# Asset/Liability Match, Set, Product

## Reconciling DB asset and pension liabilities

*Russ Proctor*

*Marty Menin*

***Defined benefit (DB) plans have endured much over the past few years, from new regulations to volatile interest rates and equity markets, all of which has led plan sponsors to find better ways to match their assets to the liabilities of the plan. Alison Cooke Mintzer, editor-in-chief of PLANSPONSOR, spoke with Pacific Life Insurance Company about their innovative Pacific Insured LDI® product. She sat down with Russ Proctor and Marty Menin, both directors of institutional sales at Pacific Life, to talk about liability-driven investing (LDI) and a new strategy for defined benefit plan sponsors.***

**PS: What are some challenges for the traditional LDI approach?**

**Proctor:** Precise asset/liability matching is difficult for pension liabilities, particularly for traditional LDI strategies. The liabilities are paid monthly over a very long period of time, and the pension liability is measured annually based on corporate bond rates. As those corporate bond rates move, the liability moves as well. The asset not only has to deliver the monthly cash flows, it also has to match the movement in the value of the liability.

Traditional LDI strategies have had trouble with that precise matching, which results in tracking error.

A lot of asset managers talk about the fact that you cannot buy the curve, and they're referring to the Citigroup Pension Discount Curve (CPDC) that's used by many actuaries and plan sponsors to measure the plan liabilities. It would be a difficult task for an asset manager to try and buy all the bonds used to develop the monthly CPDC.

Also, the bonds in the CPDC may not be a prudent investment for a pension plan, due to the concentration by industry and issuer of the bonds used in the curve. This concentration increases the downgrade and default risk of the investments, and thus will not meet the diversification requirements of the plan's investment policy. If a bond is downgraded or defaults during a month, it is simply removed from the CPDC in the following month. Thus, the CPDC never suffers losses from downgrades or defaults. However, a traditional LDI investment portfolio that actually purchased those bonds that were later downgraded or defaulted will suffer a loss.

With Pacific Insured LDI, because it follows the curve precisely and uses the same benefit payment stream as the plan actuary to measure the liabilities, relatively speaking, there is no credit risk (no downgrades or defaults), no interest-rate risk and thus no tracking error.

**PS: Can you tell me more about this Insured LDI product and how the contract works for plan sponsors?**

**Menin:** Pacific Insured LDI was developed in response to plan sponsors' need of a better asset match for their pension liability. Insured LDI provides a guaranteed contract value compared to the traditional LDI strategies that use a "best efforts" approach. Insured LDI is the first solution to precisely match that movement in the pension liability: No matter how the yield curve changes from month to month, Insured LDI will match the plan's projected liabilities; and thus, the funded ratio will remain stable.

Finance executives and their Board of Directors can spend a significant amount of time trying to understand complex traditional LDI strategies, comparing actual results to expected results and reasons for the variances. With Insured LDI, the executives of the organization can now focus their energy on running their operations and not on worrying about the funded status volatility of the pension plan.

Insured LDI is also flexible, so plan sponsors can modify the product to meet their objectives. It does not need to be used for the entire plan. For example, some plan sponsors are looking to start using Insured LDI to just stabilize their retired liability, as illustrated in the pie chart below.

It also provides liquidity through the monthly benefit payments made by Pacific Life to the pension trust. The plan sponsor can also exit the contract completely with no penalties or surrender charges. Thus, they are not locked into the contract.

**PS: You have a client who's been using this Insured LDI group annuity contract for a couple of years now. Has that product delivered what you—and your client—expected and promised?**

**Proctor:** We're very proud of the performance it's had over the last couple of years. The contract value moved exactly with their plan liability based on the projected benefits that the plan sponsor provided. So, as interest rates moved fairly violently over the last two years from month to month, Insured LDI performed exactly as advertised: It stabilized the funded ratio. Every month, no matter what happened to the yield curve or the equity markets, their funded ratio stayed the same—while providing monthly payments along the way to meet their cash-flow needs.

**PS: How has the market changed and evolved in the last three years since the product was introduced?**

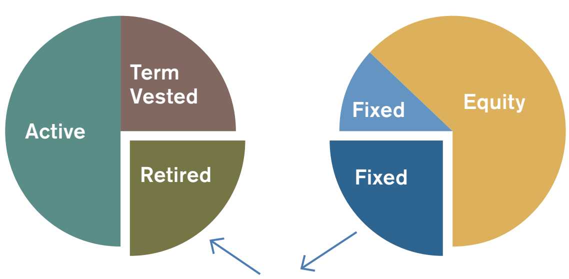
**Menin:** We saw interest rates rise pretty significantly last year, and now they've actually backed off by some 40 to 50 basis points. For a plan sponsor interested in stabilizing their funded status earlier this year, our insured LDI product would have been a great solution for them. Could interest rates continue down another 100 basis points? Perhaps, but with Insured LDI, the plan sponsor does not have to worry if rates move up or down. The product is meant to protect the asset portfolio from those volatile interest-rate changes and to provide a superior asset/liability match.

As funded status improves, shifting into a risk-protected asset like Insured LDI can help lock in the big gains some DB plans made last year. Particularly as they get close to 100% funded, there's not as much upside for the plan. If equities run up another 30%, it doesn't help much to be 30% over-funded, but you certainly pay the penalty if there is a bad year and your funded status decreases. Now is a perfect time to lock in that funded status.

Insured LDI can work for ongoing plans, but it is particularly helpful for those closed and frozen plans that are approaching full funding, now is a great time to use this type of a product. ■

*The chart below shows a plan using a portion of its fixed-income asset allocation for Insured LDI to obtain a precise asset/liability match.*

## Pacific Insured LDI for Retired Liability




- *Exact cash-flow match*
- *Exact duration match*
- *Provides liquidity for benefit payments*
- *Less need for liquidity on equity portion*

**Pacific Insured LDI:** Invest fixed-income assets in Pacific Insured LDI for better match to retired liability.

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