

## INVESTMENT FOCUS



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# Implementing liability-responsive asset allocation

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Liability-responsive asset allocation (LRAA) is a disciplined practice designed to help pension plans de-risk<sup>1</sup> their investment strategies as they move toward full funding—and it defines the steps needed to help preserve that position once they get there. Since Russell originally discussed LRAA in April 2009, we've seen defined benefit plan clients begin to adopt it in their portfolios...but how?

With an LRAA approach, changes in asset allocation are based upon changes in a defined benefit (DB) plan's funded status. An LRAA strategy outlines a systematic approach to align the duration of a portfolio with its liabilities—for many plans, this means gradually increasing allocations to long duration fixed income securities. However, implementing a new asset allocation strategy like LRAA requires investors to address key issues—several of which I'll address in this article.

## Measuring assets and liabilities to calculate funded percentage

By definition, LRAA is a customized strategy based on a plan's current situation. Some smoothing methods produce funded status measures that may vary from non-smoothed measures by as much as 30%—this would cause plans to de-risk well before they have the ability to do so. Therefore, we recommend the following:

- › **Assets:** We recommend that clients use the market value of plan assets to calculate funded percentage.
- › **Liabilities:** Several plans have chosen to use the projected benefit obligation (PBO) to measure their pension liabilities as they implement LRAA because it uses a market-type liability curve. Plans could also choose to measure plan liabilities in terms of funding target, but it is important to use the IRS full-yield curve when making this calculation.

## Implementing LRAA while considering return-seeking investments

In most cases, we recommend that clients who adopt an LRAA strategy do not increase allocations to return-seeking investments—mainly because the overall purpose of LRAA is to de-risk an investment portfolio as it moves toward full funding. However, in some circumstances when funded status decreases, clients adopting an LRAA strategy may choose to increase allocations to return-seeking investments.

<sup>1</sup> Please remember that all investments carry some level of risk. Although steps can be taken to help reduce risk, it cannot be completely removed.

### Considering upcoming contributions to calculate funded percentage and the LRAA allocation


Contributions will increase your plan's funded percentage—a key factor in an LRAA strategy. If you're considering asset allocation changes, it makes sense to think about them before making new contributions. For example, instead of putting the new contributions toward your old strategy and then moving assets later, you could decide on your new asset allocation strategy (based on LRAA) first and potentially save on transaction costs.

### Automating LRAA changes

Several of our clients have chosen an automatic approach to asset allocation changes, but they've also chosen to receive notification when changes are

made. They like the science of LRAA—the practicality of a scheduled plan helps remove some behavioral tendencies that could detour a plan from its key objectives. In addition, by voting to adopt the LRAA process, a committee can save the time it would take to re-evaluate asset allocation as its funded status changes.

### Conclusion: Implementing LRAA involves careful consideration

If you're evaluating an LRAA strategy, careful consideration of these factors (and more) can help your plan focus on its objectives and target outcomes. If you've chosen to adopt an LRAA strategy, work with your provider to address them and to develop an implementation approach that's tailored to your plan. 

For more information about LRAA strategies, see the Russell Research paper titled "Liability-responsive asset allocation" by James Gannon and Bob Collie (April 2009). You can view it at [www.russell.com/lraa](http://www.russell.com/lraa).

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