

# *Gilt market volatility – important actions to consider for DB Scheme investment strategies*

6 October 2022



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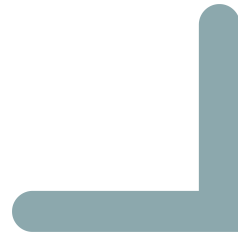
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*Gilt market volatility –  
important actions to  
consider for DB Scheme  
investment strategies*

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6 October 2022



*Introduction*



# *Agenda*

1. What has happened in gilt markets this year?

2. What might happen next?

3. What is LDI and how has it behaved?

4. What should schemes that use LDI do now?

5. What else needs considering?

6. Questions



*What has happened in gilt markets this year*



# Gilt markets 2022 to date, and general backdrop

*Inflation fears drive rising yields*

## Nominal gilt yield (20yr)

(Year to COB 5 October 2022)



## Real gilt yield (20yr)

(Year to COB 5 October 2022)



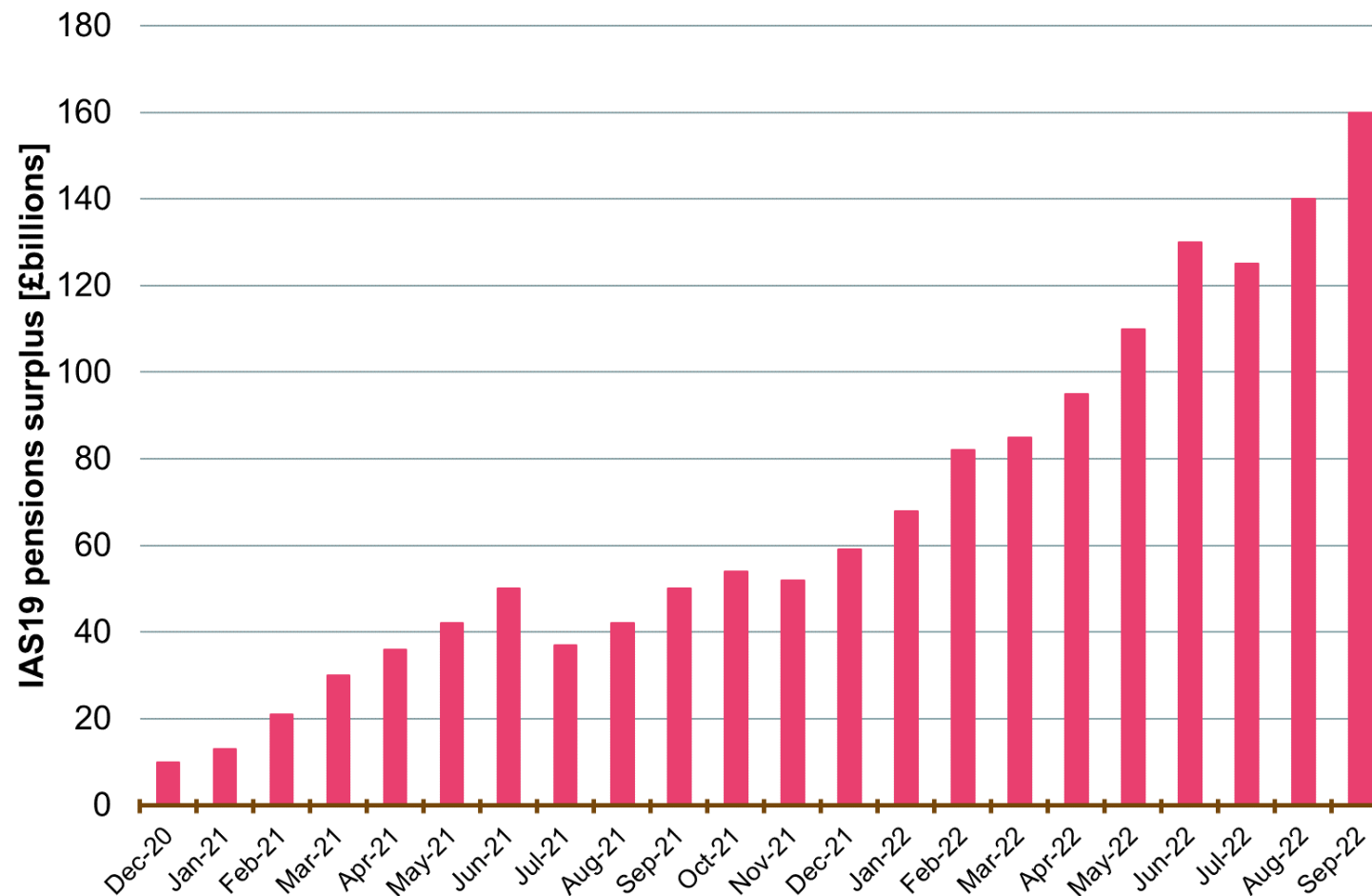
Inflation  
fears

Monetary  
Tightening

(Good for  
DB pension  
schemes)

# Most pension schemes much better funded

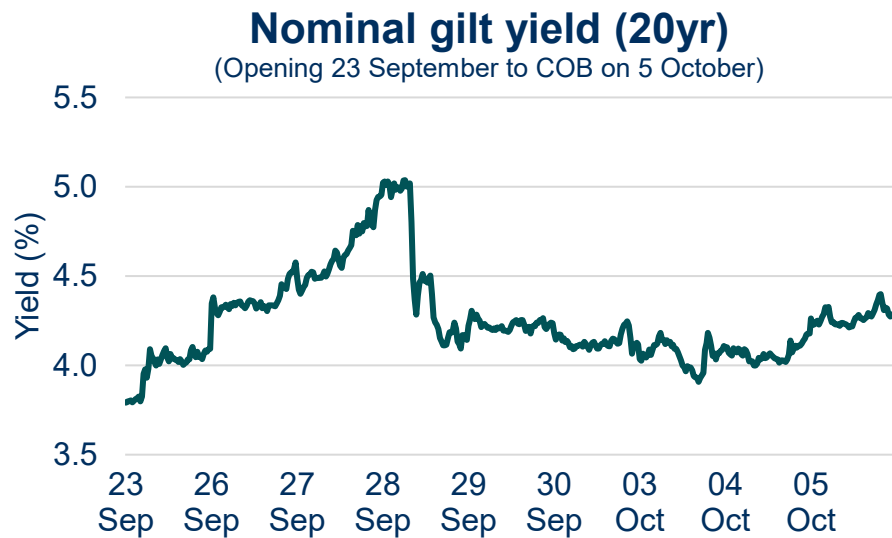
Aggregate accounting surplus of FTSE 100 company pension schemes  
(yes, this includes last week)



