

The smart approach to managing your money

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Insights from Private Wealth Management:
ILGs as the basis of risk control in a goal-based portfolio

Marcus Evans Index Linked Bonds Conference

London November 4th 2011

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LDI for individuals

- 'Balanced Management' = standardisation
- Liability Driven Investment = customisation
- LDI for individuals = goal-based = mass customisation

"The theory behind private Asset Liability Modelling is that, by representing a client's spending objectives formally as a liability benchmark and by managing his assets relative to this benchmark, risk management can be customised, and that portfolio decisions that take into account the client's specific objectives can then be made."

EDHEC Business School, November 2010

Objectives as a 'liability benchmark'

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- Goal-specific as well as person-specific
- Planning-focused not market-focused
- Driven by clients, helped by planners/consultants
 - Identify the benefits individuals want from their wealth
 - Who, what, when, how?
 - Identify and prioritise the different goals competing for resources
 - Liquidity, lifetime spending, lifetime gifting, bequest
 - Identify and describe the 'utility' of each goal
 - Objective defined by short-term, nominal variance (path)?
 - Or long-term, real – purchasing power - wealth levels or cash flows (outcome)?
 - What sources of uncertainty: inflation, capital markets, longevity?
 - How can risk management maximise this utility?
 - How is risk management supposed to react to goal progress?
 - Quantify resources, time horizon(s), target outcomes, tolerances
 - Plan by reference to needs, desires, consequences

Example:

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Retirement spending

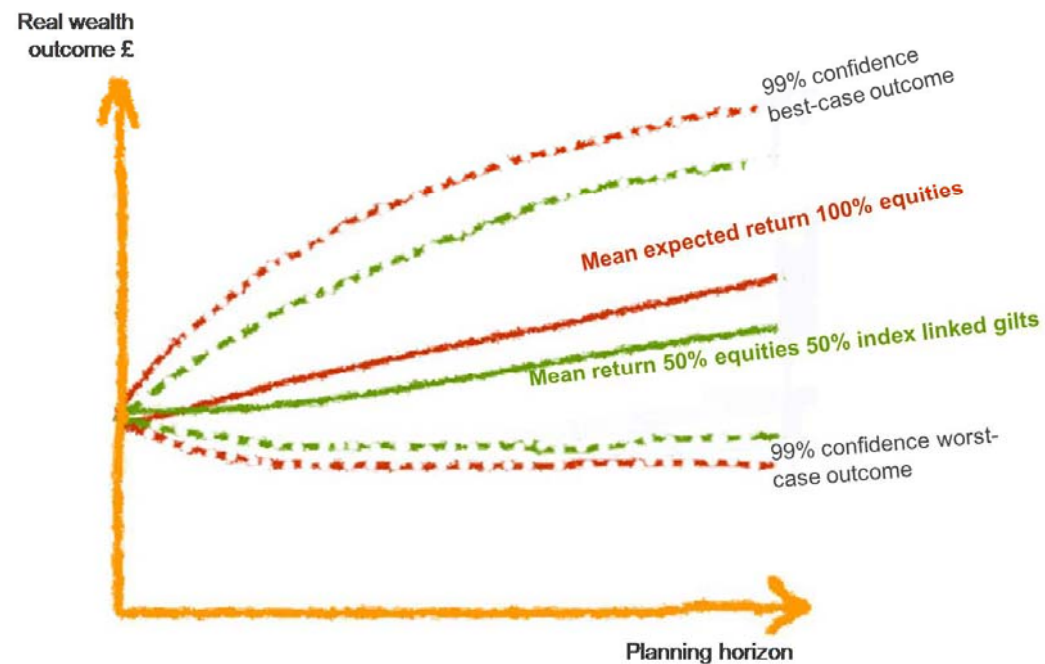
- Drawdown from capital rather than annuity purchase
 - Objective/liability = stream, not capital sum
 - Date-stamped cash flows given by spending
 - All cash flows are in real terms
- Problem: maximise spending subject to constraints:
 - Can't run out of money (or must leave a bequest)
 - Consequences of shortfall set a 'floor' for outcomes
 - Meet time preferences for spending: eg more while younger
 - Don't want to have to cut spending (except as planned)
- Risk factors
 - Asset pricing: path-dependent drawdown outcomes
 - Inflation
 - Longevity

