

LDIWatch: The crisis and the importance of choosing the right LDI manager

The gilts crisis in 2022 represented a huge test of the abilities and operations of the LDI managers. They differed in how they navigated the challenges thrown up during September and October, leading to markedly different outcomes for the pension schemes that use them.

In this note, we highlight what actions the managers took, and the consequential implications for pension schemes. It is clear that any previously held view that it made little difference which LDI manager a scheme picked has been quashed.

Background

2022 will long be remembered for the dramatic movements in gilt yields we saw and the corresponding impact on pension schemes. As reported in our [XPS DB:UK Funding Tracker](#) on 4 January 2023, pension schemes saw a huge improvement in funding position during 2022.

DB:UK – Surplus / (Deficit)



Source: XPS

In many ways, 2022 can be broken down into two distinct periods.

Up to mid-September, gilt yields steadily but substantially increased. For example, longer-dated real yields (the yield on index-linked gilts) rose from around -2.5% to 0%, a level not seen for 10 years. This drove funding level improvements for most schemes as the majority of schemes have not fully hedged their interest rate and inflation risk. As yields rose, many schemes had to increase the collateral backing their LDI mandates, but this happened without problem as the increase in yields was steady meaning schemes had time to react.

The position changed on 23 September 2022 as then Chancellor of the Exchequer, Kwasi Kwarteng announced his mini-budget. Concerns over increased government borrowing led to a sell-off in gilts causing yields to rise rapidly during the three days immediately following the mini-budget. This had a big impact on LDI funds, depleting their collateral positions, with some of them going into this period with already below target collateral positions following the increases in gilt yields seen earlier.

There was a divergence in how different LDI managers reacted to this situation. For example, some LDI managers cut positions to avoid fund leverage getting too great, meaning their funds provided less hedging, others requested capital at very short notice and others suspended trading so as to maintain hedges with low levels of capital. With the intervention from the Bank of England announced on 28 September causing gilt yields to fall spectacularly, pension schemes whose hedging positions had been cut saw their funding positions worsen more than expected.

This period represented the biggest test of LDI managers' operational procedures and abilities since the advent of LDI as well as testing trustees' and their advisors' operational governance. Now the situation has stabilised, we've conducted comprehensive research on the main LDI managers to understand how they fared.

This paper summarises how the LDI managers reacted to the situation and the impact on pension schemes that utilised their pooled LDI funds.

The analysis

In practice, pooled LDI managers typically took one or more of the following actions in response to the rapid rise and then fall in gilt yields:

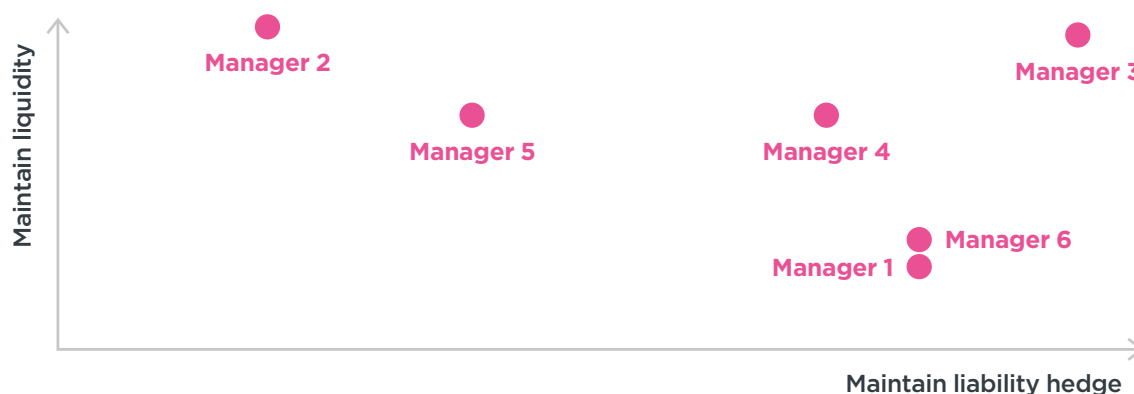
1. Called capital at short notice to avoid cutting hedging
2. Reduced the hedging exposure in the LDI funds to preserve liquidity and solvency of the pooled funds
3. Suspended pricing or suspended capital calls and distributions to maintain hedging levels or to maintain fund solvency
4. Applied a pricing adjustment in light of the illiquidity of the gilt market

The table below summarises what 6 of the main LDI managers did in reaction to the gilts crisis.

