October 2022

XPS Investment News

Bringing you the latest investment news, insights and opinion from across the pensions industry

Quarter in brief

- **Long dated gilt yields rise and fall by 1% within the space of a single week at the end of September**
- **The Bank of England had earlier raised the Bank rate by 0.5% to 2.25%, their highest levels since the global financial crisis. The Fed and the ECB both raised rates by 0.75% over September**
- **UK equities and corporate bonds slid as Sterling slumped to a record low against the Dollar**
- **Large rises in gilt yields have seen aggregate UK DB pension scheme funding positions continue to improve**

Sian Pringle
Senior Investment Consultant

Click to watch
Sian's October update

Gilt yields soar out of control before Bank of England steps in

On 23 September the new Chancellor of the Exchequer unveiled his plan to stimulate growth in the UK economy in the now infamous 'mini budget'.

The International Monetary Fund (IMF) were quick to publicly criticise the package of unfunded tax cuts announced by Kwasi Kwarteng which it believed would "likely increase inequality". Sterling sank to $1.03 against the Dollar amid concerns over the implications of the proposals on the long-term cost of UK government borrowing as gilt yields were sent sky-rocketing.

Pension schemes, the largest holders of UK government debt, became forced sellers of gilts and other liquid assets to meet collateral calls on leveraged exposure within liability driven investment (LDI) strategies. The fallout from the fiscal announcement prompted the Bank of England to instigate a short term gilt buying programme to prop up government bond markets which threatened to spiral out of control.

Yields fell back sharply after the Bank of England's pledge to buy up to £65bn of government debt, finishing the month up by 0.7%. However, some damage had already been done for many schemes resulting from hedges being trimmed or removed prior to the yield falls. Despite this, pension scheme funding levels have remained healthy.

Sterling had largely recovered by the end of the month but continues to be hampered by weak growth prospects for the economy. The Bank of England warned that the UK may already be in recession when it raised the base rate by 0.5% to 2.25% earlier in September. The Consumer Prices Index had crept back into single figures in the 12 months to August, falling 0.2% to 9.9%. However inflation is widely expected to rise again in the winter months when the energy price cap increase comes into effect.

See our 'Gilts Special – Your questions answered' on page 4

The US Federal Reserve raised rates by 0.75% for a third time in a row in September but US inflation was down 0.2% to 8.3% over August. The European Central Bank also raised its base rate by 0.75% – a record rise for the ECB. Borrowing costs in Europe are now at their highest level since 2011 as the EU combats rising inflation which was up 0.3% to 10.1% in the 12 months to August.

Energy prices rose again in September after suspicious damage to Nord Stream 1 (the primary gas pipeline from Russia to mainland Europe) was branded as "sabotage" by the European Commission but it stopped short of a direct accusation of Russian involvement. Tensions heightened between the US and Russia in the wake of Russia's annexation of parts of Ukraine which US President Joe Biden branded as a "fraudulent attempt" to claim Ukrainian territory.

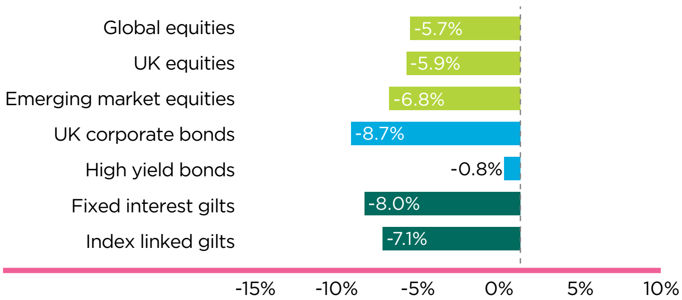
Inflation concerns continued to weigh heavy over September capping off a dismal quarter for most major asset classes. Global equities and high yield bonds managed positive returns after a strong July and August, with unhedged overseas investments benefitting from the depreciation of Sterling, but UK equities and Sterling corporate bonds finished the quarter significantly down. Gilt yields had initially fallen in July but rose seismically over August and September. Inflation expectations rose over the quarter as a whole despite a significant fall and subsequent rise in the last week of September.

