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Trimming your hedge: a thorny issue



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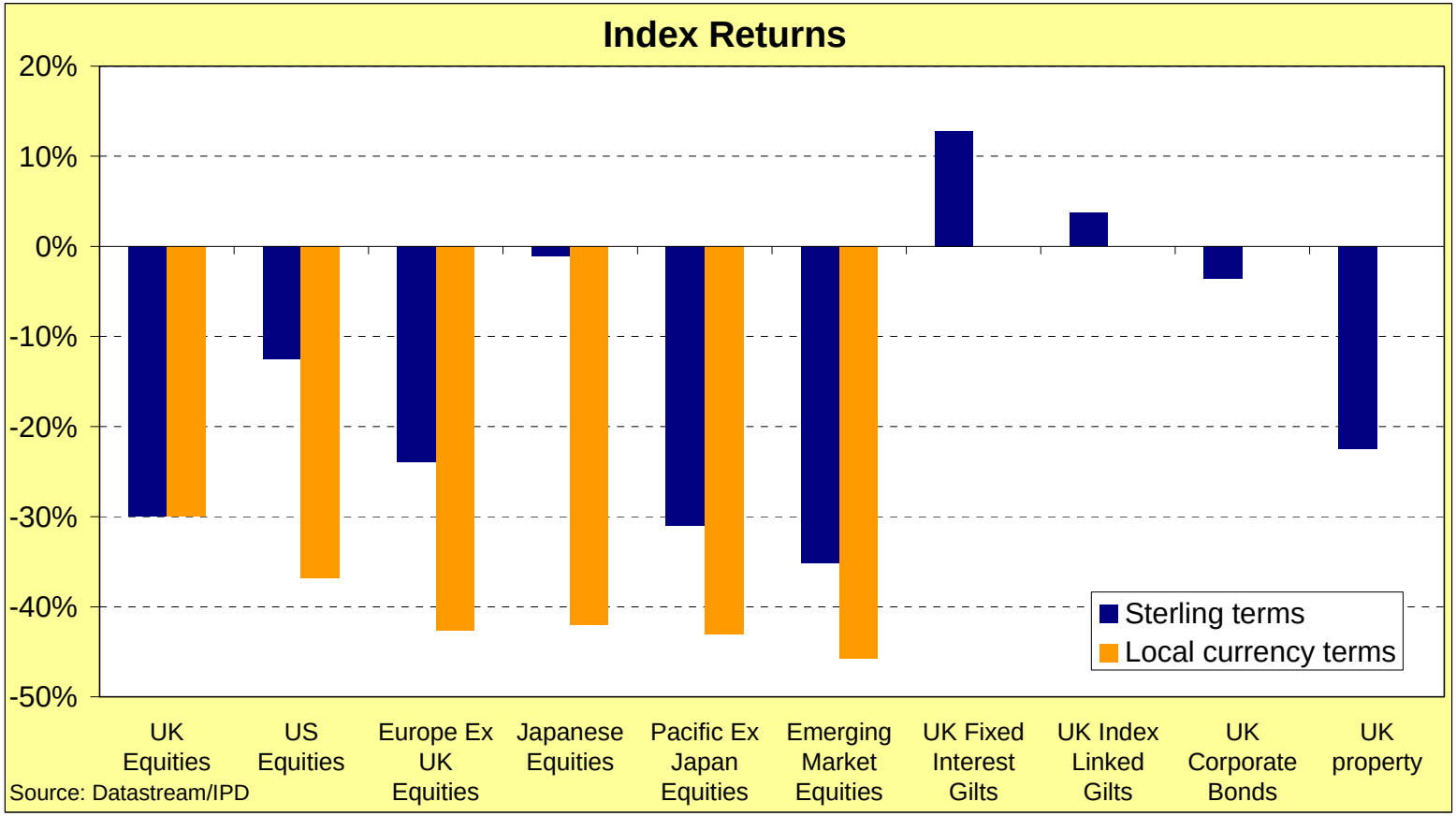
AGENDA

- Market Background
  - The good, the bad and the downright ugly
- How have LDI strategies performed?
  - A ray of sunshine in a bleak investment landscape
- Are there any market opportunities in the current environment?

Market Background – its not going that well?