Manager		1	2	3	4	5	6
Called capital at short notice	Was additional capital called at short notice?	Yes	Yes	Yes	Yes	Yes	Yes
Exposure reduction	Did any funds suffer a reduction in exposure?	No	Yes	No	Yes	Yes	No
	Temporary or permanent reduction in exposure	-	Permanent	-	Temporary 2-3 working days	Temporary 3 - 4 working days	-
	By how much was exposure reduced?	-	8-95% (average 70%)	-	3-20%	25-40%	-
Pricing or capital calls and distribution suspension	Was pricing or capital calls and distributions suspended?	Yes	Yes	No	No	No	No
	For how long?	1 day	4 working days	-	-	-	-
Pricing adjustment	Was a pricing adjustment applied?	No	No	No	No	No	Yes
	For how long?	-	-	-	-	-	1 day

Additionally, one manager discovered that some of their LDI funds had been incorrectly priced for a period of time, due to a fund accounting error, adding to the difficulty of schemes working out what they need to do to preserve or restore their hedge. To our knowledge, no investors have been left out of pocket with hedging restored and compensation provided by the manager.

Chart 1: Maintaining the hedge or maintaining liquidity



Source: XPS

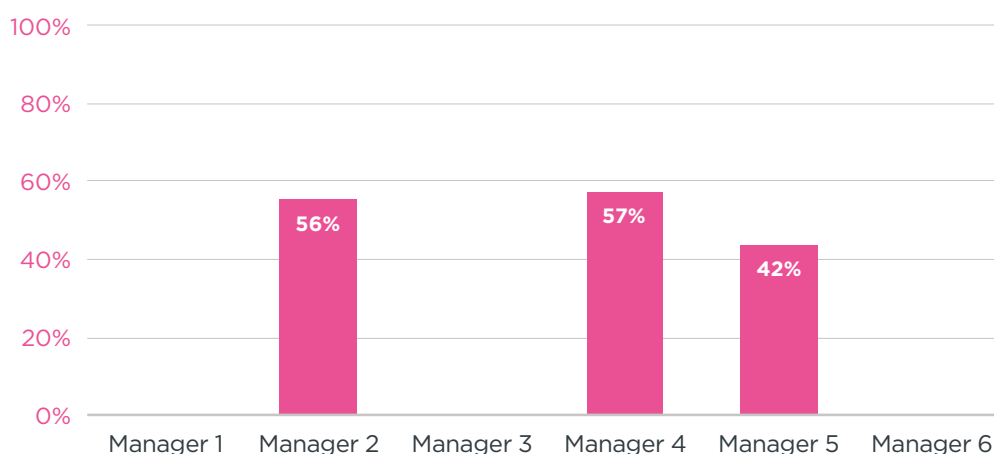
We have summarised qualitatively in the chart our perception of the general approaches that managers took to maintain liquidity and solvency versus liability hedging in their pooled LDI funds illustrated based on our experience.

As shown in Chart 1, our analysis clearly demonstrates that different managers prioritised different objectives in light of what was feasible given their specific circumstances and fund structures.

The ideal outcome for pension schemes was for the manager to maintain hedging and liquidity – manager 3 was the most effective at achieving this. Managers 1, 2, 4, 5 and 6 all chose to sacrifice one aspect (to some degree) to achieve the other given their funds' specific circumstances.

The following two charts show the impact of the actions the managers took on XPS' clients that utilise their pooled LDI funds.

