



Investment Insights | May 2023

# Inflation and gilt yields: unravelling the risk and opportunity

Rising inflation, soaring gilt yields, and a dramatic fall in global equities were all seen towards the end of 2022. So how can pension investors adjust their portfolios to the market environment?





In October 2020, with Covid-19 lockdowns still in place across much of the world, UK CPI inflation stood at only 0.7%, the Bank of England (BoE) base rate had been stuck at 0.1% for several months and UK 15-year gilt yields averaged 0.61%, close to all-time lows.

Investors were concerned that negative interest rates were just around the corner, and governments continued to provide record breaking support measures to prevent the economy falling into deflation. This support and the low interest rate environment helped drive a strong recovery in equity markets from the low point of March 2020. By October 2020, equity markets had already reached new all-time highs.

## Adapting to changing market conditions

Only two years later, UK inflation would reach a more than 40-year high of 11.1%, the BoE was on the cusp of raising rates to 3% (base rates were 4.25% at the time of writing this note) and 15-year gilt yields had soared to 4.8%, their highest level in nearly 15 years. A similar story can be told of almost every developing country and, as a result, global equities had fallen nearly 20% from their peak.

Most investment portfolios were not built for this economic environment. This briefing focusses on how investors may look to adjust their investment portfolios to the changing market environment.





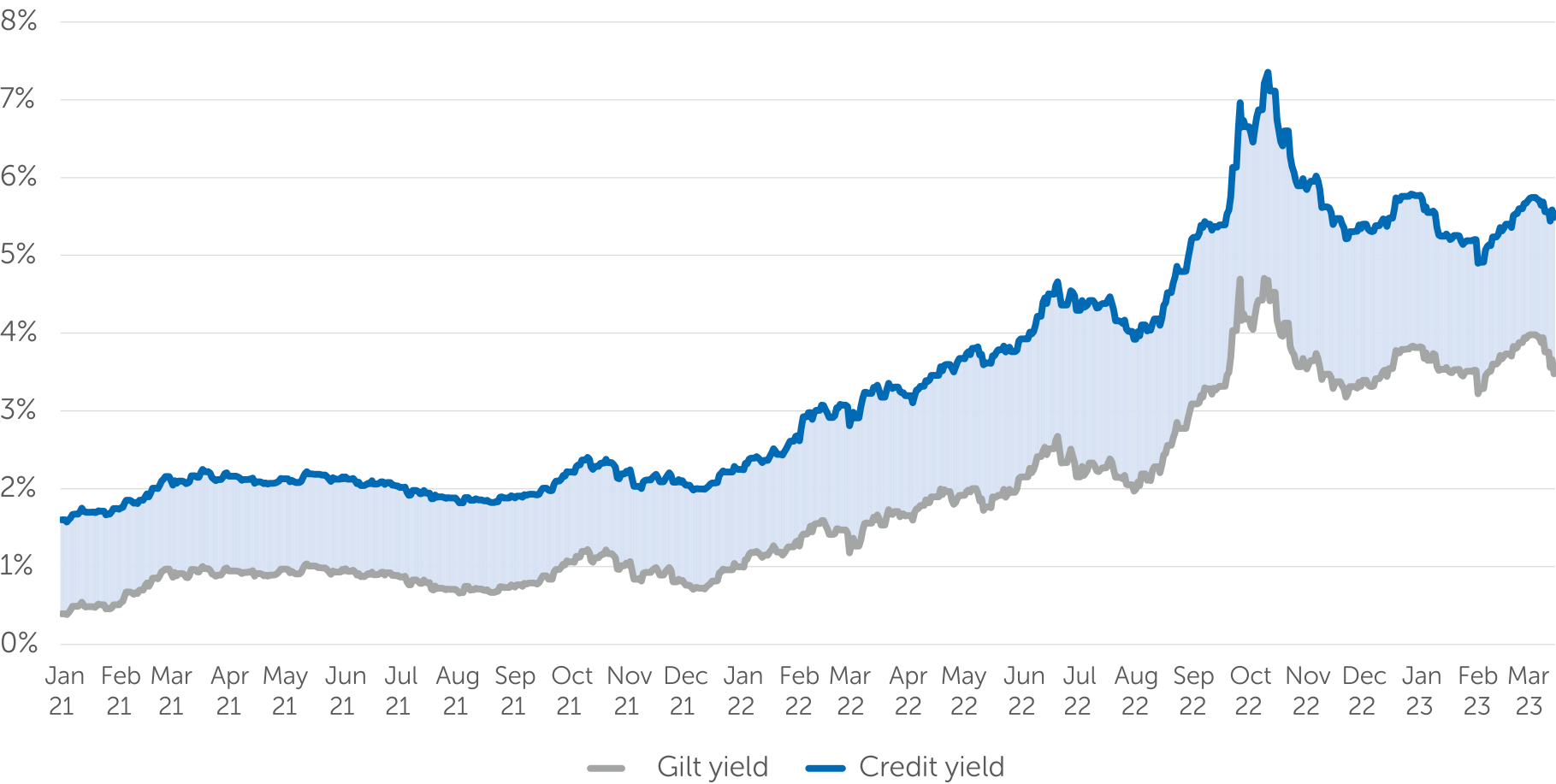
# Markets – where do we go from here?

