mallow street

LDI Report.

IN PARTNERSHIP WITH:

BMO Global Asset Management

WELCOME!

In November 2020, **BMO Global Asset Management** partnered with **mallowstreet** to conduct a survey amongst pension schemes about the current use of LDI within their portfolios. We would like to thank everyone who took the time to participate and are delighted to share the key findings with you.

Hedge accuracy is ranked as the most important component of service: according to the survey results, half of UK pension schemes worry about the risk of a hedge mismatch in their LDI portfolio. The recent RPI reform and counterparty risk are an additional worry for 41% of the schemes.

The survey also reveals that most schemes are using a third party to manage a credit allocation and are potentially missing out on efficiencies around trading and the use of collateral – 86% of schemes surveyed have an allocation to investment grade credit alongside their LDI portfolio, but 64% use a different manager for this rather than their LDI manager. There is almost certainly a cognitive dissonance here: logic shows that the two asset classes sit well together, but schemes continue to keep them apart. BMO GAM conducted a backtest analysis to determine the potential trading cost saving when using coupons from maturing bonds versus the costs when a scheme is required to sell credit assets to meet collateral calls. The outcome was that trading costs could be reduced seven times.

Another area highlighted in the survey is ESG integration: the results suggest that pressures to incorporate ESG criteria into LDI mandates has risen and will do so further. Half of pension schemes seek greater ESG integration from their LDI managers, but it is not yet the most valued manager characteristic, suggesting this is a growing focus and could play a part in retention efforts across the manager spectrum.

Finally, the survey highlights that many schemes do not retender their LDI mandate after the initial appointment. Over 70% have been with their existing manager for over 4 years. Is this an area that your scheme should look at more closely?

We hope you find this report insightful and should you wish to discuss the findings in further detail, please get in touch – we would welcome the opportunity to speak with you.

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KEY STATISTICS

60
qualified responses from UK defined benefit schemes

31
questions

35%
schemes with assets between £500mn and £2bn

68%
closed schemes

40%
schemes with a strong sponsor covenant

54%
working towards self-sufficiency

3,400+
primary data points

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EXECUTIVE SUMMARY

- **FEW UK SCHEMES ARE PLANNING TO CHANGE LDI MANAGERS:** UK schemes review LDI mandates every one-to-three years, but often choose to maintain their manager as they are happy with the relationship.
- **FEES AND EFFICIENT EXECUTION ARE MOST VALUED IN LDI:** the speed and responsiveness of client service cannot make up for poor operational execution. However, poor client service can make LDI managers vulnerable.
- **THE QUALITY OF LDI ASSETS MATTERS MORE THAN LIQUIDITY:** LDI assets should provide good hedging and require reasonable amounts of collateral, but liquidity and reinvestment risk are of lesser importance.
- **INITIAL REASONS TO HIRE A MANAGER VARY BY SCHEME SIZE:** however, other differences by size are more difficult to identify, suggesting there are other factors at play, such as the funding levels, hedge ratios and endgame plans of schemes.
- **SCHEMES WITH LOW HEDGE RATIOS ARE LESS CONFIDENT IN LDI:** they are most likely to increase their hedging but are not certain their current LDI mandate is flexible enough.
- **ESG INTEGRATION IS A CORE REQUIREMENT FOR LDI MANAGERS:** pressures to incorporate ESG criteria into LDI mandates will rise across the board and can make pension schemes re-evaluate their relationship.
- **UNDERFUNDED SCHEMES WANT BETTER EXECUTION:** they see the most room for improvement in the operational execution and hedge accuracy of their LDI managers. They are also more likely to value and prioritise capital efficiency.
- **ENDGAME COMPATIBILITY IS A KEY CONCERN FOR LDI ASSETS:** liquidity, reinvestment risk and timeliness in implementing changes are more important when schemes are close to their endgame than at longer time horizons.
- **COLLATERAL MANAGEMENT IS NOT HIGH ON SCHEMES' RADAR:** many UK schemes leave collateral management to the LDI manager, but those close to their endgame prefer liquid credit other than corporate bonds (e.g. gilts).
- **LDI IS OFTEN KEPT SEPARATE FROM INVESTMENT GRADE CREDIT:** a majority of UK schemes allocate to investment grade with a manager different from their LDI manager, missing out on potential efficiencies.

RECOMMENDATIONS

- Review your LDI manager at least every three years
- Fees are important when selecting managers, but they are not everything
- Keep a close eye on operational execution and fee accuracy – your consultant can help with monitoring the LDI mandate
- Discuss concerns around client service with your LDI manager and/or consultant
- Keep your LDI manager posted as your needs evolve with your funding level and endgame journey progress
- Consider possible synergies between LDI and other parts of your portfolio – your LDI manager may be able to offer efficiencies in investment grade and other relevant credit investments
- Also consider your need for more efficient collateral management – something that your LDI manager can help with

KEY STATISTICS

88%
do not plan to change managers

64%
review managers every one to three years

#1
hedge accuracy is the most important component of service

71%
would review LDI managers if they face recurring issues with inefficient execution

71%
would review LDI managers if faced with recurring issues with the timeliness and quality of service

60%
value efficient operational execution

47%
value fee levels

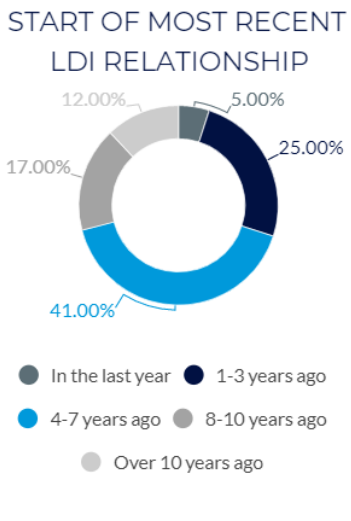
FEW UK SCHEMES ARE PLANNING TO CHANGE LDI MANAGERS

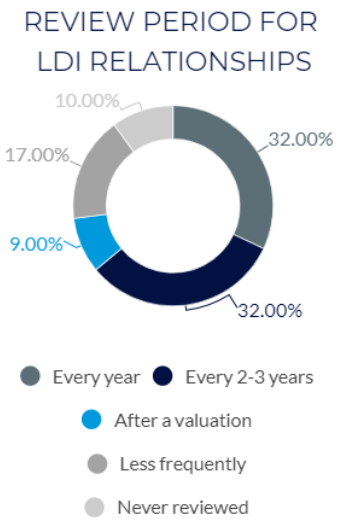
UK schemes review LDI mandates every one-to-three years but often choose to maintain their manager as they are happy with the relationship. A change in manager is perceived to be unlikely to offset the potential benefits.

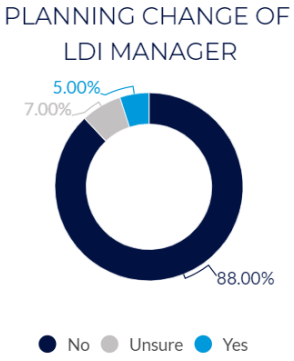
Just 5% of schemes joined forces with their current LDI manager less than a year ago. For 41%, the relationship started four to seven years ago. One-third review their LDI relationship every year, and just as many conduct a review every two or three years.

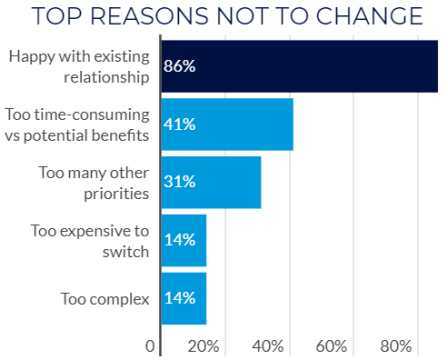
This suggests that most UK schemes have maintained their existing relationship following the last review: over 70% of schemes which hired their LDI manager four to seven years ago have not retendered since. The same applies to 70% of pension funds which hired their LDI manager eight to ten years ago, but only to 57% of schemes with longer relationships.*

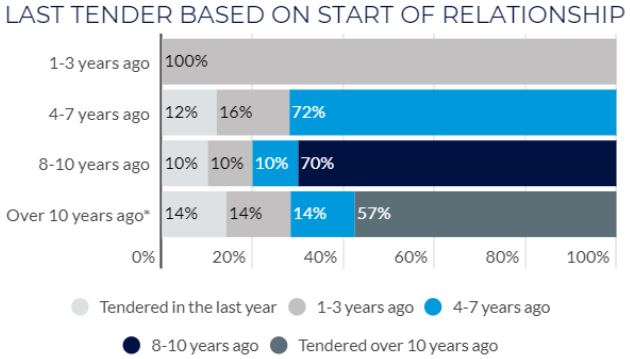
Nearly 90% of UK schemes are not planning to change LDI managers, as 86% say they are happy with the existing relationship. For many, a potential change is seen as too time consuming compared to the potential benefits or other priorities they have.