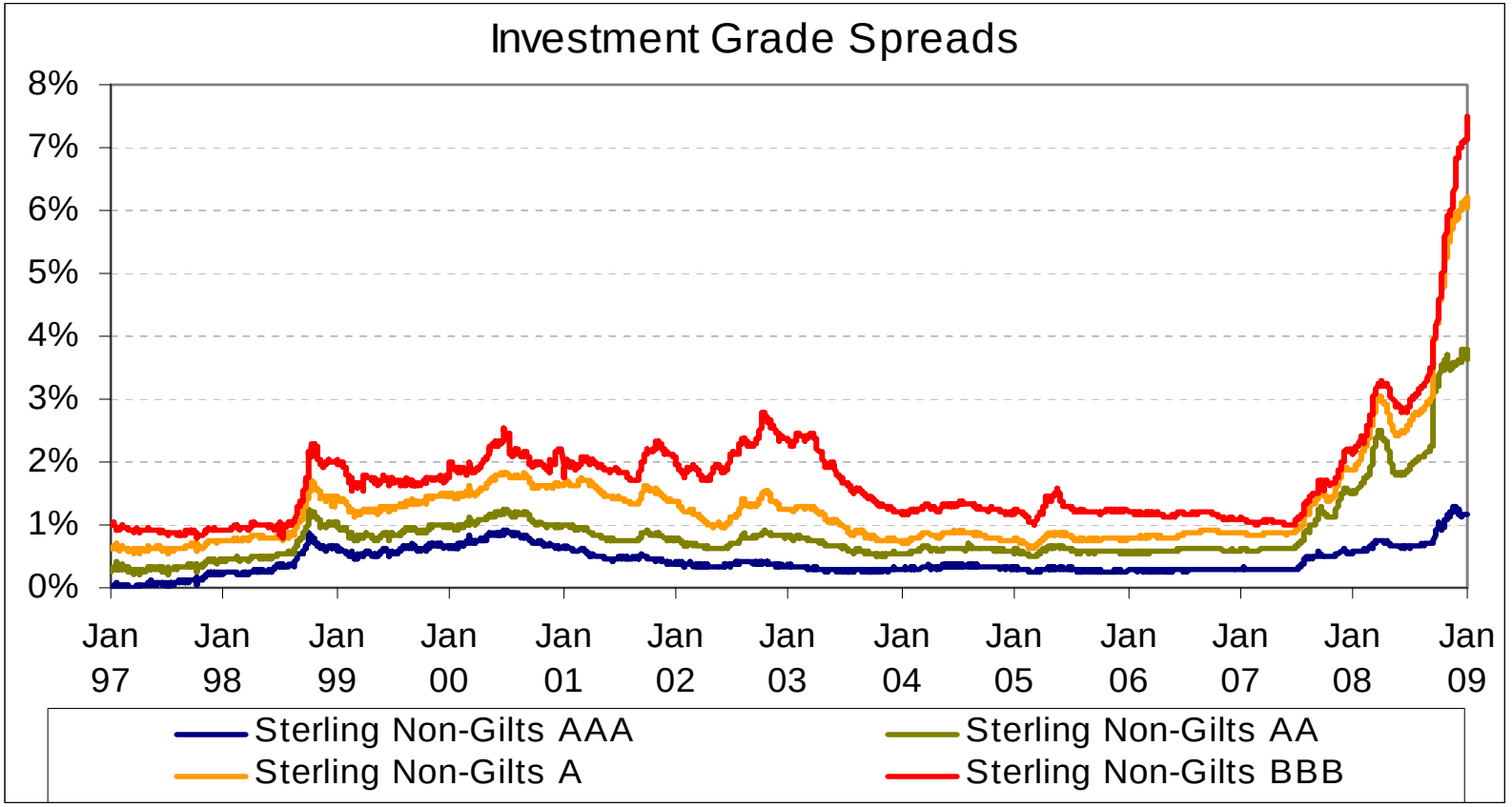


Market Background



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Market Background



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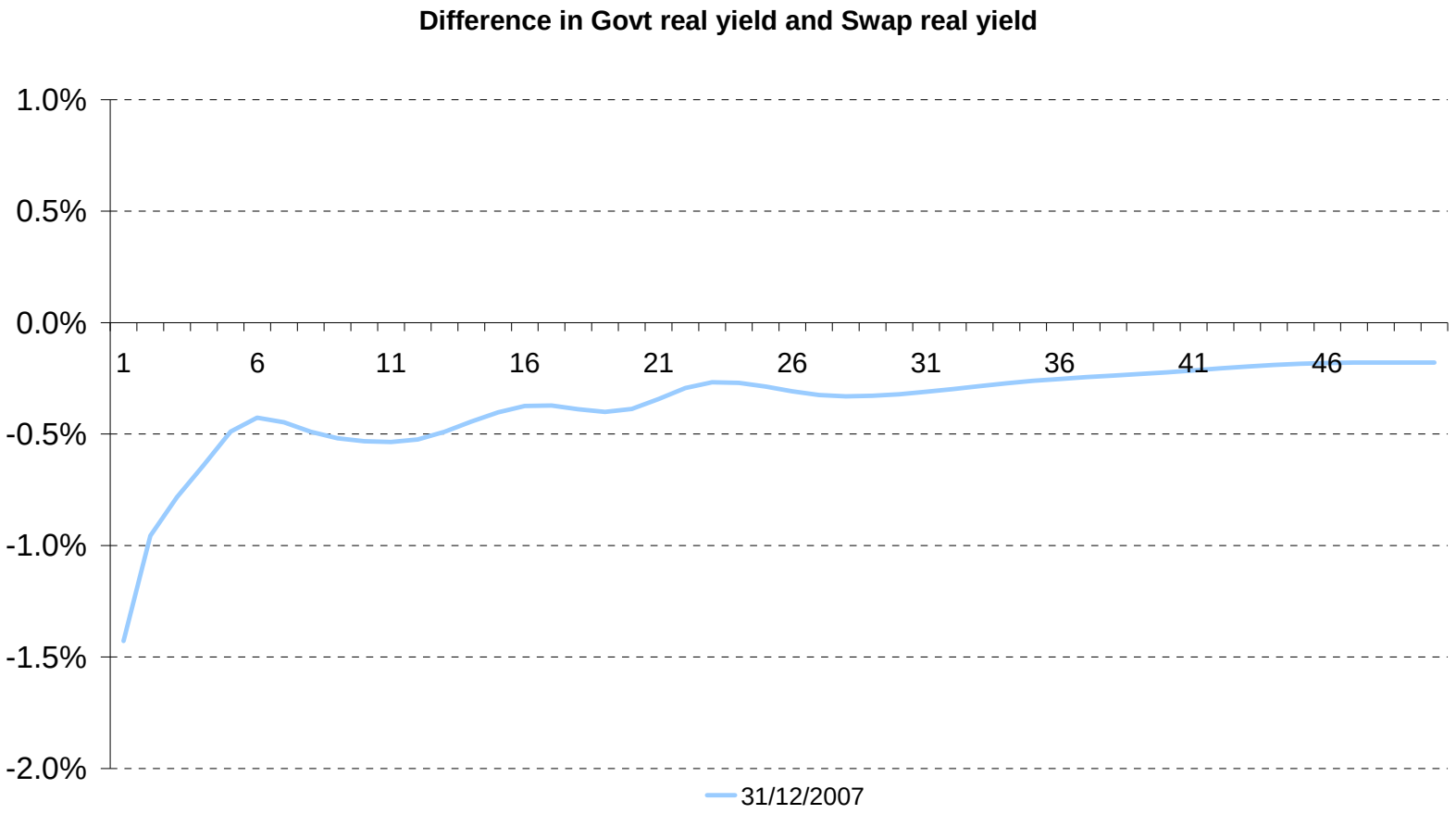
How have LDI strategies performed over 2008?

- Most pooled LDI managers on an unleveraged basis returned +25-30%
- Leverage improved returned to up to around +60%

Client 1	+27%	
Client 2	+31%	
Client 3	+25%	
Client 4	+30%	
Client 5	+29%	
Client 6	+30%	
Client 7	+45%	2 x leverage
Client 8	+60%	2-3 x leverage

