Stay on Target: Managing the Glide Path Using LDI Completion

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Defined-benefit plan sponsors exert significant effort conducting asset-liability studies to determine an appropriate policy for their glide paths. The goal of this policy is to lock in improvements to funded status by incrementally de-risking the portfolio, shifting the asset allocation from return seeking to liability hedging. However, this plan often fails to contemplate the practical challenges of implementing the glide path once funded-status triggers have been met. In this paper we'll take a brief look at glide-path management via liability-driven investing (LDI) completion. This natural extension of overlay management provides the infrastructure to create an integrated and holistic framework for more robust governance and risk control.

Key takeaways

» LDI completion streamlines the process of portfolio data consolidation, providing a snapshot of funded status, glide-path targets, and current allocations of growth and hedging assets.

» In the absence of a midperiod monitoring mechanism, pensions may find themselves unsure of their funded status and unaware of opportunities to lock in improvements.

» Sponsors should consider two key implementation enhancements: developing a mechanism to monitor location and triggers along the glide path and creating a framework for timely, efficient, and risk-controlled movement.

» The ability to unite multiple overlay components, such as cash securitization and rebalancing, can help fund sponsors capture incremental return.

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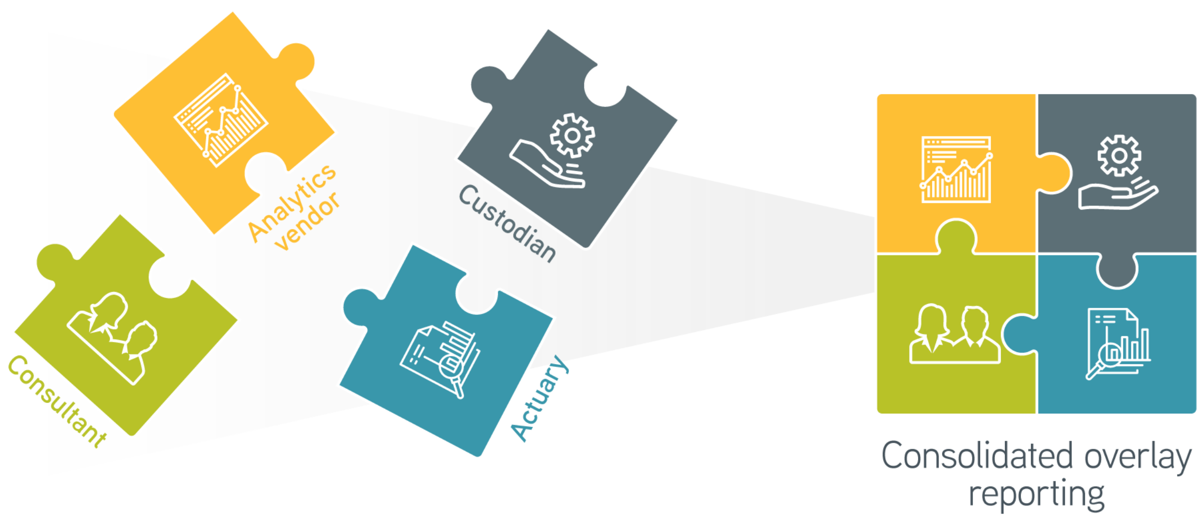
Knowing your location on the glide path

A comprehensive portfolio summary, including asset and liability information, is critical to determining a plan's funded status and, ultimately, its location on the glide path. Plan sponsors must consolidate data from a variety of sources, including custodians, actuaries, consultants, and third-party vendors. Further, friction from stale or lagged data, inconsistent reporting standards, and limited internal staff resources may make managing this process time-consuming and cumbersome. An LDI completion manager streamlines this data-consolidation process, providing a timely and accurate snapshot of funded status, glide-path targets, and current allocation of growth and hedging assets.

As funded status improves, pensions will approach and eventually reach triggers defined in the glide path's policy. That's when action is required. These triggers are often reached in between standard monthly or quarterly reporting periods. In the absence of a midperiod monitoring mechanism, pensions may frequently find themselves in limbo, unsure of their funded status and potentially missing opportunities to lock in improvements to funded status.

As a result of these lags, pensions may not make adjustments to their glide path for a month or more after hitting a trigger. In some cases a shift may never occur if the monitoring mechanism didn't capture the trigger event. An LDI completion program addresses these challenges and tracks the portfolio daily to take advantage of these market dynamics.



For illustrative purposes only.

A plan for moving along the glide path

Equipped with a streamlined monitoring mechanism, an LDI completion manager can help mitigate real-time implementation risks. Specifically, an overlay can make the necessary adjustments to the glide path shortly after the trigger has been reached and in a coordinated manner, bypassing the lags introduced by writing direction letters to investment managers and other administrative procedures.

Reallocating capital may also result in a settlement gap, whereby growth assets have been reduced but hedging assets haven't yet been added. An overlay manager can reduce these gaps, and improve policy alignment, by adding exposure to the hedging allocation in conjunction with de-risking rather than waiting for transactions to settle.

In this way an LDI completion manager provides plan sponsors with the flexibility to move capital thoughtfully, strategically, and at natural rebalancing points. Once the necessary exposures are in place, the completion manager can work with the investment staff or directly with other asset managers to coordinate a seamless transition between the completion overlay and physical assets.

Further, LDI completion can be used to more precisely hedge the unique characteristics of a given pension's liability. This aspect of a glide path's management typically becomes more important as plans grow closer to being fully funded. Interest-rate management can be further expanded to include key rate analysis to mitigate any unintended curve risks relative to the liabilities.

Lastly, a key benefit of using an LDI completion manager is the ability to seamlessly unite multiple overlay components. In addition to the efficiency and risk-control benefits outlined in this paper, fund sponsors should expect to capture incremental return through the use of components such as cash securitization and rebalancing. This beneficial outcome arises from the reduction of opportunity costs associated with cash drag and adherence to a disciplined rebalancing program. In this way LDI completion as part of a broader overlay program provides a holistic, cohesive solution.

Implementation and collateral considerations

Like any overlay program, implementation of glide-path management involves the use of derivatives. This requires sponsors to account for a number of considerations:

- Depending on the design of the glide path, each increment may lead to a sizable change in asset allocation. For this reason, sponsors should have a clear set of guidelines in place that outlines the process for implementing each glide-path shift.
- These increments may also impact the portfolio's collateral needs. Sponsors should create a liquidity waterfall—a step-by-step process for sharing the proceeds of a liquidity event—in order to support these needs.
- While sponsors can make some glide-path adjustments immediately following the activation of a trigger, others may require additional confirmation. Sponsors should clarify who will be responsible for providing this confirmation and how they should provide it.
- To ensure that all stakeholders are in agreement before beginning the program, sponsors should provide clear guidelines upfront about their implementation plans and any relevant governance issues.

Conclusion

An increasing number of corporate pensions are implementing glide paths, and plan sponsors face many challenges putting them into action. After determining a glide path, developing a robust monitoring mechanism and a seamless action plan should be key areas of focus to mitigate policy risk. An LDI completion manager can help address both in an integrated program. This new environment, focused on de-risking, adds new challenges in pension management, but with the appropriate framework in place, opportunities exist to improve the efficiency of the glide path and capture tangible benefits along the journey.

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