

Siesmic gilt yield movements: 11 key actions trustees should be taking in response

The remarkable gilt market movements seen since the 'mini Budget' was announced on Friday 23 September will have led to substantial funding level improvements for many DB pension schemes, and added to the significant gilt market movements and funding level gains that had already been experienced since the end of June.

In this note James Stewart highlights the impact of recent market events on schemes and looks at how trustees can manage this and capitalise on any opportunities.

Key actions for trustees:

1. Understand your current funding position relative to your objectives
2. Review de-risking triggers
3. Reassess your risk position in the current environment and understand impact on sponsor covenant
4. Review asset allocation and consider rebalancing
5. Top up LDI-ready collateral in case of further yield rises
6. Consider increasing hedging given more attractive gilt yields
7. Explore opportunities in credit markets
8. Ensure you are comfortable with the liquidity of your portfolio
9. Review approach to currency hedging
10. Review cashflow management procedures
11. Monitor how close you are to buyout

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Market backdrop

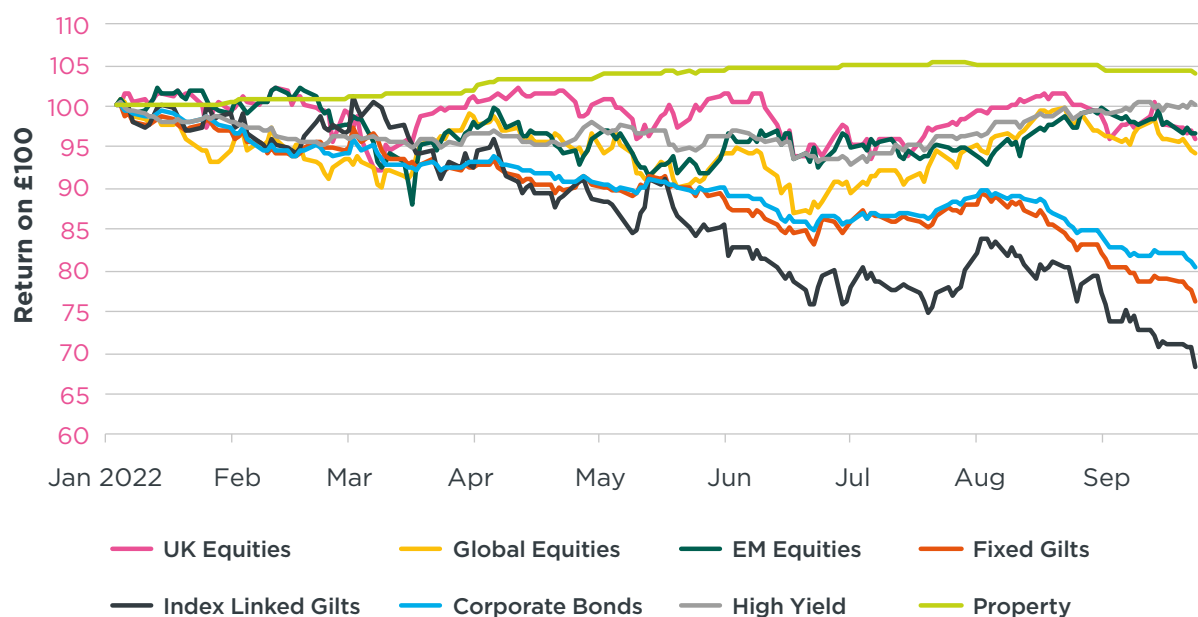
The Chancellor's announcement on 23 September has sparked a historic sell-off in UK gilts. At the time of writing, 20 year fixed gilt yields increased by around 1%pa since the announcement before partially falling back following intervention by the Bank of England.

This has been largely attributed to the extra government borrowing expected to fund the tax cuts announced, in addition to the widely anticipated energy subsidies to help households manage soaring energy costs.

Sterling has also reacted significantly to the budget announcement, falling sharply to 1.06 US Dollars to the Pound at time of writing. Equity and credit markets meanwhile have reacted more modestly, with both the FTSE World Equity Index and the iBoxx Sterling Non-gilts Index down.

These market movements have added to what's been a remarkable time for global investment markets since the beginning of the year. With the exception of property, most major asset classes have performed poorly. Whilst we have observed some improvement over Q3 so far, asset markets generally remain in a worse position to where they started the year.

