KPMG
cutting through complexity

2011 KPMG LDI SURVEY

Exploring the Evolution of the LDI Market

INVESTMENT ADVISORY

kpmg.co.uk

Executive summary

KPMG has surveyed the investment management community to establish a clear picture of the current landscape for Liability Driven Investment (LDI) in the UK pensions market.

We have received responses from 32 UK based investment managers with a combined asset base of over £6 trillion. Of these, 15 stated that they had an LDI offering of some description.

Key headline trends:

We have observed the following trends in the UK LDI market:

- There has been continued flow of assets into LDI solutions with substantial increases in assets invested in both pooled and segregated LDI strategies over the last two years.

  The value of assets invested explicitly in LDI mandates has increased by 16%, from £210bn to £243bn, over the last 2 years.

  The total number of pension scheme mandates in the UK using LDI has increased by 7%, from 584 to 624, over the same period.

- There has been consolidation in the number of investment managers operating in the LDI marketplace.

  The number of providers stating that they have an LDI offering has fallen from 23 in 2007 to 15 in 2010 with the number offering pooled solutions falling from 14 to 9.

  There is now considerable concentration of overall industry assets. The 2 largest providers in segregated solutions managed over 70% of the total segregated assets surveyed and the 2 largest pooled providers managed over 80% of pooled assets surveyed.

  Levels of choice have actually broadened compared to 2007, due to greater variety of solutions available at the remaining managers.

- There is a consensus in the fund management community that both real and nominal gilt yields will rise above that implied in the market which would have a beneficial impact by reducing the value of pension scheme liabilities

KPMG Investment Advisory expects that UK pension schemes will continue to move into LDI over the coming years, a view shared by the investment management industry.

What is LDI?

LDI or 'Liability Driven Investment' can have a number of definitions. KPMG typically defines LDI as being an investment strategy that seeks to manage overall risk arising from the liabilities (namely the impact of interest rate and inflation).

LDI captures the ethos of investing with a view to meeting a pension scheme's 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 sophisticated overlay strategy using instruments such as swaps.

LDI initially suffered from a reputation for being an overly complex technique suitable only for the largest and most sophisticated pension scheme boards. Now, some years on, the landscape has changed considerably. LDI has a firm footing within the toolkit that pension scheme trustees can employ to help manage pension scheme risks, offering solutions for practically all client circumstances, irrespective of scheme size.

KPMG and LDI

KPMG Investment Advisory is a leading specialist advising pension schemes and sponsors in relation to asset and liability risk management.

KPMG has been at the forefront of developing clients' understanding of the benefits that an LDI approach can bring, and helping clients to understand and implement the approach that is most suitable for them. For example:

- KPMG highlighted the benefit of using gilt repos to access higher yields at lower risk than conventional swaps in early 2009, promptly after the opportunity first appeared. Adding millions in additional yields to KPMG's clients' portfolios
- Demonstrating the practical benefit of LDI with modelling that builds in the features of the wider investment strategy, funding level and objectives to help clients gain a true picture of the actual benefit that will be achieved with LDI, avoiding costly over-engineered solutions

KPMG is also deeply experienced in integrating these and other investment solutions with non-investment risk management tools including benefit changes, enhanced transfer values, insurance products and longevity hedging to determine the most appropriate arrangement.

The 2011 KPMG LDI Survey follows on from the 2007 KPMG LDI Survey and is just one example of KPMG's commitment to investing in high quality research to inform and underpin our specialist advice.

LDI and the future

The results of the survey were consistent with KPMG Investment Advisory's day to day experience of the LDI market.

The market persists in the view that yields are unattractive. Despite this, more and more scheme trustees and sponsors are recognising that the extent to which their future is dependent on interest rates and inflation is introducing an unacceptable level of risk.

As a result pension schemes large and small are taking steps to manage this risk in similar ways often using triggered approaches to lock in some benefit first. Importantly, market-level triggered strategies do suffer from the implicit drawback that further deterioration in yields may be left unprotected.

