

## KEY NOTES

### Building an investment strategy around liabilities

October 2012

**BLACKROCK®**

#### Why focus on liabilities?

- ▶ “What’s the money for?” is the essential question facing any institutional investor: Regardless of their specific circumstances, the money that has been entrusted to institutional investors is there for a reason. It is ultimately there to meet an eventual claim, whether it is to pay members a contractual pension in the case of a pensions fund or an annuity or policy-related payout in the case of an insurer. So the answer to the question of “Why focus on liabilities?” is in effect identical to answering the question “Why invest for the future?” as it entails investing to provide an income or an asset in the future. As such, it is really the fundamental basis on which all institutional investing should take place.

#### How to build a successful strategy around liabilities?

- ▶ While it is important to recognise the scale of the challenge associated with meeting inherently uncertain and often complex liabilities that stretch out over long periods in the future, we believe there are a number of steps investors can take to build an effective liability driven strategy.
- ▶ As a first step it means trying to establish a sound estimate of what the liabilities represent in terms of future cashflows but also gauging the associated level of uncertainty. Based on that range of estimates, investors can then determine what their portfolio would be if they were to invest on a least risk basis. The resulting portfolio will typically consist of an appropriate combination of government bonds, often long-dated, often inflation-linked. While not a perfect match, it represents a least risk construct that can serve a good starting point for determining the appropriate level of risk an investor can take in order to meet the future liabilities.
- ▶ The additional challenge most investors face in today’s world is that most institutional investors face a significant funding shortfall, which requires them to take additional risk.
- ▶ The key point with a liability driven approach that risk is taken on a deliberate basis, in reference to the least risk position discussed above.
- ▶ Any risk that is not rewarded should be hedged out using bonds but also derivatives such as inflation swaps and interest rate swaps
- ▶ While the investment strategy should necessarily reflect the investor’s specific circumstances, the crucial ultimate point is to take investment risk relative to the liabilities and to ensure that this risk is deliberate, as much as possible diversified, and appropriately scaled to your institution.



**ROBERT HAYES**  
Head of Client  
Strategy EMEA

## How relevant is this for investors without formal liabilities?

- ▶ Investing relative to your liabilities is mostly considered within the context of pension fund and insurance portfolios. However, while there are no formal obligations in the context of DC and other collective savings schemes the money is there as deferred consumption to meet future income or expenditure needs. While these do not represent hard, formal liabilities, we believe there is a strong moral imperative to help members meet their retirement income or expenditure aspirations. As such, institutional investors can think about those aspirations as a form of liabilities.
- ▶ Meeting those 'liabilities' requires investors to adopt a genuinely outcome-orientated investment approach, through for instance the development of appropriate default options.

*“The additional challenge most investors face in today’s world is that most institutional investors face a significant funding shortfall”*

### Important information

This material is for distribution to Professional Clients and should not be relied upon by any other persons'. Issued by BlackRock Investment Management (UK) Limited, authorised and regulated by the Financial Services Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL. Tel: 020 7743 3000. Registered in England No. 2020394. For your protection telephone calls are usually recorded. BlackRock is a trading name of BlackRock Investment Management (UK) Limited. Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock Group or any part thereof and no assurances are made as to their accuracy. This document is for information purposes only and does not constitute an offer or invitation to anyone to invest in any BlackRock funds and has not been prepared in connection with any such offer. The opinions expressed are as of 30.09.12 and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will come to pass. Any investments named within this material may not necessarily be held in any accounts managed by BlackRock. Reliance upon information in this material is at the sole discretion of the reader. Past performance is no guarantee of future results. For distribution in EMEA for Professional Investors only, or 'professional clients', as such term may apply in relevant jurisdictions. In Japan, not for use with individual investors. This material is being distributed/issued in Canada, Australia and New Zealand by BlackRock Financial Management, Inc. ('BFM'), which is registered as an International Advisor with the Ontario Securities Commission. In addition, BFM is a United States domiciled entity and is exempted under Australian CO 03/1100 from the requirement to hold an Australian Financial Services License and is regulated by the Securities and Exchange Commission under US laws which differ from Australian laws. In New Zealand, this presentation is offered to institutional and wholesale clients only. It does not constitute an offer of securities to the public in New Zealand for the purpose of New Zealand securities law. BFM believes that the information in this document is correct at the time of compilation, but no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by BFM, its officers, employees or agents. This document contains general information only and is not intended to be relied upon as a forecast, research, investment advice, or a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The information does not take into account your financial circumstances. An assessment should be made as to whether the information is appropriate for you having regard to your objectives, financial situation and needs. © 2012 BlackRock, Inc. All Rights reserved. BLACKROCK, BLACKROCK SOLUTIONS, iSHARES, SO WHAT DO I DO WITH MY MONEY, INVESTING FOR A NEW WORLD, and BUILT FOR THESE TIMES are registered and unregistered trademarks of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners. (005576-12 Oct)

### FOR MORE INFORMATION

Email: [institutional.enquiries@blackrock.com](mailto:institutional.enquiries@blackrock.com)

Website: [blackrock.com/international](http://blackrock.com/international)

**BLACKROCK®**