Rising inflation and the resulting increases in base rates and gilt yields led to difficult conditions for nearly all asset classes over 2022. Global equities fell 16% and UK bonds fell over 20% as credit spreads (i.e., the excess yield on bonds issued by businesses relative to those issues by the UK Government) widened considerably.

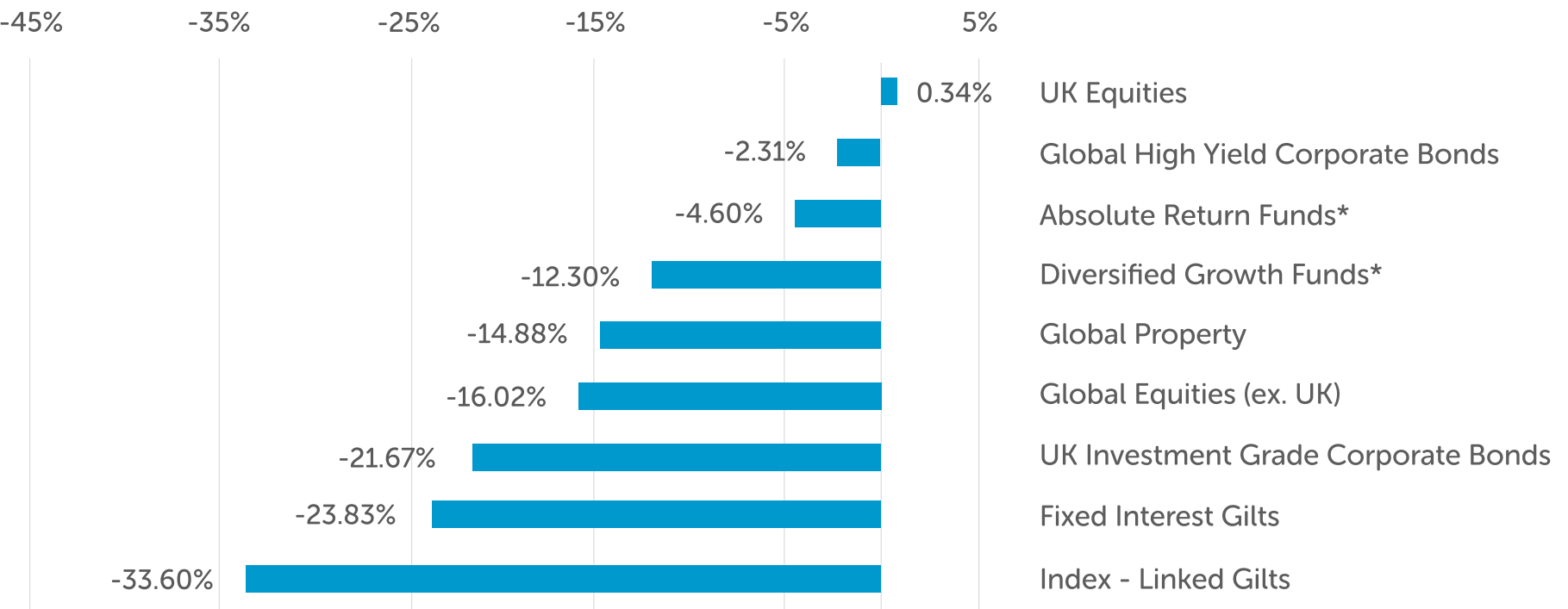
But what does this change to the backdrop mean for investors going forward? Below are what we think are the most important implications for our clients.

