BARNETT WADDINGHAM
beyond the expected

LDI market - update

This is an update on recent events in gilt and liability driven investment ("LDI") markets over the last week, after the Chancellor's mini-budget on Friday 23 September, which includes our thoughts on how clients should respond.

We are in the process of considering individual circumstances for each of our client schemes, and we will be in touch shortly with our advice. In summary, however, there are risks which have magnified within the LDI market over the last week, to such an extent that there may now be circumstances where the approach to maintaining hedging levels by funding collateral calls needs to be reviewed.

The purpose of LDI

Our approach, as always, remains to help trustees achieve their ultimate objective of ensuring that pension schemes can pay all of the benefits due to their members. Over the past 20 years, in an environment of falling gilt yields, and rising liability values, LDI has been a valuable risk management tool, providing protection against funding level volatility.

Throughout 2022, yields across all government bonds have been rising. This has been a global phenomenon as Central Banks rapidly increased interest rates in the face of very high inflation. The increase in UK gilt yields over the year resulted in collateral calls from LDI funds to maintain the operational levels of leverage within their funds. So far this year, most schemes have had sufficient liquid collateral pools available to meet these demands.

What happened in the last two weeks and how have we helped our clients?

The trend of increasing gilt yields continued through September but towards the end of the month, rose very sharply within a very short time period. This happened as the market responded to an anticipated surge in the supply of gilts due to the announcement on Thursday 22 September of Quantitative Tightening (i.e. selling back gilts purchased previously as part of Quantitative Easing) from the Bank of England (BoE) and the assumption that tax cuts (following the mini-budget on Friday 23 September) would be funded through borrowing in the gilt market.

This sharp rise in gilt yields resulted in a requirement for all holders of leveraged LDI fund exposure to make collateral payments to reduce the level of leverage within these funds. Otherwise, the fund managers would have to reduce the level of hedging provided.

Most investors could meet these collateral calls, but some were unable to, and this meant that the fund managers had to sell gilts and reduce hedging in certain cases. This, however, further increased the supply of gilts, causing a risk of spiralling gilt yields, falling prices and further collateral calls for all investors.

The Bank of England, fulfilling its objective of maintaining financial market stability, agreed a temporary measure of renewed Quantitative Easing (QE), acting as purchaser of last resort. This stabilised gilt markets, but the intervention has been described by the BoE as limited and is scheduled to end on 14 October.

Based on our initial discussions with the LDI managers, we believe that the majority of pension schemes, including our clients, were able to meet all collateral calls and maintain their hedging. However, there were some exceptions as noted below.

Operational issues +

What's happened in recent days?

Three LDI managers - BlackRock, Insight and LGIM - have announced that they are due to permanently reduce the operational levels of leverage within their pooled funds, in advance of the Bank of England's temporary QE coming to an end on 14 October. We expect other LDI managers to follow.

To date, LDI managers have typically operated their pooled funds to leverage levels within a broad range of 2.5 - 4x (at an average scheme duration). Reducing the leverage (we are still working with LDI managers to understand the level of reduction) allows them to build in more prudence, requiring investors to post more collateral to achieve the same level of hedging as previously. To achieve this, clients will either need to pay more assets into the LDI portfolio (e.g. by selling other assets, and increasing the strategic allocation to LDI funds), or lower their hedging level (i.e. allow the manager to sell down gilts from within the LDI funds, to reduce the leverage).

This is in response to the spike risk that has been highlighted in the last week around the effective operation of LDI funds, when some of the investors in the funds are unable to meet collateral calls, or yields move too quickly for collateral to be called.

How has our view evolved and how will we help you next?

Prior to the decision of investment managers to change the level of leverage within their funds, our advice to clients has typically focussed on meeting the collateral calls to maintain hedging levels. This has generally been affordable from a funding perspective, as the falls in liabilities have seen funding levels rise, and the relative allocation to return-seeking assets has been overweight. Many clients have collateral waterfalls that have worked well, or they have been able to sell liquid assets. This was a sound strategic approach, consistent with previously agreed strategies.

The latest developments represent a potentially fundamental change to a scheme's strategy in order to maintain hedging levels. We are awaiting details from the managers on how the operational leverage will change in the funds, but as an example, if they halve the leverage, then schemes will need to invest twice as much into LDI funds as they do currently to achieve the same hedging levels.

The historical argument in favour of maintaining hedging levels is that interest rate risk has generally been the largest risk to schemes, and if yields fall back from current levels after hedging has been reduced, funding levels will fall. The BoE may also step in again if yields begin to rise as more LDI funds de-leverage by selling gilt exposure.

These arguments now have to be weighed up against the operational risk that is now more prominent, which raises the question of whether continuing to deliver collateral when called remains appropriate.

At this time, we expect that for most schemes, the risk of being overly exposed to interest rate risk continues to outweigh the operational (and policy error) risks.

However, this balance of risk may move in the short term. We await further information on how much collateral specific LDI managers will need to maintain hedging. If the amount of assets needed to maintain hedging is changing materially, this represents a strategic change to a scheme's investments, with wider implications. Other considerations, which will be covered in more detail in our advice to follow, include whether now is the right time to sell growth assets, whether the BoE action really is temporary, and the actions of other market participants (e.g. short sellers).

Summary

The current market environment, combined with the sparsity of information from the investment managers on the changes they are making and speed of developments, makes decision-making challenging. Each scheme's circumstances will be different, but we are considering an appropriate approach for each client using the information we have, while also taking into account your Aims, Beliefs and Constraints. Our starting point is likely to be that it remains appropriate to top-up LDI portfolios in response to managers changing the operational leverage of their funds. This view may evolve, however, as further details of the magnitude of these changes emerges.

If you have any queries, please do not hesitate to get in touch.

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Prior to making decisions, scheme Trustees should discuss their individual circumstances with their investment adviser.

For professional use only. The above is for information purposes only and should not be construed as investment advice. Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

employers@barnett-waddingham.co.uk

0333 11 11 222

www.barnett-waddingham.co.uk