

KEY NOTES

Building an investment strategy around liabilities

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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.



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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”

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