There are structures that can mitigate this and it is vitally important that the full range of alternatives are considered when trustees and sponsors establish their long term risk management plan.

KPMG Investment Advisory expects that clients will continue to move into LDI. This view is shared by the investment management industry as all investment managers polled expected growth in their LDI assets over the next year through client inflows.

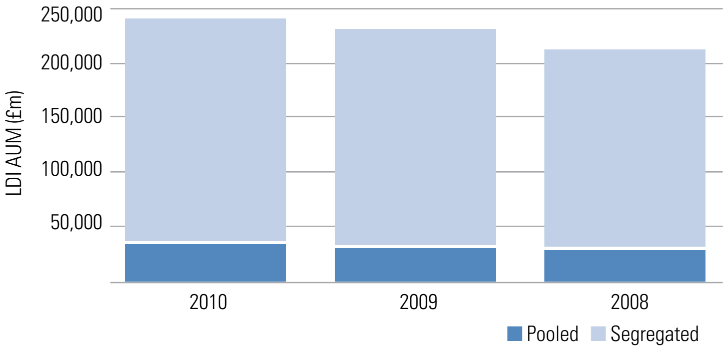
LDI trend in pension schemes

Background

There has been considerable increase in the use of LDI within UK pension schemes.

Over the past 2 years the total value of LDI assets under management in the UK has increased from £210bn at the end of 2008 to £243bn at the end of 2010.

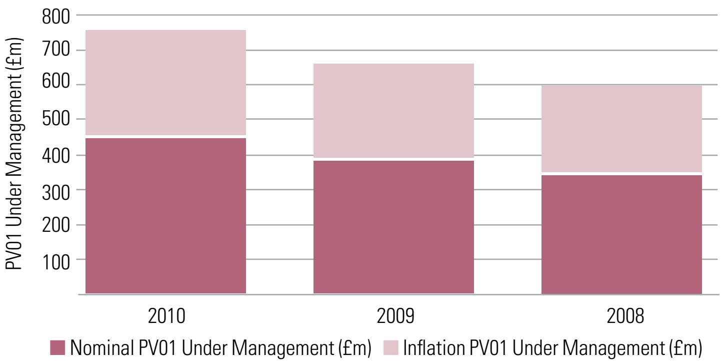
Total LDI assets under management for UK pension schemes



The size of overall LDI exposure under management for pension schemes in the UK, measured using PV01 (a common measure of interest rate and inflation risk – see glossary) shows that the amount of hedging that is taking place has increased by approximately 25% over the last 2 years.

The majority of this growth appears to have been driven by growth of existing mandates as the total number of mandates rose by only 7% over the 2 years.

Total LDI hedging by UK pension schemes - measured by PV01



Segregated LDI

The value of UK pension scheme assets invested in segregated arrangements has increased from £179bn as at end of 2008 to £208bn as the end of 2010.

The number of segregated LDI mandates in place increased from 290 in 2008 to 315 in 2010.

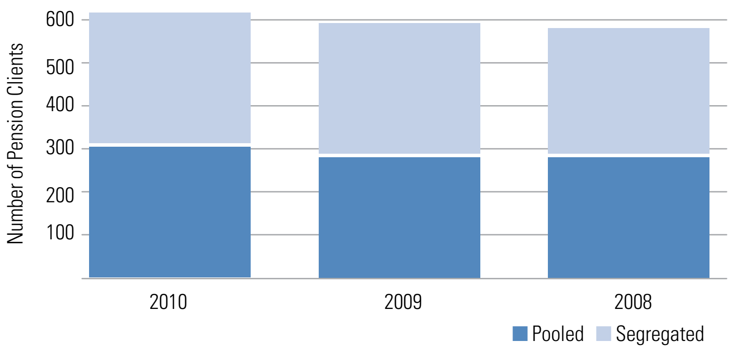
Pooled LDI

The value of UK pension assets invested in LDI pooled funds has increased by roughly £4bn from £31bn as at end of 2008 to £35bn as the end of 2010.

