BARNETT WADDINGHAM
beyond the expected

LDI update | November 2022

Recent market volatility and DB pension schemes

The recent market turmoil has affected defined benefit (DB) pension schemes in many ways. So now that the Liability-Driven Investing (LDI) dust is settling, it's important for each scheme to assess their position and consider whether strategic changes are necessary. We set out some of the strategic, investment and operational aspects to consider.

Assessing the position

How has the scheme's funding position changed?

The movement in yields in September was unprecedented. When combined with the rises in yields seen over the earlier part of 2022, it will have reduced liability values on all actuarial bases very significantly. Depending on the success of schemes' strategies, many will have seen funding ratios rise markedly, some will be in a similar place, and some will have deteriorated. Pound amount deficits will, however, generally be considerably smaller than, say, at the start of the year. Understanding the position for your scheme is the first step towards considering whether your strategy should change.

How has the journey plan been affected?

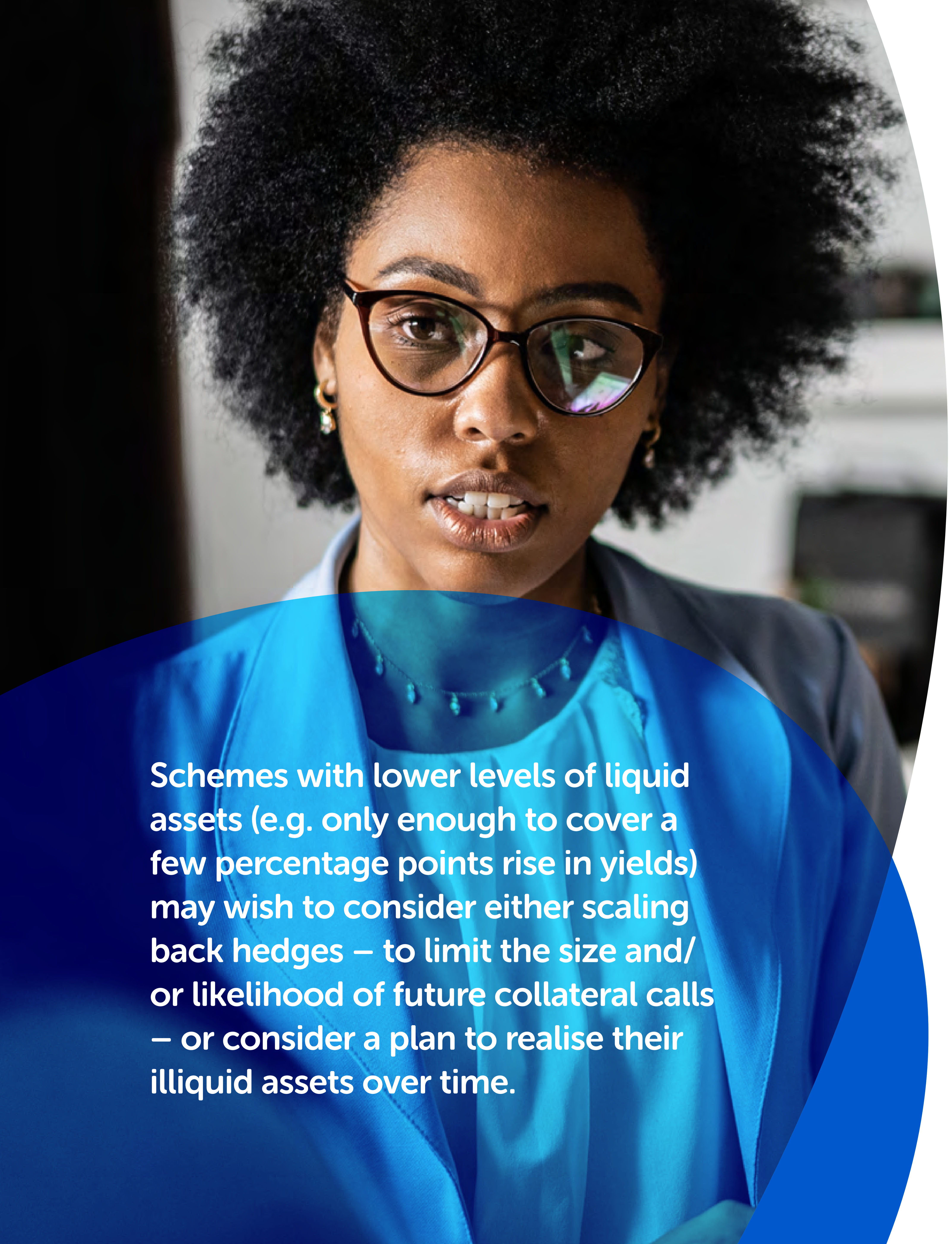
Schemes may find that the expected timeline to the endgame has shortened markedly, especially if the journey plan relied at least in part on future contributions. Many schemes will now be able to de-risk and still reach their target on time. Some, however, may find the opposite, especially where there was a considerable deficit to make up through investment returns; higher yields may mean lower liability values now, but it means they are now expected to grow at a higher rate than before as time passes.