KEY STATISTICS

88%
do not plan to change managers

86%
are satisfied with the existing relationship

41%
hired their current LDI manager four to seven years ago

25%
did so one to three years ago

32%
review managers every year

32%
review managers every two to three years instead

* Some groups are represented by only a few respondents in this survey (e.g. over 10 years ago = 7 resp.).

FEES AND EFFICIENT EXECUTION ARE MOST VALUED IN LDI

The speed and responsiveness of client service cannot make up for poor operational execution. Other manager characteristics are also valued less.

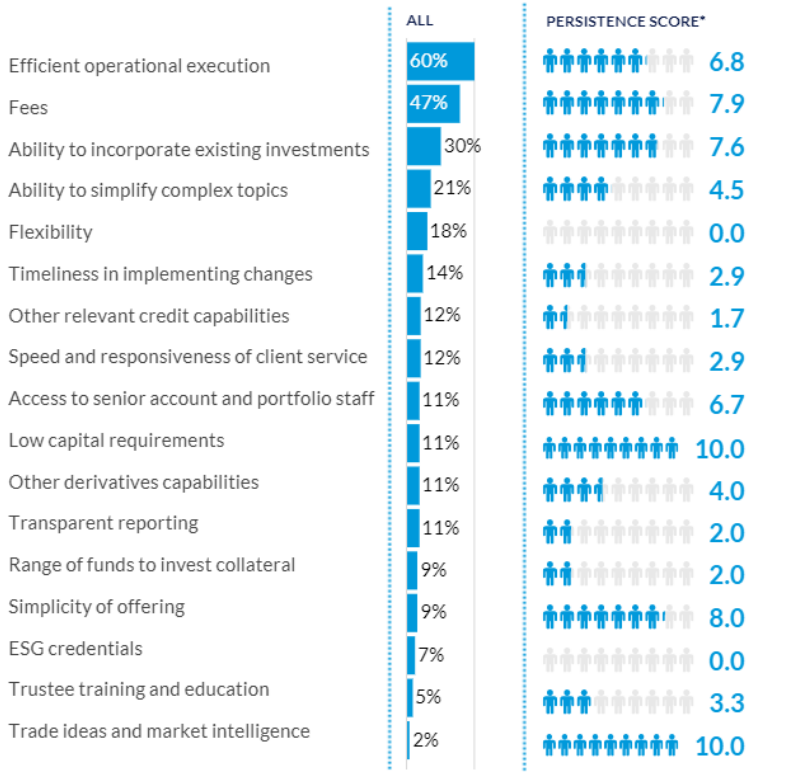
Every three in five UK schemes value efficient operational execution, and nearly half say fees top their criteria list. These criteria are also among the most persistent ones when compared to the reasons why pension schemes hired their current LDI manager in the first place.*

While one in five value an LDI manager's ability to simplify complex topics and offer flexibility, these characteristics have a low persistence score, suggesting that they were not amongst the top reason why the manager was initially hired.

Interestingly, the speed and responsiveness of client service is not amongst the top valued characteristics in an LDI manager, signalling that it cannot compensate for a lack of efficient operational execution.

Other characteristics, such as low capital requirements, range of funds to invest collateral or ESG credentials also generate less value than efficient operational execution and competitive fees.

MOST VALUED CHARACTERISTICS IN AN LDI MANAGER



KEY STATISTICS

60%
value efficient operational execution

47%
say fee levels are a top consideration

21%
value an LDI manager's ability to simplify complex topics and be flexible

12%
value fast and responsive client service

11%
value low capital requirements

9%
value a manager with a broad range of funds to invest collateral

* The persistence score denotes the number of schemes out of each 10 who hired their LDI manager because they fulfilled the same criteria they value today. Respondents chose up to three options in both questions.

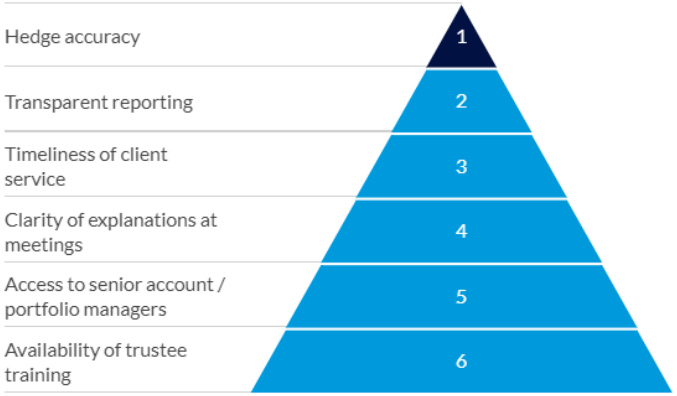
POOR SERVICE CAN MAKE LDI MANAGERS VULNERABLE

Poor client service is more likely to prompt an LDI manager review than fees, but a consultant's recommendation also plays an important role.

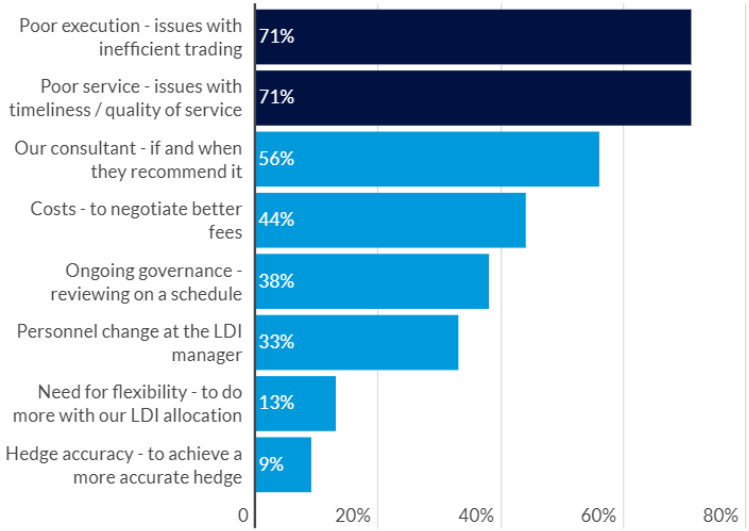
Hedge accuracy is the top component of an LDI mandate. After transparent reporting, the timeliness of client service comes third. Clarity of explanations at meetings, access to senior client and portfolio staff and trustee training are of lesser importance. This ranking also suggests that good client service cannot offset operational issues.

Poor service is just as likely to prompt a review of the existing LDI relationship as poor operational execution – 71% would review their LDI manager if there are recurrent issues with inefficient trading, and just as many would do so if there are concerns with overall service.

MOST IMPORTANT TO SERVICE



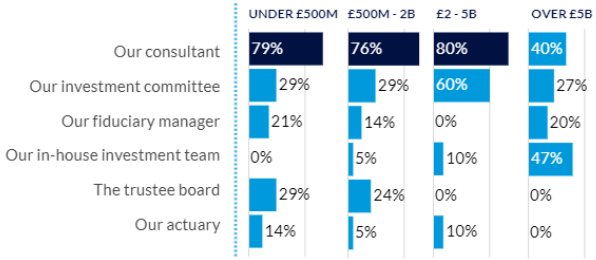
TOP PROMPTS FOR LDI MANAGER REVIEW



Costs are important but not the top reason why UK schemes may revisit their LDI manager. Just 38% review such managers on a schedule, and only 13% would seek greater flexibility.

However, over half of UK schemes rely on their consultant to prompt a review of their existing LDI relationship. This is particularly the case for smaller schemes – for over 75% of those with assets under £5bn, the consultant does most of the work when it comes to monitoring and reviewing the LDI manager.

KEY DECISION-MAKERS IN LDI MANDATES



KEY STATISTICS

#1
hedge accuracy is the most important component of service

71%
would review LDI managers if they face recurring issues with inefficient execution

71%
would review LDI managers if faced with recurring issues with the timeliness and quality of service

56%
would review LDI managers if prompted by their consultant

44%
would review LDI managers to negotiate better fees

38%
review LDI managers on a schedule

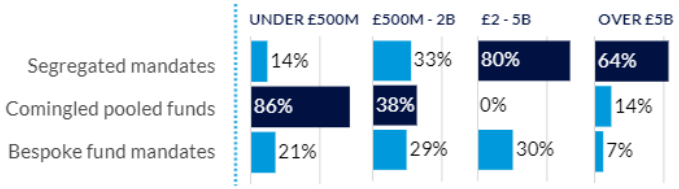
PREFERRED WAYS TO ACCESS LDI VARY BY SCHEME SIZE

Smaller schemes prefer pooled funds, whereas larger ones favour segregated mandates. Bespoke fund mandates are less popular.

Over 85% of schemes under £500mn and an additional 38% of schemes with assets up to £2bn prefer to access LDI via comingled pooled funds. In contrast, 80% of schemes up to £5bn and 64% of larger schemes prefer segregated mandates.

