KPMG

Powering ahead

The current UK LDI Market

June 2016

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Executive summary

The UK Liability Driven Investment (LDI) industry powered ahead during 2015 with the number of mandates increasing by 256 and the total pension scheme liability hedged growing 13% to £741 billion.

LDI's role in overall strategy

"It's about so much more than just avoiding car crashes"

Simeon Willis,
Head of Investment Strategy

2015 has been another exceptional year for LDI growth with 256 new mandates being implemented – that's around one new mandate awarded for each working day of the year!

Being a parent of 2 young children I couldn't help but notice that the benefit that LDI has brought to the pensions industry has a lot in common with the benefit that the child seats has brought to UK road safety over the last decade.

Back in 2006, when child car seats became required by UK law, both child seats and LDI were largely alien concepts and were initially met with scepticism. However, it's now clear that both have met their main objective: a year on year reduction in the number of road deaths and protecting schemes from a persistent fall in yields, respectively.

More interestingly, they have both also provided an underestimated ancillary benefit of creating a far smoother journey, not just protection in an extreme "car crash" scenario. The child now sleeps happily through the lumps and bumps of a protracted car journey and LDI reduces the funding level volatility experienced. This allows the person in control – whether the parent or the pension trustee – to concentrate on navigating the way to their eventual destination.

Insight on the LDI industry

"We are at risk of LDI assets being more appropriately valued than the liabilities they are matching"

Barry Jones,
Head of LDI

In last year's survey we highlighted that small schemes were the least represented in the LDI market. Therefore it comes as no surprise to us that pooled LDI was the most keenly fought area over 2015, with mandates being consistently won by five managers: LGIM, Insight, BlackRock, BMO and Schroder.

This year's survey results clearly indicate that a large proportion of UK DB pension schemes now have term-based investment strategies, using the suite of LDI and other contractual income generating assets. In simple terms, schemes are focusing their portfolios to match their liability cash flows. This introduces a challenge to the actuarial profession who will increasingly need to ensure the valuation of "off market" liabilities is consistent with corresponding "on market" assets. This particularly applies to the use of inflation risk premia, static credit premia, and simplified single discount rate and inflation approaches, which may lead to "undeserved" deviation between liabilities and the market assets that match them. It also creates opportunity for valuation approaches to evolve towards true scheme specific, market consistent approaches. Here the liabilities are referenced to the actual yield of the scheme's contractual income asset portfolio, thereby reflecting the reduced asset / liability mismatch.

Executive summary

Key headline trends

13%

growth in liabilities hedged

The LDI Market continues its extraordinary growth – with £0.74 trillion of liabilities hedged and over 1250 mandates.

2015 witnessed further rapid growth of the LDI industry. The number of LDI mandates increased by 256 to 1,287 and the total liabilities hedged increased by £83bn to £741bn.

The increase from new mandates was even greater than this, estimated to be £108bn as the impact of increasing yields over the period had a negative impact on the size of the LDI market.

193

new pooled mandates

The growth in pooled LDI mandates continues apace, accounting for three quarters of new LDI mandates.

Despite now making up 56% of LDI mandates, pooled LDI still accounts for just 9% of the industry as measured by value of liability hedged. Pooled LDI mandates remain most popular with small to medium sized pension schemes, with an average mandate size of just £96m compared to £1,224m for segregated and bespoke pooled mandates.

85%

'Big 3' count for 85% of overall market share*

Overall, the Big 3 managers have retained their strong lead across the LDI market. However, within the pooled space there is now a Big 5.

Over the past four years, the concentration of pooled LDI mandates within the "Big 3" (LGIM, Insight and BlackRock) has fallen slightly from 67% to 62%, yet within the Big 5, which includes Schroders and BMO, it has increased from 87% to 96%.

LGIM now account for 32% of all mandates and 44% of the industry by value of liabilities hedged.

*Market share has been calculated as the total number of LDI mandates.

76%

expect rates to rise faster than the market

0%

increase in mandates using triggers

Trigger based strategies have started to go out of favour.

Despite the 25% increase in the number of mandates in 2015, the net number of trigger strategies in place remained the same over the year.

In particular, yield based triggers fell substantially in 2015 by over 30%, which given only modest increase in yields over the year, is likely to have been driven by pension schemes abandoning the strategy of "calling the market" when implementing LDI.

The fund management industry remains positive on interest rates, but no longer expects "normalisation" of rates.