Care needs to be taken with TPR's definition of "significant maturity." This is sensitive to market yields and many schemes that previously had several years to significant maturity may find they are now much closer or have even arrived. We understand TPR is reviewing the definition.

What is the current liquidity position?

Many schemes faced larger than expected collateral calls from their LDI managers. These schemes may find they have depleted their most liquid assets and now have insufficient liquidity to support further rises in yields. What was once a low proportion in illiquid assets could now be a large allocation.

Schemes should stress-test their liquidity levels against the potential collateral calls they may face. Ideally, a scheme should have more than enough liquid assets to cover an extreme upward move in yields as, although this might not be likely to happen immediately, it could happen over a prolonged period and it may be challenging to rebalance out of illiquid assets. Also, remember that liquidity is critical for meeting member benefits as well as supporting hedging strategies. A suitable buffer should always be retained for ongoing cashflow needs.



Schemes with lower levels of liquid assets (e.g. only enough to cover a few percentage points rise in yields) may wish to consider either scaling back hedges – to limit the size and/or likelihood of future collateral calls – or consider a plan to realise their illiquid assets over time.

Think about the true underlying liquidity of your holdings, not just the fund's standard notification and settlement times. Investment funds that invest a significant proportion of their assets in less liquid sectors may restrict disinvestments or levy significant charges to schemes that do disinvest. A good example is a weekly dealt open-ended real estate fund. Such funds should not be considered as liquid, even though in ordinary market conditions it might be possible to realise them at a few days' notice.

Were hedges (both liability and currency) maintained?

Any hedging relies on the implicit use of leverage and, whenever there is the combination of leverage and extreme volatility, there is the possibility that investors become forced to unwind hedges. In our experience most schemes successfully maintained all their hedging strategies throughout, but some schemes missed collateral calls and some asset managers were forced to unwind hedges. Where this happened it probably did so following a rise in yields. Whilst most of the focus has been on liability hedges it is worth remembering that sterling also faced high volatility and so currency hedging strategies should be reviewed too.

If hedges were unwound then careful consideration should be given to whether/how they should be replaced. Take account of the latest funding estimate, current market conditions and your liquidity position. Otherwise, you may find that you become over-hedged, lock in a loss, or can no longer support the same hedging strategy as before.

Where hedges have been unwound and this has significantly affected the funding position, it is important for trustees to understand why this happened. Trustees should seek to understand whether their managers acted appropriately in doing so.

Even where hedges were maintained, remember that most hedging strategies were not designed with such large movements in yields in mind. Generally, hedging strategies have been calibrated to hedge against much smaller movements in yields. It could therefore be the case that hedge ratios have drifted from target. Reviewing hedge ratios and liability benchmarks against an up-to-date estimate of the liabilities would be wise.

Understand the asset allocation

The huge rise in yields will mean matching assets have underperformed growth assets, potentially very significantly. Furthermore, many LDI managers have strategically reduced their target leverage levels, meaning more money is now invested in LDI funds than previously would have been the case for any given level of hedging.

Most, but not all, schemes will have become overweight growth assets. Not only does this likely mean available collateral to cover any leverage in the matching assets may be low, it also means the scheme is likely to be running an excess amount of funding level risk from volatile growth assets. Schemes should consider whether to rebalance growth assets back to target weights, or whether more amendments to strategy are required.

Market outlook

Gilts

There could be, in our view, an emerging structural supply/demand imbalance in the ultra-long end of the UK gilt market. This is because UK pension schemes have been the primary buyers of long-dated gilts for many years and the average pension scheme now has a high hedge ratio.

We believe there may be reduced demand from pension schemes for long-dated gilts going forwards. Ultra-long gilts (i.e. 30-years and above) may struggle to find support.

Yields may rise further as the Bank of England continues to raise interest rates and commences its quantitative tightening programme. On the other hand, there may be downward pressure on yields as recessionary fears bite.

Overall, we expect yields to remain at heightened levels of volatility for the foreseeable future.

Credit

In some parts of the credit market, spreads have widened considerably in recent weeks. This can be explained by global recessionary pressures increasing the risk of default and, in the Sterling market especially, by selling pressures from UK pension schemes to raise cash. However, there are arguments why it may be a good time to buy credit. Credit spreads do tend to mean-revert, and spreads are currently above their long-term historical averages. Long-term investors who can take the risk that credit spreads may worsen further, before improving, may take the view that now is a good time to begin phasing in an increased allocation to credit.

Illiquids

The illiquidity premium is likely to rise. For those that can take illiquidity risk the rewards may improve. This is because many investors' capacity to take illiquidity risk has significantly diminished. There may be good opportunities on the secondary market especially.

Equities

Higher rates and higher inflation, as well as recessionary pressures, may continue to weigh on equity markets.

We are also in a period where equity style is almost as important as total equity exposure. Growth stocks (i.e. those with lower short-term profitability but higher long-term profitability potential) may continue to underperform if rates rise further. Schemes should understand any underlying style biases in their equity portfolios, especially where their investment time horizon may be contracting.

Refining the strategy

Schemes should review their investment strategies, even those whose funding level has been relatively flat.