The total number of clients investing in pooled mandates has increased from 294 as at the end of 2008 to 309 at the end of 2010.

The number of clients using segregated and pooled approaches is broadly similar but, due to the greater average size of segregated mandates, the value of assets invested is roughly 6 times greater than for pooled.

Total number of UK pension scheme LDI mandates



Pension scheme too small for LDI?

Historically, size has been seen as a barrier to LDI. The survey reveals that the smallest UK client with LDI had assets of £4m, with the smallest segregated LDI mandate across the UK industry having £28m invested in the arrangement. This is strong evidence that size no longer hinders the potential to benefit from LDI.

LDI trends in fund management

Background

LDI is one of a number of fund management areas that has seen substantial changes over the past 10 years.

Following an initial flood of entrants to the market, the market has matured somewhat with the number of providers reducing in recent years despite continuing inflows of assets under management in the LDI market.

The number of providers stating that they have an LDI offering has fallen from 23 in 2007 to 15 in 2010.

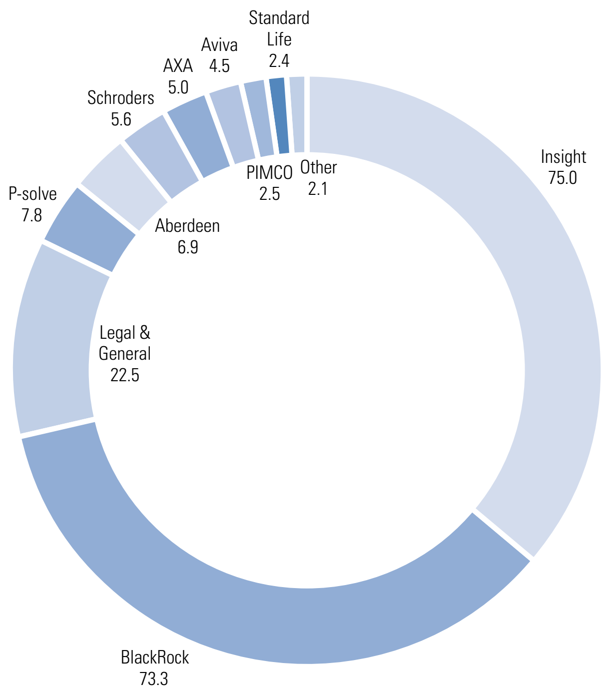
There is now considerable concentration of overall industry assets in both pooled and segregated markets.

Segregated LDI

The market share of the segregated fund market is illustrated right with the split of assets under management as at 31 December 2010. Please note, there are a number of different ways to measure market share in LDI, assets under management is one approach.

The 2 largest providers in segregated solutions managed over 70% of the total segregated assets surveyed.

Segregated assets under management 31/12/10 (£bn)*



*F&C were not able to provide a figure split in the format used in the survey, but stated that they are a key provider in the segregated LDI market.

Pooled LDI

The pooled LDI fund market has gone through a considerable degree of change in the last 6 years. The first pooled funds became available in 2005, growing to a peak of 14 providers with pooled funds in 2007.