Asset class returns between 31 December 2021 and 23 September 2022



Source Refinitiv and XPS calculations

Inflation also remains at the forefront of investor concerns; supply chain disruptions persist, energy prices remain high and labour markets remain very tight.

Central banks have responded by increasing base rates faster than initially expected, as demonstrated by the latest Bank of England's Bank rate increase of 0.5% to 2.25% announced on 22 September. Similarly, as the UK economy finds itself amidst a cost of living crisis, plans for increased government spending and tax cuts are expected to apply upward pressure on interest rates also. In response to disorderly gilt market movements the Bank of England announced on 28 September it will intervene in the gilt market to buy gilts in order to stabilise the market.

The market movements seen have also led to a large fall in pension scheme liabilities over the year. This has continued apace since the end of June, particularly so in late September following the mini budget.

Using XPS Radar, we monitor estimated funding positions for our clients on a daily basis as well as monitoring aggregate UK defined benefit pension scheme funding levels using XPS DB:UK. At the end of August 2022, XPS announced that the aggregate funding level of UK DB schemes had reached 100% on a low dependency (gilts + 0.5%) basis for the first time and remains well above this level.

As yields rise, liabilities fall, providing an opportunity for schemes as funding levels improve.

The heat map below shows an estimate of how different schemes will have been impacted by the market movements since the end of June to mid-September. Each scheme's experience will have been different but the heat map below illustrates that the combination of positive growth market returns and rising yields is expected to have led to a funding improvement for the vast majority of schemes.

Funding level improvements since 30 June 2022 for schemes with different level of hedging and equity exposure

Equity allocation (assumes 30% in LDI and remainder in corporate bonds)

		0%	10%	20%	30%	40%	50%	60%	70%
LDI hedging level (% liabilities)	100%	0%	0%	1%	2%	3%	3%	4%	5%
	90%	2%	3%	3%	4%	5%	6%	6%	7%
	80%	4%	5%	6%	6%	7%	8%	9%	9%
	70%	6%	7%	8%	9%	9%	10%	11%	12%
	60%	9%	9%	10%	11%	12%	12%	13%	14%
	50%	11%	12%	12%	13%	14%	15%	16%	16%
	40%	13%	14%	15%	15%	16%	17%	18%	19%
	30%	15%	16%	17%	18%	18%	19%	20%	21%
	20%	18%	18%	19%	20%	21%	22%	22%	23%
	10%	20%	21%	21%	22%	23%	24%	25%	25%
	0%	22%	23%	24%	24%	25%	26%	27%	28%

Source: XPS calculations. The analysis assumes that 30% is invested in cash or gilt assets, and the remaining assets are invested in a mix of either global equities or all stocks corporate bonds with interest rate and inflation hedging applied to the given % of liabilities proportionally across all liabilities. Please note this analysis is for guidance only and some illustrated portfolios will be difficult to achieve in practice.



The erratic movements in gilt yields has presented near term operational challenges for pension schemes, but where there is a bigger picture opportunity to de-risk, this should not be overlooked.

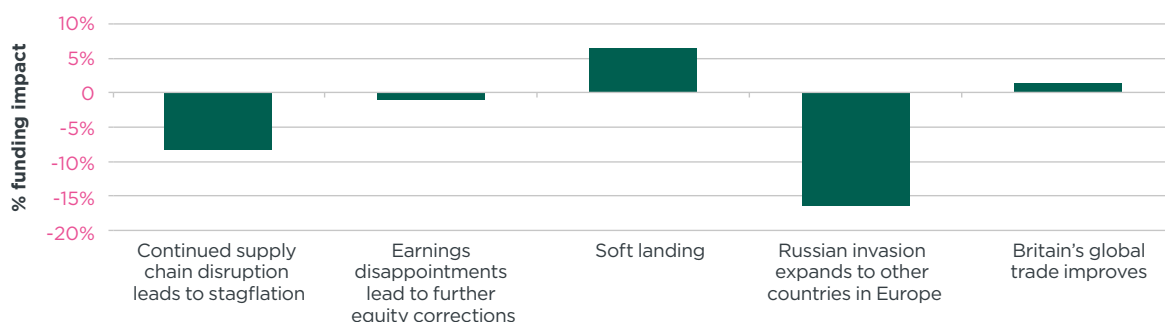
The opportunities and challenges

Whilst the funding level for many pension schemes will have improved, the primary cause of the funding improvements, namely gilt yield rises, has also created some notable challenges for schemes in terms of maintaining hedging and liquidity buffers.