The aggregate funding level of UK DB pension schemes was up 8% to 105% on a low risk basis over the quarter despite the period of dramatic volatility in gilt yields culminating in the spike at the end of September.

Read our paper on 11 key actions Trustees should be taking to navigate the opportunities and challenges of the current environment here. Read here

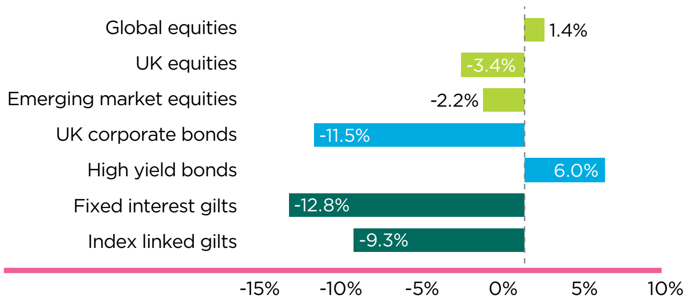
Market returns

1 month to 30 September 2022



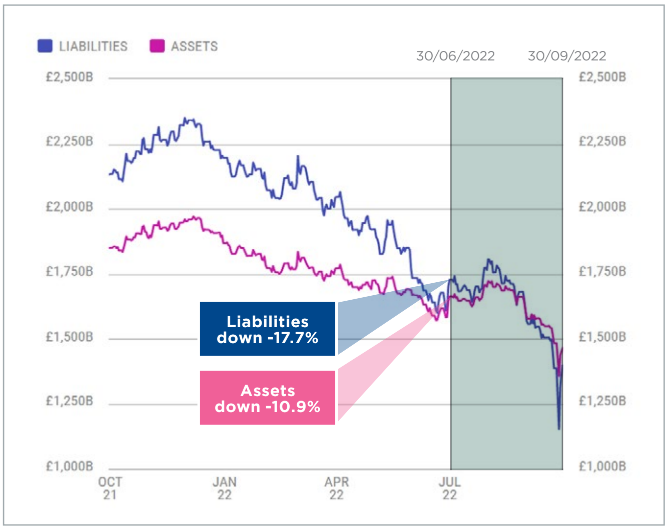
Source: Refinitiv

3 months to 30 September 2022

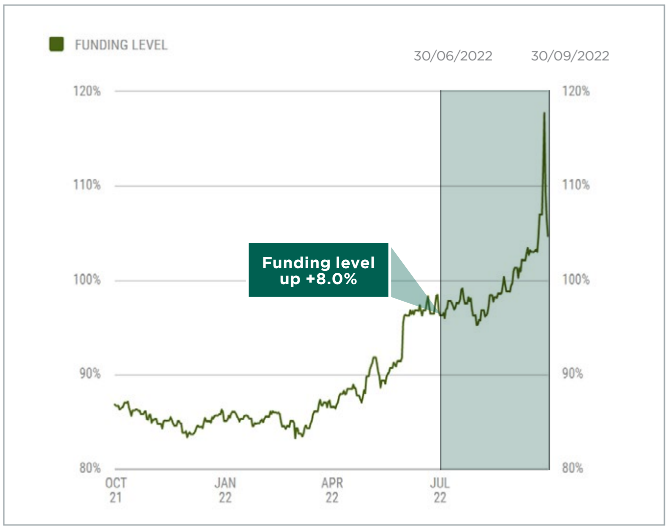


Source: Refinitiv

Asset and liability progression
for the DB:UK universe



Funding level progression
for the DB:UK universe



Source: XPS DB:UK | www.xpsgroup.com/services/xps-pensions/xps-dbuk-funding-watch

The charts above are based on data from The Pensions Regulator, the PPF 7800 Index and the XPS data pool. The assumptions used in the UK:DB long-term target basis include a discount interest rate of gilt yields plus 0.5%. The assumed asset allocation is 16.9% equities, 20.0% corporate bonds, 6.9% multi-asset, 5.1% property, 3.8% private markets and 47.3% in liability driven investment (LDI) with the LDI overlay providing a 60% hedge on inflation and interest rates.