Whilst 76% of our survey respondents expect nominal yields to increase faster than market expectations, only 12% believe the increase will be by more than 0.5% over the next three years.

Manager	Total number of mandates			
	2012	2013	2014	2015
LGIM	195	236	288	414
Insight	119	139	173	217
BMO	82	104	153	189
BlackRock	97	110	151	166
Schroders	36	59	79	98
River & Mercantile	76	87	89	94
State Street	25	27	29	32
PIMCO	9	15	17	16
Cardano	12	14	14	16
Aberdeen	n/a	n/a	8	13
Goldman Sachs	9	8	7	9
Standard Life	16	13	12	9
AXA	1	6	5	9
Aviva	2	2	3	3
Rogge	n/a	2	2	2
Ignis	4	3	1	0
TOTAL	683	825	1031	1287

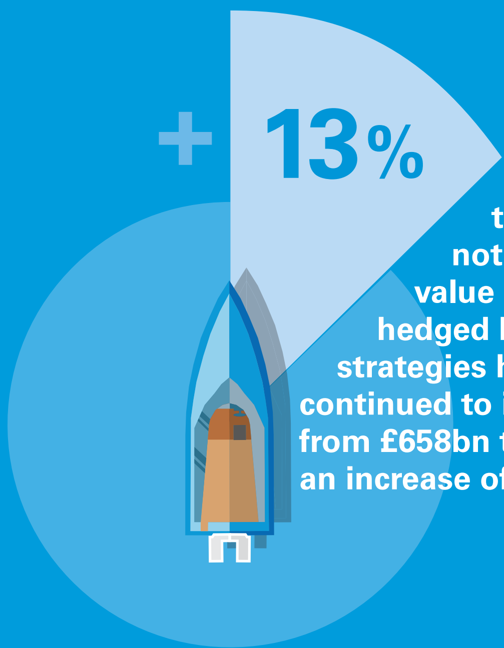
What is LDI?

LDI or 'Liability Driven Investment' has evolved a number of definitions. It captures the ethos of investing with a view to meeting your future liabilities rather than simply delivering a positive investment return. This can be achieved using approaches ranging anywhere between simply increasing duration of a gilt portfolio, to the use of a more sophisticated overlay strategy using instruments such as swaps.

"LDI is a key risk management tool given the impact that movements in liabilities have on scheme funding levels and deficits."

For the purposes of this survey KPMG has defined an LDI mandate as one which either has some sort of liability cashflow benchmark, or uses derivatives to gain exposure to nominal interest rate, real interest rate or inflation hedging, primarily for the purpose of liability risk management. Mandates simply with broad bond or gilt index benchmarks have been excluded, as have single stock funds.

LDI trends



Over 2015 the total notional value of liabilities hedged by LDI strategies has continued to increase from £658bn to £741bn – an increase of 13%.

Growth

Using the level of hedging in place at the end of 2015 and the known market movements, we estimate that the £83bn growth can be broadly attributed:

- £108bn from new mandates (of which there were 256 new LDI mandates) and extensions
- -£25bn from market movements (yields rising).

We note that the largest mandate (which is segregated) hedges around £25bn of liabilities, which is the same as last year.

The number of new mandates

The largest area of growth in the LDI market has been in pooled space, where 193 new mandates were implemented. There were 255 new LDI mandates in total.

Pooled vs Segregated

There are now almost 25% more pooled mandates than segregated mandates with 714 versus 572 respectively. This has shown the continuation of the recent trend in pension scheme demand for simple and low governance solutions to provide hedging.

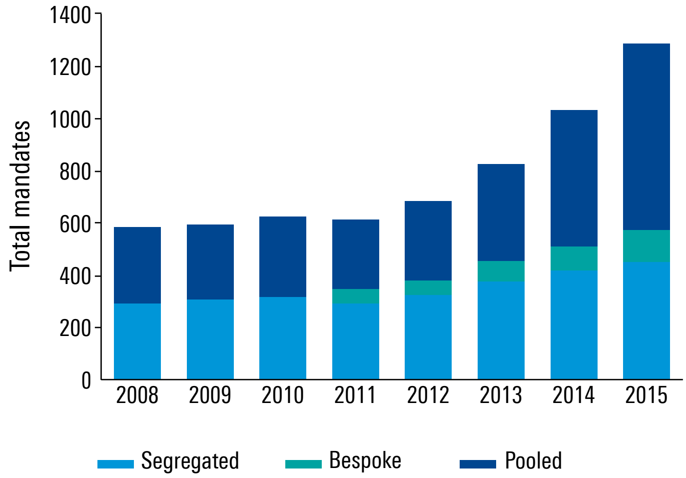
Inflation vs interest rate hedging

Over 2015, pension schemes increased interest rate and inflation hedging at the same rate. The level of PV01 coverage increased from £1,164m to £1,310m (a 12% increase) and the IE01 coverage has increased from £807m to £900m (a 12% increase). This continues the trend from last year of pension schemes hedging interest rate and inflation risks at the same rate and not accelerating the rate of hedging in favour of either element in isolation.