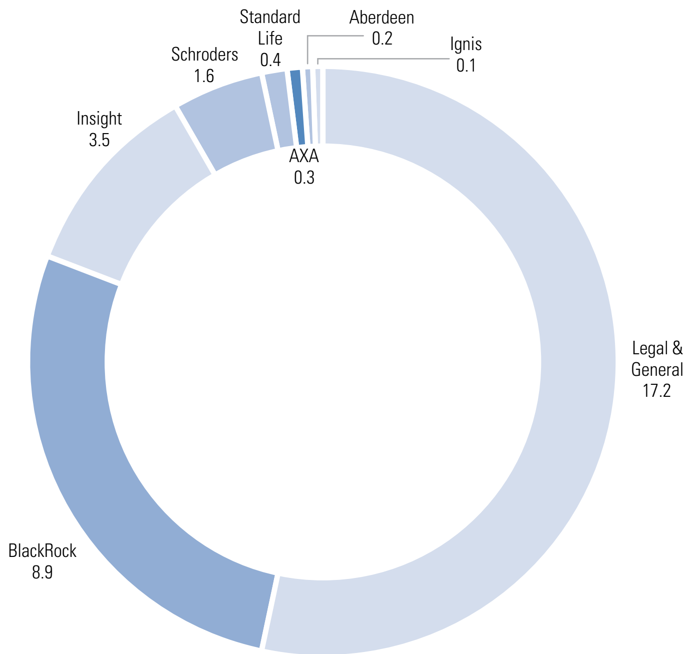
Since 2007, the level of assets invested has continued to grow along with the variety and sophistication of the underlying products. Meanwhile, however, the surveyed number of providers with pooled funds has reduced to 9 as at end 2010, with no new investment managers entering the pooled fund market since 2007.

The market share of the pooled fund market is illustrated right with the split of assets under management of pooled fund providers as at 31 December 2010. The 2 largest pooled providers managed over 80% of pooled assets surveyed.

8 pooled LDI fund providers offer leverage, of which 3 offer 'gilt repo' or Total Return Swaps so as to benefit from additional yield through leveraged exposure to gilts. This gives pooled fund investors a wider range of choice so as to invest in the most efficient arrangement.

The trading frequency of pooled funds has improved across the board, with all but one manager offering daily or weekly liquidity. This provides schemes with greater flexibility compared with 2007 when more than half the funds traded less frequently than weekly.

Pooled assets under management 31/12/10 (£bn)



Outlook for the LDI market

Background

LDI is a means of reducing risk, but it is important that the question of market levels is factored into the decision making process. Locking into yields at unfavourable levels could lead to pension schemes missing out on a reduction in deficit that a rise in yields could bring.

At least 20% of the c.600 LDI mandates surveyed have market level trigger strategies which the fund manager monitors and implements. This implies that there are a number of participants that wish to hedge but with a view on market levels.