Bespoke fund mandates (i.e. 'funds of one') are less popular overall, but appeal to schemes of varied sizes. They may be a welcome flexibility feature for some.

PREFERRED WAYS TO ACCESS LDI SOLUTIONS



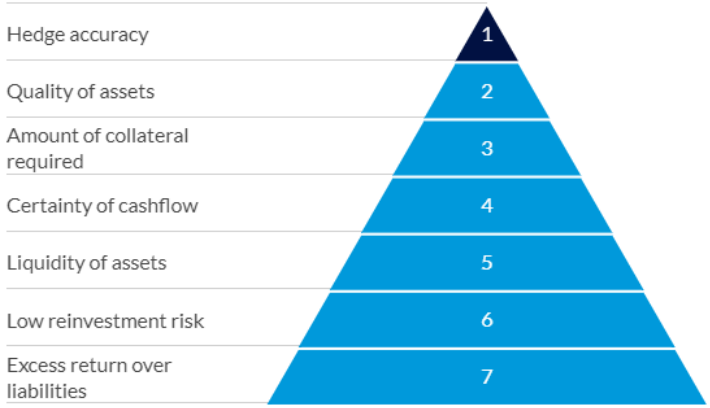
THE QUALITY OF LDI ASSETS MATTERS MORE THAN LIQUIDITY

LDI assets should provide good hedging and require reasonable amounts of collateral, but liquidity and reinvestment risk matter less.

Hedge accuracy is the top priority when it comes to LDI assets. This is also the most important characteristic in an LDI manager's service, as already discussed. The quality of LDI assets is the second most important consideration, followed by the amount of collateral required.

However, the liquidity of assets and low reinvestment risk matter far less than accuracy and quality. Additionally, excess return over liabilities is less important than the certainty of cashflow that LDI assets can provide.

MOST IMPORTANT FOR LDI ASSETS



KEY STATISTICS

86%
of small schemes prefer accessing LDI in a pooled fund

64%
of large schemes prefer investing in a segregated mandate

#1
hedge accuracy is most important when selecting LDI assets

#2
quality of assets is the second top consideration

#3
the amount of collateral required is the third-most consideration when it comes to LDI assets

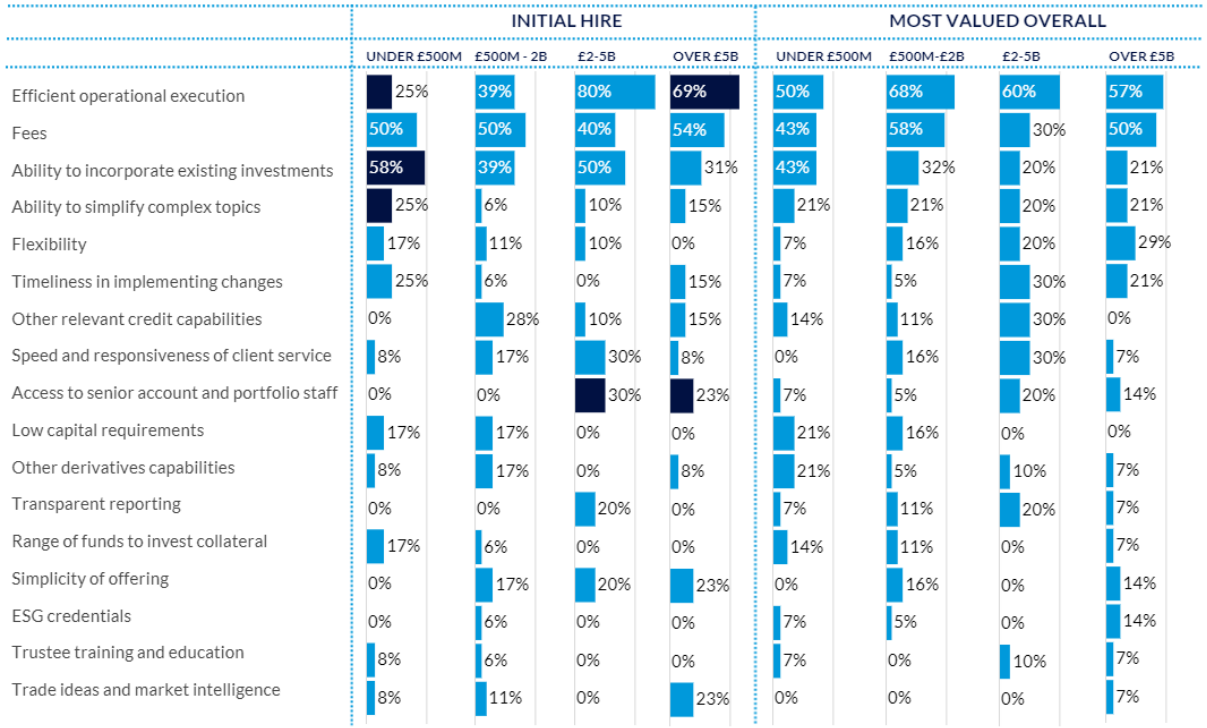
INITIAL REASONS TO HIRE A MANAGER VARY BY SCHEME SIZE

Large schemes are initially more drawn to excellence and senior expertise, whereas small schemes opt for ease of implementation.

When they initially hired their current LDI manager, 69% of schemes over £5bn favoured efficient operational execution – compared to just 25% of schemes under £500mn. Larger schemes also wanted access to senior account managers and portfolio strategists. Even though some of these differences disappear when looking at most valued manager characteristics overall, they suggest that large schemes are initially attracted to excellence and senior expertise.

In contrast, 58% of schemes under £500mn chose their LDI manager because they were able to incorporate their existing investments into the LDI mandate. They may have already been working with that manager in another way, e.g. as a credit portfolio manager. Smaller schemes also placed greater importance on the manager's ability to simplify complex topics, their low capital requirements, and the range of funds to invest collateral. While these differences are less pronounced when looking at most valued characteristics overall, they suggest that smaller schemes value ease of initial implementation.

MOST VALUED CHARACTERISTICS IN AN LDI MANAGER



KEY STATISTICS

69%
of large schemes favoured efficient operational execution when they first hired their LDI manager

23%
also wanted access to senior account and portfolio staff

58%
of small schemes placed greater importance on the ability to bring in existing investments instead

25%
wanted a manager that can simplify complex topics

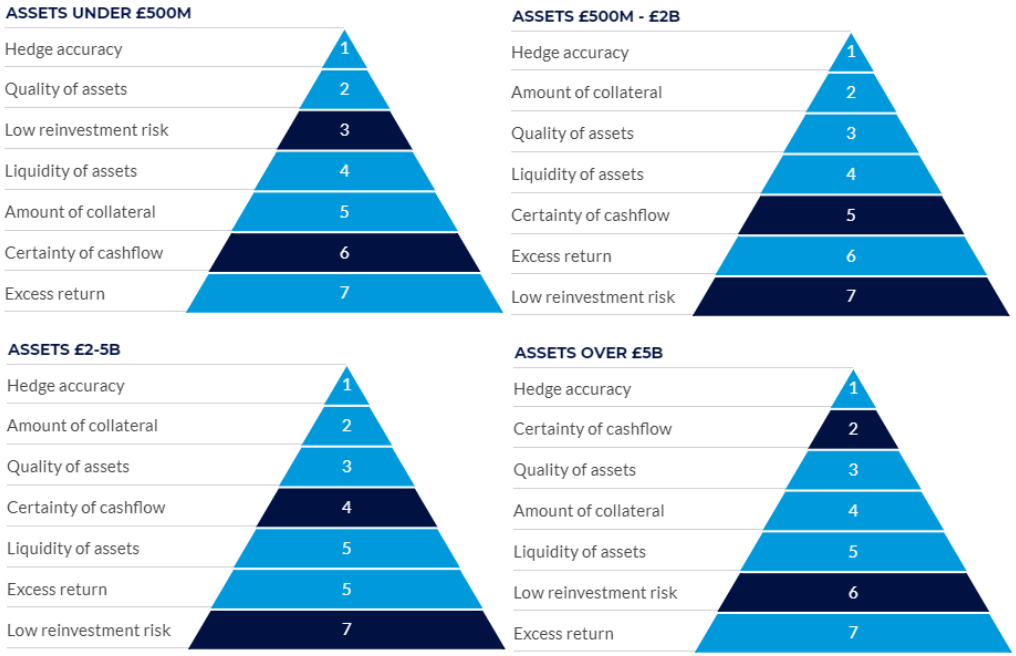
A LOOK BEYOND SCHEME SIZE CAN HELP IN UNDERSTANDING THE MARKET

There are variations by size across a number of preferences, but they are difficult to interpret, suggesting other drivers are at play.