We have listed 11 actions that trustees should be taking in response.

1	Understand your current funding position relative to your objectives	<p>Market movements experienced since the end of June, and particularly the extreme movements of the last few days, will have led to substantial funding level improvements for many pension schemes.</p> <p>It is important for trustees to take stock of their scheme's updated funding position to check whether the current strategy remains suitable to meet the scheme objectives in place. This is very important for schemes employing Fiduciary Management given trustees will typically be further removed from the day to day management.</p>
2	Review de-risking triggers	<p>Many schemes have put in place a de-risking strategy with soft or hard triggers. These triggers are usually time dependent and as such, funding improvements have likely occurred a lot earlier than may have been assumed when setting the triggers.</p> <p>This means there is often scope to de-risk further whilst still expecting to achieve the same long term target by a given date. This is because where you have more years to work with, you can achieve a given level of overall outperformance whilst targeting a lower rate of outperformance per year.</p>
3	Reassess your risk position in the current environment and understand impact on sponsor covenant	<p>Schemes will need to consider whether their current positioning is still reflective of their long-term objectives, and whether any misalignment with their target allocation leaves them unnecessarily exposed to further funding level volatility. Trustees can better understand their exposure to these risks through scenario analysis as shown in the chart.</p> <p>If you are interested in scenario analysis, XPS has a user-friendly interactive model you can use on our website which will demonstrate the impact of our 5 current scenarios on your scheme. To access it, simply click here and see what the future might hold for your scheme.</p>

Scenario analysis (example scheme)



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Review asset allocation and consider rebalancing

Although most asset classes have fallen in value, some assets have fallen by more than others. This may have left some portfolios off-kilter with their strategic asset allocation. This then provides a good opportunity for schemes to consider implementing a rebalancing policy so that their investment strategy remains aligned to their long term objectives despite the increased volatility.

The asset allocation will need to be considered in closer detail where schemes have made allocations to illiquid investments. Due to less frequent pricing these allocations tend to lag the performance of their public market counterparts. The resulting effect is that these allocations may now appear to be significantly overweight compared to their target allocations, placing further strain on strategic and liquidity objectives. This is most acute where these assets are still within their investment period and actively drawing assets from the main portfolio.

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Top up LDI ready-collateral in case of further yield rises

Trustees should ensure collateral assets remain sufficient to cover further recapitalisation events if nominal yields continue to rise. This is important as liquid assets may now make up a significantly smaller proportion of the investment strategy, and no longer be a sustainable source of capital for future cashflow needs. It may be necessary to make plans to release some assets from less liquid areas of the portfolio to replenish the more liquid assets.

Therefore, it is essential that trustees understand their current liquidity position and outline a clear plan for the long term should the current sources of liquidity no longer be sustainable.

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Consider increasing hedging given more attractive gilt yields

Where schemes have had lower levels of hedging in place, they may now find themselves materially better funded against both their long term and end-game objectives. This may present an opportune time to increase the level of hedging in place against the new, lower liability value, locking in those recent funding level gains and protecting against further funding level volatility.

For schemes that have had high levels of hedging and may be questioning whether these should be maintained in light of the rising yield environment, we would strongly encourage all hedging to be maintained as far as possible.

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Explore opportunities in credit markets

Credit markets now offer higher returns to compensate for the greater level of risk perceived in markets. Whilst to some extent this is a result of a greater perceived risk of default and downgrade risk within the market, it also follows a period of time where high quality credit has offered relatively little compensation for risk when compared to more traditional growth assets. Therefore, the scope to de-risk out of equity assets into fixed income has increased. Further, for schemes already invested in credit, one way to capitalise on this is to extend the duration of their portfolio to lock into the higher yields for a longer period of time, without affecting the credit risk being taken.

