What is Liability Aware Investing?

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Aberdeen Standard Investments is dedicated to helping investors around the world reach their desired investment goals and broaden their financial horizons.

We seek to provide world-class investment expertise across a breadth of markets and asset classes. Our full range of solutions span equities, multi-asset, fixed income, liquidity, sovereign wealth funds, real estate and private markets. Coupled with a range of investment approaches, from quantitatively-managed ‘smart beta’ to highly active alpha-seeking strategies, we transform new investment ideas into practical investment products designed to deliver real value for money to investors.

We have one of the world’s largest teams of investment professionals with approximately 1,000 portfolio managers, analysts and product, risk and trading specialists located globally ensuring close proximity to our clients and the markets in which we invest. In addition, we have 500 client specialists working closely with investors and professional advisors to understand their goals and deliver innovative, world class investment solutions. Today, we manage €649 billion (£576 bn/US$779bn) of assets on behalf of governments, pension funds, insurers, companies, charities, foundations and individuals across 80 countries (as at 31 December 2017). The largest active asset manager in the UK, we are also one of the top five asset managers headquartered in Europe and one of the biggest active asset managers worldwide not owned by a bank. As a responsible global investor, we leverage our scale and market leadership to raise standards in both the companies and industries in which we invest, and drive best practice across the asset management industry.

*Aberdeen Standard Investments is a brand of the investment businesses of Aberdeen Asset Management and Standard Life Investments.*

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What is liability aware investing?

Liability aware investing (LAI) is an investment framework provided by Standard Life Investments for managing and potentially exploiting the various risks faced by investors who have specific liabilities to meet from their assets. Among these investors are insurance companies and the trustees and sponsors of defined benefit (DB) pension schemes. Here, we focus on LAI in the context of DB pension schemes.

We purposely describe our own liability management approach as LAI, distinct from the more common industry term, liability driven investment (LDI). LDI has become a label for hedging products on the market, many of which are passively managed, whereas we manage our solutions actively and seek to add value beyond providing a pure liability hedge.

For many years, pension schemes’ investment strategies focused primarily on the assets, with the aim of maximising returns. Reserves were made for the liabilities on the assumption that the scheme’s assets would consistently deliver strong performance. However, since the turn of the century the move to ‘fair value’ accounting principles for pension schemes has placed a much greater focus on their finances, with the value of liabilities disclosed on corporate balance sheets being independent of the assets held in the scheme. Given the long-term nature of a pension scheme’s payment obligations, the value of the liabilities can be much more volatile than that of the assets held, giving rise to periods when the assets and liabilities become significantly misaligned.

LAI is a means of controlling such misalignment, by using investment strategies designed to target the risk and return of the asset portfolio relative to the value of the liabilities.

Adopting an LAI approach provides an opportunity for a pension scheme to increase the certainty with which it can meet its payment obligations, without compromising expected returns from its assets or raising the long-term cost of the scheme to the sponsor.

In addition to accounting changes, several other factors have prompted growing numbers of pension schemes to adopt a liability aware investment framework.

• Increased legislation around funding and investment, including the introduction of the Pensions Regulator in the UK, has encouraged trustees to pay more attention to the risks embedded in the liabilities (for example, the risk of funding strain caused by higher-than-expected inflation).

• Falling interest rates and expected returns on assets, coupled with rising longevity, have greatly increased the projected cost of providing guaranteed pensions. Consequently, many DB schemes have fallen into a funding deficit. In turn, this has led to widespread closures of DB pension schemes, initially to new members and subsequently to all future accrual of benefits.

• Many schemes have reached a mature state where an increasing proportion of the accrued liabilities comes into payment. The transition of schemes to a ‘cashflow negative’ position (i.e. where annual benefit outgoings exceed contribution income) has compelled trustees and sponsors to focus more intently on ‘matching’ assets to liabilities.

Given this background, scheme trustees and sponsors have generally been looking to de-risk their investments. Where risk is retained, it is concentrated on market exposures where that risk is expected to be rewarded.
What is liability aware investing?