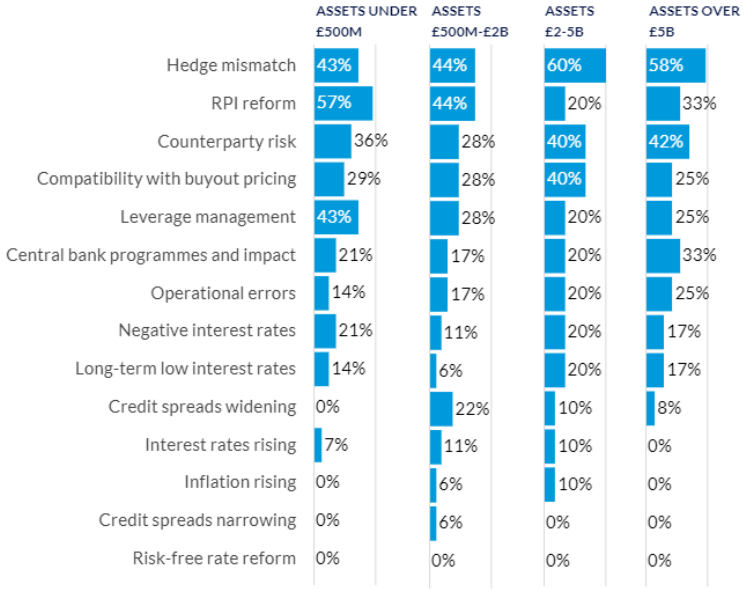
For example, schemes with smaller assets place greater importance on the low reinvestment risk of LDI assets than the certainty of the cashflows they produce, whereas the opposite is true of larger schemes. However, it is hard to understand why this is by looking at the size of the scheme alone.*

Additionally, schemes with assets up to £500mn are most concerned about RPI reform when it comes to their LDI portfolios, but it is difficult to see why, as RPI reform affects schemes of all sizes.

MOST IMPORTANT FOR LDI ASSETS

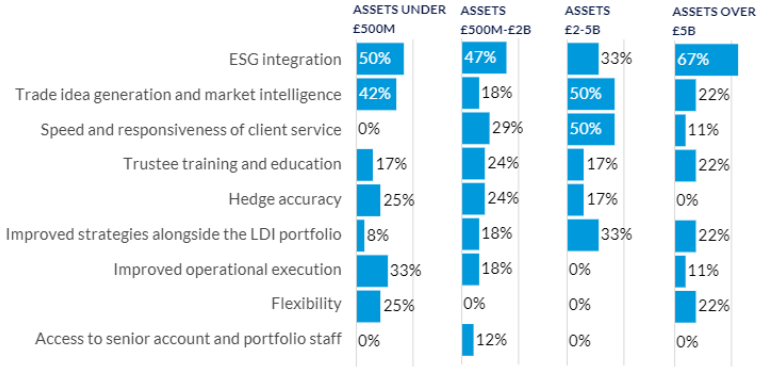


TOP CONCERNS FOR LDI PORTFOLIOS



A similar logic applies to differences in concern over leverage management within the LDI portfolio, the impact of central bank programmes or credit spreads widening. It is also difficult to determine why schemes of different sizes might see different areas in which their LDI managers could improve. This suggests there are other drivers at play.

AREAS FOR POSSIBLE IMPROVEMENT



* Please also note that some considerations tie in the rankings, e.g. for schemes with assets of £2-5bn.

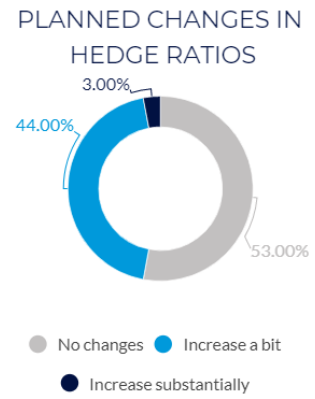
SCHEMES WITH LOW HEDGE RATIOS ARE LESS CONFIDENT IN LDI

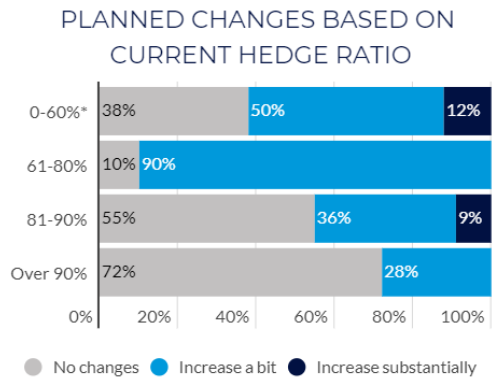
They are most likely to increase their hedge ratio but are not certain their current LDI mandate is flexible enough to meet their long-term objectives.

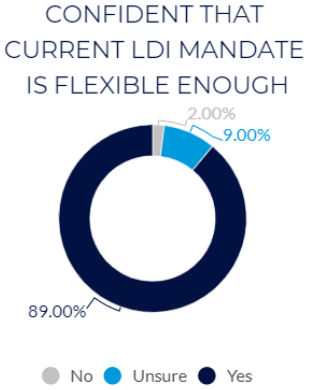
Nearly half of UK pension schemes are considering at least a small increase of their hedge ratio within the next 12 months. Just 3% are planning substantial increases.

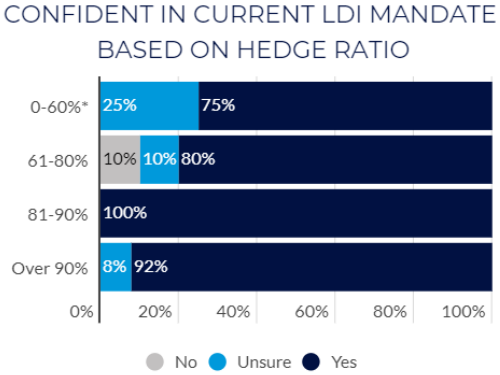
Schemes with a low hedge ratio are most likely to plan increases. For example, 62% of schemes hedging less than 60% of their liabilities plan changes, and 12% want to increase their hedge ratio substantially. Similarly, 90% of schemes hedging up to 80% of their liabilities are planning an increase.*

However, schemes with lower hedge ratios report more concern that their current LDI mandate is not flexible enough for them to meet their long-term objective. In particular, 25% of schemes with the lowest hedge ratios are unsure of the suitability of their current LDI approach, and an additional 20% of schemes with a hedge ratio of 61-80% are either unsure or outright state they do not think the approach fits.









KEY STATISTICS

44%
plan to increase their LDI hedge ratio a bit

3%
plan to increase it substantially

50%
of schemes hedging up to 60% of their liabilities plan to increase their hedge ratio somewhat

12%
plan to increase it significantly

25%
are not confident in their current LDI mandate helping them achieve their endgame

* Some groups are represented by few respondents in this survey (e.g. hedge ratio up to 60% = 9 resp.). For more information, please see the appendix.

HEDGE RATIOS DRIVE APPETITE FOR OTHER CAPABILITES

Buy and maintain credit and similar solutions are more attractive to schemes with a high hedge ratio, while other derivatives capabilities, such as synthetic credit or equities, appeal more to schemes with a low hedge ratio.

Schemes whose hedge ratio is below 60% have a smaller proportion of their assets in LDI. They are also less focused on efficient execution than schemes with higher hedge ratios. However, they are interested in the derivatives capabilities an LDI manager can offer (e.g. synthetic credit or equities) over other relevant credit capabilities (e.g. buy and maintain). For example, 14% of schemes hedged up to 60% initially chose an LDI manager for their derivatives capabilities. A quarter of schemes hedging 61-80% of their liabilities did the same, but the proportion drops significantly at higher hedge ratio levels.*

In contrast, a third of schemes hedging 81-90% of their liabilities hired their LDI manager for their credit capabilities in addition to their LDI capabilities. The same applies for almost two out of every five schemes with a hedge ratio above 90%, but for none of the schemes with lower hedge ratios.

Even though these differences shrink when looking at the most valued characteristics overall, schemes with higher hedge ratios are likely to be initially attracted to the credit capabilities their LDI manager can offer.