Can we de-risk?

There may be opportunities to de-risk further, especially for schemes whose funding positions improved. But, even for those where the funding position is broadly unchanged, the recovery plan may now be expected to bring the scheme into surplus, given the deficit will have fallen in pound terms.

Where schemes are targeting buy-out they may now be much closer, or possibly even fully funded. The deficit may now be well within "cheque writing distance."

De-risking could be as simple as selling down growth assets and reducing LDI leverage. It may also include adopting a cashflow matching approach using fixed income assets (i.e. a mix of gilts and credit without leverage). Consideration should also be given to the target actuarial basis for hedging strategies.

What are the implications of new lower LDI leverage levels?

Most LDI pooled fund managers have lowered their target leverage levels in order to make their funds more resilient to volatility going forwards. This has several key implications, as discussed below.

Schemes that continue to use leveraged LDI will find that they need a greater percentage allocation to LDI funds in order to target any given level of hedging. This means less assets will be available to invest in other areas and will, in many cases, mean that either hedging or expected returns (or both) will need to be scaled back.

> It is also important to question whether the new leverage levels are low enough. Whenever there is leverage, there are associated risks, and whilst lowering these leverage levels will mean these risks are reduced, they will not be eliminated.

Trustees should be comfortable that the new leverage levels are suitably conservative to withstand the higher levels of volatility we expect to see going forwards. Our LDI research team is working through this with the LDI managers currently. Note that holding cash alongside a leveraged LDI fund does not immunise the scheme against the risks of using leverage; it may be that the LDI fund itself is forced to sell assets before it is able to draw down that cash.

Has the balance between asset/liability mismatch risk and leverage-related risks changed?

The use of leverage in LDI strategies allows schemes to manage down asset/liability risk at the cost of bearing the risks related to leverage. Clearly, the recent events have highlighted leverage-related risks. It would be prudent to reconsider the balance of these risks. Removing all leverage eliminates leverage-related risks but will usually come at the cost of forcing the scheme to take more asset/liability mismatch risks or reducing expected returns. Hedging all liabilities with leverage minimises asset/liability mismatch risk but means taking a significant degree of leverage-related risks.

There is a balance to be struck between these risks, and we think that balance has likely changed. This is an argument to reduce hedge levels that are obtained through leverage.

Does the liquidity buffer and collateral waterfall need reviewing?

In a volatile market there remains the possibility of receiving large capital calls to de-lever LDI funds. Where leveraged LDI remains a key part of the strategy it is important to be confident that capital calls can be met. If not, then hedges may be unwound immediately after a rise in yields (i.e. gilts will be sold within the LDI fund at relatively low prices). This opens the scheme up to the risk that yields drop back, but with the scheme having a lower hedging level (i.e. "whipsaw risk"). It is therefore critical to consider how much cash could be required and how quickly it could be provided. Collateral waterfalls may need reviewing.

Is it appropriate to leverage over illiquid assets?

Leveraging over illiquid assets poses the risk that yields rise significantly, to the extent that the losses on the hedge consume all liquid assets. In this scenario either hedges would then need to be unwound, exposing the scheme to the risk that yields fell back down, or illiquid assets would need to be sold in advance, potentially in a "firesale" if yields rose quickly.

Care therefore needs to be taken over the extent to which hedges are overlaid onto illiquid assets. The best way to do this is by considering the yield level at which the scheme's liquidity level is likely to become problematic. A view can then be formed as to its likelihood. For example, if this only becomes a problem if yields reach 25% pa then it is probably an acceptable risk, whereas if it becomes a problem if yields rise another 2-3% pa then it would probably be inappropriate.

What about partial buy-ins?

Many schemes have a plan to execute a partial buy-in at some point; that is, to buy a bulk annuity policy covering a subset of members as an investment.

The heightened volatility environment and the changes to LDI fund leverage levels may have affected the strategic rationale for this plan. Specifically, lower leverage levels in LDI funds may mean that a buy-in makes it harder to maintain the same liability hedge as before (as the assets that would be used for the premium could otherwise be used to support a lightly leveraged liability hedge).

Furthermore, a buy-in is an inherently illiquid asset and if other illiquid assets are now a more significant proportion of the whole, then the liquidity profile of the residual assets may now be considered insufficient. This will need to be reviewed on a case-by-case basis.

Are there new opportunities?

Whenever there is market disruption there are both opportunities and threats. Whilst the focus for most schemes has been on dealing with the threats, the sooner the opportunities can be considered the more likely schemes are to be able to capitalise. Some of the key opportunities that we are considering are:

- Increasing allocations to credit, especially sterling credit;
- Adding hedging at higher yields (although consider using unleveraged funds where possible);
- Buying illiquid assets, especially on the secondary market, where there's suitable capacity for illiquidity risk;
- Increasing currency hedge ratios on overseas assets to lock-in the cheap pound, especially against the US dollar; and
- Buying domestic equities, especially mid-cap and small-cap.

As with all opportunities created by market turmoil, be prepared for the possibility that things get cheaper before they recover.

For professional use only. The above is for information purposes only and should not be construed as investment advice.

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

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