XPS Investment asset class views

Asset class	Favourable	Neutral	Unfavourable	Movement
Developed equities			●	↓
Emerging market equities			●	↓
Investment grade corporate bonds		●		
High yield bonds		●		
Private debt			●	↓
Balanced property (UK)			●	↓
Long lease property		●		↓
Diversified private markets		●		↓
Secure income		●		↓
Private equity			●	↓
Equity option strategies	●			
Pensioner buy-in	●			
Cash	●			↑

Gilts Special:
Your questions answered

On 3 October XPS held a webinar, 'XPS Live | Turbulent Market Conditions Update', discussing the key issues around the gilt market turmoil.

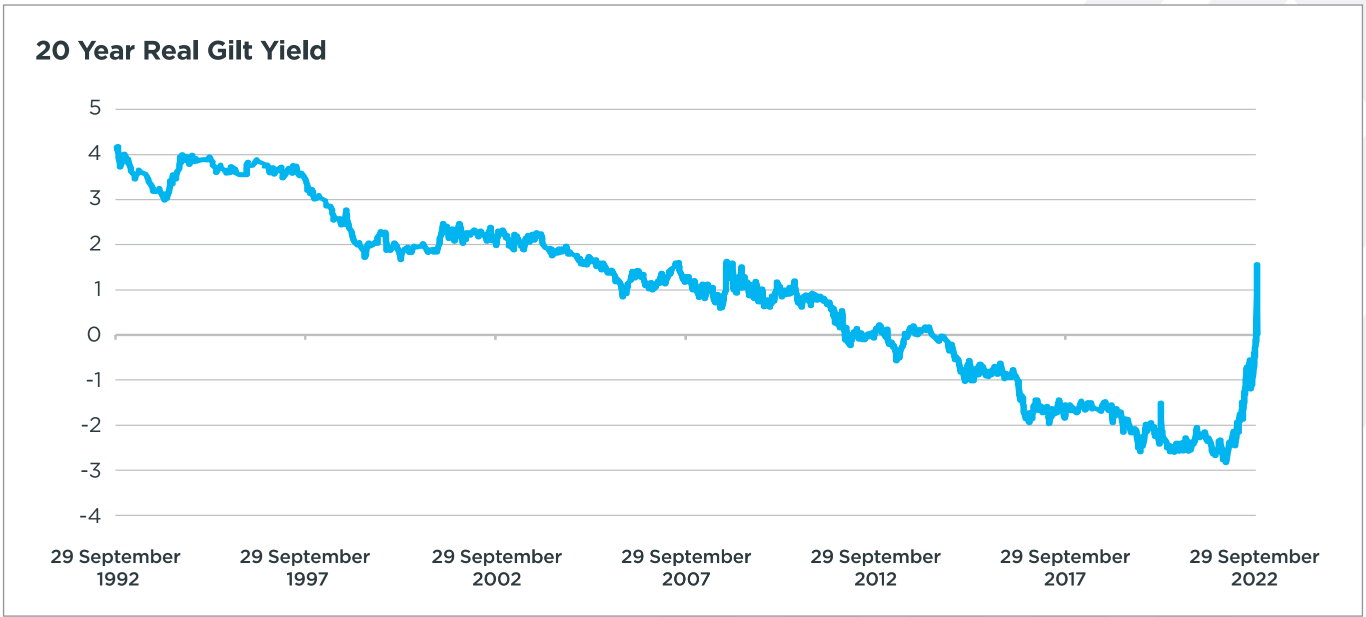
The audience asked a number of questions and in this piece we have collated a selection of the most commonly asked questions and provided our thoughts.

To view the full webinar please click here

1 What went wrong with gilt markets in the last week of September?

Gilt yields experienced a monumental surge following the announcement of the 'mini budget' on Friday 23 September which implied significant additional gilt issuance to fund the policies.

The chart below shows the magnitude of the move in index linked gilts yields compared to its historic level over the previous 3 decades.