1. A return to a higher inflation and higher interest rate market environment will mean that riskier asset classes must offer a greater yield or premium to compensate investors.
2. Continued elevated spreads in high-rated corporate bonds may offer an opportunity for investors to reduce the level of credit risk in their portfolios.
3. Similarly, higher premiums on publicly listed assets mean investors may be able to achieve return objectives without needing the illiquidity and complexity premiums from private markets.
4. Asset valuations will be volatile in the short-term (over the next one to two years) as investors are overly sensitive to new macroeconomic information, and the increases to base rates start to feed through into economies. In addition, there are uncertainties over recessions, and the outlook for inflation remains high.

iBoxx corporates credit yield and spread



Returns of various asset classes over 2022

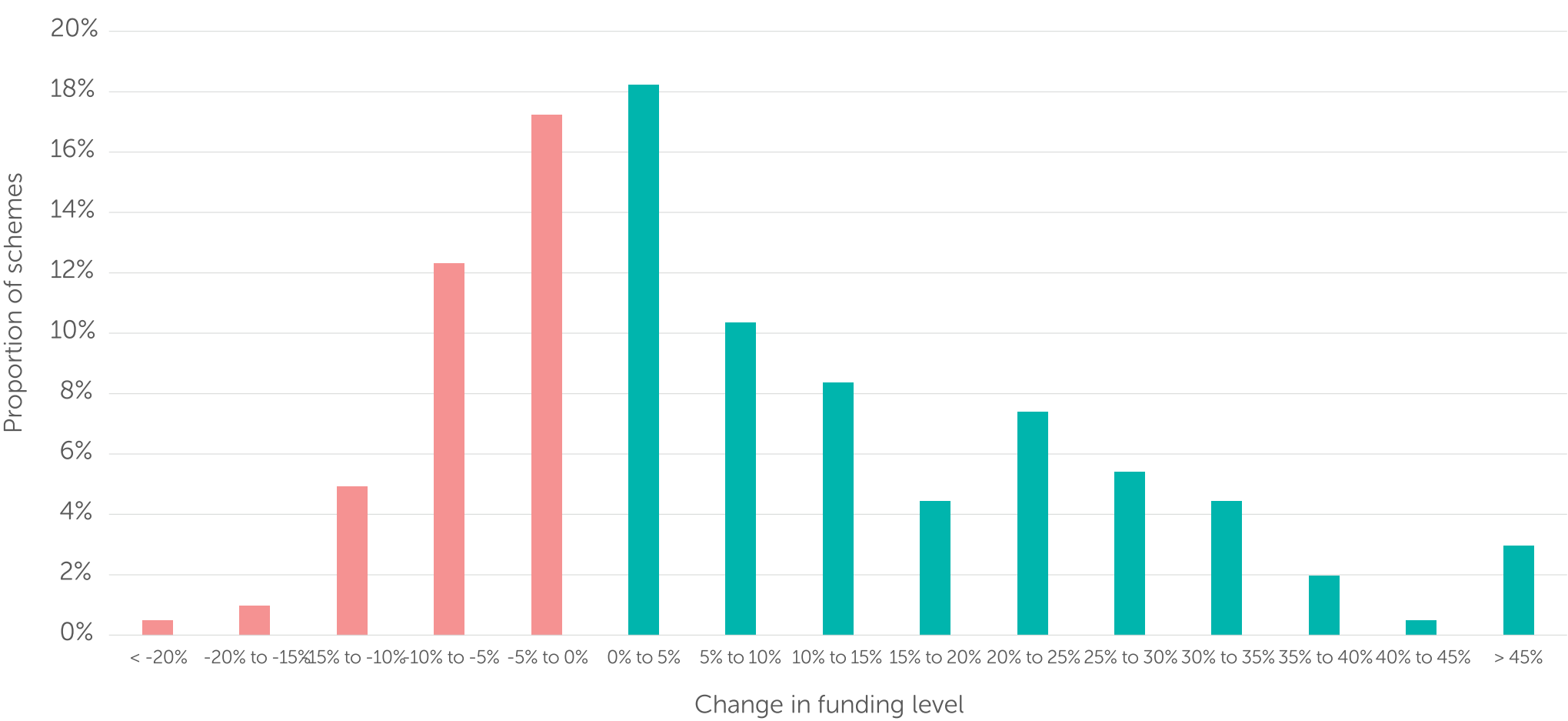


\*Figure shown is the median performance of that particular stlye of investment manager BW monitor