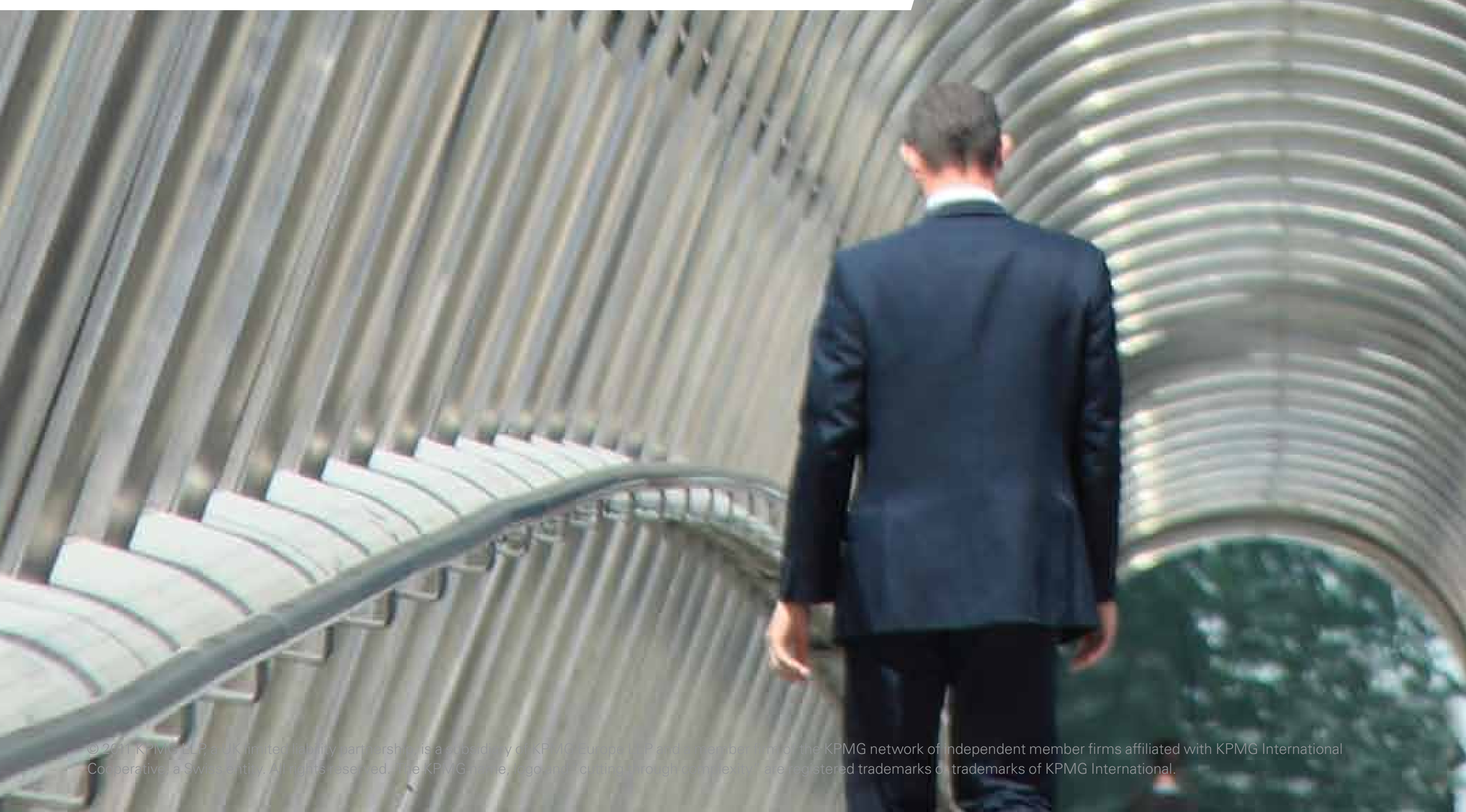
Survey of market views

KPMG Investment Advisory produces Medium Terms Views (MTVs) on a quarterly basis to assist clients in their decision making.

To complement our MTV work, we have polled the UK investment management community on areas of specific interest in the LDI survey.

Of the 32 respondees to the survey, 19 managers had a view on the direction of gilt markets over the next 3 years. These managers accounted for 70% of the total assets under management of the surveyed managers.

The opinions polled by the survey are illustrated right along with the historic market levels for reference.



1. Nominal gilt yields

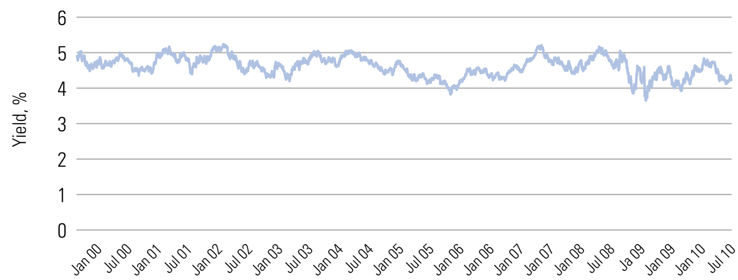
Nominal gilt yields are a principal factor used when valuing liabilities. The higher the gilt yield the lower the value of the liabilities.

The chart right illustrates historical 15 year fixed interest gilt yields.

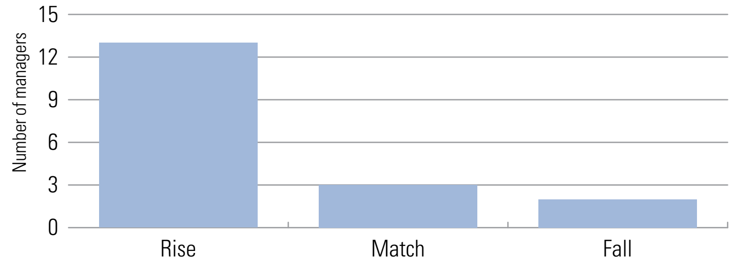
We asked the investment managers if they expect nominal gilt yields to rise, match or fall, over the next 3 years relative to what is currently priced into the market?