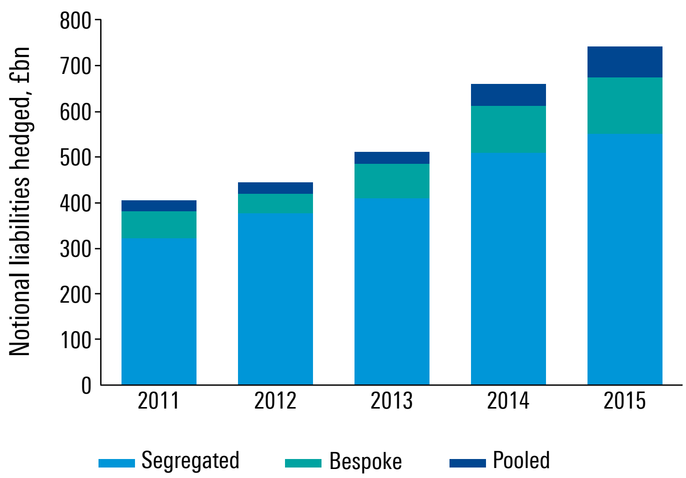
Legislative changes

We asked fund managers: "What is the most important issue for the LDI industry in 2016?". 75% believed legislative changes are the most important issue for 2016. Managers identified a range of possible issues contributing to the regulatory uncertainty in 2016, including the Basel III (bank regulation), Solvency II (insurance industry), EMIR (central clearing) and the impact of these on market liquidity.

Total number of mandates under management



Notional amount of liabilities hedged for UK pension schemes split by type of mandate



Triggers

Despite the 25% increase in the number of mandates in 2015, the number of trigger strategies in place remained the same over the year, which indicates that trigger strategies are falling out of favour with pension schemes setting up new LDI mandates or increasing their hedge.

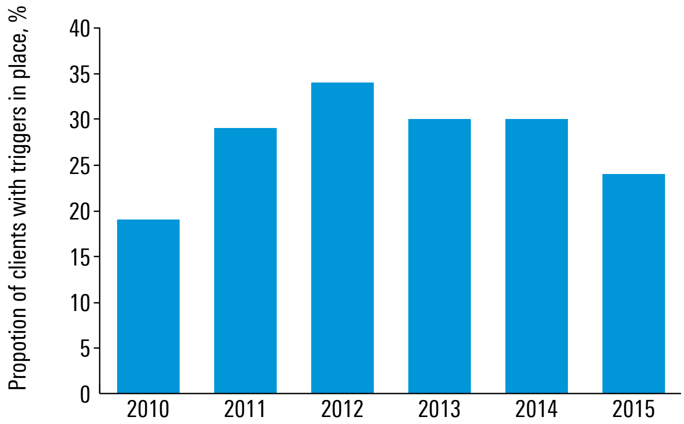
Use of yield based triggers fell substantially in 2015 from 63% to 47%, which given only modest increase in yields over the year, is likely to have been driven by pension schemes abandoning the strategy of "calling the market" when implementing LDI.

The number of time-based triggers decreased modestly, which is likely a result of those already in place running their course.

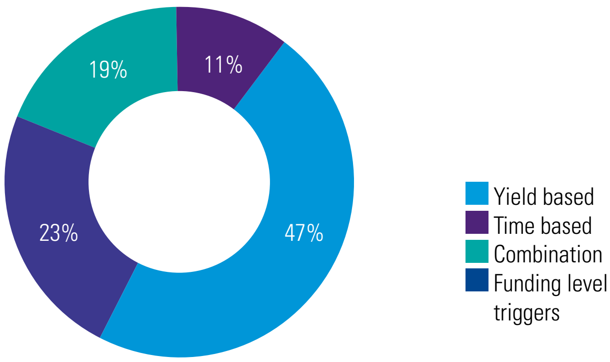
There was an increase from 19 to 38 in the use of a combination of different trigger strategies that try to get the "best of both worlds", although this was not sufficient to offset the fall in yield and time based triggers. In addition, there was a modest increase in funding level triggers.