Chart 2: The proportion of XPS Investment's clients that experienced a forced hedge reduction by the manager within one or more of their pooled LDI funds

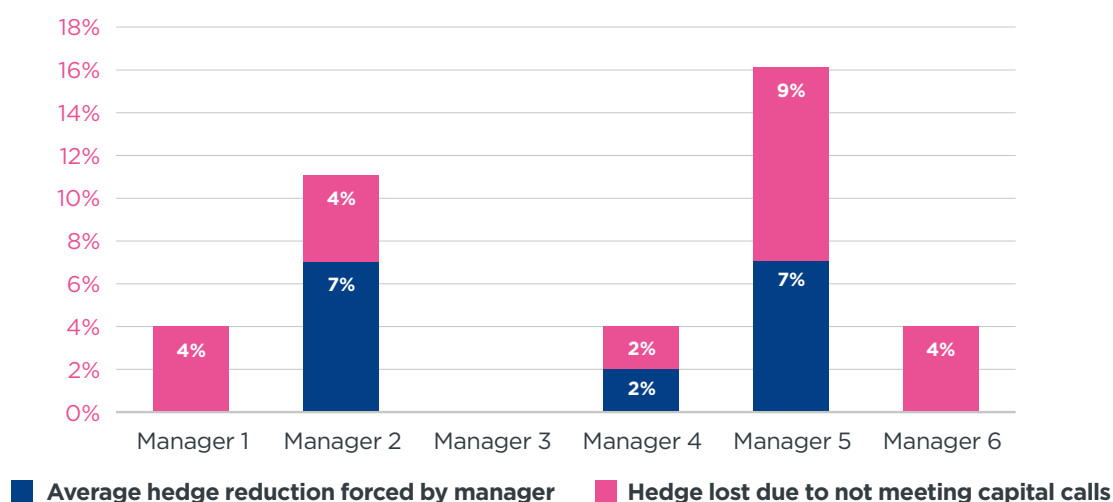


Source: XPS, average calculations weighted by number of clients, not assets under management

Across our client base, some schemes that utilised LDI managers 2, 4 or 5 had a forced hedge reduction imposed on them by their LDI manager. Across our client base, around 50% of the clients with exposure to each of these managers used funds where the manager imposed a reduction in hedging.

The next chart looks at the average magnitude of any hedge reduction experienced by schemes. The % hedge reduction is expressed as a proportion of the clients' hedges. For instance, a client with a 50% target hedge who experienced a 10% hedge reduction shown in the chart, would have seen their hedging reduce by 5% of liabilities.

Chart 3: The average reduction in hedge experienced by all XPS Investment's trustee clients that use pooled LDI funds



Source: XPS, averaged weighted by number of clients, not value of assets under management

This chart shows the average impact on schemes' hedging levels for each manager from either the manager taking a decision to reduce hedging in the funds or schemes not meeting requested capital calls in time.

We note that behind this data there is also a material dispersion in the hedge reduction experienced by the clients utilising any given manager's LDI pooled funds.

The clients of LDI manager 3 suffered no reduction in hedging. These clients were well protected against the fall in yields seen in the days following the BoE's intervention on 28 September 2022.

The clients of managers 1,4 and 6 suffered small reductions in hedging of less than 5% on average. The clients of LDI managers 2 and 5 suffered the largest reduction in hedging on average, around 11-16% and therefore the greatest impact when yields fell on 28 September 2022. The financial impact on a scheme will depend on their target level of hedging and the specific period that the hedge was reduced. For a typical scheme with, say, a 70% target hedge, a reasonable rule of thumb is that a 10% reduction in hedging would have resulted in a 7% reduction in liabilities hedged, leading to a 1.5% impact on funding level. This reflects the 1% reduction in yields which was roughly the fall seen on 28 September following the BoE's intervention.

For context, the average reduction in hedge across XPS Investment's pooled LDI fund client base during the gilts crisis was 5%, with 2% of this resulting from forced hedge reductions. This translates to a c.4% reduction once the target hedge is accounted for. 45% of pooled LDI clients experienced no reduction. Across our overall trustee client base the average reduction in hedge was 4% (which equates to 3% after adjusting for target hedge level) and 63% of XPS Investment's client base did not experience a reduction.