Solution

- Asset prices: model the return probabilities
 - Specific to current conditions / portfolio value
 - Specific to time horizon
- Inflation risk:
 - Model real returns rather than inflation itself
- Longevity risk: fund conservatively
 - Assume at least 100
 - Allow for contingent asset sales: home(s)
- Risk tolerance: model the plan outcomes
 - Function of range of probable spending outcomes
 - You *live with* volatility but you *live off* outcomes
 - If resources and floor outcome are given: risk = output of model
 - Otherwise trade off between resources and target outcome range

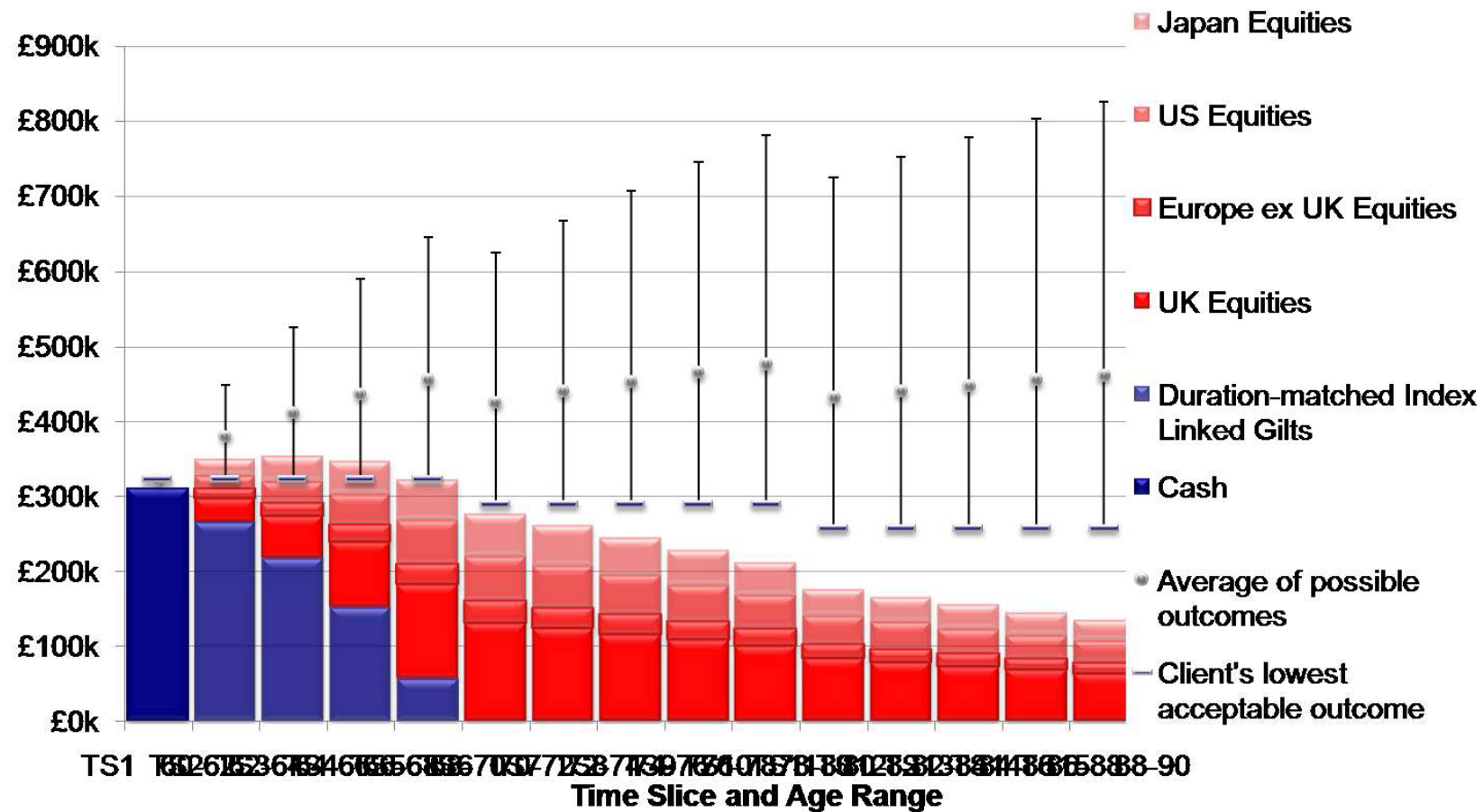
How to control the outcome ranges with ILGs

- Balanced management relies on **diversification**
- LDI relies on hedging or insurance - **dilution**
- ILGs are the hedge for capital market and inflation risks
- An index linked annuity hedges both plus longevity



