Investment briefing
November 2022

Setting an investment strategy in a post gilts crisis world

Ben Rogers looks at the lasting impact of the gilts crisis and what action trustees need to take in response.

Ben Rogers
Investment Consultant

Since the government's 'mini budget' announcement in late September we have seen extraordinarily sharp rises and falls in government bond 'gilt' markets.

This has already resulted in some significant changes in the investment industry which will place new constraints on what can be achieved when determining a pension scheme's investment strategy. Trustees must think carefully about how they balance the return, liquidity and risk management aspects of their portfolios to ensure they are appropriate for their scheme, whilst working within manageable operational and governance constraints.

In this note we have set out the following:

1. What has the impact been on pension schemes?
2. What has the industry learnt?
3. How is the industry likely to change?
4. What are the implications for schemes' investment strategies?

As a result of the gilts crisis there will be significant changes in the investment industry. Schemes must reassess their investment strategy to ensure it remains appropriate to achieve their objectives.

1. What has the impact been on pension schemes?

Whilst many of the policies set out have been reversed and Liz Truss has been replaced by Rishi Sunak as prime minister, events witnessed during late September and October will have significant implications both for the operation and funding positions of UK defined benefit pension schemes who collectively are the largest investors in long dated gilts.

As rates have now fallen back to levels near those seen before the mini-budget, schemes that were able to maintain their hedging level (be it at either high or low levels of hedging) may have emerged from the gilts crisis with largely the same funding position as they had before the mini-budget (all else being equal).

However, through this period many schemes have been unable to maintain their hedges. This has occurred under a range of circumstances such as:

- **Capital calls** – Schemes being unable to satisfy capital calls from managers which needed to be paid to maintain hedging positions. Due to the size of yield movements many managers accelerated their capital calls from the 5-10 business days which were typical previously, to a one or two day notice period to deliver funds.
- **LDI manager decisions** – Some LDI managers unilaterally reduced exposures and in some cases subsequently added this exposure back after markets had fallen. Their reasoning for this was to preserve the integrity of their funds and it was done in response to the scale and speed of the rise in yields under obligation to their counterparties to post the required collateral and maintain an adequate buffer.

Varying hedging levels during the period of volatility may have negatively impacted the funding positions of many schemes. We estimate that for every 10% of hedging that was taken off at the peak on 11 October, a scheme's funding level is likely to be around 2% worse than it would have otherwise been if the hedging level was not reduced.

We estimate that for every 10% of hedging that was taken off at the peak on 11 October, a scheme's funding level is likely to be around 2% worse than it would have otherwise been if the hedging level was not reduced.

2. What the industry has learnt

The recent level of volatility in gilt markets has been unprecedented. The chart below illustrates this.

Source: Refinitiv

This has been caused by a combination of factors, the two most prominent ones being:

- The expected increase in government borrowing after the announcement of the mini budget on 23 September 2022, which has subsequently been largely repealed.
- Pension schemes being forced sellers of long dated gilts into a relatively illiquid market. This created a negative feedback loop which continued to put upward pressure on yields until the Bank of England intervened, but volatility subsequently persisted for some weeks.

Further detail on the causes of the volatility are set out in our Q3 quarterly update paper (**click here**).

Whilst largely unforeseeable, the industry must learn lessons from the events:

- **Sufficient ready-collateral** – The main lesson learnt will be that LDI funds and pension schemes need to take action to ensure that LDI funds are sufficiently well capitalised so that hedging exposures can be maintained in extreme market conditions. This has been supported by strong signals from the Bank of England about what they expect moving forwards.
- **Liquidity** – Ensuring sufficient additional liquid assets are available to top up any LDI funds at short notice.
- **Governance arrangements** – Ensuring that trustees are aware and have appropriate processes in place for the operational requirements of topping up any positions and being able to respond quickly. Furthermore, trustees need to ensure that the details of portfolio construction, their liquidity waterfall and more generally the nature of how LDI funds work are well understood.