MOST VALUED CHARACTERISTICS IN AN LDI MANAGER

	INITIAL HIRE				MOST VALUED OVERALL			
	0-60%*	61-80%*	81-90%	OVER 90%	0-60%*	61-80%*	81-90%	OVER 90%
Efficient operational execution	43%	50%	30%	58%	38%	70%	45%	65%
Fees	43%	50%	60%	42%	50%	50%	55%	38%
Ability to incorporate existing investments	57%	25%	60%	38%	62%	20%	55%	12%
Ability to simplify complex topics	14%	38%	10%	8%	25%	40%	18%	15%
Flexibility	14%	12%	0%	12%	50%	0%	9%	19%
Timeliness in implementing changes	14%	25%	0%	12%	0%	20%	0%	23%
Other relevant credit capabilities	0%	0%	30%	19%	0%	10%	27%	12%
Speed and responsiveness of client service	29%	12%	0%	15%	0%	10%	9%	19%
Access to senior account and portfolio staff	14%	12%	10%	12%	0%	10%	9%	12%
Low capital requirements	0%	12%	20%	8%	0%	20%	18%	8%
Other derivatives capabilities	14%	25%	0%	8%	0%	20%	9%	12%
Transparent reporting	0%	0%	0%	8%	12%	0%	9%	15%
Range of funds to invest collateral	14%	0%	20%	0%	12%	0%	9%	12%
Simplicity of offering	0%	25%	0%	23%	0%	10%	0%	15%
ESG credentials	0%	0%	0%	4%	12%	10%	9%	4%
Trustee training and education	0%	0%	20%	0%	0%	0%	9%	8%
Trade ideas and market intelligence	29%	12%	0%	12%	0%	0%	0%	4%

KEY STATISTICS

14%
of schemes with a hedge ratio under 60% chose an LDI manager for their extra derivatives capabilities

25%
of schemes with a hedge ratio up to 80% did the same

30%
of schemes hedging up to 90% of their liabilities hired an LDI manager for their extra credit capabilities instead

19%
of schemes with a hedge ratio above 90% did the same

* Some groups are represented by few respondents in this survey (e.g. hedge ratio 0-60% = 9 resp.). For more information, please see the appendix.

SCHEMES WITH LOW HEDGING WORRY ABOUT THE LONG TERM

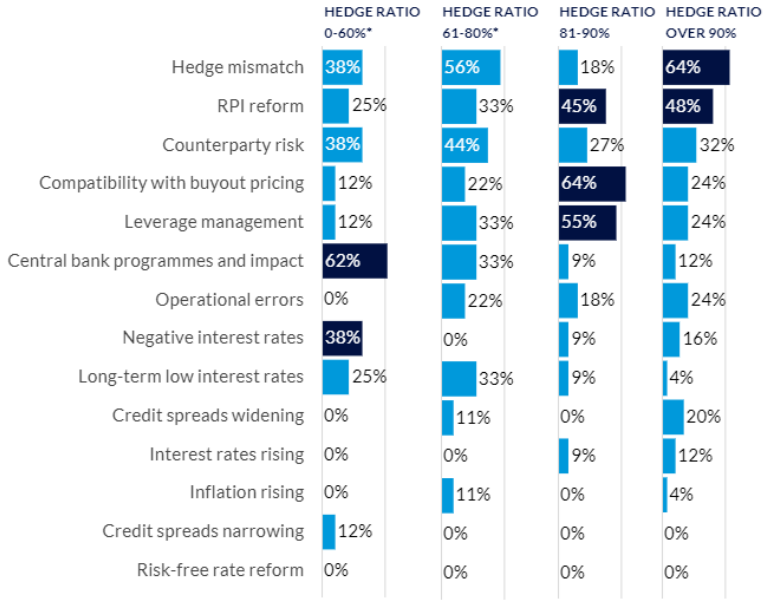
Schemes with low hedge ratios worry about the economic impact of central bank programmes, suggesting a concern about long-term prospects.

For 62% of schemes hedging up to 60% of their liabilities, central bank programmes and their impact are a top concern when it comes to their LDI portfolios. They are also more concerned about negative interest rates than peers, suggesting a focus on the future economic outlook and a longer investment horizon.*

In contrast, 64% of schemes hedging 81-90% of their liabilities are worried about the compatibility of their LDI portfolio with buyout pricing, while 55% are concerned about leverage management – as, for instance, collateral calls can have a negative impact on scheme liquidity. The impact of RPI reform on future benefits also becomes more important at higher scheme hedge ratios.

Meanwhile, schemes with hedge ratios above 90% are much more focused on the risk of a hedge mismatch as they aim to protect their position.

TOP CONCERNS FOR LDI PORTFOLIOS



KEY STATISTICS

62%
of schemes with low hedge ratios focus on central bank programmes and their impact

38%
of them also worry about negative interest rates

64%
of schemes with high hedge ratios worry about the compatibility of their LDI assets with buyout pricing

55%
of them also worry about leverage management

45%
of them are concerned about RPI reform

* Respondents were able to choose up to three options. Some groups are represented by few respondents in this survey (e.g. hedge ratio 0-60% = 9 resp.). For more information, please see the appendix.

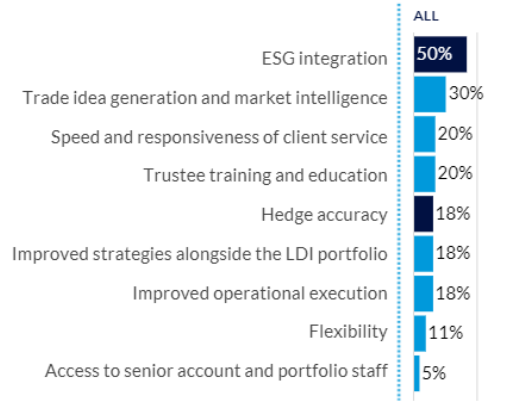
ESG INTEGRATION IS A CORE REQUIREMENT FOR LDI MANAGERS

Pressures to incorporate ESG criteria into LDI mandates will rise across the board and can make pension schemes re-evaluate their relationship.

Half of all pension schemes seek greater ESG integration from their LDI managers, but it is not among the most highly valued characteristics. This suggests that ESG is increasingly turning into a core requirement for LDI managers as much as for other asset managers and, if not sufficiently integrated into LDI solutions, can make pension schemes re-evaluate their relationship.

In contrast, just 18% of all schemes think hedge accuracy needs improvement. Given that it is a top consideration in LDI mandates, the low proportion of schemes seeking improvement is a testament that most LDI managers have delivered on this key objective for their mandate. This is perhaps why so few schemes are looking to change LDI managers.

AREAS FOR POSSIBLE IMPROVEMENT



KEY STATISTICS

50%
think ESG integration is an area needing improvement among LDI managers

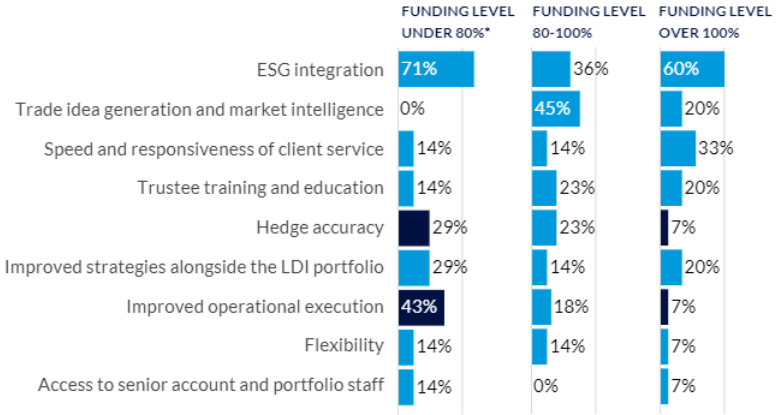
43%
of underfunded schemes think their LDI manager could improve operational execution

29%
of underfunded schemes think their LDI manager could improve hedge accuracy further

7%
of overfunded schemes agree

UNDERFUNDED SCHEMES WANT BETTER EXECUTION

AREAS FOR POSSIBLE IMPROVEMENT



Schemes with lower funding ratios see the most room for improvement in the operational execution and hedge accuracy of their LDI managers.

Over a quarter of schemes with a funding level up to 80% think their LDI manager could improve hedge accuracy, compared to only 7% of those with a funding level above 100%.* Similarly, 43% of underfunded schemes believe their LDI manager could improve operational execution further. Only 7% of overfunded schemes share this view.

Underfunded schemes stand to gain the most from LDI – it can protect their funding level in the long term. Against this backdrop, their concerns about accuracy and execution warrant the attention of LDI managers.

* Respondents were able to choose up to three options. ESG integration is the biggest area where LDI managers should improve, but this is covered later in the report. Some groups are represented by few respondents in this survey (e.g. funding level under 80% = 9 resp.). For more information, please see the appendix.

UNDERFUNDED SCHEMES VALUE CAPITAL EFFICIENCY

Schemes with low funding levels place much greater importance on the low capital requirements of an LDI manager than their peers.

Two of every five schemes funded to a level below 80% (based on technical provisions) initially hired their LDI manager for their low capital requirements, compared to only 5% of overfunded schemes (with a funding level over 100%). Beyond the initial hire, 38% of underfunded schemes (with a funding level below 80%) value this feature in LDI managers overall. These preferences suggest they need to put their capital to better work and would favour LDI solutions with high capital efficiency.