# Investors with defined benefit liabilities

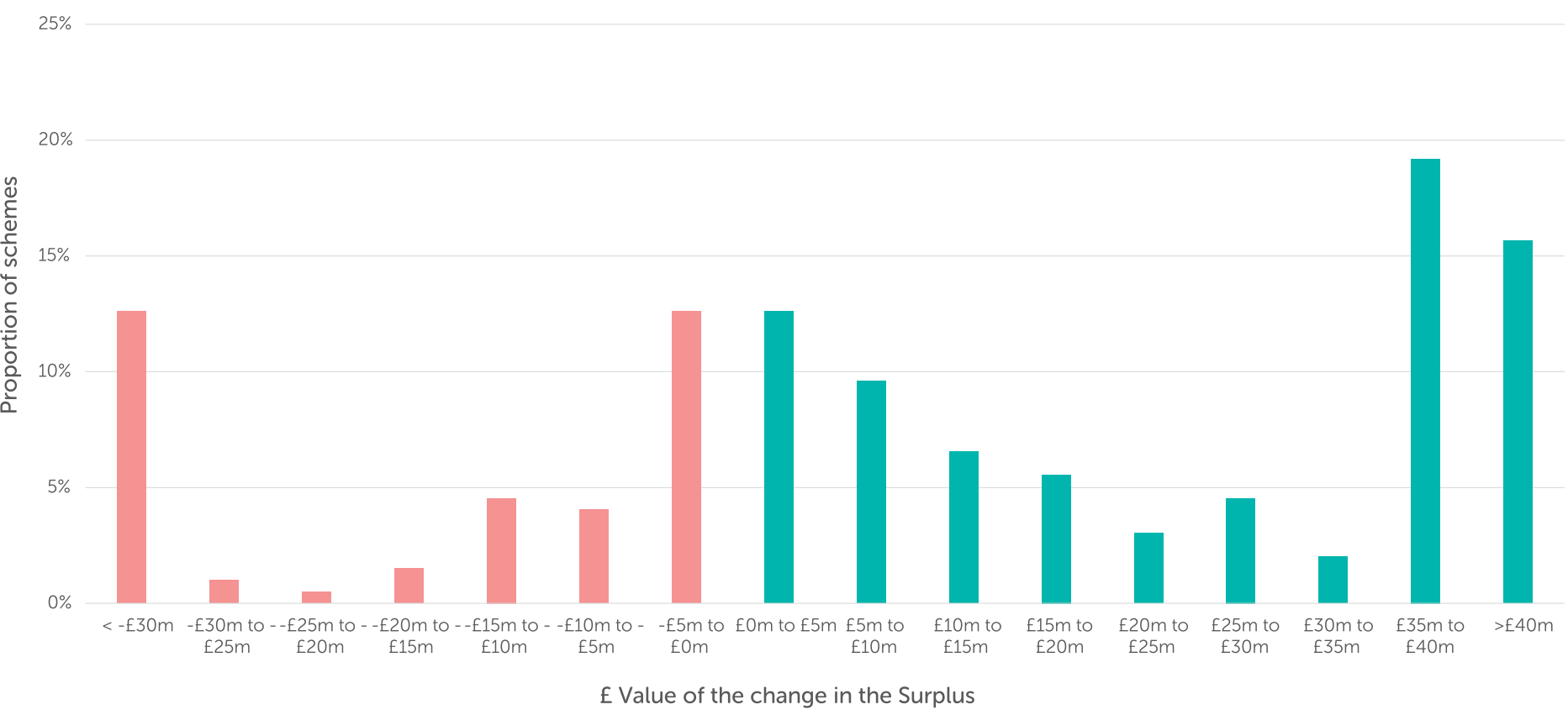
Over 2022, the yield on a 15-year UK Government bond (gilt) increased by 2.6%. The net impact of the incredible shift in the macroeconomic environment on DB investors has been varied, depending predominantly on hedging positions and exposure to growth assets. For most schemes the impact of the rise in gilt yields on the value of their liabilities has more than offset losses on assets. As such, in general, we have seen an improvement in funding levels for the DB schemes that we monitor – 64% of schemes have seen an improvement in their funding position.