3. How is the industry likely to change?

In terms of the impact on LDI funds this is likely to mean the following:

- **Overall reduction in leverage** – LDI managers are in the process of reducing target leverage in their funds. This will reduce the volatility of funds and hence reduce the speed of any falls in asset values if yields were to rise significantly. Lower leverage will reduce the hedging provided per pound invested so schemes will have to invest more in these funds in order to maintain hedge levels. The information currently received suggests hedging leverage will fall from around £3 to around £2 per pound invested. This could change further following a review of the market by participants and regulators.
- In order to ensure managers have sufficient ready-collateral to run their funds without the need to reduce exposures, managers are likely to **tighten the yield movements which trigger a collateral call**.
- In general, the timeframes in which asset managers expect to receive monies are being shortened with **more frequent smaller recapitalisation events being likely**.

We still believe LDI has a key role to play in schemes' investment strategies. The Department for Work and Pensions' draft funding regulations stress the need for significantly mature pension schemes' asset strategies to be constructed so that funding positions are 'highly resilient' to changes in market conditions. We believe this still implies high levels of hedging which is likely to require schemes to continue to use LDI in most cases. However, hedging must be balanced with the other portfolio objectives. This is explored further in section four.

> We still believe LDI has a key role to play in schemes' investment strategies. However it is vital that the level of hedging is balanced with the other portfolio objectives.

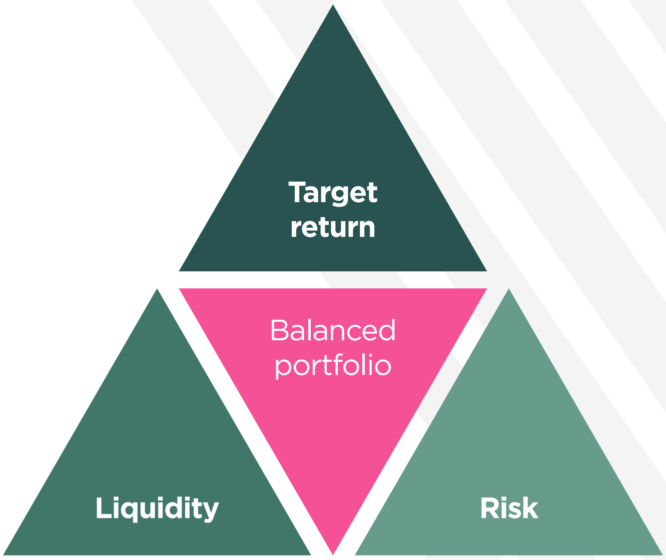
4. What are the implications for schemes' investment strategies?

Schemes need to revisit their overall investment strategy to ensure that the balance of the portfolio is appropriate. In the following section we explore in more detail the implications of the market developments on a scheme's investment strategy.

There are 3 key aspects to a pension scheme's portfolio:

- **Sufficient target level of return given long term objectives**
- **Sufficient liquidity**
- **Appropriate levels of risk**

All portfolios represent a balance of these three factors whilst also working within a trustee's governance constraints.



Pension schemes are subject to a wide range of risks – the key risks we believe should be considered when setting investment strategy are:

- Hedging levels (how is the funding position affected by interest rate and inflation movements);
- Growth asset risk and diversification;
- Operational and liquidity risks; and
- Other risk management activities such as currency hedging.

Balancing risk, return and liquidity in the new world

Recent gilt market developments mean that we have now moved to a fundamentally new environment where we have to assume markets are more volatile and consequently leverage levels will be substantially lower with more conservative collateralisation practices.

In addition to this, we believe schemes should hold a buffer in easily accessible liquid assets ('secondary collateral pool') which can be used to top up LDI funds if existing buffers are eaten into through losses on the derivative contracts. This is important as failure to do so could result in schemes' hedges being reduced when the market is most volatile.

The new balance between returns, risk and liquidity means (all else being equal) a scheme needs to either allocate more liquidity towards its LDI portfolio, reduce expected returns or reduce levels of hedging. The relevant combination of these levers will depend on a scheme's priorities and circumstances.

