Principal® Global Investors

LDI: Planning, Process and Precision

Steps Your Plan Can Take Now to Implement the Right Liability-Driven Investing Solution

EXECUTIVE SUMMARY

Liability-driven investing (LDI) is expanding beyond its traditional boundaries of simply "long-duration fixed income" and into a more precise solution involving great levels of customization and detail. Today, an LDI provider needs to be able to help its clients in three key areas:

- **Planning** – Consider the ultimate goal of the pension plan. Determine the plan's objectives and constraints, then develop a robust asset-allocation model, or glide path, to move the plan towards its goals. The steps that will follow are highly customized, so understanding current market conditions, the plan's liability cash flows, and funding status is crucial to success.
- **Process** – The implementation of the glide path is different for every plan. Depending on client objectives, it can range from precise matching of the liability profile to a more flexible approach. The key is to establish a process that will effectively achieve the desired funding status. Typical moves will be to initially extend the duration of the fixed income allocation.
- **Precision** – Required on two levels, precision is important in understanding and managing the asset-liability match and in monitoring the plan's progress along the glide path.

The good news is that, regardless of the current state of your pension plan or the current level of interest rates, there are steps you can take right now to begin implementing an appropriate LDI solution.

Pension plans are in the middle of a sea change. New accounting rules have moved a plan's funded status onto the balance sheet. Funding rules in the Pension Protection Act will create greater volatility in the timing and amount of plan contributions. This comes at a time when plan sponsors can ill afford higher and more volatile costs. Therefore, plan sponsors are set to the unenviable task of balancing two somewhat conflicting priorities: reduce the funding-status volatility to lessen the negative impact on the firm's financial statements, and increase the return on plan assets to help reduce the need for cash contributions. Setting up the right liability-driven investment (LDI) solution can help plan sponsors strike the right balance between funding levels and asset returns. In fact, even incremental changes can have a measurable, positive impact on the plan. The best part – there are steps you can take right now to begin implementing the LDI solution that's right for your pension plan.

WHAT IS THE "RIGHT" LDI SOLUTION?

While plan sponsors considering terminating or freezing their plans will usually have a greater interest in funding levels and plan sponsors with ongoing plans might have more focus on the return on plan assets, the right LDI solution can help plan sponsors no matter the ultimate goals for their plan. The key is that the "right" solution is different for each plan and will change for each plan as it progresses towards its goals. So, the right LDI solution is one that examines the details of a plan's liabilities and its assets; it's one that is based upon the goals and risk tolerances of the plan sponsor; it's one that actively adapts as the plan's funding status changes and as market conditions warrant; and, most importantly, it's one that starts now.

STEPS YOU CAN TAKE TO IMPLEMENT THE RIGHT LDI SOLUTION

You can start putting an effective LDI solution in place today. It doesn't matter what the current funding status of your pensions plan is; it doesn't matter whether your pension plan is frozen or ongoing. You can begin by collecting information and establishing a plan.

Planning is the essential first step on the path to creating an effective LDI solution. Effective planning will help ensure that all pertinent factors are considered and that changes are made when the time is right.

PLANNING

1 ▶ If you need help, ask for it; a qualified LDI solution provider will be able to assist at all stages, from planning to implementation.

2 ▶ Consider the ultimate goal of the pension plan: freeze, terminate, or ongoing. Terminating or freezing a pension plan will draw a plan sponsor's attention more towards bridging a funding gap, while an ongoing pension will require more focus on funding-level volatility and effectively managing contributions and expenses.

3 ▶ Next, consider internal and external factors.

