

by David Adler



Thursday, June 25, 2009 provided by

Using liability-driven investing to better meet your retirement goals.

It works for the big dogs, and it might just work for you. "Liability-driven investing," a strategy that has been sweeping the world of pension-fund management, could be the next big trend in retirement planning for wealthy individuals.

LDI, as it's known, calls for matching or at least explicitly considering your future expenses when designing a portfolio, rather than focusing on asset growth alone. The idea is to assemble investments that will generate enough gains, and at the right times, to cover everything from greens fees to a bequest to your alma mater. So far, it's mostly being used for portfolios of the super-rich, but experts say it can work just as well for the merely well-off.

LDI certainly has taken hold among large U.S. pension funds, about half of which now use it or are considering doing so. The big liabilities of these funds -- future payments to retirees -- resemble long-term bonds and are extremely dependent on interest rates. If interest rates fall, it's harder for a fund to earn the money needed to make the payments. Therefore, "the heart of most LDI strategies used by pension funds is to try to take this interest-rate risk off the table, so that assets and liabilities move in lock step when interest rates change," says Mark Ruloff, the director of asset allocation at Watson Wyatt Investment Consulting.

This can mean something as simple as investing the whole fund in bonds with the same interest-rate sensitivities as the liabilities. But liability-driven investing also has more sophisticated variants. For instance, a pension fund may run two separate portfolios -- one focused on hedging interest-rate risk using derivatives such as swaps, the other aiming to grow assets through exposure to stocks or other investments. Combined, the two portfolios remove the unwanted risk of an interest-rate mismatch but still offer the possibility of growth.

Individuals planning for retirement might not need swaps and the like, but they do have plenty of liabilities that need funding, including essential ones like food, health care and housing. Retirees also will want money for theater tickets, hockey games or foreign travel, and they will want some left over to leave a bequest. Put more bluntly, individuals planning for retirement seemingly have irreconcilable goals: money that they need and money that they want. Call it fear and greed.

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Which is where LDI comes in: It precisely targets both goals through separate portfolios, making sure that the retiree has enough to live on, but also has the opportunity to boost his principal. In contrast, the traditional approach to retirement investing mashes both aims together in one portfolio, which meets neither goal with precision. Though this single portfolio may implicitly acknowledge future cash flows, liability-driven investing, as its name implies, explicitly keeps the liabilities in mind, creating very different -- and, advocates argue -- better portfolios than are common among retirees today.

"Typically, wealth managers begin by asking what you need to live on. But they are not attentive to the time pattern of the needs or the minimum you can't do without," observes Andrew Rosenfield, CEO of Guggenheim Investment Advisors in Chicago. "And none of this is tightly bound with the question of how to invest the money, which is just amazing."

Perhaps not surprisingly, the moneyed world of family offices has emerged as the first LDI beachhead for individuals. These outfits routinely handle portfolios of \$50 million and up. A handful of family offices, including such prominent ones as Guggenheim, already have implemented LDI-style approaches, and asset-manager BlackRock is studying how to bring the approach to a broader swath of wealthy individuals.

"Historically, the wealth-management business has focused on the asset side," says Brian Feurtado, BlackRock's head of wealth management. "Tying investments to liabilities has been long overdue." BlackRock is working with Boxwood Strategic Advisors, a New York consultant, to find the best application to individuals. Their first step is to get a handle on a wealthy client's true balance sheet, including hard-to-value luxury assets like art.

David Rosenberg, chief investment officer of the Threshold Group, a family office outside Seattle that uses the LDI framework, breaks clients' goals into three different categories: lifestyle, risk-taking and legacy. Each carries with it different level of risks and rewards the client is willing to tolerate. Rosenberg then creates distinct portfolios to optimally serve each need.

Take, for example, the cash outflows needed to fund a client's lifestyle. Clients tend to want to immunize themselves from most potential risks when it comes to meeting these basic payments. Taking an approach similar to a pension fund's, Rosenberg has found this liability stream can be fruitfully addressed by matching it with a fixed-income portfolio of similar "duration," a measure of interest-rate sensitivity. For example, if you plan to contribute to a grandchild's college education, you might want four bond investments with different maturities, with one maturing in each year of college.