(Please note our statistic is likely to underestimate the true level as it does not capture any extension triggers that are monitored and implemented by in-house pensions teams and investment advisors.)

Proportion of clients with triggers in place



Mandates with triggers split by type of trigger, 2015



> Schemes appear to have recognised the shortcomings of yield based trigger strategies in isolation.

Segregated and bespoke pooled LDI

As we have seen previously in our past surveys, there continues to be a large concentration within the industry amongst the largest providers and this was unchanged over 2015.

We note that due to refinements in definitions within the questionnaire and reporting methodology for the asset managers, certain figures reported in previous surveys may differ in this survey.

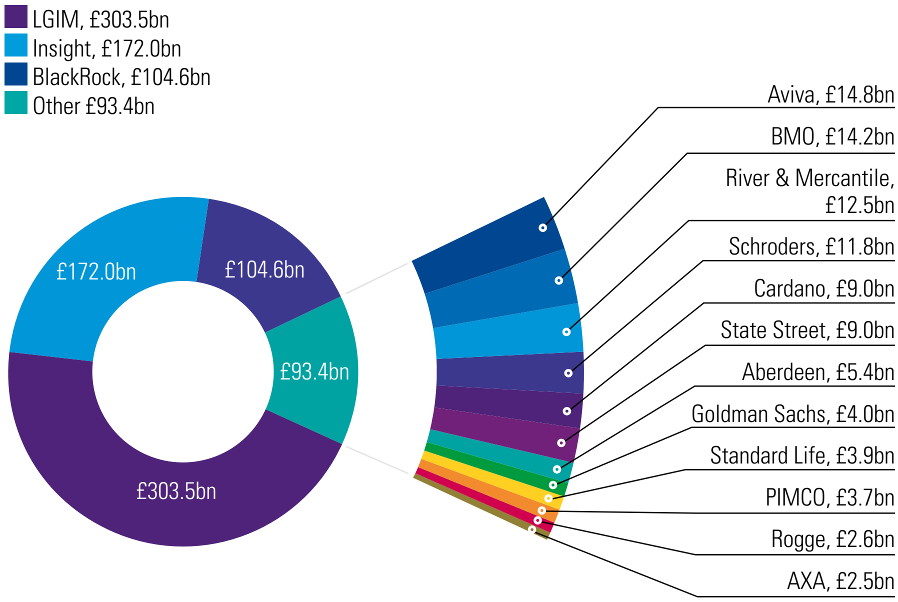
Key headlines

The market share of the segregated and bespoke pooled fund market is illustrated to the right. We have used the amount of hedged notional liabilities as a measure of this.

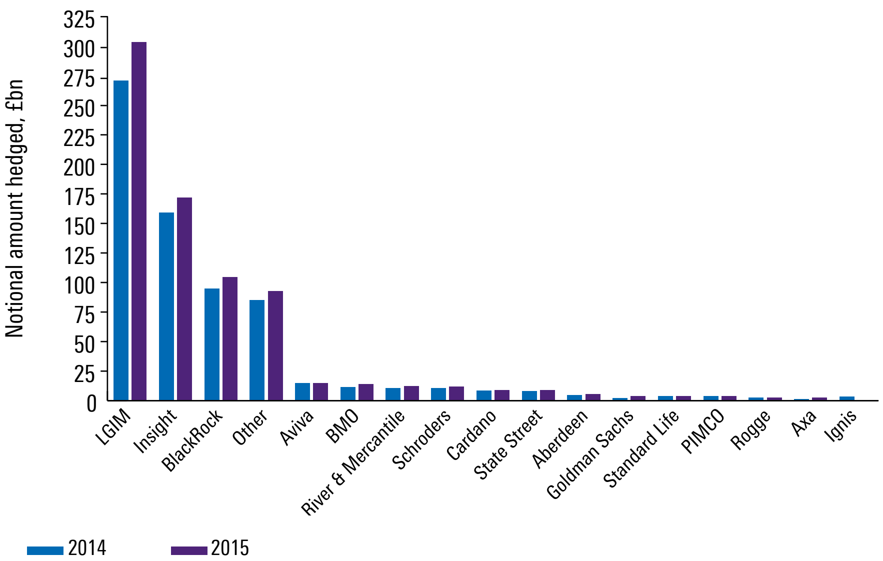
The number of segregated and bespoke mandates rose by 12% over 2015 from 510 to 572.