**Scheme Funding - Illustrative changes in funding levels  
(31 December 2021 to 31 December 2022)**



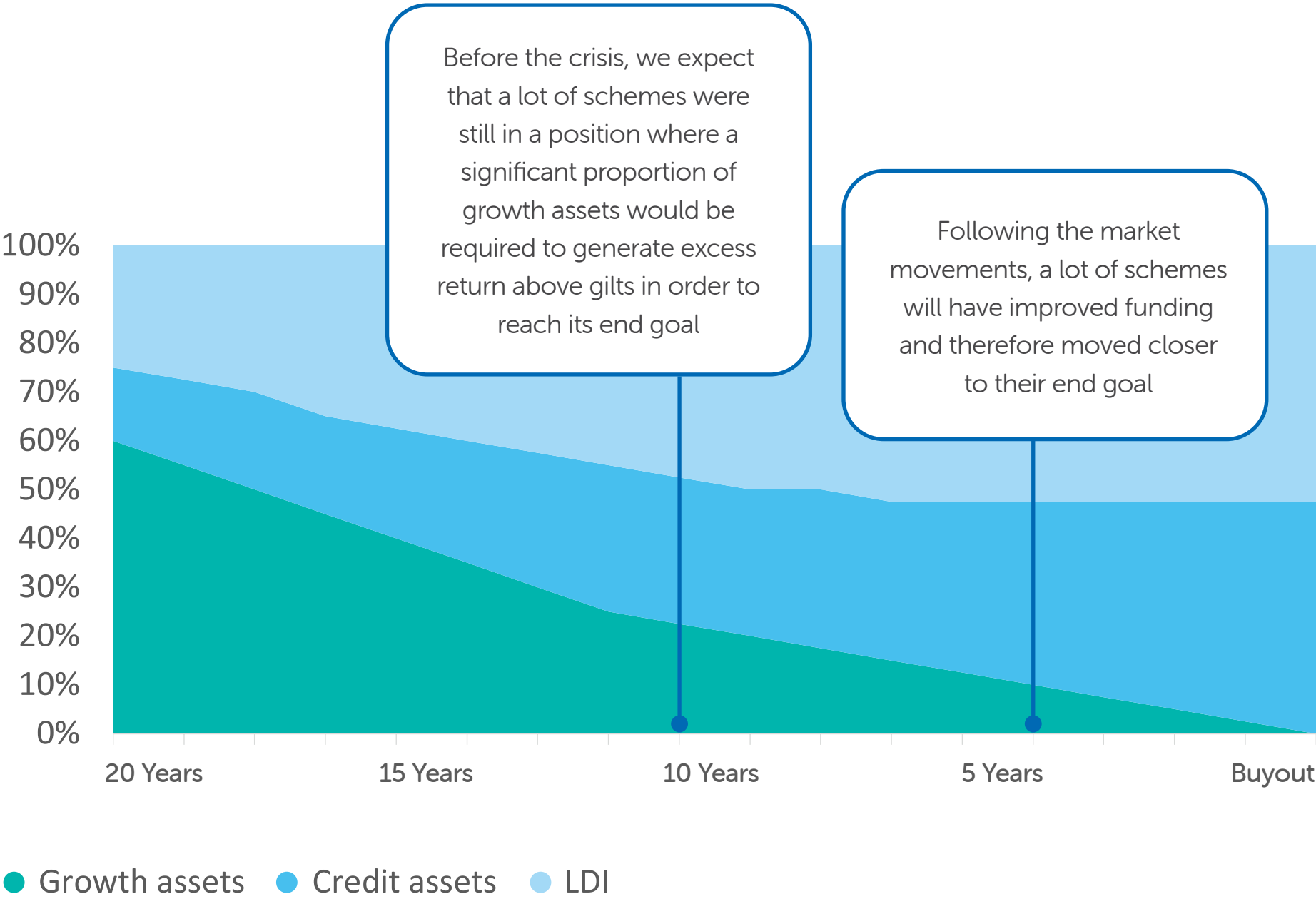
Source: Barnett Waddingham, Illuminate

**Scheme Funding - Illustrative changes in buyout deficit**



Whilst the impact on funding level may be uncertain, there are a few things below that we can be sure of.