Moves like that allow you to breathe easier. Says Rosenberg: "With their lifestyle not under the threat of financial stress, clients can begin to make more thoughtful and open-minded

decisions about risk with the rest of the portfolio." Since these portfolios are no longer encumbered with having to meet any cash-flow needs, the world of asset classes is opened up, including hedge funds, private equity and other investments with potentially high returns.

Last year, in the darkest days of the financial crisis, LDI fared well. Rosenberg says that his clients were better able to handle the crisis -- both financially and psychologically -- than if they had used traditional investment approaches. "Instead of saying the world is falling apart, they could say 'my world is secure, and the rest of world now has lots of opportunities,'" he adds.

Who Should Consider LDI

The LDI framework is most useful when people are living primarily off investment income, which is why it has attracted the attention of family offices. Those outfits also have the resources and technical expertise to create the sophisticated portfolios required. But many retirees with far less wealth also depend on investment income.

The sweet spot for LDI is investors with portfolios in the \$500,000 to \$10 million range, argues Larry Siegel, research director at the CFA Institute's Research Foundation. Above this level, investors aren't likely to run out of money during retirement, even if it means wriggling out of philanthropic commitments, should the portfolio tank. Below this range, a retiree doesn't really have enough assets to be able to implement the liability-driven investment approach.

A more critical stumbling block for people approaching retirement is the lack of a perfect or easily available liability hedge. There simply is no off-the-shelf product that leaves individuals with perfectly matched assets and future liabilities.

Annuities, with their insurance features, are one excellent way to hedge your longevity risk -- the danger that you will outlive your money. However, they expose investors to the credit risk of the insurance company. TIPS, or Treasury inflation-protected securities, provide inflation protection, but the returns are painfully low. Bonds, for their part, bring interest-rate risk and inflation risk. Individuals might somehow be able to cobble together a bond portfolio that matches their personal liabilities, but it won't be nearly as precise as the efforts of pension plans. That's because pension managers have the know-how and technology to keep durations matched through frequent trading.

Right now, many investors don't even try to match their assets with future expenses. "Just look at their portfolios," says M. Barton Waring, chief investment officer for investment policy and strategy, emeritus, at Barclays Global. "You don't see many attempts to match liabilities with Tips or annuities or long bonds." Instead, he says, many retiree portfolios are simply too equity-heavy.

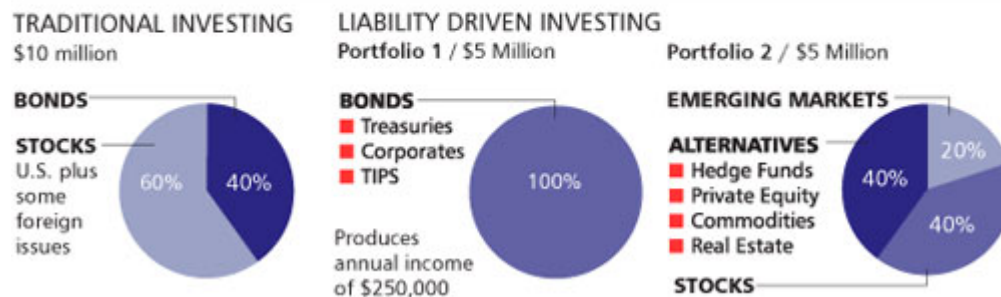
While traditional retirement portfolios often include bonds to offset the risks of stocks, the payment streams of the bonds are rarely matched closely with future expenses. For instance, a mutual fund benchmarked to the popular Barcap (formerly Lehman) Aggregate bond index would have too short a duration to match such liabilities as long-term care.

Is all this theoretical, or does liability-driven investing really pay? Watson Wyatt's analysis of corporate pension funds found that those who used LDI, rather than traditional strategies, had a higher return on assets over the past two years. But the main argument in favor of LDI is much starker: "Traditional portfolio strategies failed in 2008," says Watson Wyatt's Mark Ruloff. "Simple diversification is no longer the whole story. Hedge funds, REITs and the stock market all went down together."

LDI, though still in its infancy, could be the missing part of the story. It just might put a real shine in the golden years.

A BETTER NEST EGG

In traditional retirement investing, a general collection of bonds serves simply as ballast to stocks. In liability-based investing, a separate fixed-income portfolio is constructed to produce a dependable return to cover living expenses, in this case \$250,000 a year. A separate, more adventurous portfolio aims for growth.



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