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Integrated LDI

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Let your LDI do more of the 'heavy-lifting', and with reduced governance

Making your LDI allocation more capital-efficient can have significant implications on your scheme's journey plan, whether through increased expected returns, flexibility to reduce risk elsewhere, or both.

At Isio, we've developed a new type of LDI investment strategy, which has sparked innovation within the wider LDI industry. New LDI products are now available which allow for increased return within a low governance framework and a reduced risk of 'forced-selling' of LDI-supporting assets in extreme market environments.

LDI has become a more meaningful and burdensome component of pension scheme portfolios

Decisions around LDI are becoming increasingly important

- **LDI allocations today are significant, and likely to become larger, acting as a 'drag' on asset investment returns** – As pension scheme hedge ratios have increased and gilt yields have fallen, LDI has become a bigger part of portfolios. LDI could now feasibly be used to do a bigger part of the 'lifting' across a scheme's journey by generating additional return.

- **Governance burdens on trustees have increased** – As gilt yield volatility over the last 18 months has increased, LDI funds have become more burdensome, with trustees having to deal with frequent capital calls and distributions. In a world of prevailing uncertainty, this has highlighted the importance for schemes having sufficient liquidity outside of LDI, as well as having a robust governance framework in place for transferring assets to the LDI manager when needed.

Chart 1: 20-year nominal gilt yield movements to 30 September 2021

Source: Bank of England, Isio calculations

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What is currently available in the market?

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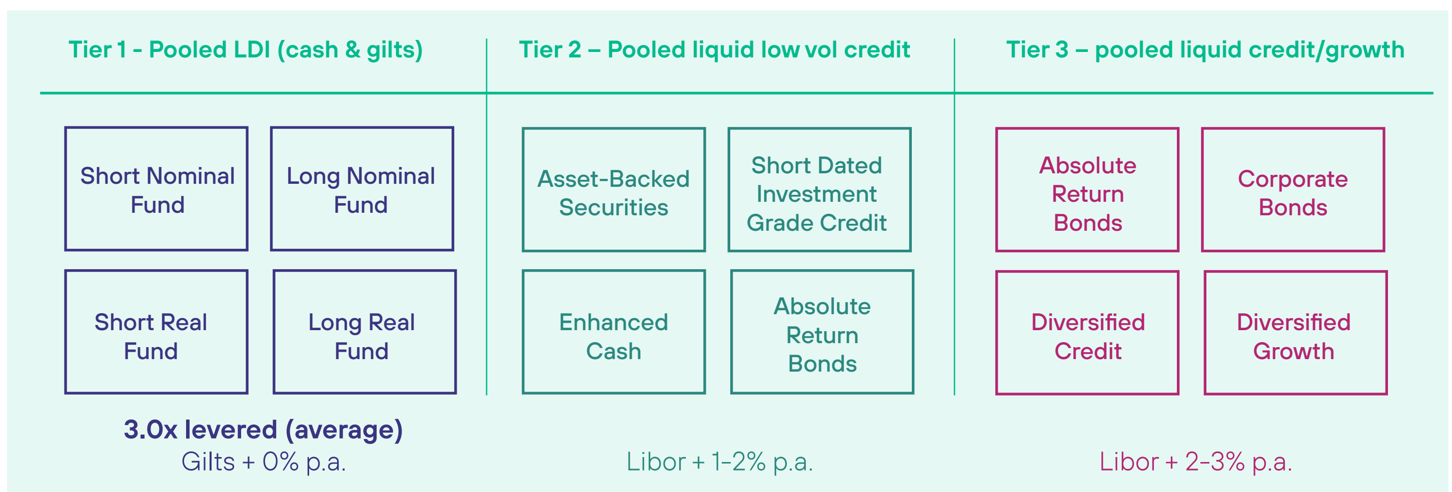
We believe the best way to think about LDI and supporting collateral is to separate it into "Tiers". As yields rise (or inflation expectations fall), additional collateral maybe required in Tier 1 to support the hedge. Tier 2 assets would be used to top-up Tier 1, and Tier 3 would subsequently be used to top up Tier 2, in a 'waterfall' manner.

Chart 2: Illustrative pooled LDI collateral tiers



Significant LDI allocations and rising volatility are placing pressure on schemes' existing arrangements

Problems can arise within existing pooled LDI arrangements

Existing pooled LDI arrangements form an important pillar for many schemes in protecting their journey plans from being 'blown off course'. Nevertheless, the backdrop of significant, and increasing, LDI allocations and rising volatility is placing pressure on many schemes' existing arrangements:

- **Return** – Higher allocations to LDI reduce the capital available to generate return, putting greater pressure on a scheme's non-LDI assets.
- **Governance** – Uncharacteristically short notification periods from some LDI managers in March 2020, when gilt yield volatility spiked, made raising the required capital impossible, putting schemes' hedges at risk of being unwound.
- **Liquidity** – In periods of higher volatility, collateral calls may be made at a time when asset classes experience a significant fall in value and liquidity has dried up, as in March 2020.