This is illustrated by the example below:

	Previous	New world – same hedge	New world – same return	New world – more liquidity
Allocation to LDI	35%	45%	35%	45%
Liquid diversified growth	45%	35%	45%	0%
Liquid equity assets	0%	0%	0%	55%
Illiquid credit assets	20%	20%	20%	0%
Return	Gilts +2.5%	Gilts+2.1%	Gilts +2.5%	Gilts + 2.5%
Hedging level (% of assets)	100%	100%	70%	100%
Approximate LDI leverage	3X	2X	2X	2X
Growth asset diversification	High	High	High	Low

As can be seen above, previously schemes could achieve a full liability hedge by allocating 35% of their assets to LDI. This leaves the remaining 65% which can be allocated to growth funds which indicatively could be expected to return gilts + 2.5%.

In the new world funds will use less leverage. As a result, if a scheme wishes to maintain a full liability hedge we estimate they will need around 45% of their assets to be allocated to LDI. This leaves around 55% of the assets to be allocated to growth assets which will reduce the expected return.

Alternatively, if a scheme wishes to maintain the same return target and growth asset diversification then they will need to maintain the allocation to growth markets and so the 35% allocation to LDI will now hedge around 70% of liabilities.

Another option to maintain the level of hedging is by ensuring that all the remaining growth assets are invested in a high returning liquid equity allocation. This maintains expected returns but results in a less diversified portfolio that is more reliant on equity markets.

We believe to answer the question on how best to balance these risks the starting point should be assessing a scheme's funding position and where it is in its journey to its end goal. Following the yield rises during the first 9 months of 2022 many schemes may be much closer to their end goal than previously expected.

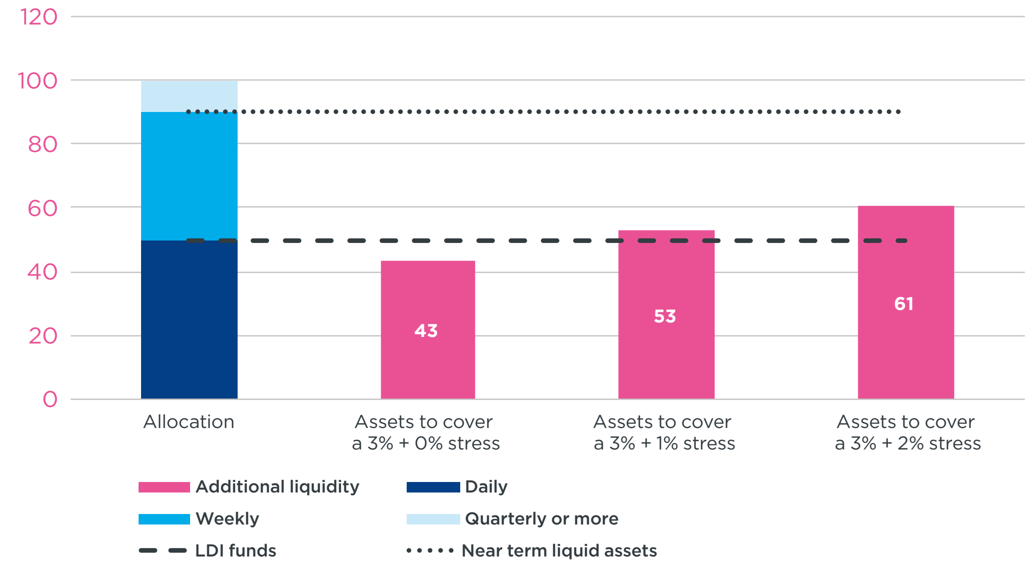
If a scheme is well funded or on track to meet their end goal in an appealing timeframe then looking to maintain hedging at the expense of return may be viable and appropriate. However, if a scheme is not projected to reach its end goal in a suitable timeframe then looking to maintain return at the expense of hedging may be necessary.

As with any strategic decision, it is vital schemes consider the strength of the employer covenant and that this is sufficient to support the chosen strategy.

