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## Managers Prep Marketing for Looming LDI Wave

By Scott Johnson

The market crisis pushed some reluctant corporate pensions into the open arms of managers of liability-driven investment (LDI) strategies, but it will take additional catalysts to transform that into significant industry-wide flows, according to officials at nine LDI managers of all sizes. As they await an expected flood of assets, managers say they are differentiating themselves on the basis of investment performance and communication.

In 2008, the second “perfect storm” in a decade for pensions helped to “galvanize a desire for change,” says BlackRock managing director Andy Hunt, a member of the firm’s multi-asset client solutions group. But the response so far has been conservative.

“What you didn’t see was an immediate rush to do something after the horse had left the barn,” says Hunt. “There was no immediate flood of money. What we did see was a lot of substantive conversations, planning for multiple-year implementations.”

Managers across the industry say those conversations are taking place with increasing frequency. Firms including Goldman Sachs Asset Management, State Street Global Advisors, JPMorgan Asset Management, Northern Trust and Wells Capital Management say they expect LDI assets to rise in 2010, lending momentum to what has been a gradual adoption of the investment approach in the U.S.

Popular in Europe, LDI entails matching a corporate pension’s assets to its liabilities, often through sophisticated modeling and with a combination of fixed income securities and derivatives. Early phases of LDI implementation typically extend the duration of an investor’s fixed income portfolio, while later phases might reallocate almost the entire plan into fixed income.

Managers say the market volatility that bookended the last decade has spurred interest in LDI as a way of bringing risk under control. BlackRock, which manages \$50 billion for more than 100 LDI clients in the U.S. – and \$100 billion Europe, the Middle East and Africa – says global demand has grown rapidly over the last five to 10 years. And JPMorgan says its long-duration bond business – a crucial component of LDI programs – has doubled in three years; the firm manages \$9 billion in duration-extension strategies in the U.S.

A more immediate gauge of demand comes from Piper Jaffray affiliate Fiduciary Asset Management, a firm that formed out of the trust investment division managing pension assets for General Dynamics. FAMCO has raised more than \$1 billion from existing clients over the past 14 months in its LDI program, but most prospects still appear to be in the early stages of analysis, says president and CEO Wiley Angell. “This includes extensive liability analysis with actuaries and conducting interviews and RFPs with consultants,” he says.

Other managers say implementation has already begun. Wells Capital senior portfolio manager Michael Bray says plan sponsors have already taken sufficient time to evaluate the virtues of LDI.

### **When will the assets arrive?**

Managers are waiting on more than the usual length of the institutional sales cycle. They need some combination of three catalysts to drive assets in the coming years. First, managers expect additional changes in accounting standards to heighten demand, as pension volatility becomes an even greater burden for U.S. plan sponsors. Second, pensions will need to see a sustained market recovery to regain their funded status before committing fully to LDI.

Of course, that doesn't preclude taking the first steps. It makes a "great deal of sense" for well-funded, frozen plans to implement now, says Jim Reidy, head of JPMorgan's long-duration fixed income product team. "But even for the plans that are not fully funded, the benefit of implementing a duration-extension strategy is that it keeps things from getting much worse."

Finally, a meaningful rise in long-term interest rates would decrease the value of liabilities, helping to boost funded status even more. "The best thing that could happen to corporate defined benefit plans would be rising rates," says Reidy. "You're far better off cheering for higher interest rates [than improved equities performance] because that improves the funded status of the plan much more rapidly."

And Jennifer Tretheway, a managing director in Northern Trust's investment program solutions group, says it's not a question of "whether" but rather "when" investors will begin extending the duration of their portfolios. Northern manages \$4.8 billion in long-duration assets as a component of LDI strategies, she says. "Those waiting for the 'when' are on the sidelines, ready to pounce once their funded status improves and/or interest rates rise."

### **Managers are marketing long-bond strength.**

Managers say growth in LDI demand will track with overall growth in fixed income allocations, but firms with the strongest long-duration strategies stand to pick up the most assets. "For any of the big managers, a natural source of long-duration portfolios is going to be the existing core client base," says Reidy.

But that may give managers a chance to poach clients from their competitors. Reidy adds, "Being a good long-duration manager is not necessarily the same as being a good core bond manager." JPMorgan has two long-duration bond teams – one in New York, one in Columbus, Ohio – that take slightly different investment approaches.

While LDI is chiefly about risk management, clients and consultants still expect managers to meet or exceed their benchmarks, says Steve Kane, a portfolio manager for TCW Metropolitan West Asset Management. "Very simply put, it comes down in many ways to traditional active fixed income management – that's really what we're being asked to do."

Still, SSgA says it has been the beneficiary of asset flows into index strategies to implement LDI programs. “Clients view the transparency and minimal surprise of an index strategy to be a better fit to a de-risking solution,” says Tom Kennelly, head of the firm’s U.S.-based LDI group.

And SSgA says its broad custodial and investment infrastructure enables it to tailor LDI solutions to any client. Several other large firms echo that statement. For example, with more than \$3 trillion under management, BlackRock is “generally product and capability agnostic because we’ve got it all,” says Hunt.

**But don’t forget about communications.**

Managers say winning – and keeping – LDI clients also requires more than the usual degree of client service. BNY Mellon Asset Management, which constructs LDI strategies across two affiliates and a team of actuaries, says it has invested significantly in personnel and proprietary tools for reporting the progress of LDI programs.

“In many cases, the tools and approaches are not dissimilar [across managers],” says Peter Austin, executive director of BNY Mellon Pension Services. “But I think the difference is perhaps in how these programs are constructed, implemented and monitored – and what proprietary capabilities firms have, not only in designing these programs but in communicating them.”

Indeed, LDI programs often require tweaks along the way. For example, early movers implemented their programs using swaps, an approach that survived the market crisis but that nonetheless currently proves inferior to the use of long-duration bonds, according to most managers. BlackRock’s Hunt says that shift demonstrates that “LDI is something to be managed through time.”

That emphasis on client service may distinguish small managers in a field of giants. FAMCO’s Angell believes his firm’s relatively small size is an advantage because it can give clients “specialized attention” and allow them access to its senior management team.