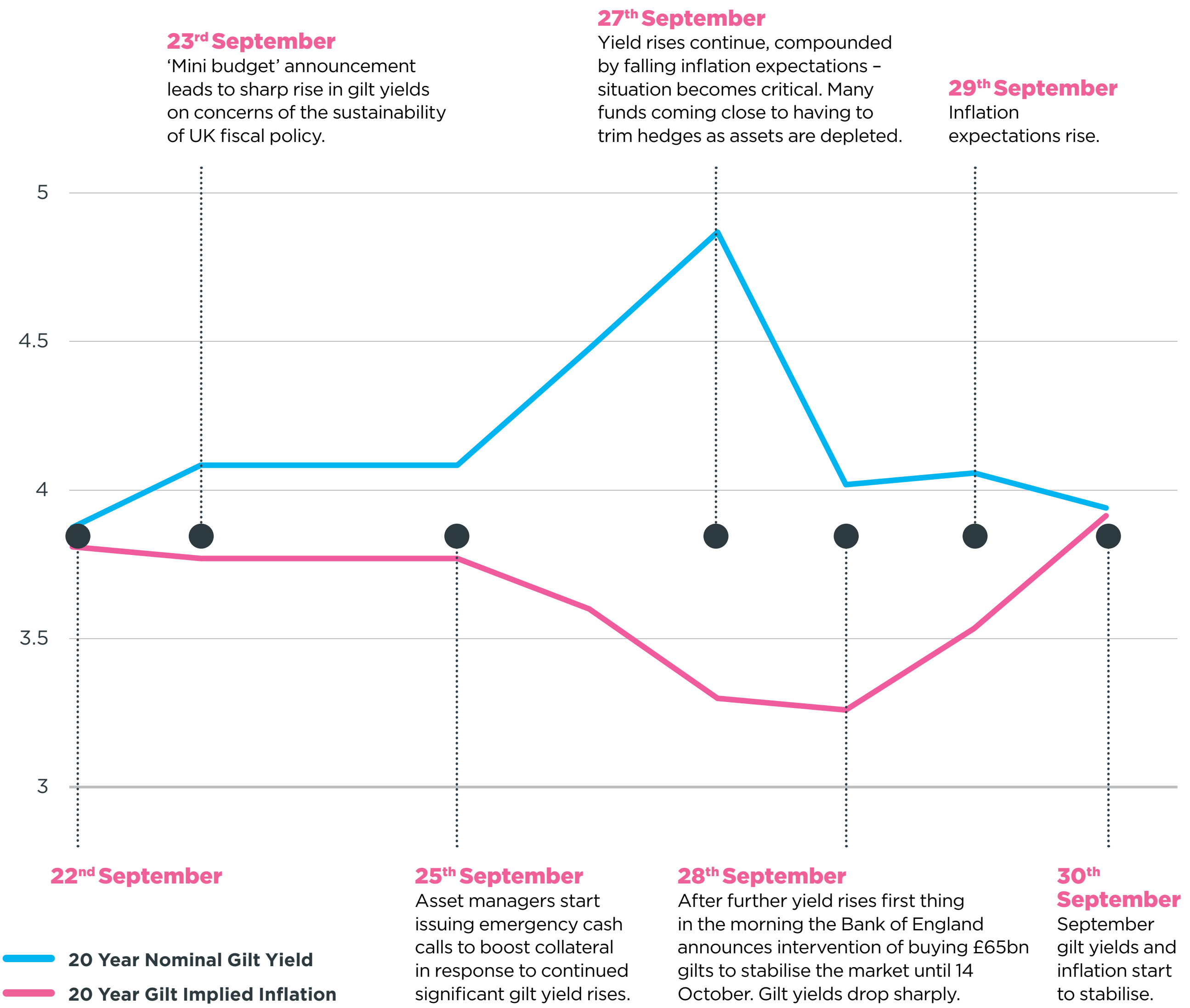


Source: Refinitiv

During that week the gilt market behaved like a wild animal. This represented a failure of orderly markets and could only be resolved through intervention.

Timeline of events – September 2022

Nominal Gilt Yield and Gilt Implied Inflation in days following ‘mini budget’



2 How did DB pension schemes fare with the volatility experienced post the mini budget?

The sharp spike in yields and subsequent decline has been largely neutral for pension schemes funding positions. Further, because yields had risen in the earlier part of September and have subsequently risen at the start of October, in the main pension schemes are expected to be significantly better funded that they were a month ago.