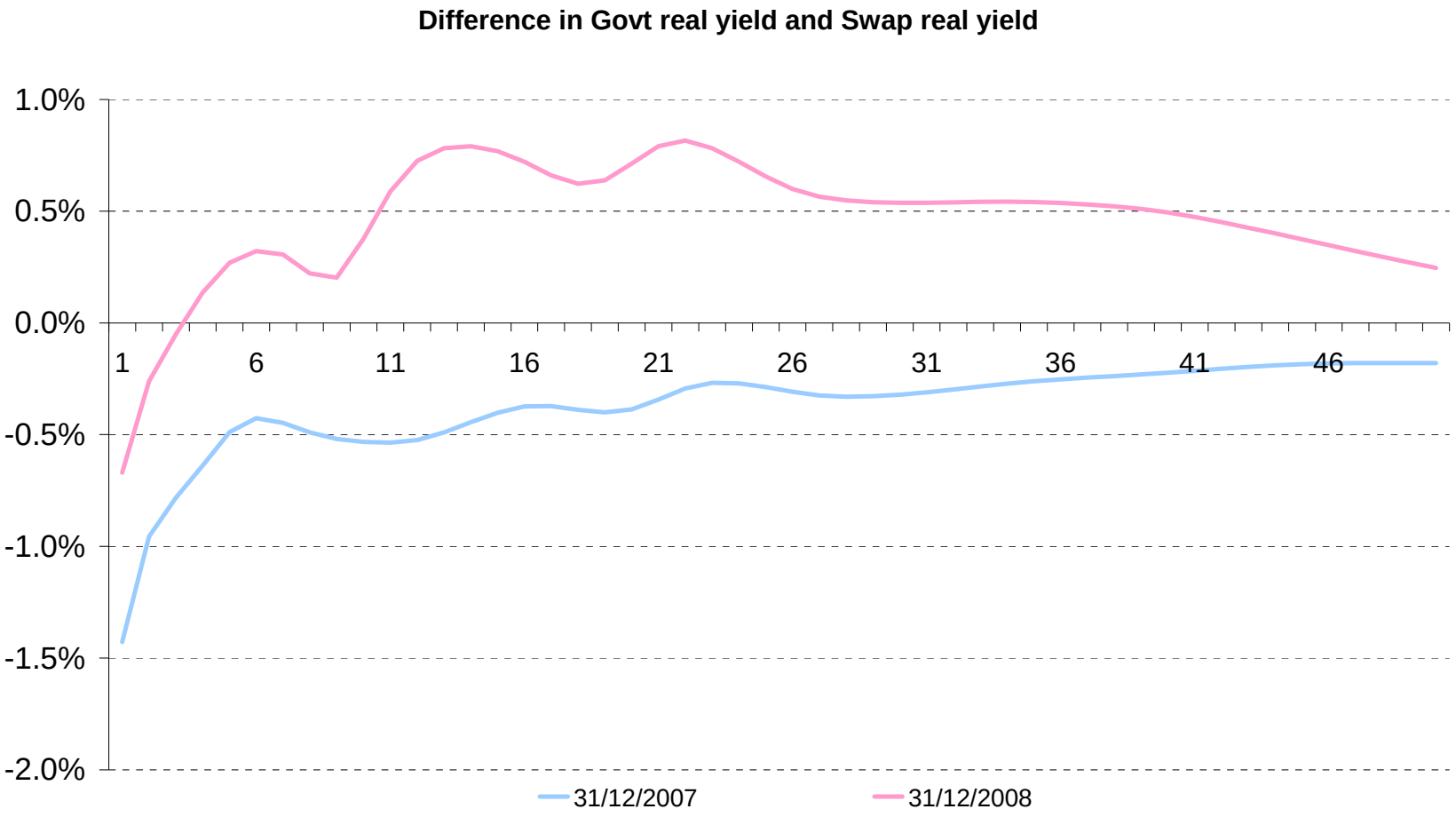
  - However money market funds backing swap portfolios have generally detracted from performance varying from poor to downright ugly

Difference in zero real yields as at 31 December 2007



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Swaps now have lower zero real yields than gilts



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Why?

The following reasons have been put forward:

- Lack of capital
- Gilt Issuance
- Rebalancing by credit managers
- However, it is difficult obtaining any clear data to ascertain the true drivers of the market

Are there any opportunities?

Despite the turbulence in the market there are opportunities available that could help enhance the efficiency of LDI strategies.

- Opportunity 1a
  - As index-linked gilts are offering more attractive yields than real swap yields there is the opportunity to terminate the swaps and invest the assets backing the swaps into index-linked gilts

  BUT

  - There will be a cost to this trade
    - It is capital intensive and cannot be leveraged
    - Index-linked gilts do not exist for all tenors (so if very close matching is required this may not be appropriate)

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Are there any opportunities?

- When I said we could not use leverage . . . . . .
- Opportunity 1b – Use the repo market or a Total Return Swap
  - These are both extensions to Opportunity 1, allow the Scheme to gain leverage and have broadly the same effect.
  - Using the repo market the index-linked gilts are sold once purchased but with an agreement to purchase them back at a set price at a later date. The cash obtained by this transaction can then be used to purchase further index-linked gilts.
  - This solution can be levered as a pension scheme has some flexibility as to how to use the cash realised by this type of transaction.
  - Enter into a total return swap with a bank to receive the return on index-linked gilts and pay Libor. As the swap is unfunded the exposure can be levered to give the desired level of exposure.

Are there any opportunities?

- Opportunity 2 – Enter into an Asset Backed Swap
  - The is a different type of opportunity to those previously mentioned
  - Under this option a scheme would retain its current swaps but use the cash backing the swaps to purchase index-linked gilts. A pension scheme could then enter into a swap arrangement with a bank whereby it Libor plus a fixed spread in return for paying the bank the return on the index-linked gilts.

Summary

LDI strategies provided one bright spot in a truly dismal year

Although LDI strategies are intended to be long term it is still worthwhile monitoring the markets for any opportunities

Current market dislocations have given rise to a number of opportunities that can be used by pension schemes to enhance the efficiency of their LDI arrangements



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