### Model journey plan



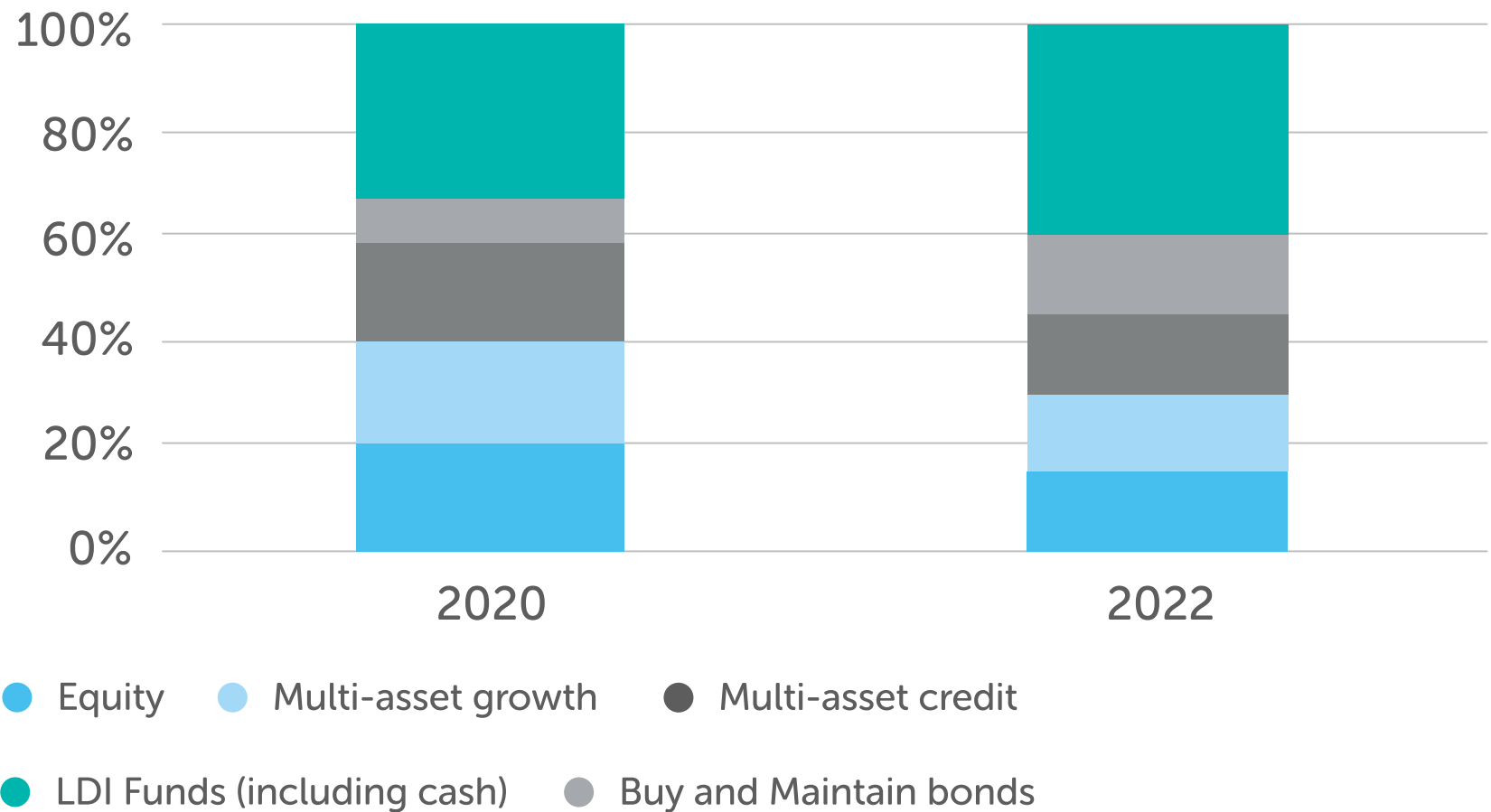
### The takeaway

For many schemes, these changes have implications on the returns required and the cashflow position. The reduction in the monetary size of the deficit has materially reduced the timeframe over which many schemes can target a buyout and/or the returns required to get there. In due course, it may also mean lower deficit reduction contributions, meaning trustees must generate more income from the investment portfolio sooner than expected.

These changes require a fundamental re-think of the investment strategy. At its core, this re-think should focus on your appetite for risk.

We expect most schemes to target less risk, since the timeframe for recovery following any adverse event is much shorter and because the size of the asset pool is smaller, relative to the pound amount of benefits being paid out.

The chart below illustrates how a DB investor might change their strategy to reflect the above. It compares the composition of a gilts+2% portfolio based on either 2020 or 2022 market conditions.



