig: Hello and welcome to the BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis through the lens of sustainability on the topics that really matter to investors.

In this episode, we'll be discussing recent developments with regard to liability-driven investing. Simply put, liability-driven investing is a strategy employed by institutional investors such as pension funds to reduce balance sheet risk and match their investments, cash payouts to the future cash needs of their members. Pension plans are major investors in asset markets and in some regions, such as the UK, there has been a major shift over the last 20 years to liability-driven investing strategies. In September this year, when the UK government announced a large package of unfunded tax cuts, it contributed to setting off a major rise in 30-year UK government bond yields. That set in motion a vicious circle of further selling and further rises in bond yields, ultimately forcing the Bank of England to step in as the buyer of last resort and restore stability in the UK government bond market.

I'm Andy Craig, co-head of the Investment Insights Centre. And who better to talk us through the intricacies of liability-driven investing than Sergey Pergamentsev, who's head of Institutional Structured Management in the Multi Asset Quantitative and Solutions Team. Welcome to Talking Head, Sergey.

Sergey Pergamentsev: Thank you, Andy. Nice to be here.

Andrew Craig: Now, just as a way of introduction, you, Sergey, and your colleagues who number about 30 investment professionals across Europe, you're specialised in balance sheet management for institutional investors under various regulatory frameworks. That includes the Dutch pension fund laws, solvency and regulation, as well as specific accountancy regimes. You work on strategies including liability investing, fiduciary management, and then overlay strategies, be it interest rate, equity or currency. In addition, those strategies may be linear or involve the use of options. You do risk overlay. You also manage multi-asset portfolios under specific constraints. In some cases, you use multi management. Last but not least, you run a set of private market strategies which includes the planning for decommissioning, be it nuclear plants, oil and waste installations, as well as waste management. And across those strategies, your team managed assets of around EUR 31 billion at the end of October, half of which comes from the Dutch institutional market and the rest from clients in France, Germany, Belgium, the UK, Ireland, as well as supranational entities. Sergey, perhaps we can start by having you explain to us what is liability-driven investing and what are its origins? Is it something relatively new?

Sergey Pergamentsev: LDI – liability-driven investing – is generally an investment strategy meant to decrease risks on the balance sheet of a client. It's in most cases not used to provide excess return, but rather really about risk management. The origins of LDI can be traced to British actuary Frank Redington, who in the beginning of the 1950s published a paper on immunisation strategy. Frank Redington was an actuary at Prudential life insurance and life insurance had to take care of a very long stream of cash flows that they were promising to their clients. Frank developed a way of looking into these cash flows and immunising the exposure they created on the balance sheet of the insurance company from moves of interest rates. Later, his ideas led to other investors actually taking this on board and starting to do LDI. And here it expanded not only to life insurance companies, but also, for instance, to pension funds. In the 1980s and nineties when interest rates were quite high, quite a lot of US defined benefit pension funds implemented LDI strategies. That was quite favourable given the high rates at the time, and it allowed them to immunise portfolios and decrease the risk on the balance sheet. Later, at the end of the nineties, the strategy became also popular in the UK, where some of the prominent pension funds started implementing it and in some cases, even to almost 100% of the liability cash flows. And they did quite well because when the crisis came in 2001, their returns were very stable and actually very good. In the Netherlands, pension fund reform introduced market discounting for the liability cash flows. Around that time, many, if not all, Dutch pension funds started to look at LDI strategies as well and implemented them to various degree. So now there's more than, what, 50, maybe even 70 years history that can be traced to LDI type strategies.



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Andrew Craig: So it has a long history. What would you say then is the present status of the liability-driven investing strategies that have been around for this period?

Sergey Pergamentsev: With this kind of base of market participants deploying it, it became quite a mainstream approach when a company pension fund has a long stream of future liability cash flows, and when there is a pool of assets that needs to provide for these cash flows. In essence, LDI is actually about solvency because when you have future cash flows, you wonder do I have enough assets, do I have enough money to pay those cash flows? And that's where some kind of discounting of the cash flows to calculate the present value of these liabilities comes into play, and then you apply the same to the usage side. So when you divide your assets by liabilities, that would be your solvency. And to calculate the solvency and to manage this solvency is something that really quite a lot of investors and market participants do. LDI strategies in Europe are mainly implemented by pension funds in the UK, the Netherlands and Denmark. But there is also an increase in interest and in the number of life portfolios in countries such as Germany or Ireland. So it became actually a quite broadly used technique on the pension fund side, but also on the life insurance side where the whole story actually has originated. The way the strategy is implemented differs: Dutch pension funds usually apply little or no leverage in LDI strategies. That's related to the fact that in most of the cases, they don't hedge the full set of the liability cash flows, but rather a percentage. Quite typically, this would be about 50%, but not always. In this way, they take part of the balance sheet risk away and they don't need to leverage. They still have a sufficient amount of money to generate excess returns in many cases. And there the instruments that they use usually are government bonds, supranational and agency bonds. In some cases, these may be less liquid like pools of Dutch mortgages, but they provide a bit of pick-up in terms of return. And they also usually use interest rate swaps, so leaner instruments.

In the UK, what we see is that most of the investments are done through the use of UK gilts or inflation-linked bonds and that's where part of the trouble that happened in October started. But there is also quite a lot of leverage. It's not always leveraged directly on the balance sheet of the pension fund, although in some cases, there is often leverage put in bonds that they use as building blocks to hedge their exposure. And those funds often have leverage of three times, if not more, and very often, either swaps or repo transactions are used. So the techniques are slightly different, the specificities are slightly different, but the ideas are quite, quite similar.

Andrew Craig: Thank you, Sergey. o how do you think liability-driven investing will develop in the foreseeable future? We've had this event in the UK in October, as you mentioned. How do you see the strategy evolving?

Sergey Pergamentsev: So to begin with, currently higher interest rate levels allow for implementing LDI strategies at better levels than, say, a year ago. But how will people be doing this, that's a question. There will be a lot of soul searching and probably adjustment of stress testing techniques with new tools to generate liquidity, maybe a re-evaluation of the amount of liquid assets on the balance sheet and how fast they can be accessed by clients. All these lessons will be taken on board and we already see both clients and regulators looking into these questions. There can be probably a bit more use of optionality in structuring LDI strategies whereby your downside can be limited and your collateral margins can be decreased. So that is something quite sensible, in our view. We also think that there can be a bigger shift from LDI to so-called CDI, cash flow-driven investing strategies. The strategies were employed in the past often as well, and sometimes even now by pension funds who are probably close to running out, are already closed and have quite definite cash flows. They usually use government bonds or secured assets to replicate those cash flows as part of the run-off process. But the technique can be used also with other assets and with riskier assets as well for longer-term liabilities. We have developed over the last couple of years strategies on how this can be implemented. So we see more of the cash flow machine moving closer to exactly what the client needs to pay out from more general hedges. That's possible. Over the last 20 years, we have developed such strategies and we continue looking into this. We are also publishing in a paper on the developments of the LDI market in the coming couple of weeks.

Andrew Craig: Thank you very much. And we'll look forward to the paper and we'll certainly be featuring that on Viewpoint in due course.
Sergey: Thank you very much.