However, underfunded schemes overlook other capabilities their LDI manager may have, such as relevant credit (e.g. buy and maintain) or derivatives capabilities (e.g. synthetic equity and credit), which could also help put their capital to better use. They do not value highly such characteristics in an LDI manager overall.**

MOST VALUED CHARACTERISTICS IN AN LDI MANAGER

	INITIAL HIRE			MOST VALUED OVERALL		
	UNDER 80%	80-100%**	OVER 100%	UNDER 80%	80-100%**	OVER 100%
Efficient operational execution	40%	54%	50%	62%	64%	52%
Fees	80%	50%	40%	88%	46%	33%
Ability to incorporate existing investments	20%	39%	55%	25%	36%	24%
Ability to simplify complex topics	40%	7%	15%	25%	25%	14%
Flexibility	0%	11%	10%	0%	18%	24%
Timeliness in implementing changes	20%	11%	10%	0%	11%	24%
Other relevant credit capabilities	20%	14%	15%	0%	11%	19%
Speed and responsiveness of client service	20%	21%	5%	0%	11%	19%
Access to senior account and portfolio staff	0%	11%	15%	12%	7%	14%
Low capital requirements	40%	7%	5%	38%	7%	5%
Other derivatives capabilities	0%	11%	10%	0%	11%	14%
Transparent reporting	0%	0%	10%	12%	7%	14%
Range of funds to invest collateral	0%	11%	0%	0%	7%	14%
Simplicity of offering	0%	18%	15%	0%	11%	10%
ESG credentials	0%	4%	0%	12%	7%	5%
Trustee training and education	0%	4%	5%	0%	4%	10%
Trade ideas and market intelligence	20%	7%	15%	0%	4%	0%

KEY STATISTICS

40%

of underfunded schemes selected their LDI manager based on their low capital requirements

38%

value this characteristic

0%

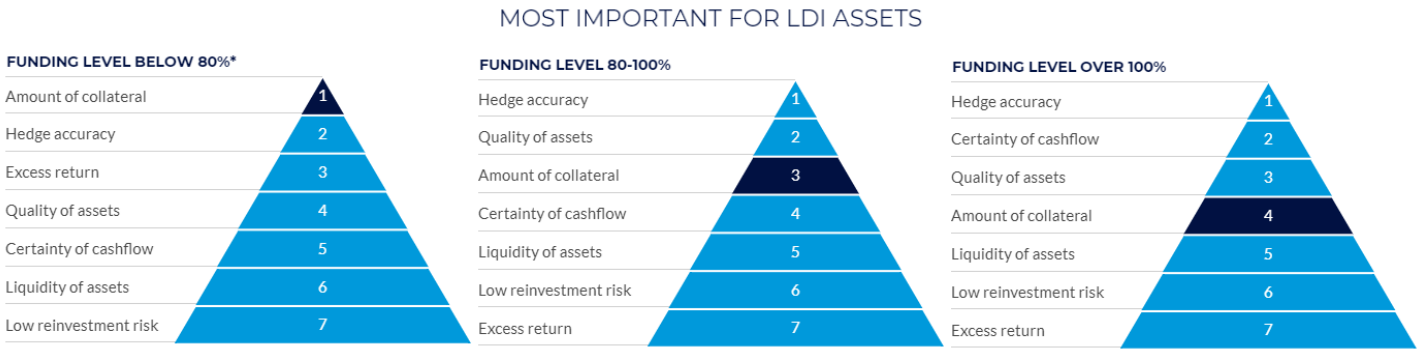
None of the underfunded schemes value relevant credit or derivative capabilities

** Some groups are represented by few respondents in this survey (e.g. funding level under 80% = 9 resp.). For more information, please see the appendix.

UNDERFUNDED SCHEMES PRIORITISE COLLATERAL EFFICIENCY IN LDI ASSETS

Schemes with low funding levels prioritise the amount of collateral required in the selection of LDI assets.

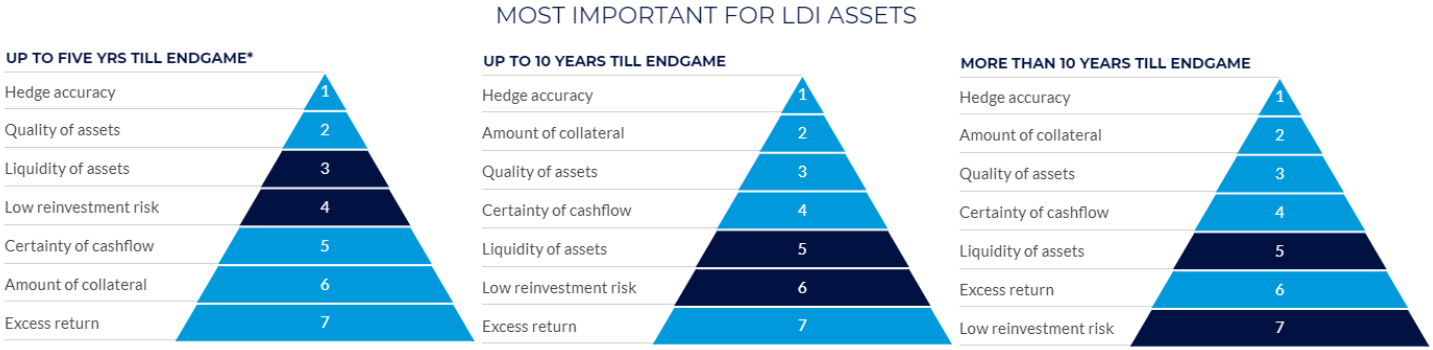
Schemes with a funding level below 80% pick the amount of collateral required as their top consideration, which possibly reflects a shortage of free cash not earning a return. In fact, excess return over liabilities is their third most important consideration, while schemes with higher funding levels place much lower importance on that. In contrast, overfunded schemes focus on cashflow certainty, possibly as they evolve their LDI portfolio to meet future cashflow needs.



SCHEMES APPROACHING THEIR ENDGAME PRIORITISE LIQUID LDI ASSETS

Liquidity and reinvestment risk are more important when schemes are close to their endgame than they are at longer time horizons.

For schemes approaching their endgame, LDI assets should be liquid and with low reinvestment risk. These considerations are third and fourth in their priority rankings, while schemes that have more time till their endgame tend to assign lesser importance to them. In contrast, they give greater importance to collateral requirements.*



* Some groups are represented by few respondents in this survey (e.g. funding level under 80% = 9 resp., up to 5 yrs till endgame = 7 resp.). For more information, please see the appendix.

TIMELINESS MATTERS FOR SCHEMES HEADED FOR BUYOUT

Schemes planning a buyout value the timely implementation of changes and a responsive client service more than their peers.

Even though these features did not stand out when they initially hired their current LDI manager, 32% of UK pension funds aiming for buyout value an LDI manager who can implement changes to the LDI mandate and strategy in a timely fashion. Speed and responsiveness of client service is crucial for a quick turnaround of change requests, which is possibly why 21% of schemes headed for buyout value this characteristic.*

In contrast, less than 10% of schemes aiming for self-sufficiency or low dependency on their sponsor share these priorities. This suggests that time is of the essence for schemes whose endgame naturally restricts their time horizon.

MOST VALUED CHARACTERISTICS IN AN LDI MANAGER

	INITIAL HIRE			MOST VALUED OVERALL		
	BUYOUT	SELF-SUFFICIENCY	UNDECIDED*	BUYOUT	SELF-SUFFICIENCY	UNDECIDED*
Efficient operational execution	41%	55%	67%	68%	55%	67%
Fees	41%	55%	50%	42%	55%	33%
Ability to incorporate existing investments	59%	38%	33%	37%	32%	0%
Ability to simplify complex topics	6%	14%	33%	21%	19%	33%
Flexibility	12%	10%	0%	16%	19%	17%
Timeliness in implementing changes	6%	14%	17%	32%	6%	0%
Other relevant credit capabilities	24%	14%	0%	5%	13%	17%
Speed and responsiveness of client service	12%	17%	17%	21%	10%	0%
Access to senior account and portfolio staff	6%	14%	17%	5%	13%	17%
Low capital requirements	12%	10%	0%	11%	13%	0%
Other derivatives capabilities	6%	10%	0%	5%	10%	33%
Transparent reporting	6%	3%	0%	5%	16%	0%
Range of funds to invest collateral	12%	3%	0%	11%	0%	33%
Simplicity of offering	12%	14%	17%	5%	10%	0%
ESG credentials	0%	3%	0%	0%	10%	17%
Trustee training and education	12%	0%	0%	11%	0%	17%
Trade ideas and market intelligence	12%	10%	17%	0%	3%	0%

KEY STATISTICS

32%
of schemes aiming for buyout value an LDI manager's timeliness in implementing changes

21%
value the speed and responsiveness of client service

6%
of schemes aiming to become self-sufficient favour a manager that can make changes in a timely manner

10%
value a fast and responsive client service

* Some groups are represented by few respondents in this survey (e.g. undecided = 7 resp.). For more information, please see the appendix.