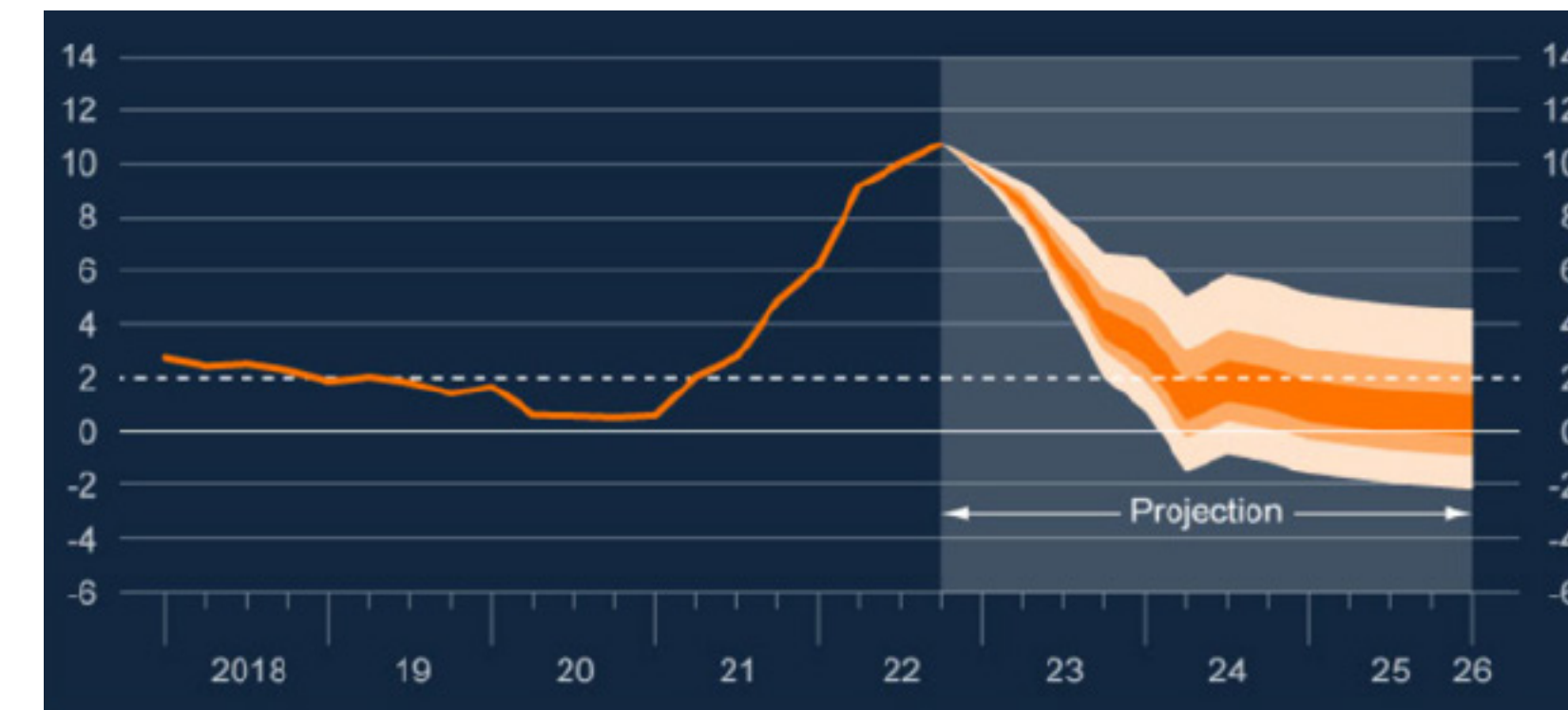
## Investors with inflation+ target

Long-term investors without defined liabilities typically aim to outperform inflation. The conundrum these investors face – whether defined contribution (DC) schemes, charities, endowments or family offices – is how to keep up with such an objective in an environment where inflation is in double digits. The pertinent question concerns whether it is necessary to take more investment risk.

There are two important observations to make. Firstly, it was not possible to generate returns in line with inflation in 2022 (see chart on page 3), without adopting a very high-risk strategy (such as one reliant on ‘short’ strategies or with huge concentration risk in individual companies/sectors).

Secondly, long-term investors should consider the bigger picture before changing portfolios based on short-term inflation movements. Many investors have outperformed inflation over longer backward-looking periods, and most central banks maintain a 2% target for inflation and will take steps to prevent inflation remaining as high as it has been. In fact, the BoE’s central forecast is for annual CPI to fall quickly over 2023, such that it is broadly in line with the 2% target by the end of the year, and most likely falling below the target in 2024 and beyond.