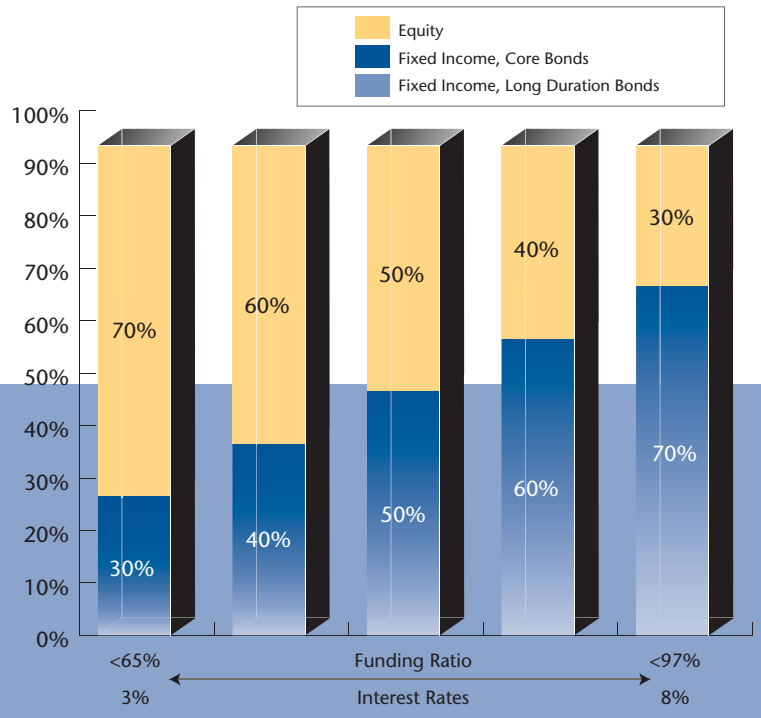
— **Internal** – current conditions and future objectives for plan characteristics like funding status, plan expenses, contributions, and asset mix.

— **External** – current market conditions and the level of interest rates.

Combined with the ultimate goal for the pension plan, these characteristics will help establish the destination to which an LDI solution will lead.

4 ▶ The next step is to examine the risk tolerances, return expectations, and constraints your pension plan faces. The acceptable volatility of the funding status, the asset returns, the allocation parameters, and the likely liability stream – all of these items frame the dialogue for how quickly and in what direction your LDI solution can move.

5 ▶ Once you know where your pension plan is, where you want it to go, and what restrictions you face, you and your LDI provider can create a map to illustrate how the pension plan will traverse the distance. For most LDI solutions, that map is a dynamic asset-allocation glide path. An LDI provider will take into account the goals and constraints of the plan sponsor and develop a guide that identifies when to make asset allocation shifts and what those shifts should look like. A glide path will help plan sponsors identify asset allocation shifts before they need to occur so that the pension plan can be more proactive rather than reactive. Because they are customized to the pension plan's specific needs, dynamic asset-allocation glide paths can include any number of asset classes and can provide recommendations within each asset class based on the level of interest rates. For example, as the plan sponsor moves to adjust the assets to more effectively match the liabilities, the glide path will help transition the assets of the fixed income portion to orient towards the pension plan's liability profile. A qualified LDI provider should also be able to assist in creating a custom benchmark that will represent those liability cash flows.



Ideally, a dynamic asset-allocation model should have more than just a single dimension so that it can react to both external and internal factors, e.g. funding status and interest rates. An asset allocation model that relies on both funding level and interest rates will allow the plan the potential for excess returns while still helping tame funding-level volatility. This means a fund could allow its assets to help close the funding gap more quickly than if the plan went directly to a long-duration fixed income portfolio.

PRECISION

Precision is required at two levels for successful implementation of an LDI solution. First, precision of the duration match of the pension plan's assets with its liabilities is important. Depending upon the plan sponsor's goals and limitations, the asset-liability match can be extremely precise, or the tolerance can be broader. Depending on the level of precision required, managers can utilize long-duration bonds, Treasury strips, or derivative instruments to manage the fixed income portfolio duration and yield curve positioning. The level of precision is based primarily on the needs, objectives and risk tolerance of the plan sponsor. Accuracy of the inputs into the process will also affect the true level of matching between the performance of plan assets and liabilities.

Second, precision is required in monitoring the pension plan's progress along the glide path. Typically this progress should be reported and discussed quarterly with the plans actuaries and advisors, based on several factors:

- changes in the market
- funding status
- contributions or other changes that impact the funding status
- position on the glide path

Accuracy in the measurement of the various factors is important and will help ensure that the process is moving efficiently, that each component is performing its function, and that there will be no surprises.

PROCESS

Once an effective and efficient glide path is established for the pension plan, the task becomes implementation. Each situation is unique, but the first typical shift is one that will help align the pension plan's fixed income allocation with the plan's liabilities. This will usually entail a move from intermediate-term bonds (Barclays Aggregate-type mandates) to longer-duration bonds. Shifting duration more in line with the liability profile is fairly simple to implement and will go a long way toward stabilizing the funding status. Depending on the current level of interest rates and the speed at which the plan wants to move toward full asset-liability matching, it could be beneficial to manage the duration of the fixed income allocation shorter than that of the liability profile, so long as the funding volatility is suitable for the pension plan. As the plan progresses toward the glide path's ultimate goal, the duration tolerance can be tightened to ensure funding status is maintained; this typically goes hand in hand with a higher allocation to fixed income. The glide path should make future asset-allocation decisions clear to a plan's sponsors, as well as the flexibility that exits within the fixed income allocation.