Conventional investment strategies that focused on delivering strong expected returns over the long term (these were typically heavily biased towards equities) have been found inadequate in dealing with the short-term risks presented by accounting and valuation disclosures.

Under an LAI approach, investments are measured relative to the performance of a scheme’s liabilities, rather than an arbitrary market index (the FTSE All-Share Index, for example).
# Implementing a liability aware approach

In implementing a liability aware approach, we work closely with clients and follow five key steps.

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<tr>
<th>Step</th>
<th>Description</th>
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<tr>
<td>01</td>
<td>Understand your objectives</td>
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<tr>
<td>02</td>
<td>Determine your ‘risk budget’</td>
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<td>03</td>
<td>Understand which risk exposures are expected to be rewarded and those that are not</td>
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<tr>
<td>04</td>
<td>Decide how to deploy the risk budget as efficiently as possible</td>
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<td>05</td>
<td>Monitor and reassess</td>
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What is Liability Aware Investing?

Our LAI approach evolved from the need to address our own Staff Pension Scheme funding shortfall.

By 2005, several years of volatile markets had taken their toll and, like many defined benefit pension plans, the Standard Life Staff Pension Scheme was running a sizeable accounting deficit. The existing investment strategy relied on a traditional equity/bond investment approach. However, this was clearly ineffective. A new solution was sought that would both close the funding gap and ensure the liabilities could be met on a sustainable basis.

An innovative solution

Standard Life Investments proposed a solution that marked a complete change of strategy. It involved the creation of a ‘liability plus’ approach that focused on outperforming the pension scheme liabilities rather than a benchmark index. Importantly, it considered the assets and liabilities holistically to create a portfolio with a dual objective:

- **Return generation** – we constructed a diversified multi-asset absolute return strategy to seek consistent positive returns (the foundation for our flagship Global Absolute Return Strategies portfolio).

- **Liability management** – we used liability hedging techniques to help protect the scheme against increases in liabilities arising from adverse movements in interest rates and inflation expectations.

By integrating these two components, we built an efficient, effective and durable strategy. The approach has proved successful in restoring the Staff Pension Scheme to full funding.

The chart below shows how the Scheme’s liability plus strategy has performed, relative to both its liability benchmark and to a more traditional multi-asset investment strategy.

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**Liability aware investing in practice**

[Image of chart showing performance comparison]

Our liability aware solutions

We have built a suite of pooled funds to make available the successful liability aware approach we have used to manage our own Standard Life Staff Pension Scheme.

The Integrated Liability Plus Solutions (ILPS) combine a Hedging Portfolio with a Growth Portfolio within a suite of single pooled funds, to target a return in excess of a pension scheme’s liabilities.

### ILPS – a cash-efficient integrated approach

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<tr>
<th>Hedging Portfolio</th>
<th>Growth Portfolio</th>
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<td>Protection on c.£2 of liabilities</td>
<td>£1 exposure to absolute return strategies</td>
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Every £1 invested in an ILPS fund provides both:

- **Hedging Portfolio** - To provide c.£2 protection (i.e. hedge) against changes in the value of liabilities arising from movements in interest rates and (in the Real Funds) inflation expectations; and
- **Growth Portfolio** - at the same time, to seek a return in excess of cash on the £1 invested in the fund.

### Why choose ILPS?

- ILPS is a unique, innovative approach to liability-management. By integrating a cash-efficient return engine with leveraged liability hedging, it provides exposure to both liability hedging tools and multi-asset growth assets within a suite of single pooled funds.
- Each ILPS fund is an integrated solution which, through efficient collateral management, seeks to control both asset and liability risks while also maintaining a client’s return target.
- Liability protection no longer entails a performance sacrifice, providing enhanced return potential.
- ILPS is a simple, low governance solution, with easy implementation and ongoing support.
- Using flexible building blocks, our ILPS solutions can be constructed to accommodate clients’ liability characteristics.

### Find out more

If you would like to find out more about our liability aware approach, please visit www.aberdeenstandard.com where you will find contact details for your location.
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