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Investment Strategies: A Case Study

Liability-Driven Investment (LDI) Strategy: Migrating from Long Bonds to a Customized Portfolio Benchmark

Background

Three decades of declining interest rates have prompted many pension plans to extend the duration of their fixed income assets in order to better match the interest rate sensitivity of their plans' liabilities. In many cases, plans benchmarked their fixed income portfolios against the FTSE TMX Canada Long Bond index.

The Long Bond index, however, does not always provide a perfect (or even workable) match for pension fund liabilities. This is particularly true for mature or closed pension plans that have significant cash outflows, as this index is limited to bonds maturing after 10 years and therefore has limited cash flows during the first 10 years.

Investment Problem

Our client provides a large and mature defined-benefit pension plan to their employees, with approximately $50 million in assets.

Historically, the client had used long bonds as part of a balanced portfolio, but wanted to more closely match the expected cash flows of their pension liabilities, while retaining the ability to add extra return through active management.

The client also wanted to ensure that the portfolio remained highly liquid, while minimizing transaction costs from expected cash flows and rebalancing.

Our Assessment and Proposed Solution

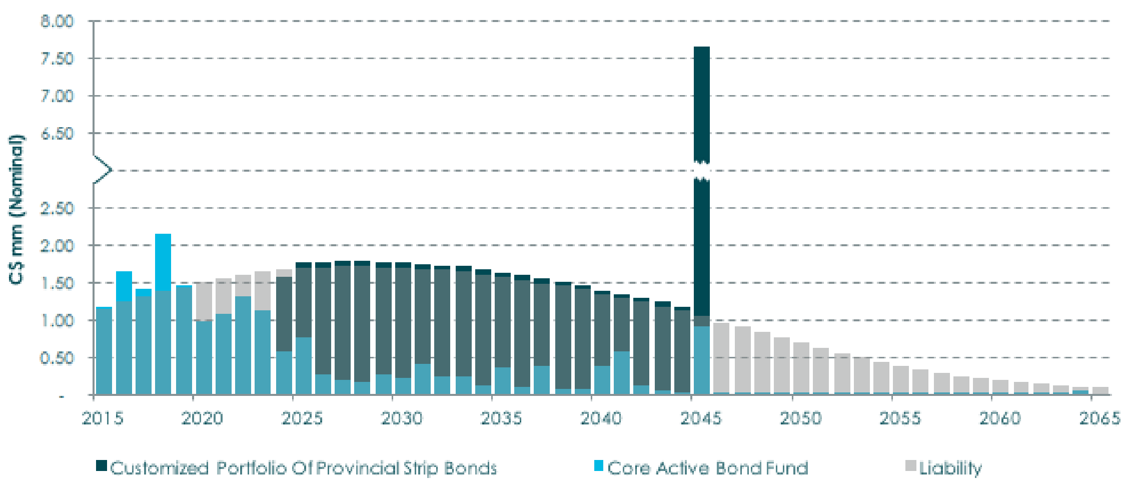
We performed an assessment of our client's risk tolerance and return objectives. This analysis helped us to determine how best to balance the client's desire to reduce the interest rate sensitivity of the portfolio with their fixed income return and liquidity expectations.

We proposed and subsequently implemented a unique, customized portfolio solution for our client by combining both pooled and segregated components when constructing the portfolio.

The portfolio was partially invested in our firm's Universe-benchmarked Core Active Bond Fund strategy, where cash flows predominantly occurred in the first 10 years. This pooled fund structure provided the client with access to our best strategies and a proven track-record for generating alpha, while simultaneously providing them daily liquidity with limited transaction costs when the plan was required to make cash flows.

The balance of the portfolio consisted primarily of provincial strip bonds that, essentially, supplemented the cash flows from the Core Active Bond Fund. When combined, these two portfolios provided significantly better cash flow matching and lower tracking error than by simply using a Long Bond-benchmarked portfolio.

Proposed (and implemented) portfolio with custom liability benchmark



Conclusion

By having a close working relationship with our client and an in-depth understanding of their investment goals, we were able to deliver a unique, customized solution that provided the best match for their diverse and often competing needs.

And by offering a solution that provided both a pooled fund component and a custom segregated component, the client benefited from the best attributes of both of these solutions, obtaining both a high degree of liquidity and active management, and a high degree of customization to reduce interest rate risk.

We are proud of the creative, effective solution we were able to provide and that the client's continued, deep relationship with Leith Wheeler reflects the trust we've earned.

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