The majority of managers indicated that they expect nominal gilt yields to rise. This view would suggest that hedging interest rate risk now is less attractive than it might be in the future.

Nominal 15 year gilt yields



Views of investment managers polled



2. Real gilt yields

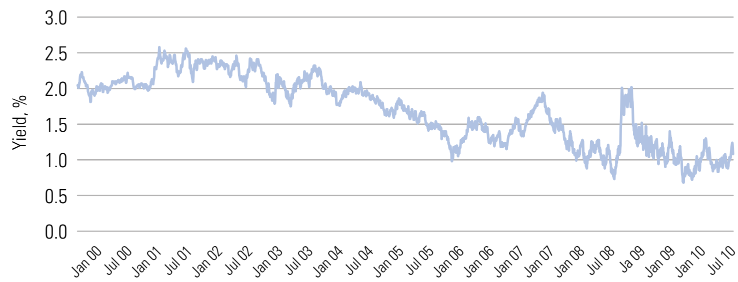
Real gilt yields are a principal factor used when valuing inflation linked liabilities. The higher the real gilt yield the lower the value of the liabilities.

The chart right illustrates historical 15 year real interest gilt yields, which represents the interest rate adjusted for expected inflation.

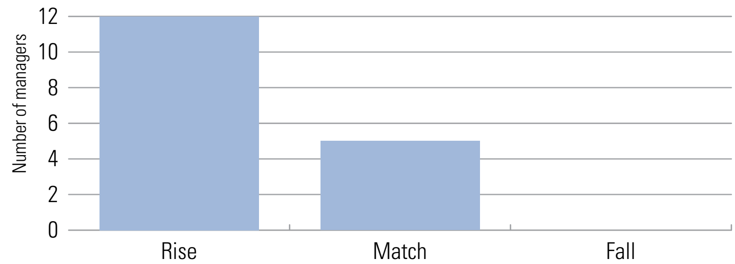
We asked managers if they expect real gilt yields to rise, match or fall, relative to what is currently priced into the market?

The majority of managers indicated that they expect real gilt yields to rise. This view would suggest that hedging interest rate risk and inflation now is less attractive than it might be in the future.

Real 15 year gilt yields



Views of investment managers polled



3. Gilts/Swap Spread

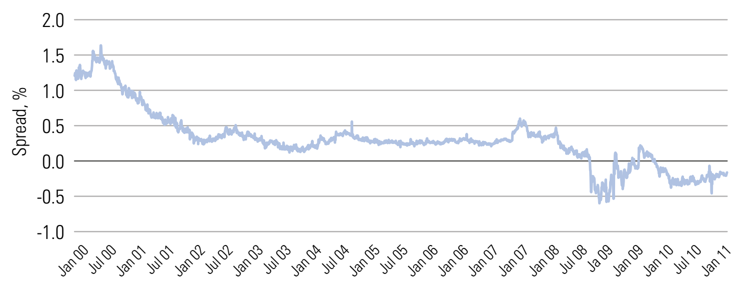
The gilts/swap spread relates to the difference between gilt and swap yields. Where the spread is negative, gilts are yielding more than swaps which is unusual given that gilts are practically risk free.

The chart right illustrates the difference in yield between a 20 year swap spreads and an equivalent 20 year gilt.