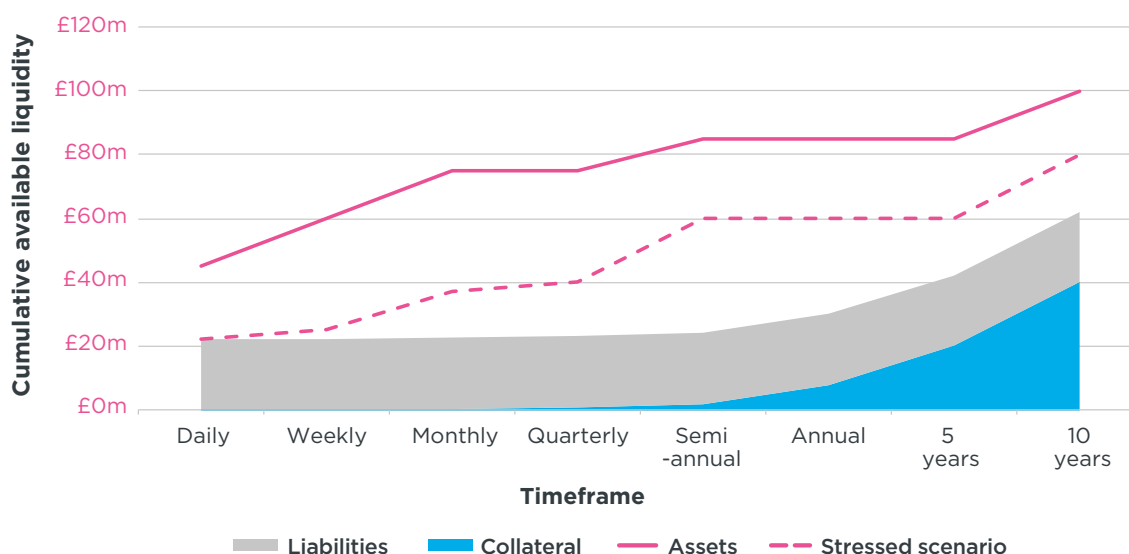
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Ensure you are comfortable with the liquidity of your portfolio

Trustees should take a holistic view of their scheme's liquidity to ensure it meets their requirements. We have been through a liquidity stress event with recent movements but there is still scope for liquidity to continue to be challenging from here.

This risk can be assessed through liquidity analysis, which outlines a portfolio's resilience to meeting its cashflow requirements in a range of scenarios and stresses. Schemes with strong liquidity would be able to meet their cashflow and collateral requirements in both the normal and stressed environments. The current environment is abnormal and requires closer attention to immediate liquidity – i.e cash and money market instruments.

Liquidity ladder (example scheme)



Available liquidity (pink lines) should exceed liquidity requirements (filled area) under normal and stressed conditions.

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Review approach to currency hedging

Sterling's depreciation versus the US Dollar and the Euro has been significant and this will have generally benefitted schemes with unhedged overseas investments.

It may have also placed further liquidity pressure on schemes using currency hedging, where required to post further collateral to meet margin calls. Schemes should ensure they capture currency hedging considerations within liquidity analysis undertaken on the wider portfolio.

Currency hedging is a detailed subject that should be considered in light of a scheme's specific asset allocation but, in the main, XPS supports currency hedging of developed market currencies for fixed income investments and some hedging of developed equity investments. Emerging market currencies needs a more nuanced approach however and it is often desirable to retain currency risk depending on the particular asset and currency.

Whilst hedging is by its nature not a tactical decision, current market levels appear good value relative to recent levels to lock in foreign currency rates and remove the risk.

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Review cashflow management procedures

Where investors have observed their assets fall in value across the board, attention turns towards a scheme's 'treasury function' as cashflow management moves up the agenda.

Whilst trustees may have witnessed their liabilities fall considerably over recent months, ongoing cashflow requirements remain unchanged or have increased where higher levels of inflation begin to feed through to a scheme's expenses. Where schemes rely on their growth assets as a core source of liquidity, they may consider themselves a forced seller. This may not be the issue it appears to be as falling liabilities naturally means a scheme is getting smaller, and so selling some equities is in many cases a desirable action.

In light of current conditions, Trustees should revisit their cashflow management procedures to ensure that standing orders and regular disinvestments remain appropriate. XPS offers an implementation service, XPS Concierge, where we can carry out delegated functions on trustees' behalf whilst the trustees continue to own all decision making.

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Monitor how close you are to buyout

In addition to the improvement against long term objectives, the impact of rising rates and wider credit spreads has also had a positive effect on insurer pricing. As insurers compete for business and begin to offer more attractive pricing, schemes now find themselves better funded on a buyout basis than ever before.

However, schemes can't insure liabilities overnight, irrespective of how well funded they may be. There is a relatively long lead time to transacting, involving many stages of preparation, so if buyout is now looking to be within reach, there's no better time to start preparing.

If you wish to discuss these or any other investment related issues, please contact **James Stewart** or your regular XPS consultant



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