ENDGAME COMPATIBILITY IS A KEY CONCERN FOR LDI ASSETS

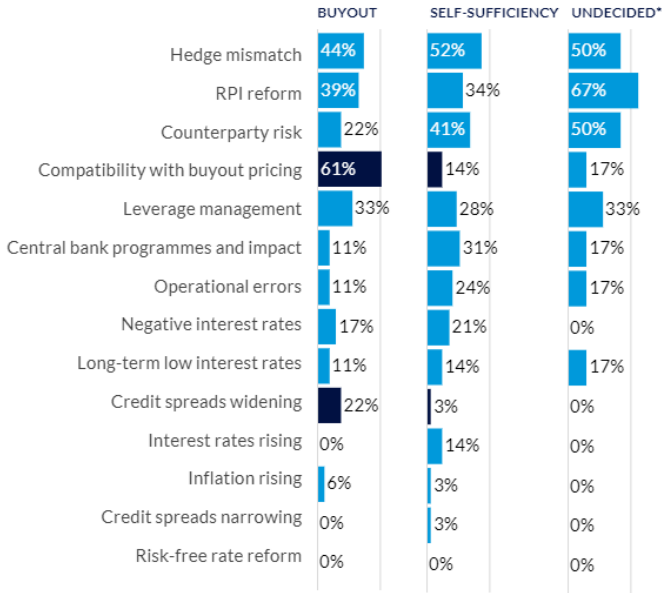
Compatibility with endgame plans is a bigger worry for schemes aiming for buyout.

About half of UK pension schemes worry about the risk of a hedge mismatch in their LDI portfolio, irrespective of their endgame plans. But beyond this core requirement for LDI assets, what schemes worry about varies depending on their endgame plans.*

For 61% of schemes working towards buyout, the key concern around their LDI portfolio is its compatibility with buyout pricing and a transition to an insurer.

Credit spread movements are not of major concern overall. However, schemes aiming for buyout are twice as likely to worry about credit spread expansion. The reasons for this are not clear but could reflect concerns about the compatibility of the credit assets held versus their goal.

TOP CONCERNS FOR LDI PORTFOLIOS



KEY STATISTICS

50%
worry about a hedge mismatch in their LDI portfolio

61%
of schemes aiming for buyout worry about the compatibility of their LDI portfolio with their endgame

22%
of them also worry about credit spreads widening

* Respondents were able to choose up to three options. Some groups are represented by few respondents in this survey (e.g. undecided = 7 resp.). For more information, please see the appendix.

IMPROVING EXECUTION IS LESS IMPORTANT CLOSE TO ENDGAMES

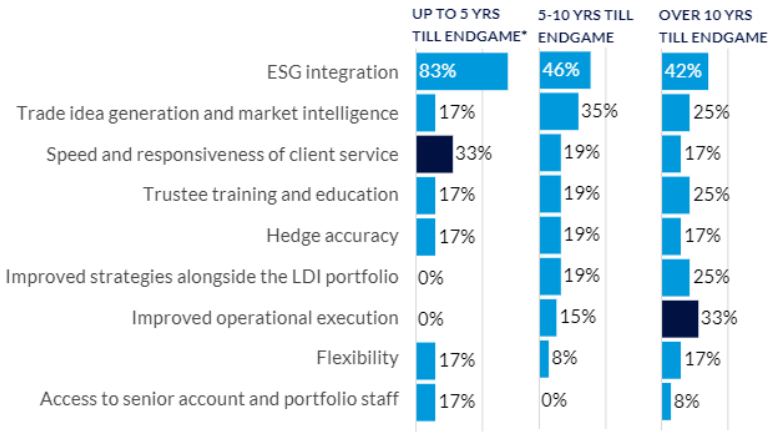
Schemes approaching their endgame do not see a need for their LDI managers to improve operational execution, focusing instead on speed of client service.

Improved operational execution is more important to pension funds with a long-term horizon – 33% of those who have more than 10 years until their endgame think their LDI manager's operational execution can be improved.*

In contrast, none of those about to achieve their endgame in the next five years see a need for improvement in this area. Instead, 33% focus on improving the speed and responsiveness of client service.

Interestingly, improved strategies alongside LDI matter more to schemes with a longer horizon. None of the schemes with a five-year horizon until their endgame are interested in these LDI add-ons, compared to 25% of those with more than 10 years to go.

AREAS FOR POSSIBLE IMPROVEMENT



KEY STATISTICS

33%

of schemes over 10 years away from their endgame think operational execution can be improved

25%

of them also think their manager could offer improved strategies alongside the LDI portfolio

0%

None of the schemes with less than five years to go see a need for LDI managers to improve operational execution or offer improved strategies alongside the LDI portfolio

* Respondents were able to choose up to three options. ESG integration is the biggest area where LDI managers should improve, but this is covered later in the report. Some groups are represented by few respondents in this survey (e.g. up to 5 yrs till endgame = 7 resp.). For more information, please see the appendix.

COLLATERAL MANAGEMENT IS NOT HIGH ON SCHEMES' RADAR

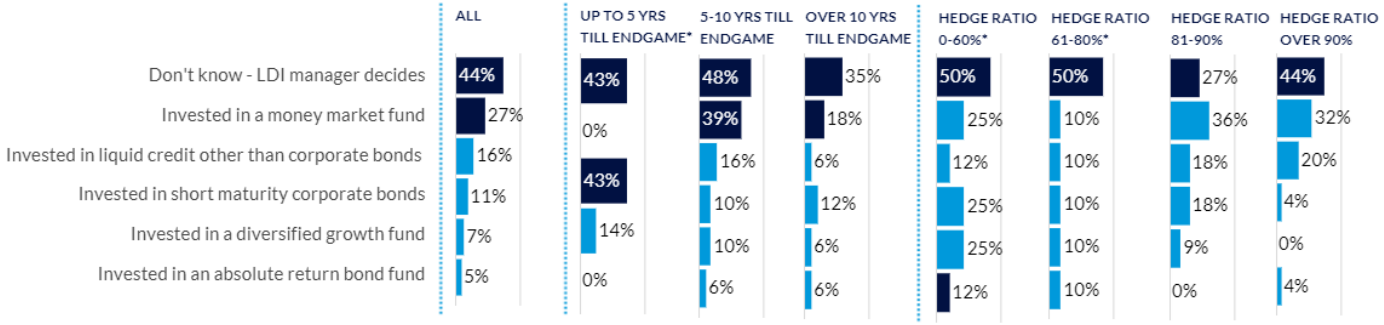
Many UK schemes leave collateral management to the LDI manager, although schemes close to their endgame prefer liquid credit other than corporate bonds.

About half of UK schemes say they are unaware of how their LDI collateral is managed, as this is something their manager decides. Just over a quarter have invested their collateral in a money market fund. Liquid credit other than corporate bonds (e.g. gilts or asset-backed securities) is used for collateral management by just over 15%, but some schemes are able to use existing gilt investments in this way and supplement them with cash. Just over 10% invest in short maturity corporate bonds. Diversified growth funds (DGFs) and absolute return bond funds are used more rarely.

However, schemes within five years of their endgame do not invest in money market funds at all. Instead, 43% invest in liquid credit other than corporate bonds. This may reflect a desire to construct an insurance-ready or self-sufficiency portfolio as the endgame approaches. In contrast, 39% of schemes who have five to ten years to go, and an additional 18% of schemes with a longer horizon, use money market funds for collateral management.*

DGFs and absolute return bond funds are much more relevant to schemes with low hedge ratios. For example, 25% of those hedging less than 60% of their liabilities invest their collateral in DGFs, and 12% in absolute return bond funds, compared to under 5% amongst schemes with hedge ratios above 90%.

COLLATERAL MANAGEMENT PREFERENCES



KEY STATISTICS

44%
leave collateral management decisions to their LDI managers

27%
invest their collateral in money market funds

16%
prefer liquid credit other than corporate bonds (e.g. gilts or asset-backed securities)

43%
of schemes close to their endgame prefer such assets

25%
of schemes with low hedge ratios invest their collateral in DGFs

12%
use absolute return bond funds

* Respondents were able to choose as many options as suitable. Some groups are represented by few respondents in this survey (e.g. up to 5 yrs till endgame = 7 resp., hedge ratio 0-60% = 9 resp.). For more information, please see the appendix.

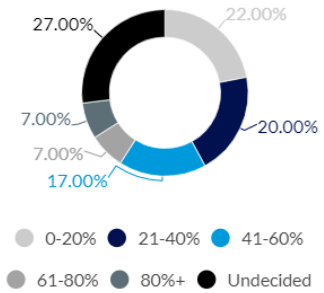
LDI IS OFTEN KEPT SEPARATE FROM INVESTMENT GRADE CREDIT

A majority of UK schemes allocate to investment grade with a manager different from their LDI manager, missing out on potential efficiencies.

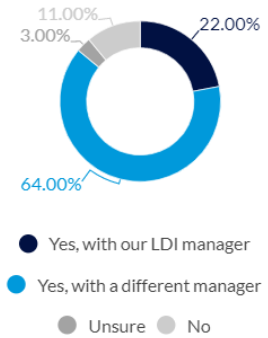
Expected allocations to investment grade within the last five years of the endgame journey vary substantially, with no clear trend by size, endgame or horizon. Over a quarter have not decided yet what this allocation will be, while equal proportions expect it to be either up to 20% of total assets, or 20-40% instead. Only a small proportion envision holding more than 60% of their assets in investment grade as they approach their endgame.