The smallest segregated mandate was £3.0m and the largest was c.£25bn, which demonstrates the wide range of mandates segregated LDI managers are able to accommodate, despite the pooled approach being the favourite for small and medium sized schemes.

Notional amount hedged in segregated and bespoke mandates

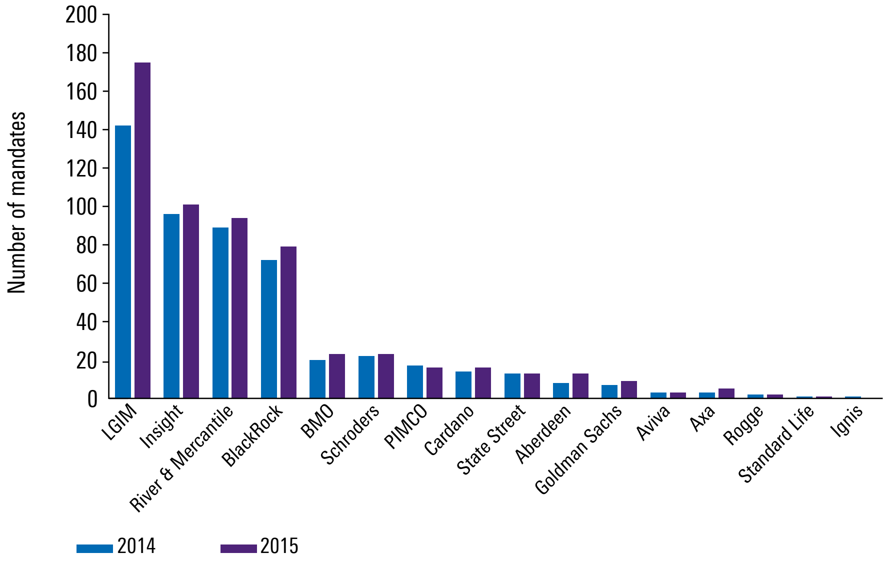


Notional amount hedged in segregated and bespoke mandates



> Overall, the Big 3 managers have retained their strong lead across the LDI market. However, within the pooled space there is now a Big 5.

Number of segregated/bespoke pooled



Bespoke Pooled

We have defined Bespoke Pooled arrangements as client-specific segregated mandates that are contained within a pooled fund structure. These can provide ease of access for schemes without lengthy legal setup and counterparty negotiation. Within the segregated data we have captured bespoke pooled mandates given the scheme-specific nature of the mandates and comparable skill sets required by fund managers. For completeness, we have carved out the managers that offer these structures and the number and size of the client mandates.

