Insights
Liability-Driven Investing

June 2021

Changing Your LDI Manager

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As schemes mature, the accuracy and efficiency of an LDI portfolio become increasingly important. It is, therefore, vital that schemes do not feel limited to the LDI solution and service provided by their incumbent manager. There is often apprehension about the perceived complexity of changing an LDI manager, and we seek to address some of these concerns, for both pooled and segregated mandates.

We have heard consultants and pension schemes compare the process of changing their LDI manager to going through a divorce — expensive and messy! We, however, believe it is closer to upgrading your phone — finding the best package tailored to your requirements, at the right price and with the best service.

As LDI mandates and their implementation have changed over time, it is much easier and less costly now to move mandates from one manager to another, for both pooled and segregated accounts. These changes include a move away from swaps-based to gilt-based hedging for many schemes. Where swaps-based hedging is still in place, the widespread move away from bilateral swaps and non-cash CSAs towards cleared swaps and standardised legal agreements has materially reduced transaction costs.

Furthermore, as schemes mature, funding levels improve and hedge ratios increase, the accuracy and efficiency of an LDI portfolio become increasingly important. Schemes should not feel limited to the LDI solution and service provided by their incumbent manager. We seek to address some common concerns that arise while considering a change in an LDI manager, for both pooled and segregated mandates.

As Your Scheme Matures, Does Your LDI Mandate Need Closer Attention and Better Hedge Accuracy?

>70% of schemes which hired their LDI managers 4–10 years ago have not retendered since.

Source: Mallow Street LDI Report.

It's Complicated!

At State Street Global Advisors, the LDI team, in partnership with our client implementation team, handle the process of moving an ongoing LDI mandate, without charging any transition fees. In collaboration with the investment consultant, we model the current exposure of the LDI mandate with the incumbent manager and propose trading or transferring of assets that would replicate the level of hedging against liabilities.

Is Contemplating How to Make the Move and Who Will Coordinate the Process Daunting for You?

We determine the suitable transition period depending on the amount of trading and manage the implementation over the transition period. Throughout the transition our LDI team provide regular updates on the progress and upon completion, provide a full summary report of the transition, detailing the portfolio before and after trading.

It's Going to Cost Me!

Concerns that arise while considering a change in LDI manager often focus on whether there are market risks and transaction costs involved. Let us consider these aspects for pooled fund investors as well as segregated mandates.

Pooled Fund Investors

- For a successful transition, a common dealing date between the incumbent manager and State Street Global Advisors can be agreed. Transition can happen on that day to avoid any out-of-market exposure

- If holdings are within unleveraged and leveraged gilts and index-linked gilt funds, the transition can usually happen without any transaction costs. For instance, we aim to trade our gilt-based funds at Tradeweb closing prices, resulting in no broker transaction costs

86% of notional liabilities hedge using gilt-based derivatives rather than swaps.

Source: XPS Annual LDI Survey 2019.

- Transition of swaps-based funds may incur some transaction costs, but where it is of benefit to a mandate, it could be combined with a move from swaps to gilt-based funds to alleviate the transaction cost of buying new swaps. These make sense from a relative value, as well as a reducing basis risk, perspective if the scheme has gilt-based liabilities

- Depending on the size, we can also manage the transition across multiple dealing days to minimise transaction costs and market impact

Segregated Mandates

- State Street Global Advisors can often simply step into an account previously managed by an incumbent manager at no cost to the client

- Where the portfolio includes derivatives, there are several approaches to help avoid out-of-market exposure and minimise or eliminate costs depending on the type of instrument and legal agreement. For example:

  — If the scheme has its own legal trading documentations (ISDAs, CDEAs, GMRAs): we can simply take over the management of the derivatives, as we would do for physical holdings, without incurring costs

  — If the scheme trades under the incumbent asset manager umbrella trading documentations: the swaps can either be novated to the new account with or without transaction costs, depending on the nature of the legal agreements, or back-to-back positions can be entered where the incumbent manager closes its positions at an agreed time for us to enter the same positions. Given the advent of cleared swap trading and standardised legal documentation, such transition can be done with minimal transaction costs and no out-of-market exposure, including the possibility of porting cleared positions

  — There are different strategies to employ when transferring repo positions if novation is not possible — the approach taken may depend on the term of the repo

Whilst potential one-off costs associated with a transition to a new manager are important, it is important to consider these in context of the benefits to the scheme on a long-term basis — including the impact on the portfolio, the services received and the ongoing management fees.

What is the Difference?

A common misconception among investors is that LDI products and services have not evolved or improved over time. At State Street Global Advisors, this is clearly not the case:

Could Another Manager Deliver a Superior Product and Service?

- We have successfully launched innovative leveraged pooled funds, designed to provide improved capital and collateral efficiency, with flexible allocation across growth and matching assets (Target Leverage Funds and DB+ Service Brochure)

- Our DB+ service for pooled fund investors offers services that are tailored for clients but in a pooled fund format. The services include weekly monitoring of portfolios against targets and tolerances to improve the accuracy and efficiency of the LDI portfolio, as well as managing capital calls and redemptions from leveraged funds and incorporating other hedging assets into the portfolio

- With the One State Street solution, our segregated clients can benefit from efficiencies and pricing that we can bring by operating all services from asset management to custody as one relationship

- Charles River Investment Management Solution is an enterprise wide system that is used to manage all aspects of an LDI mandate, including portfolio management, trading, compliance and collateral management

- We have launched cashflow driven investment (CDI) based buy-and-maintain strategy, built on our index heritage, with systematic and qualitative screening. We have made this available to clients of all sizes with our three pooled funds. These funds can be the bedrock of clients' CDI allocations by investing in global investment grade corporate bonds, fully currency hedged and maturing over time:

  — State Street CDI Credit 2021–2025 ESG Screened Fund

  — State Street CDI Credit 2026–2030 ESG Screened Fund

  — State Street CDI Credit 2031–2035 ESG Screened Fund

- In keeping with the environmental, social and governance (ESG) screens that have been applied to our extensive core index fund range across equity and corporate bond funds, we screen for UN Global Compact violators and controversial weapons

In Conclusion

Over the past year we have successfully transitioned and consolidated many LDI holdings without our clients incurring any transaction costs or having any out-of-market exposure. We would be happy to talk to you in detail about how our experience, quality of service, pricing and portfolio management technology can help with the management of your scheme.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigourous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $3.59 trillion* under our care.

* This figure is presented as of 31 March 2021 and includes approximately $60.33 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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The returns on a portfolio of securities which exclude companies that do not meet the portfolio's specified ESG criteria may trail the returns on a portfolio of securities which include such companies. A portfolio's ESG criteria may result in the portfolio investing in industry sectors or securities which underperform the market as a whole.

The use of leverage, as part of the investment process, can multiply market movements into greater changes in an investment's value, thus resulting in increased volatility of returns.

Derivative investments may involve risks such as potential illiquidity of the markets and additional risk of loss of principal.

Investing in swaps is highly risky. Swap contracts are not standardised, nor are they traded on an index. Rather, they are negotiated privately between the counterparties and are not settled by a centralised clearing-house. As such, swap contracts subject a party to significant counterparty risk. Swap positions are considered highly leveraged because the initial margins are significantly smaller than the notional value of the contracts. The smaller the value of the margin in comparison to the notional value of the swap contract, the higher the leverage. There are a number of risks associated with forward investing including but not limited to counterparty credit risk, currency risk, derivatives risk, foreign issuer exposure risk, sector concentration risk, leveraging and liquidity risks.

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ID581171-3634958.1.1.EMEA.INST 0621
Exp. Date: 31/07/2022