Despite this variation, 86% of UK pension funds have an allocation to investment grade outside of their LDI portfolio already. However, 64% invest in investment grade via a manager different from their current LDI manager. This is surprising, considering that LDI portfolios may include high quality corporate bonds and other liquid fixed income. This suggests that many UK pension plans may be missing out on potential synergies between their LDI and credit portfolios.

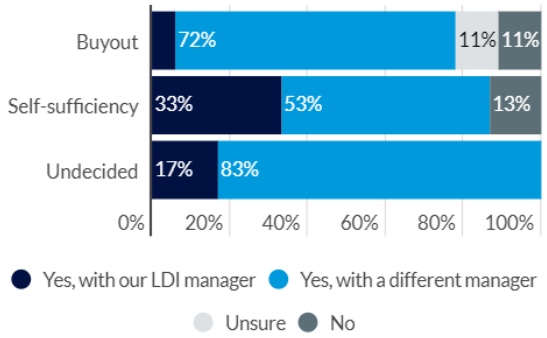
EXPECTED ALLOCATION TO INVESTMENT GRADE IN FINAL FIVE YEARS OF JOURNEY



ALREADY INVESTING IN INVESTMENT GRADE ALONGSIDE LDI



ALREADY INVESTING IN INVESTMENT GRADE ALONGSIDE LDI



Schemes working towards self-sufficiency or low dependency on their sponsor are most likely to have an investment grade portfolio with their LDI manager – 33% already do this, compared to only 6% of schemes working towards buyout and 17% of those who do not yet have a long-term funding objective.

KEY STATISTICS

86%
have an allocation to investment grade alongside their LDI portfolio

64%
use an investment grade credit manager who is different from their LDI manager

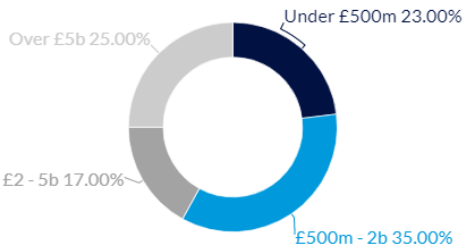
33%
of schemes aiming for self-sufficiency have their LDI and investment grade portfolios with the same manager

6%
of schemes working towards buyout do the same

27%
do not know how big their allocation to investment grade would be in the final five years of their endgame journey

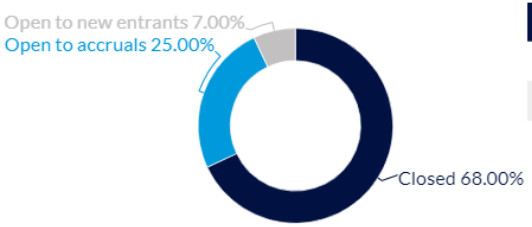
APPENDIX: AUDIENCE BREAKDOWN

BREAKDOWN BY SCHEME ASSET SIZE



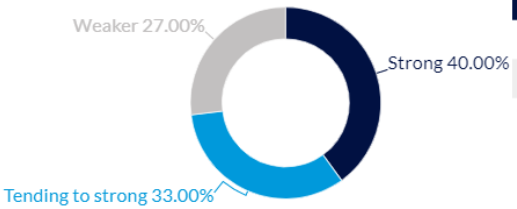
Asset Size	Count
Under £500m	14
£500m - 2b	21
£2 - 5b	10
Over £5b	15

BREAKDOWN BY SCHEME STATUS



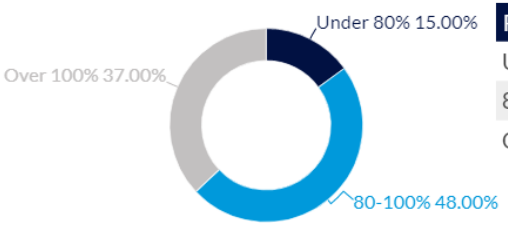
Status	Count
Closed	41
Open to accruals	15
Open to new entrants	4

BREAKDOWN BY SPONSOR COVENANT



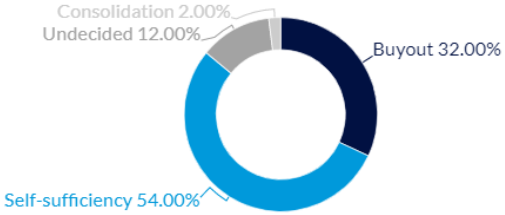
Sponsor Covenant	Count
Strong	24
Tending to strong	20
Weaker	16

BREAKDOWN BY FUNDING LEVEL



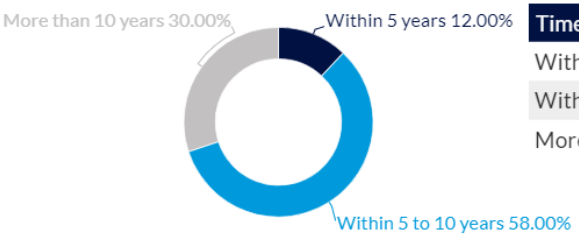
Funding Level	Count
Under 80%	9
80-100%	29
Over 100%	22

BREAKDOWN BY ENDGAME



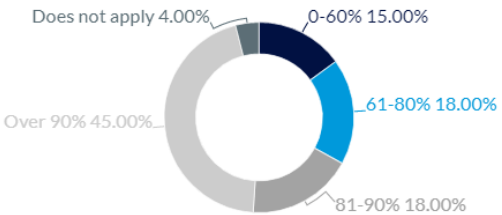
Endgame	Count
Buyout	19
Self-sufficiency	33
Undecided	7
Consolidation	1

BREAKDOWN BY TIME TO ENDGAME



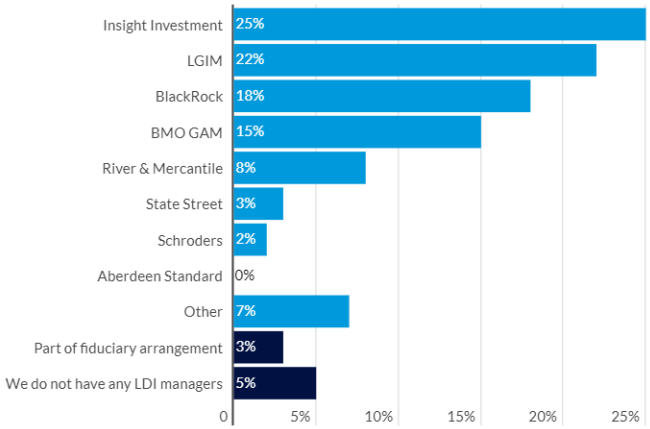
Time fo Endgame	Count
Within 5 years	7
Within 5 to 10 years	35
More than 10 years	18

BREAKDOWN BY HEDGE RATIO



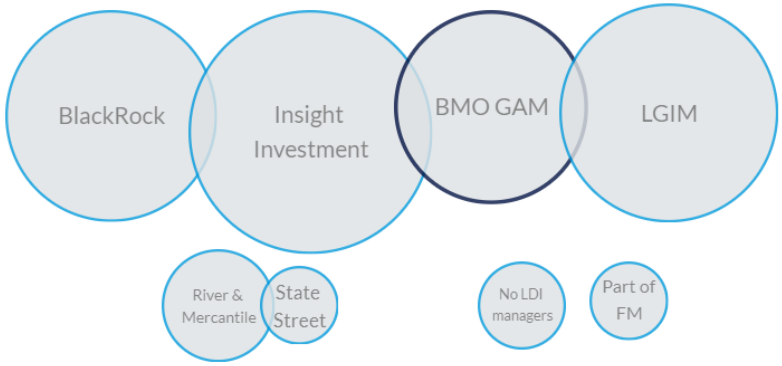
Hedge Ratio	Count
0-60%	9
61-80%	11
81-90%	11
Over 90%	27
Does not apply	2

BREAKDOWN OF RESPONDENTS BY EXISTING MANAGER



Manager	Scheme Count
Insight Investment	15
LGIM	13
BlackRock	11
BMO GAM	9
River & Mercantile	5
Aberdeen Standard	
State Street	2
Schroders	1
Other	4
Part of fiduciary arrangement	2
No LDI managers	3

OVERLAP BETWEEN MANAGERS



Only four schemes in our sample had multiple LDI managers.

About mallowstreet Insights

mallowstreet Insights is our research division.
It allows trustees to stay one step ahead, extensively equipping them to fulfil their jobs and responsibilities.

Insights also provides pivotal input to asset managers, proactively challenging and improving their understanding of the pension industry. Our research allows them to develop and deliver the solutions that are needed to help create a better retirement for everyone.

Contact us to discuss how our research projects can help you achieve your strategic goals.

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