Bespoke Pooled Mandate Providers

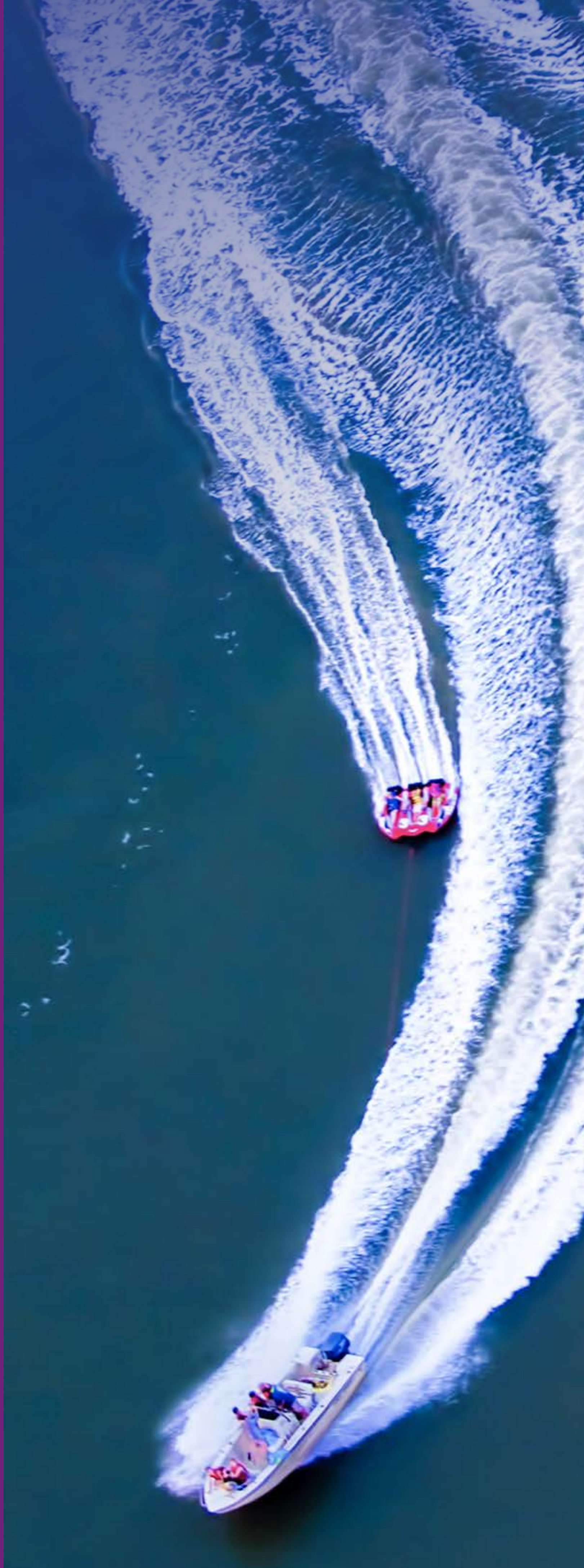
Manager	2014 Mandates	2014 LUM	2015 Mandates	2015 LUM
LGIM	40	£51.2bn	52	£55.1bn
BlackRock	19	£19.4bn	30	£33.4bn
Insight	21	£25.8bn	23	£27.0bn
BMO	9	£4.4bn	12	£4.6bn
AXA	2	£0.5bn	4	£1.8bn
State Street	1	£1.2bn	1	£1.3bn
PIMCO	1	£0.2bn	1	£0.2bn
TOTAL	**93**	**£102.6bn**	**123**	**£123.4bn**

"There was a significant growth in bespoke pooled mandates in 2015 with an increase in notional liabilities hedged of 20%."

Pooled LDI

The pooled LDI market looks to have settled into a Big 5 consisting of LGIM, Insight, BlackRock, BMO and Schroders.

We have continued to use the number of mandates as the primary measure of this as we believe better reflects the growth and decisions taken by pension schemes within this space.



Key headlines

Pooled LDI mandates continue to be significantly more popular than segregated mandates for schemes new to LDI. Having overtaken in terms of total mandates during 2014, pooled mandates accounted for over 75% of new mandates in 2015. Reflecting this, pooled LDI remains the fastest evolving area of the industry.

Total liability hedged using pooled LDI increased by 41% over 2015 from £48bn to £68bn.

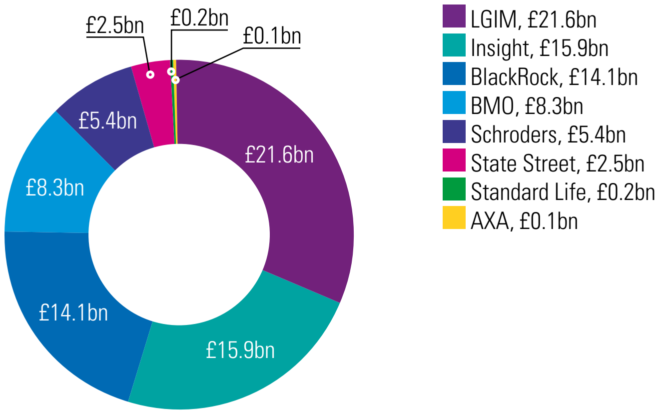
The number of pooled mandates rose strongly over 2015 from 521 to 714, an increase of 37%.

96% of the pooled mandates are shared between 5 providers; the "Big 3" plus BMO and Schroders.

