

Letters to the Editor

LDI misses the philosophical mark

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In a Dec. 22, page 6 article headlined “Plan losses may spur shift to LDI strategy,” the subhead stated that “Those that made switch couple of years ago reaping benefits during current market drop.” Further along in the article a consultant was quoted as saying, “Folks who chose to go LDI two or three years ago are looking real smart.”

The issue not addressed in the article was whether or not the LDI strategy performed as advertised. LDI proponents have argued that it will result in assets and liabilities moving in lock step, up or down, depending on economic conditions and thus lower relative volatility between the two. A quick look at the recent outcome would suggest that LDI completely missed the philosophical mark and, in the process, generated extreme volatility that exacerbated rather than mitigated the relationship between assets and liabilities — it coincidentally did so in a way that favored those that adopted the strategy. In implementing the strategy, a common approach would have been for the plan sponsor to use a combination of Treasury securities and interest-rate swaps with the combined duration being approximately equal to the computed duration of the plan's liabilities. Given the big rally in the bond market during the fourth quarter of 2008, that combination produced big, real money gains for the plan. On the mythical market value of liabilities side of the equation, an AA corporate bond index was probably used to determine the discount rate. A reasonable expectation might have been for that index to have a spread over Treasuries of 50 to 100 basis points — not the 400 or so that materialized that resulted in a dramatic drop in computed liabilities. (That's an accounting number and not real money, but it does result in real money in terms of the determination of the required contribution to the plan.)

Those who adopted the strategy are faced with an interesting dilemma. Will they let it ride or take their real money asset winnings off the table, unwind the strategy, and put their gains into relatively low-priced equities? Given that the strategy clearly did not work as had been suggested, I'd make a serious bet on them not letting it ride.

This is all just further evidence of the truth of the statement that if you have a choice between being lucky and being good, go with lucky every time.

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