Percentage increase in prices on a year earlier



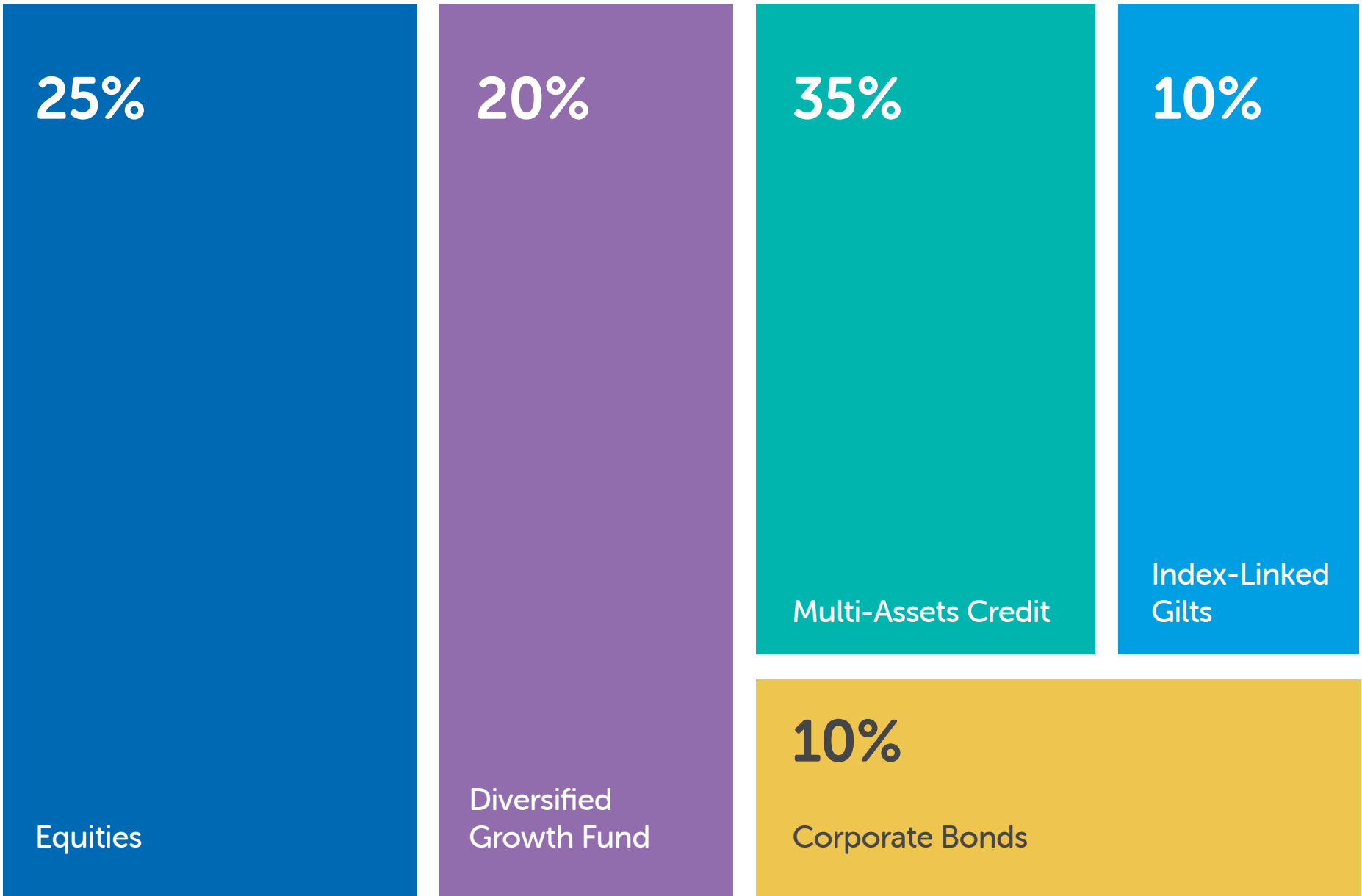
Source - BoE February report

As such, where you are truly focussed on the long term, the changing environment shouldn't lead to a major shift in the portfolio's composition.

There is, however, value in investigating the following.



The chart below illustrates a portfolio that targets a return of CPI by 4% p.a. over the long term (i.e., over ten years or more), factoring in the above opportunities.



Finally, we must bear in mind that objectives can change over time. For members of a DC pension scheme, their focus should move from achieving an ‘inflation plus’ return towards being ‘ready for retirement’ as they get older. What this means in practice depends on how members are expected to retire; for example, a drawdown route requires a different approach to annuity and cash routes.

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If members are targeting drawdown, schemes need to consider volatility carefully. Whatever approach is taken, the new outlook for credit markets is a key area to consider, along with the use of index-linked gilts which remain a key tool to limit the erosion of pot values by inflation. We were pleased to see TPR encouraging schemes to think carefully about how to support their DC members after the unprecedented moves last year (see the statement [here](#)).

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## Conclusion

A lot of our clients have become accustomed to thinking as long-term investors. For DB investors the rises in gilts over 2022 have meant timeframes for investing have come in dramatically, which will have a material impact on risk attitude. At the same time, the need for liquidity has increased and returns on some public markets and credit look attractive. When combined, this could mean it is sensible to make some significant changes to portfolio – reducing private market allocations and moving higher up the credit spectrum being just two.

For investors without defined liabilities who are looking to outperform inflation, be aware that some underperformance is to be expected in the short term. Look out for opportunities in credit markets and secondary private markets, but be wary of what’s under the bonnet.



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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