Liquidity analysis

When thinking about liquidity and collateral headroom, we typically look to ensure our clients have sufficient liquid assets to meet any collateral calls from yield rises of at least 3%. In addition it is very important for schemes to consider what funds they have to top up available collateral for additional movements in yields. In order to establish this when setting any strategy, stress tests such as the example below can be carried out for different hedging strategies.

Example allocation – liquidity of portfolio in stressed yield environment



Source: Example scheme, XPS calculations

Liquidity analysis shouldn't just be considered when setting a strategy – we also believe that when LDI is in place trustees should ensure they are receiving appropriate liquidity reporting. A sensible approach could be to look to include charts such as the one above in quarterly monitoring reports. This helps trustees ensure they are up to date on the levels of liquidity in their portfolios. This in turn will allow them to make proactive decisions around hedging levels and the level of liquid assets needed to support LDI mandates.

Governance

Given that the timeframes in which LDI managers expect to receive capital top ups are being reduced, schemes must adjust their operational procedures to ensure they can meet calls in the time periods required. This could involve having a larger liquid growth holding with the scheme's LDI manager, to avoid having to deal with multiple managers on very short notice.

Many smaller schemes who held all of their assets with one manager saw the benefits of this through the recent crisis as it meant they were able to meet all collateral calls in the required timeframes which meant their hedging exposures were maintained.

Where schemes use multiple managers it is important that they understand the process and timescales to transfer monies to their LDI manager if required.

Summary

Ultimately, events witnessed have created a need for greater constraints around the use of liquidity and leverage which means the scope for trustees to achieve high levels of hedging whilst also pursuing a high level of return is reduced.

To manage this delicate balance, trustees must first reassess where they are on their journey plan to their end goal. This will allow them to determine what should be prioritised between liquidity, risk management and the return target.

Liquidity has now moved higher up the agenda and stress testing should be carried out to ensure schemes have adequate collateral for their chosen hedge level.

Finally, once the appropriate strategic allocation has been determined, trustees will benefit from actively monitoring the liquidity of their portfolios to assess their scheme's ability to withstand liquidity events in future volatile markets.

How XPS can help

We believe that following the gilts crisis and the resulting changes to the industry all trustees should be working with their consultants to review their investment strategy to ensure it remains appropriate.

LDI health check – an independent survey of your scheme

We have developed an **LDI health check** to assist trustees who are unsure how they have been impacted by the recent LDI liquidity crisis. The aim is to aid trustees' understanding, and ensure risk is being managed appropriately looking ahead. This covers liquidity analysis of your portfolio and a summary of suggested key areas that trustees should be considering. We also believe moving forwards that all schemes with LDI in place should ensure they are receiving a detailed liquidity analysis on a regular basis as a part of their monitoring reports.

Please get in touch if this would be helpful for your scheme.

If you wish to discuss these or any other investment related issues, please contact Ben Rogers or your regular XPS consultant

t 01483 330 172

e ben.rogers@xpsgroup.com

@xpsgroup.com

in xpspensionsgroup

XPS Investment

Important information: Please note the opinions expressed herein do not take into account the circumstances of individual pension funds and accordingly may not be suitable for your fund. The information expressed is provided in good faith and has been prepared using sources considered to be reasonable and appropriate. While information from third parties is believed to be reliable, no representations, guarantees or warranties are made as to the accuracy of information presented, and no responsibility or liability can be accepted for any error, omission or inaccuracy in respect of this. This document may also include our views and expectations, which cannot be taken as fact. The value of investments and the income from them can go down as well as up as a result of market and currency fluctuations and investors may not get back the amount invested. Past performance is not necessarily a guide to future returns. The views set out in this document are intentionally broad market views and are not intended to constitute investment advice as they do not take into account any client's particular circumstances.

Please note that all material produced by XPS Investments is directed at, and intended solely for the consideration of, professional clients within the meaning of the Financial Services and Markets Act 2000 (FSMA). Retail or other clients must not place any reliance upon the contents. This document should not be distributed to any third parties and is not intended to, and must not, be relied upon by them. Unauthorised copying of this document is prohibited.

This document should not be distributed to any third parties and is not intended to, and must not be, relied upon by them. Unauthorised copying of this document is prohibited.