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# RISK REVOLUTION

*Explaining LDI can be a challenge—but it's worth doing.*



In some respects, the Colleges of Applied Arts and Technology (CAAT) Pension Plan is similar to many other Canadian defined benefit (DB) plans. The $5 billion plan is 100% externally managed. It is grappling with today's more complicated portfolio choices such as considering whether or not to branch out from traditional debt and public equity investments into private equities, real estate, commodities and hedge funds. Lately it's running a small funding deficit.

Unlike many other plans, however, the CAAT Plan is moving beyond basic issues of asset mix to seek a better framework to manage risk as it strives to fulfill its mission of meeting the present and future pension promises. The Plan is moving into the realm of liability-driven investing (LDI) and its natural companion, risk budgeting. Some of Canada's largest plans have already moved in this direction. Both the $95 billion Ontario Teachers' Pension Plan and the $100 billion Canada Pension Plan Investment Board, for example, have been playing the LDI game for a long time—just look at the holdings of long-dated, real return bonds and other such assets on their balance sheets.

The problem for funds like the CAAT plan, which has a primarily lay board and investment committee, is the difficulty in explaining exactly what LDI and risk budgeting are about and how they differ from conventional pension fund management practices.

For pension fund fiduciaries, the first step (really, a risk decision) in being able to grasp LDI is to ask which risk is the most important to them. The answer is the pension fund's liabilities; its future obligations to beneficiaries. This is the risk that deserves the greatest management attention. The second step is to ask how this risk can be managed most efficiently.

To think of it another way, LDI can be seen as a process that ensures there is alignment in practice, not merely in theory, between a pension fund's investment strategy and its mission (meeting its obligations), values and beliefs. Risk budgeting, then, is the process of allocating and controlling the risks that matter in a way that is explicit so that they are better understood and, therefore, better managed.

This is a fundamental break with conventional pension fund management. Put simply, the typical—old—approach is to focus on asset mix, seeking a target rate of return and then manipulating asset weightings in an effort to get there. It's an innately simple approach and one that essentially treats risk as a by-product. On the other hand, under an LDI umbrella, risk budgeting becomes the framework that holds things together. It asks salient questions about the risks that should be managed, the required returns, the risk limits, where risk should be taken. Importantly it also asks whether the pension fund is being adequately paid for the risks it is taking. Only when you get the answers to these questions can you design the content of a portfolio. Risk is a key input—not a four-letter word to be avoided—and asset mix becomes the by-product, not the other way around.

In the relatively few instances where LDI and risk budgeting have taken root, we're seeing new risk management frameworks that include such things as minimum risk portfolios, which provide a benchmark for assessing risk and performance. These frameworks acknowledge the cost of risk capital (risk being a scarce resource that has a cost or risk premium) and impose risk limits in place of asset-based limits. They also have target levels of risk or risk budgets and an assessment process that measures risks as frequently as returns.

Compared to the focus on the active management and asset mix status quo, LDI and risk budgeting are considerably harder to understand and tougher to execute. Still, they lead to a better understanding of risk, better portfolio choices and higher risk-adjusted returns. Some major pension fund managers have adopted these practices. So, indeed, may the CAAT Plan and others like it. ■