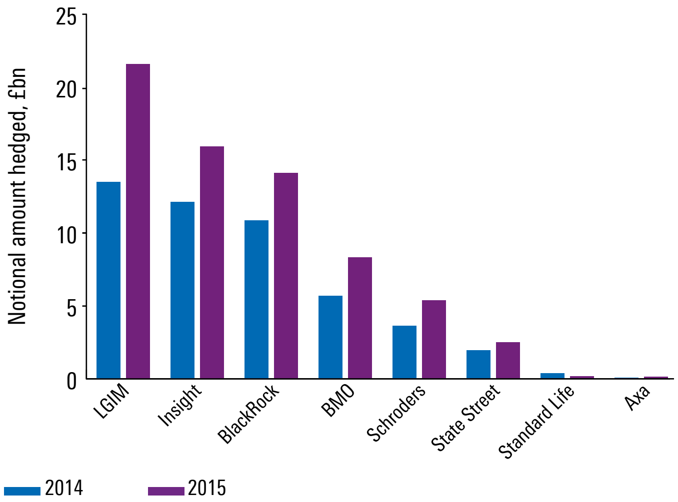
The smallest pooled mandate was £1m and the largest was £1bn. This highlights considerable overlap with use of segregated accounts, demonstrating the sophistication of the pooled funds to accommodate larger mandates even where segregated is a viable alternative.

> "Pooled LDI remains the fastest evolving area of the industry."

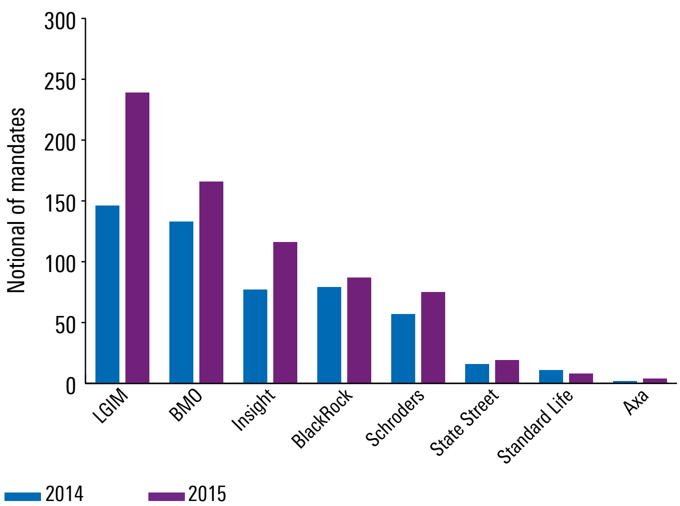
Notional amount hedged in pooled mandates



Notional amount hedged in pooled mandates



Number of pooled mandates



Outlook

Due to the magnitude of the impact on funding levels, having a clear policy on how tactical views influence long term strategy is critical.

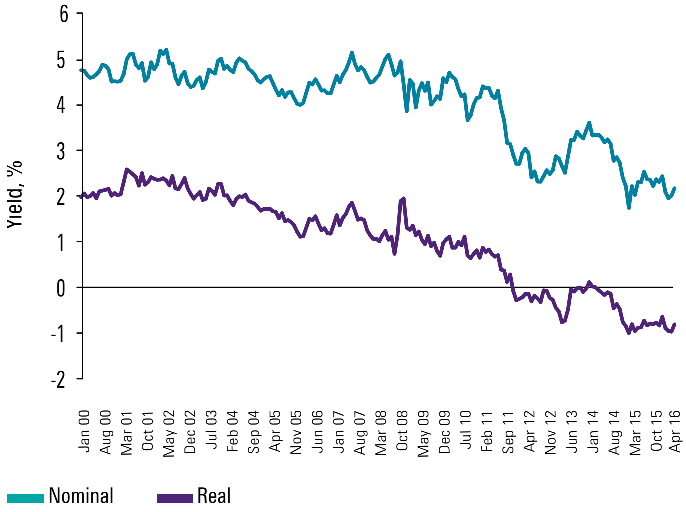
Whilst the fund management industry remain positive on interest rates, they no longer expect "normalisation" within the next three years."

Key headlines

We asked all investment managers what they thought about gilt yields and inflation. We summarise the results below, which includes the responses from a total of 25 fund management houses.

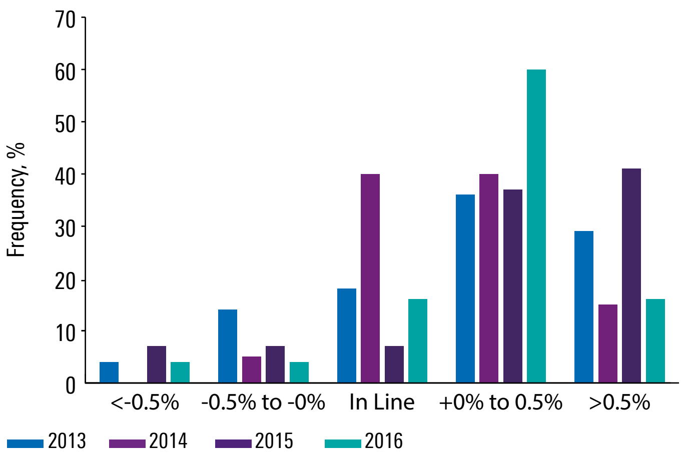
For nominal yields, there has been a significant fall in the number of institutional managers expecting rates will rise by over 0.5% above market expectations within the next 3 years, i.e. from 26% of managers to 12%.