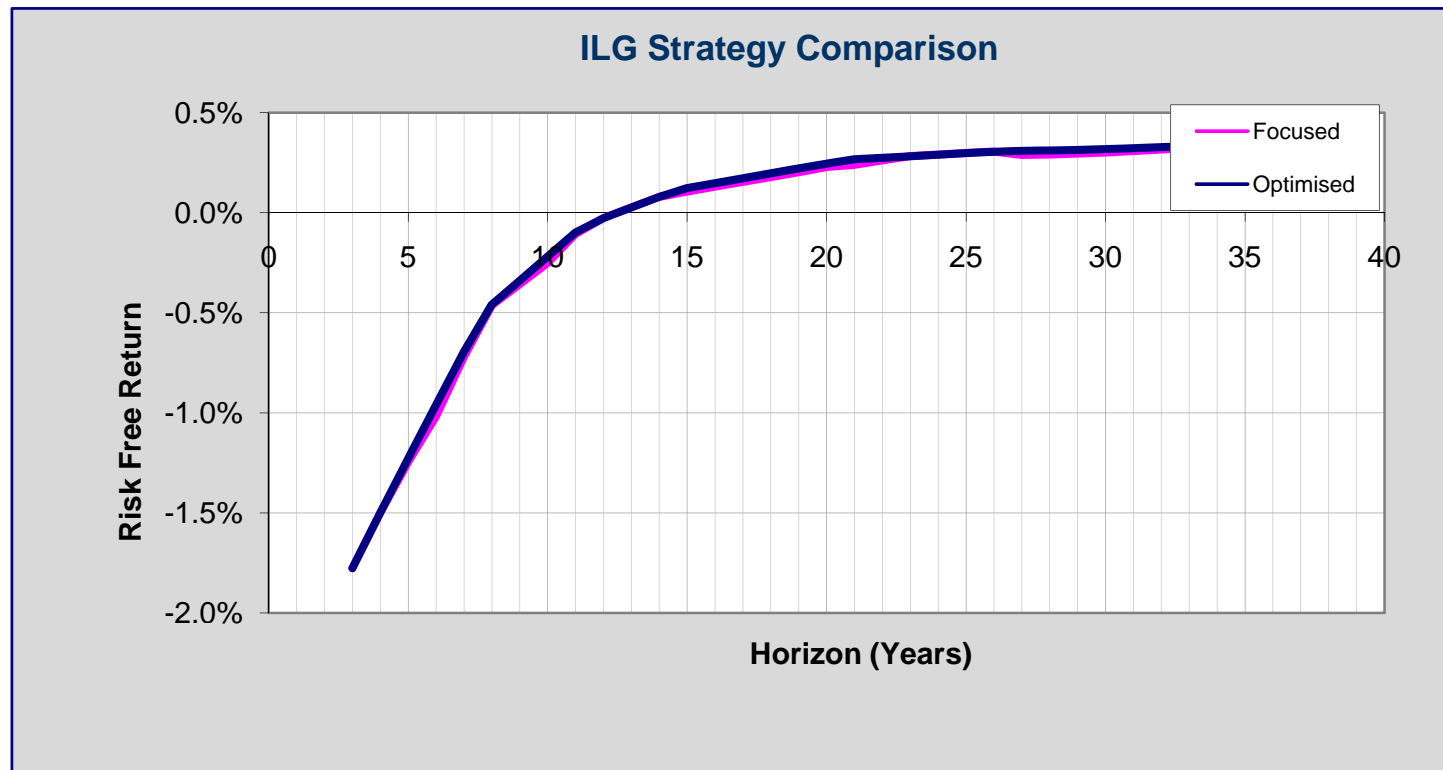
Example:

3-year time-slice portfolios age 60-90
funding 3 years of spending

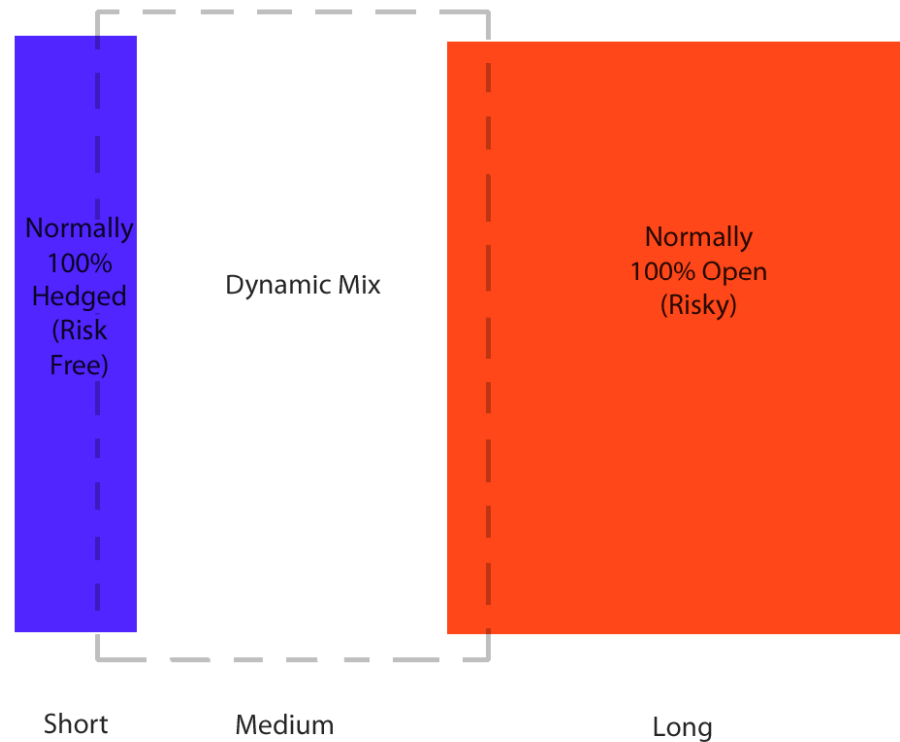


Duration matching (without strips)

Closest pair (focused) or barbell strategy (optimised)



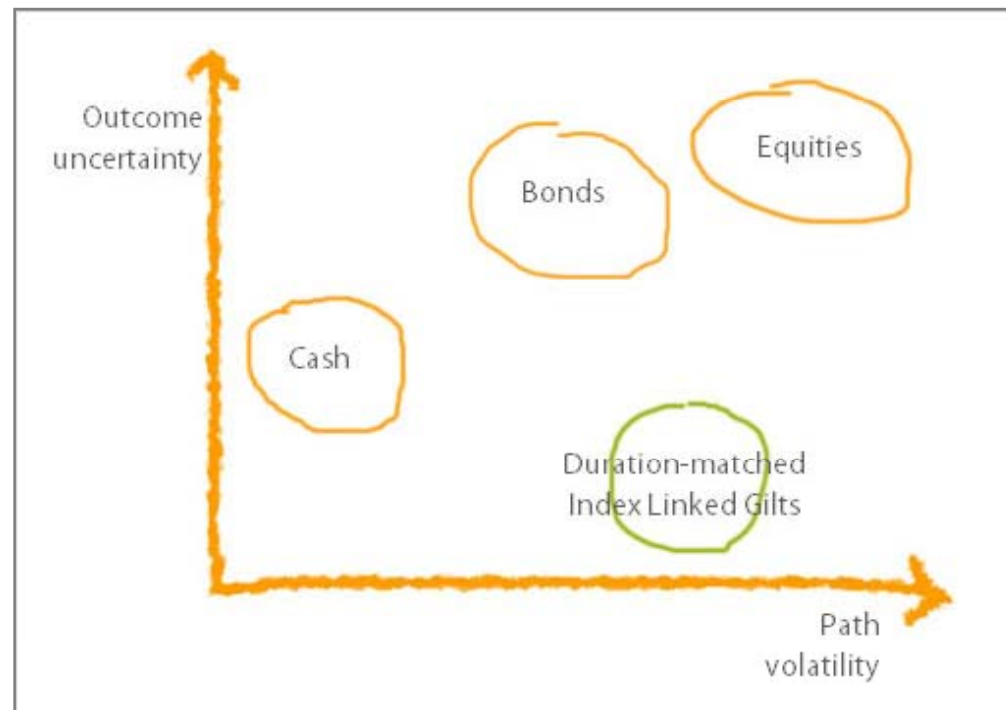
Portfolio management as dynamic risk management



Risky portfolio contents when combined with ILGs

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- No role for conventional bonds: why swap inflation risk for equity risk?
- No need for expensive alternatives to equity beta



Can we teach anything to institutional investors?

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- Is utility really defined mainly by path rather than outcomes?
- Whose utility is it anyway?
- Can accountants/regulators make conventional bonds 'risk free' at the stroke of a pen?
- Is the return-seeking portfolio in typical LDI structures unnecessarily expensive and are the diversification benefits wrongly described?
- Why are so few stochastic models specific to initial conditions and time horizons even when they assume equity mean reversion?
- If you don't believe in mean reversion, why do you hold anything but ILGs?

