

Positioning LDI portfolios in today's volatile market conditions

SEPTEMBER 2011

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This note addresses the outlook for LDI (liability-driven investments) portfolios as of the end of August 2011 and how they should be structured at this time.

At the start of August, there were three big questions hanging over the financial markets: the prospects for the global economy; the level of debt among certain members of the euro zone; and the credit rating of U.S. government debt. The last of these appears to have been clarified: S&P downgraded U.S. Treasury debt from AAA to AA+ on August 5, while the other ratings agencies now appear likely to retain their highest ratings. As we highlighted prior to S&P's downgrade in the note "Potential downgrade of U.S. Treasuries and implications for LDI programs"¹, there were a number of ways the market might have responded to that decision: the flight to safety in which we saw government bond yields fall significantly, while one possibility, was far from the obvious outcome prior to the event.

While the uncertainty associated with the downgrade and highlighted in that note has now largely passed, the uncertainty associated with other big questions of the day is likely to persist for some time. The outlook for the global economy remains murky, with policymakers facing difficult choices, made even more difficult by political and other influences. Meanwhile, the best that can be hoped for in Europe appears to be a restoration of confidence and stability in stages over months – while the pessimistic assessment would be that the euro-related troubles may have barely even started. In other words, neither situation is likely to become clear overnight, so market conditions appear set to remain volatile for the medium term.

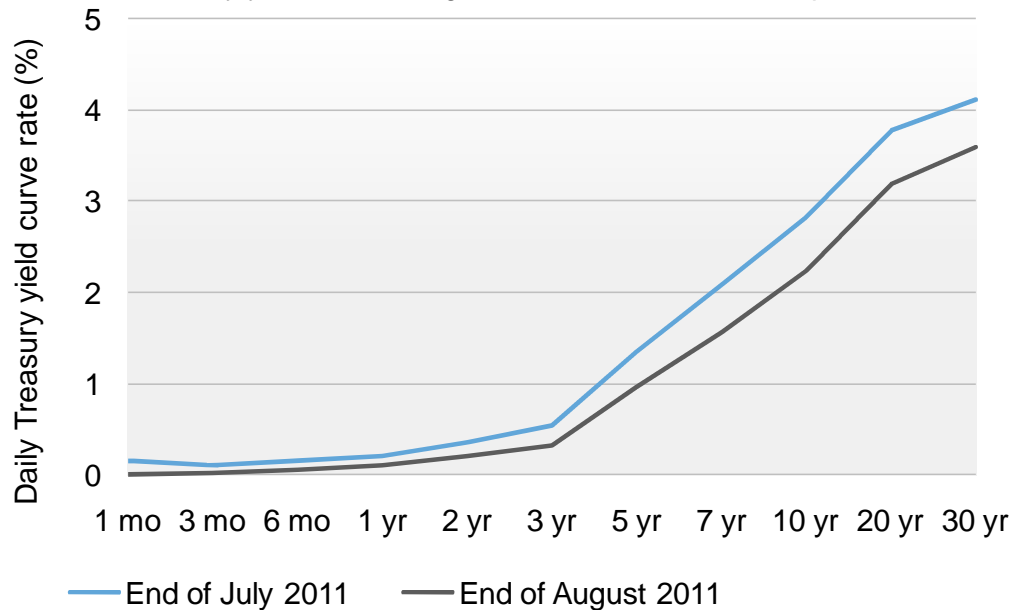
Liability-driven investment – two fundamental questions

We start with three key observations on current market conditions:

1. Treasury yields are exceptionally low – the yield on the bellwether 10-year Treasury note at the end of August was barely over 2%. The drop in yields in recent weeks – shown in exhibit 1 below – is all the more remarkable, since rates were already at levels not seen since the 1950s (and are now at levels not seen since the 1940s).
2. The spread between corporate yields and Treasury yields remains high. This spread rose from around 0.5% (well below the historical average) at the start of 2007 to almost 4% during the financial crisis. It has fallen somewhat since then, but the spread remains above its long-term historical average by historical standards and increased in August following S&P's downgrade.
3. Both the Treasury and the corporate yield curves remain steep.

¹ Jaugietis, Martin, Collie, Bob, and Sylvanus, Mike, "Potential downgrade of U.S. Treasuries and implications for LDI programs" *Russell Research*, July 27, 2011.

Exhibit 1: Treasury yields fell in August, but curve remains steep



Source: www.treasury.gov.

Data is historical and is not indicative of future results.

In these circumstances – a volatile outlook and unusual yield patterns – defined benefit pension plans with liability-driven investment (LDI) programs must keep their eyes on two questions:

1. What is the best available hedge for my liabilities at the present time?
2. What positions away from that best-hedged portfolio are appropriate and how big should those positions be?

It would be easy – and convenient – to overlook the first of these two questions. That would be a mistake, however; not only does the risk vary (i.e. different portfolios vary in their effectiveness in tracking liability behavior in different market conditions) but also the available yields move over time. That means that the returns that can be expected also vary. So as we consider the outlook for LDI portfolios at the current time, that is where we must begin.

To hedge a liability calculation that is based on the corporate yield curve, Treasury bonds are most effective when the spread is low. When the spread is low, there is less likelihood of Treasuries losing significant value against liabilities. And, of course, Treasuries offer better liquidity, lower trading costs and a better prospect of capital preservation during extreme market events. But when the spread is high, Treasuries can fail to match liability growth.

Thus our first observation on current conditions is that investors should continue to look for long corporate physical exposure to the extent that it is available. Since the peak of the credit crisis, we have recommended an emphasis on long corporate bonds in LDI portfolios. While investors would also have been well-served in the past few months by inclusion of long duration (for example, through swaps or long Treasury holdings), an emphasis on corporate bonds remains appropriate in the current low yield environment.

We turn next to the second question above, the question of deviations from the hedge position. Our recommended approach to this question is described in “A framework for

making interest rate bets”.² An important principle in that framework is that the lower the hedge ratio, the less appropriate it is to take tactical positions that reduce the hedging position further. Hence the application of the points below will be quite different in the case of a plan which has taken only early steps to a hedged LDI position than in the case of a plan which has made significant moves.

Within that framework, current conditions imply (as they have done for some time) that plans with a high current hedge ratio could consider taking an underweight position within their tactical range. For those (the majority) whose hedge ratio is still in the process of being increased toward a strategically hedged position, any reduction in interest rate exposure would represent too great a risk to the balance sheet, despite the possibility of a rise in rates from their current levels. Even if the plan doesn't take steps to adjust its duration exposure down, significant comfort should be taken in the observation that the plan's funded status will still improve in a rising interest rate environment for all hedge ratios below 100%.

Finally, we would note that for those plans that are comfortable with derivative exposures, the current steepness in yield curves presents an opportunity to protect from falling interest rates through options on interest rate swaps, otherwise known as swaptions. That is to say, many market participants (who unlike pension plans have more to fear from a rise in interest rates than from a fall) are currently seeking protection from a rise in interest rates and this has made the market for buying protection from falling rates (which hedge rising liability value) attractively priced. One such strategy is described, for example, in “Interest rate swaptions – downside protection you can live with”.³

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First used: September 2011

USI-10734-09-13

² Jaugietis, Martin, “A framework for making interest rate bets”, *Russell Research*, February 2011

³ Thomas, Michael and Nordquist, Greg. “Interest rate swaptions – downside protection you can live with”. *Russell Research*, June 2011