Unlike segregated or bespoke-pooled arrangements, current pooled offerings don't have sufficient flexibility to manage all these risks in a closed system, and are both capital and governance intensive.

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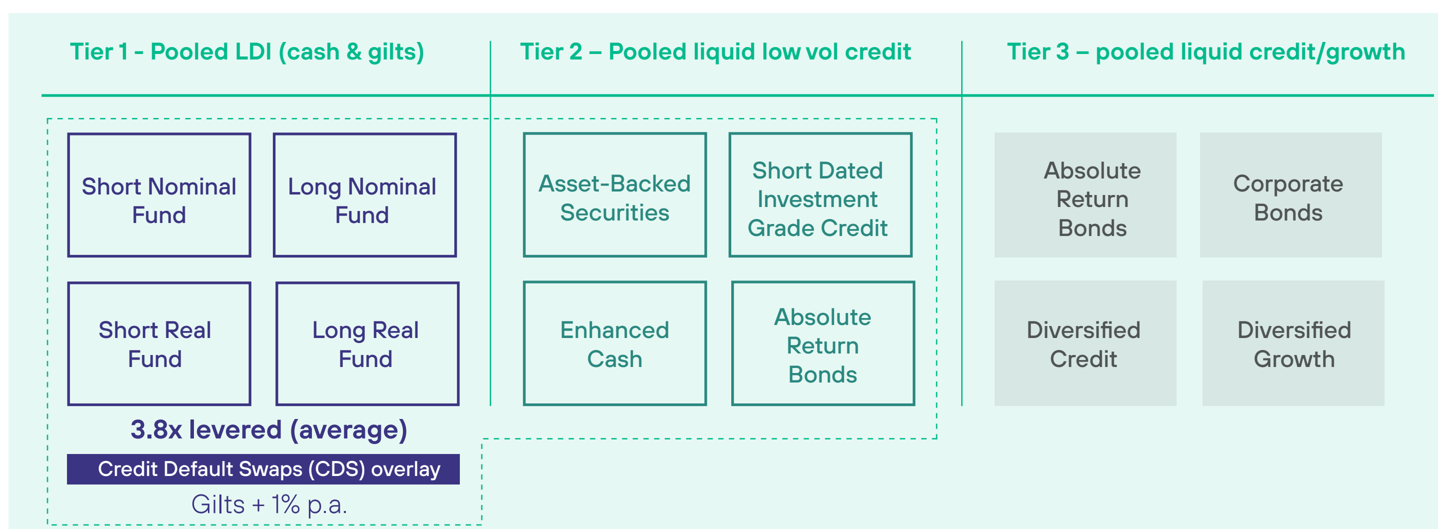
A new series of LDI products have come to market

A new strategy is now available in the market...

A series of more capital-efficient pooled LDI funds, with a managed collateral waterfall, are now available in the market off the back of Isio's new strategic concept. These will bring significant benefits to schemes, enabling them greater flexibility to adjust their risk/return budget as they see fit:

- **Additional return**
  - Using higher-levered LDI funds, less capital is required to maintain a hedge, freeing-up assets to be used to generate additional returns.
  - A Credit Default Swap (CDS) overlay generates an increased expected return for no additional capital commitment.
- **Reduced governance and risk**
  - The LDI manager will sell down and purchase Tier 1 and Tier 2 assets on behalf of the scheme, resulting in a low governance solution and in a manner that mitigates forced-selling risk.

Chart 3: Example new pooled LDI strategy coming to market



The new LDI strategy will lead to increased return, low governance and reduced risk of forced-selling of LDI supporting assets

For a typical scheme, we expect to be able to increase expected return by 0.3% p.a. (net of fees), without reducing the target hedge, under a low governance arrangement and with reduced risk of being forced to sell Tier 2 assets on a particularly unfavourable day in the markets.

Time for an LDI 'upgrade'?

We believe this strategy is appropriate in almost all cases where schemes have an allocation to pooled LDI and the 'upgrade' is certainly capital-efficient.

We would be delighted to discuss this further with you to help you upgrade your own LDI arrangement and to take advantage of the next generation of LDI funds to come to market.

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