Introduction to Dynamic LDI

Trustees have a range of different hedging strategies available to them. Choosing the right one can add significant value. One such strategy, switching between hedging assets, has previously been the preserve of larger schemes. Our Dynamic LDI approach offers this in a straightforward pooled fund format making it accessible to pension schemes of all sizes. The approach ensures that schemes will be invested in the most cost-effective hedging asset whilst still taking into account the instruments’ liquidity, funding and transaction costs. Our Funds dynamically transition from a more expensive instrument into a cheaper one, adding incremental value in a systematic and orderly way, using a clearly articulated investment process.

Hedging liabilities effectively

The liabilities of a pension scheme are cash flows that are due to be paid to members at different points in the future. These cash flows will be fixed or inflation-linked. In that sense, the cash flows are very similar to those of a bond or an equivalent swap and will increase in value as interest rates fall (or inflation expectations rise) and vice versa.
The range of low-risk assets that pension schemes may ordinarily use to hedge their liabilities is quite wide and can include: conventional gilts; index-linked gilts; interest rate or inflation swaps; total return swaps on conventional gilts or index-linked gilts and repurchase agreements (repo) on conventional gilts or index-linked gilts. A pension scheme should look to implement a hedge using the cheapest of these hedging assets. This decision will change at each maturity point as the best asset to use at short maturities will not necessarily be the same as the best asset to use at longer maturities. In addition, the best asset for interest rate hedging may not be the same as the best asset for inflation hedging. Therefore, pension schemes are faced with complex decisions when designing and maintaining their optimal hedging strategy.

The Dynamic LDI Funds solve this problem. Day-to-day decision-making is delegated to market-facing professionals so that the pension scheme always favours the cheapest hedging asset.

Why is BMO Global Asset Management’s Dynamic strategy beneficial?

Our Dynamic LDI strategy can benefit pension schemes in three main areas:

• **Capturing returns**: By combining the cheapest hedging asset at each maturity point, we can construct a portfolio that always exhibits a higher yield than a 50/50 blend of gilts and swaps.

• **Switching between assets**: As the returns between gilts and swaps change, we gradually sell out of the more expensive asset and buy into the cheaper, higher-yielding asset, resulting in a capital gain.

• **Combining assets**: By looking at the full range of hedging assets we are able to construct a more attractive portfolio than would be the case if we were constrained to a binary choice between gilts and swaps.

The Dynamic LDI strategy is designed to be a long-term added value liability hedging strategy. Over the short-term, it may exhibit volatility compared to a pure gilt or pure swap-based hedging strategy.

Leaders in LDI

The LDI team at BMO Global Asset Management has been at the forefront of the market since 2003. We are renowned within the industry for our innovation and have been first to market with a wide range of pooled fund solutions, in turn allowing schemes of all sizes to have access to strategies that have historically been the preserve of larger segregated schemes.

Our innovation, client service and keen focus on risk management has led to us receiving a number of industry awards, listed opposite. This successful framework means we now manage solutions for over 550 clients and have implemented over £532bn in notional derivatives overlay transactions (as at 30-Sept-19).

The scale and importance of this capability means that we are committed to the continued growth and reinforcement of the product platform.
**Dynamic LDI in action**

The chart below shows the extra yield available for holding long-dated gilts compared to swaps when hedging interest rate risk. To put it another way, the higher the line the cheaper gilts are compared to swaps. The green areas show where we have purchased gilts and sold swaps and the red areas show the opposite trade (buy swaps and sell gilts). Generally, we buy gilts as they cheapen and then sell them again as they become expensive compared to swaps. The chart illustrates a number of useful points:

- A gradual switching process is important as it allows us to take advantage of both a trending market and shorter-term volatility.
- The opportunity set is meaningful but one needs to move quickly to take advantage of it. Hence why delegating instrument selection to your LDI manager makes good sense.
- The annotations describe the catalyst for the opportunity. This highlights that most opportunities are caused by non-LDI market factors which, in our view, are likely to persist making this a good long-term strategy.

**Interest rate trading activity**

![Chart showing interest rate trading activity]

**Fund characteristics**

**Fund choices:**
- BMO Real Dynamic LDI Fund (targeting real interest rate risk of RPI-linked liabilities)
- BMO Short Profile Real Dynamic LDI Fund (targeting real interest rate risk of RPI-linked liabilities)
- BMO Nominal Dynamic LDI Fund (targeting interest rate risk of nominal liabilities)
- BMO Short Profile Nominal Dynamic LDI Fund (targeting interest rate risk of nominal liabilities)
- BMO Inflation-only Dynamic LDI Fund (targeting inflation-only risk of RPI-linked liabilities)

**Fund vehicle:** Luxembourg FCP

**Leverage target:**
- Real, Nominal and Inflation-only Funds: approximately 3 times
- Short-Profile Real and Nominal Funds: approximately 4 times

**Dealing Frequency:**
- Daily

**Permitted instruments:**
- Conventional gilts and index-linked gilts
- GBP denominated interest rate swaps and inflation swaps
- Gilt futures
- Total return swaps on conventional gilts or index-linked gilts
- Repo on conventional gilts or index-linked gilts
- AAA-rated supranational/sovereign-guaranteed Sterling bonds
- AAA-rated overseas government bonds hedged back to Sterling
- Money market instruments

**Team and resources**

Led by Alex Soulsby, the LDI team is a sub-set of a team of 39 investment professionals, 26 of whom are dedicated to LDI and derivative portfolios. The team includes derivatives fund managers, quantitative analysts and investment specialists who are experts in derivatives, insurance, pensions, quantitative methods and fund management, with an average of 13 years in the industry.

The team is well supported in its activities by the global rates and dealing teams, as well as a deep pool of middle office and client servicing functions. The seamless delivery of investment solutions to our clients is underpinned by a first-class technology and systems infrastructure.
**Fund benchmarks**

The Funds aim to track a set of liability cash flows resembling a typical defined benefit pension scheme. The cash flows in the benchmark mature through time.

**Cashflow Profile: Real & Inflation-only Dynamic LDI Funds**

**Cashflow Profile: Short-Profile Real Dynamic LDI Fund**

**Cashflow Profile: Nominal Dynamic LDI Fund**

**Cashflow Profile: Short Profile Nominal Dynamic LDI Fund**

Source: BMO Global Asset Management. For illustrative purposes only.

Past performance should not be seen as an indication of future performance.
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The Funds are sub funds of BMO LDI Fund, a fonds commun de placement, registered in Luxembourg and authorised by the Commission de Surveillance du Secteur Financier (CSSF).

English language copies of the Fund’s Prospectus can be obtained from BMO Global Asset Management, Exchange House, Primrose Street, London EC2A 2NY, telephone: Client Services on 0044 (0)20 7011 4444, email: client.service@bmogam.com or electronically at www.bmogam.com. Please read the Prospectus before taking any investment decision.

The information provided in the marketing material does not constitute, and should not be construed as, investment advice or a recommendation to buy, sell or otherwise transact in the Funds.

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