20 year Nominal and Real Gilt Yields



Nominal gilt yields

We asked the investment managers: "Where do you expect the 20 year fixed gilt nominal yield will be in three years time relative to what the market is implying?"

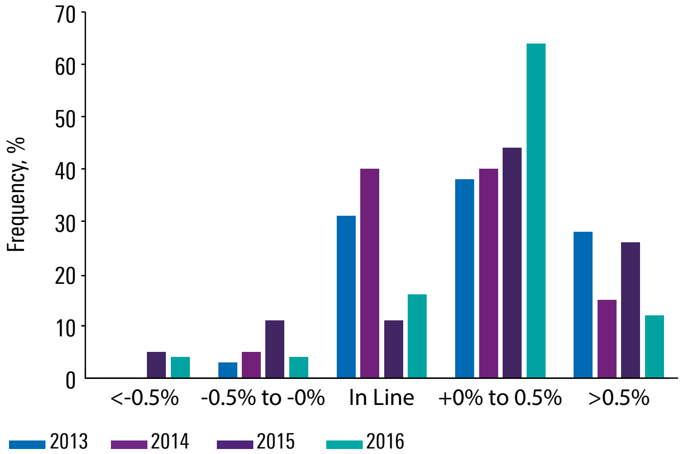


Key headlines

Managers' expectations of inflation expectations has remained reasonably constant over the past couple of years, with the majority of respondents expecting that inflation will be in line or above what is currently implied by the market. Only 8% of correspondents expect a large shift in inflation expectations of greater than 0.5% in either direction."

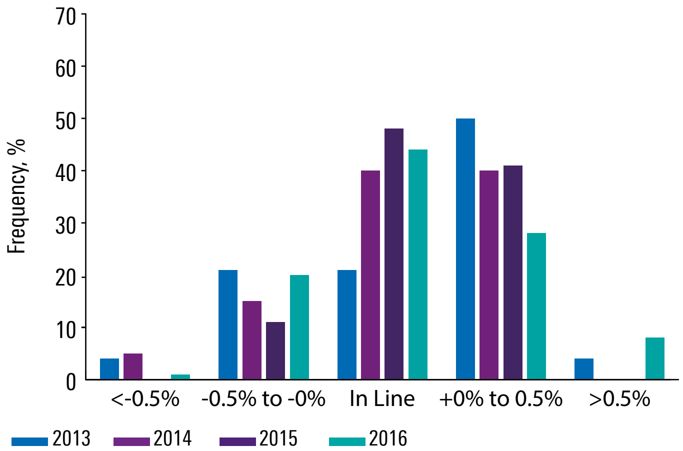
Real gilt yields

We asked the investment managers: "Where do you expect the 20 year index-linked gilt real yield will be in three years time relative to what the market is implying?"



Implied Inflation

We asked the investment managers: "Relative to what is implied by the market, where do you think 20 year gilt implied inflation will be in three years time?"



Appendix

LDI can be a technical topic, so for ease, we briefly define some of the key terms used in this report to the right.

Key terms

- **Notional Value:** this is the value of liabilities whose interest rate or inflation risk has been hedged.
- **PV01:** A measure of the sensitivity of a pension scheme's asset or liability value to changes in interest rates. It is the change in present value of the asset or liability for a 1 basis point (or 0.01%) change in yields. It is commonly used in swap markets as a convenient summary measure of trade size as it captures both notional value and duration in one figure.
- **IE01:** A measure of the sensitivity of a pension scheme's asset or liability value to changes in expected inflation. It is the change in present value of the asset or liability for a 1 basis point change in inflation, and is also known as 'Inflation PV01'.
- **Swap:** A contract where two parties agree to pay the other a series of cashflows based on an agreed economic variable or interest rate. It is a way of trading different risks, for instance interest rate or inflation risks.

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