BENEFITS OF A DYNAMIC ASSET-ALLOCATION GLIDE PATH

- Plan sponsors can act quickly when opportunities/circumstances warrant action.
- Provides structure to decision making process. No need for "from the gut" decisions.
- Glide paths can be customized to suit a specific plan's goals and risk tolerances – works well for frozen plans and ongoing plans.
- Plan sponsors can incorporate varying asset classes and varying LDI solutions.
- Planning can begin now, no need to wait for rates to increase. Implementation and execution will follow on a predetermined path.
- Assures the plan participants and investors that a strategy is in place to address potential concerns: underfunding, volatility in funding status, expenses, and contributions.

WHAT YOU NEED TO LOOK FOR IN AN LDI SOLUTION PROVIDER

A plan sponsor looking for a provider in developing an effective LDI solution should focus on four main attributes.

Robust Dynamic Asset-Allocation Glide Path—This is one of the primary services a strong LDI solution provider can offer, so it's important that you identify one that can offer a customized asset-allocation plan that will adapt and evolve as the pension plan and the market conditions change. A glide path is not a one-size-fits-all solution; customization is key and your LDI provider should devote the time and effort to understanding your goals and constraints. Ideally, the glide path your LDI provider develops will be based on multiple dimensions. Asset-allocation models that are just focused on funding status could recommend changes that seem arbitrary in a broader context. It's important to make sure that allocation changes are based on a robust model that incorporates external and internal factors.

Strength and Experience in Fixed Income—Fixed income will play a greater role in the pension plan's allocations as the plan matures. High-quality corporate securities are the basis for the discount rate used to determine a pension plan's liability, so an LDI provider with extensive knowledge in fixed income investing will be invaluable.

Considering that one of the first changes is likely to be extending the duration of the fixed income allocation to help match assets to liabilities, plan sponsors should look for an LDI provider with particular experience in long-duration bonds. Further, experience should have a strong focus on corporate credit, since a significant amount of portfolio duration will come with corporate bonds.

History of Working with Customized Fixed Income Clients—Liability-driven investing is all about customized precision, especially when you consider the detail required to match a pension plan's liability cash flows. So it's important that your LDI provider have the demonstrated ability to create customized solutions and liability-matching benchmarks.

Breadth of Investment Capabilities—As a pension plan moves towards its goals, the right LDI provider can provide asset-management capabilities that will help the plan sponsor with new investment solutions that can meet the asset-allocation glide path's recommendations. Plan sponsors concerned with costs will find particular value in an asset manager that has the competence to invest in multiple asset classes; it's less expensive and more efficient to retask an asset manager than to replace one.

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WHAT PRINCIPAL GLOBAL INVESTORS AND THE PRINCIPAL FINANCIAL GROUP® CAN OFFER

Principal Global Investors and our affiliate organization the Principal Financial Group offer a unique approach to LDI solutions. Together we are able to offer the customization, flexibility, and expertise that plan sponsors require from an LDI provider. To create tailored LDI solutions, we use a robust multi-dimensional asset-allocation model that helps plans adapt as funding levels and interest rates change. We offer a wide range of fixed income, equity, and real estate solutions, and as your LDI provider, we'll be able to continually add value as your plan moves towards its goals. Our firms also have an established track record as asset allocation specialists, from target-date funds to customized institutional solutions. Throughout our history, our experienced fixed income team has always maintained a determined focus on corporate credit and has developed a particular strength in long-duration investing.

Principal Global Investors and the Principal Financial Group have a shared heritage of serving the complex needs of pension and insurance clients. We have a long track record of developing individualized solutions and have worked with major index providers to develop customized benchmarks for our clients.

Most importantly, we believe that you can start planning your LDI solution today and we stand ready to help you.

NO NEED TO WAIT

An effective LDI solution isn't something that can wait until next year. The **planning** needs to start soon so that you can move quickly and efficiently when the time is right and your pension plan is ready. Once you find an LDI provider that can deliver the customized solution you need, start developing your plan. This should include a dynamic asset-allocation glide path that will map out the changes your plan needs to make. Once your glide path is established, follow the **process** that will take your plan towards its goals. Initially, this may mean small changes like extending the duration of your fixed income allocation. Finally, focus on **precision**, both in matching your liability profile and monitoring the overall progress of the plan towards its goals.

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