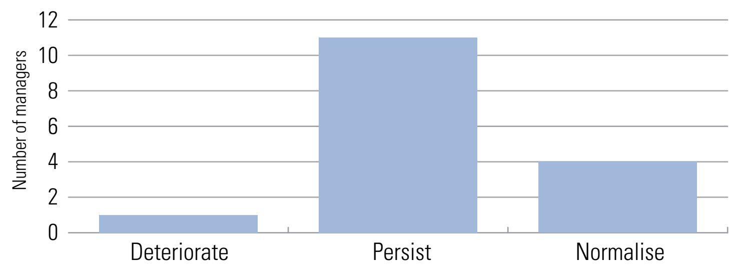
We asked managers if they expect the current negative swap spread to deteriorate, normalise, or persist over 2011?

The majority of managers indicated that they expect negative swap spreads to persist during 2011. This would suggest that there may still be time to switch out of swaps into gilts but that the size of the opportunity is not expected to grow.

20 year gilt/swap spread



Views of investment managers polled



KPMG would like to thank the following managers for their participation in the LDI survey:

Aberdeen Asset Management

Arden Asset Management

Aviva Investors Global Services Limited

AXA Investment Managers

Baillie Gifford & Co

BlackRock Inc

Comgest SA

Edinburgh Partners

European Credit Management Ltd

F&C Management Limited

Fidelity International

Franklin Templeton Investments

Friess Associates

Henderson Global Investors

Ignis Asset Management

Insight Investment

Investec Asset Management

Jupiter Fund Management plc

Key Asset Management

Legal and General Investment Management

MFS Investment Management

Nordea Investment Management

PIMCO

Psolve

Quantitative Management Associates LLC

Rathbone Unit Trust Management

Schroders

Standard Life

State Street Global Advisors

Stenham Asset Management

SVM Asset Management

Western Asset Management Company Limited

GLOSSARY	
Basis Point	0.01 % or one hundredth of one percent.
Collateral	Assets transferred between counterparties of a derivative transaction to be used as security to cover losses/profits incurred on the contract.
Gilt Repo	An arrangement which allows an investor to gain leveraged exposure to gilts.
Inflation Swap	A method to hedge inflation risk. An agreement between two parties (e.g. a pension scheme and a bank) to exchange a fixed stream of cashflows for a stream of cashflows linked to inflation (typically RPI) to match liabilities.
Interest Rate Swap	A method to hedge interest rate risk. An agreement between two counterparties (e.g. a pension scheme and a bank) to exchange a floating stream of interest payments (typically LIBOR) for a fixed stream to match liabilities.
LDI	Liability Driven Investment, an investment strategy designed to control risks emanating from liabilities as well as the assets. For pension schemes, it usually involves hedging interest rate and inflation risks using swaps or bond investments.
LIBOR	London Interbank Offered Rate, the interest rate at which banks offer to lend funds to one another in the international interbank market. Calculated as an average of what a panel of 16 banks believe they would be charged when borrowing for a specified period.
LPI	Limited Price Indexation, same as RPI (see RPI) but with a cap or a floor applied e.g. LPI 0-5: min 0%, max 5%.
Present Value	The value today of a cashflow occurring in the future, calculated by reducing the amount by an interest rate (discount rate). Assumes that cash amounting to the present value could be invested and earn interest so as to grow to the required cashflow value in the future.
PV01	A measure of the sensitivity of a pension scheme's asset or liability value to interest rates or inflation. It is the change in present value of the asset or liability for 1 basis point change in yields. Used in swap markets as a convenient summary measure of trade size.
RPI	Retail Price Index, the prices of goods sold to retail customers, as measured by change over time in the price of a fixed basket of goods and services bought by a typical customer.
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.
Total Return Swap	A swap the provides the total return on a defined asset in exchange for an agreed floating rate such as LIBOR over a fixed term. TRS can be used to gain leveraged exposure to gilts.
Z Spread	Short for Zero-volatility spread. A measure of the additional yield available on a bond relative to the yield available on an equivalent swap. An example would be the difference in yields between gilts and interest rate swaps. Swap spread is a type of Z spread.

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RR Donnelley | RRD-257346 | July 2011 | Printed on recycled material.