The characteristics of success

The characteristics of an LDI pooled fund that typically led schemes to experience an easier navigation through the gilts crisis were:

1. More frequent topping up and distribution of the collateral pool to maintain leverage closer to the target level.
2. Automatic recourse to additional sources of collateral, either other funds managed by the same manager or externally managed funds.
3. Short settlement time between non-LDI and LDI assets.
4. Lower levels of leverage.

Interestingly, higher levels of leverage didn't automatically mean an LDI fund would be more impacted by the gilts crisis. Funds with higher levels of leverage coped well during the crisis if they had 1, 2 or 3 in place, and ideally all three.

The changes LDI managers made since the crisis unfolded

Unsurprisingly, LDI managers have evolved their propositions to increase robustness following the learnings from the gilts crisis. The main change we've seen all LDI managers make since the gilt crisis is to reduce leverage (or to put it another way, hold higher levels of ready collateral) within their pooled LDI funds. Additionally, they are encouraging schemes themselves to hold an additional source of potential collateral in liquid investments in case of capital calls at short notice.

Alongside this, individual managers have made changes to improve their operational procedures reflecting what they've learnt during the crisis.

Further, trustees have also been learning the lessons in terms of both investment strategy and their operational procedures. In November 2022 the Pensions Regulator issued detailed guidance on how trustees should look to improve their operational processes as well which is expected to be an area of considerable focus for most schemes in the coming months.

Segregated LDI mandates

There was much less impact from the gilts crisis on clients that utilised segregated LDI mandates, in our experience. These mandates often had more frequent topping up of the collateral pool and recourse to additional sources of collateral, being two of the three key characteristics of success highlighted above.

The conclusions

Prior to the crisis, LDI was considered something of a passive product with little distinction between managers. The crisis has been the first big test of LDI managers' operational procedures, highlighting which managers had the most robust operational procedures, thereby quashing that belief.

The speed and magnitude of the rise in yields meant some managers had to make a tough call on whether to maintain the hedge, or whether to maintain liquidity and prevent funds becoming insolvent. This was a highly uncertain period, and it is important to recognise that it was not known how the gilt market situation was going to be resolved. In light of this uncertainty there was considerable deviation in the approach taken by managers to deal with the stress events which ultimately significantly impacted how well they navigated the crisis. Whilst managers were forced to make difficult decisions in short time scales the crisis represented an extreme test point of the robustness of operational processes and procedures.

As shown, and perhaps contrary to previous beliefs, LDI manager selection actually made a big difference to the performance schemes experienced during the crisis. It also had a big impact on the actions and time schemes needed to spend on their portfolio during the crisis.



The gilts crisis clearly highlighted that the choice of LDI manager can lead to a material impact in outcome for schemes.

Schemes need to ensure they are comfortable with their manager's approach, and their decision whether to use pooled funds or a segregated mandate for their LDI portfolio.

Next steps for pension scheme trustees

Trustees need to be actively considering the impact of the gilts crisis and subsequent changes and guidance by doing the following:

- **Review your LDI manager:**
 - Understand how they performed during the crisis and the nature of the factors that led to this.
 - Understand what changes they've made to their LDI operation since the crisis.
- **Review your arrangements against TPR's detailed guidance, including:**
 - Ensuring you have an appropriate collateral management strategy including a plan for realising additional collateral (possibly at short notice) if needed.
 - Undertaking stress testing to ensure robustness.
 - Reviewing your own operational procedures to make sure you can react quickly if needed.
- **Ensure you carefully monitor your LDI portfolio going forwards.**

XPS has launched an LDI Oversight Service to help trustees review their LDI arrangements, catering for existing XPS clients or as a stand-alone service alongside advice from an incumbent investment consultant.

Additionally, many schemes find themselves in a much improved funding position now compared to a year ago, so make sure you understand your current funding position and if necessary review your investment strategy accordingly.

For further information, please get in touch with Ben Gold or Mark Minnis.



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