That said, different schemes will have had different experiences depending on their portfolio and operational set up. Schemes that have been least disrupted are those with segregated arrangements combined with lower levels of leverage. The schemes affected greatest were those with pooled LDI funds at higher levels of leverage although the experience here was still different between funds.

It is still not clear to what extent schemes had their hedges reduced. At our webinar on the 5 October almost 30% of those polled did not know how their scheme had been affected.

3 What might have happened if the Bank of England hadn't stepped in to stabilise the market?

At the point the Bank of England stepped in on Wednesday 28th September, gilt yields were out of control. What started as general negative sentiment around UK fiscal discipline, was by that point being compounded by defined benefit pension schemes starting to become forced sellers of gilts in order to reduce their leverage. This was creating a self-fulfilling spiral where forced selling of gilts leads to more losses on contracts, leading to more forced selling of gilts.

Had the Bank of England not intervened it is likely that gilt yields would have continued to rise, potentially forcing schemes to remove all derivative based hedges. Claims of pension schemes potentially becoming insolvent in this scenario were unfounded. This scenario would have left schemes exposed to increased funding level volatility due to a lower interest rate and inflation hedging level, but not insolvent. Ironically their funding positions would likely have improved further in this scenario, at least initially.

On 5 October the Bank of England Deputy Governor, Sir Jon Cunliffe, wrote to the Chair of the Treasury Committee, Mel Stride with a detailed factual account of what caused the crisis, and the action that the Bank took to stabilise the market. In this letter it explains the rationale for pension schemes employing leverage to hedge interest rate and inflation risk and the sheer magnitude of the market movements. It noted that "On Wednesday 28 September the intraday range of the yield on 30 year gilts of 127 basis points was higher than the annual range for 30 year gilts in all but 4 of the last 27 years." And in light of this "While it might not be reasonable to expect market participants to insure against all extreme market outcomes, it is important that lessons are learned and appropriate levels of resilience ensured."

To read this letter please **click here**

4 Does Liability Driven Investment have a role in DB pension scheme portfolios going forwards? If so, are there things that can be done to help avoid the disruption many schemes with LDI experienced?

LDI continues to play an essential role in pension scheme management. Its job is to reduce risk by enabling a better match between assets and liabilities. Where the hedges were maintained it did precisely this over the volatile period at the end of September.

That said, as is appropriate following any system failure, lessons need to be learnt so mistakes are not repeated.

These are likely to include a number of measures. An obvious one is lower levels of leverage – we have already seen managers starting to do this.

This can be combined with greater direct access to short term liquid assets. For instance LDI managers managing some non-LDI funds that can be accessed at short notice, or setting up a revolving credit facility which would work like an overdraft for a pooled fund.

The LDI industry has demonstrated its ability to innovate and adapt over the years and we are confident it will rise to this challenge.

5 Did any specific governance model stand out in helping trustees manage the disruption to ultimately benefit the scheme?

Anecdotally, schemes supported by both traditional investment consulting and fiduciary management will have experienced similar financial impact over the period. It will probably have felt different for the trustees under the different approaches but at this stage there is not an obvious pattern between the governance model and whether schemes have lost hedging as a result of the market volatility.

Trustees working on schemes which have delegated arrangements, however, will have had less work to do as their Fiduciary Manager will have been able to implement decisions on their behalf.

6 Do you expect any further extreme gilt yield volatility in the short-term or has the 'crisis' now been averted?

Markets are forward-looking and the current price today captures the information available, which includes the knowledge that BoE purchases will cease from 14th October.

This means we should not expect prices to move in one direction or the other after 14th October.

However, we would expect liquidity to reduce from the 14th October – the primary consequence of which is higher trading costs and greater fluctuation of prices. Trading costs are already elevated so it is important for pension schemes to make adjustments required to their strategy whilst liquidity remains adequate and the market is stable.

It is important for all pension schemes to consider both the immediate and longer term aspects that the current market conditions have created.

Once the urgent matters are addressed we encourage clients to think about their overall strategy and whether there is scope to benefit from the funding improvement that we have seen across the industry.

Find out more

To discuss any of the issues covered in this edition, please get in touch with Simeon Willis or Sian Pringle:

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