Source: LCP calculations

# Gilt market reaction to “mini” budget

*Not good, but dramatically stabilised by BoE on 28 September*



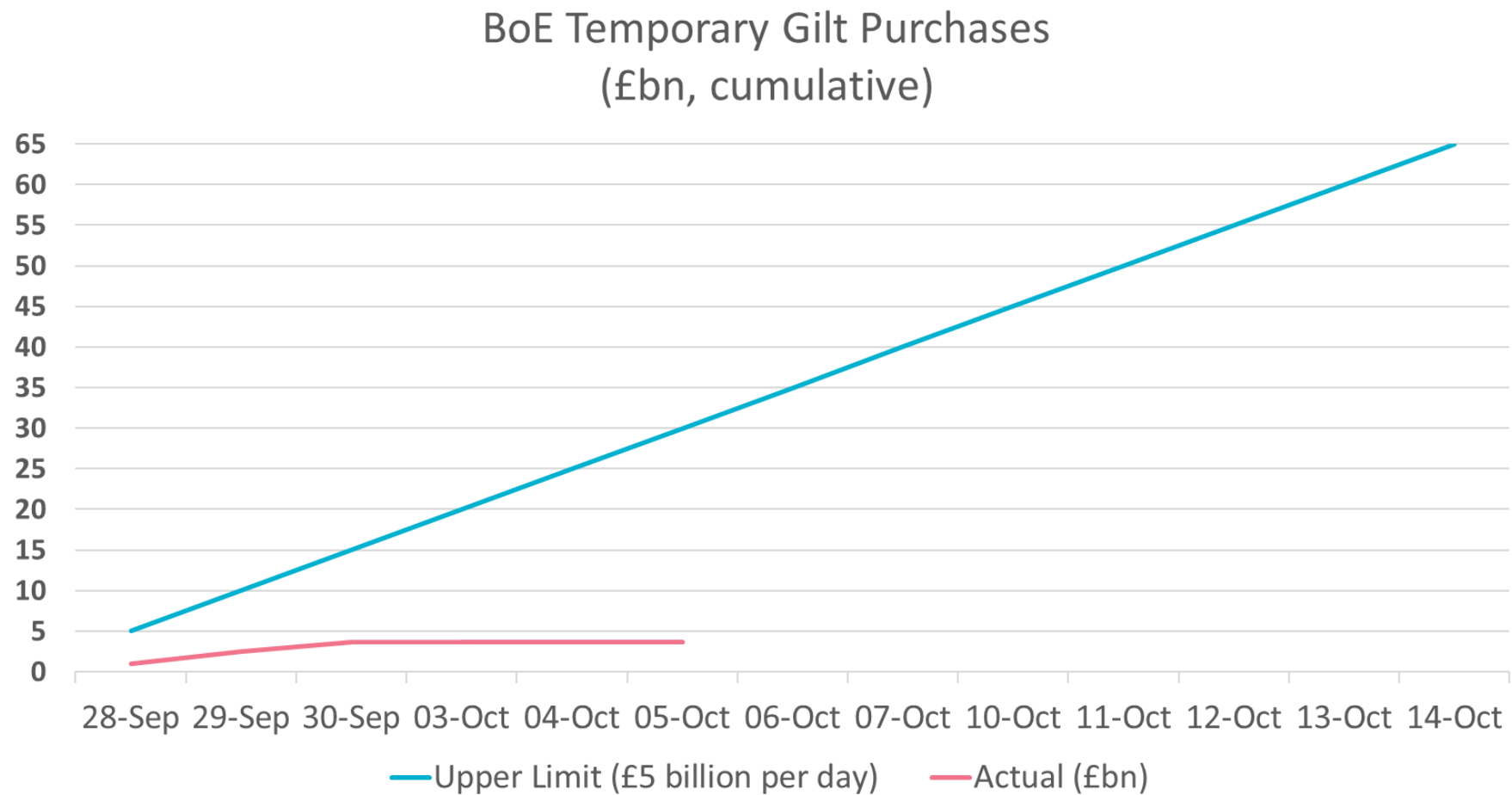
Unfunded promises

Concern as to due process

Unprecedented ?



# Bank of England intervention



Power of  
commitment

Limited action  
(so far)

Exit  
strategy?

## *Poll*

- Do you think the Bank of England support will end:
- on 14 October in an orderly way
- on 14 October in a disorderly way
- After 14 October: the Bank will be forced to extend support

## *Poll Results*

- Do you think the Bank of England support will end:
  - on 14 October in an orderly way – 34%
  - on 14 October in a disorderly way – 11.8%
  - After 14 October: the Bank will be forced to extend support – 54.2%



*What might happen next?*



# *A series of “50/50” events*

*Take a strong view at your caution*

Bank unwinds  
gilt market  
support –  
orderly reaction?

“Mini” budget  
proves politically  
acceptable?

Publication of  
OBR economic  
and fiscal  
forecast –  
brought forward  
to when?

Further back-  
tracks on “mini”  
budget?

Approach to  
spending cuts,  
and political  
reaction?

*...and don't forget everything else going on*

Inflation

Bank unwinds  
gilt market  
support –  
orderly reaction?

“Mini” budget  
proves politically  
acceptable?

Global interest  
rates

Brexit

Russia / Ukraine

Publication of  
OBR economic  
and fiscal  
forecast –  
brought forward  
to when?

Increased  
Government  
borrowing

Sterling

Further back-  
tracks on “mini”  
budget?

Approach to  
spending cuts,  
and political  
reaction?

Quantitative  
Tightening?



*What is LDI and how has it behaved?*



## *What is LDI?*

Pension liabilities (generally) measured against bonds.



Buying those bonds = stability.



But high-quality bonds are expensive.  
Can't also generate decent returns.



LDI allows Schemes to buy more high-quality bonds,  
AND retain healthy long-term growth.



Many schemes have achieved better funding levels, with much more stability,  
using LDI.



# What is LDI?

Pension liabilities (generally) measured against bonds.



Typical Scheme funding

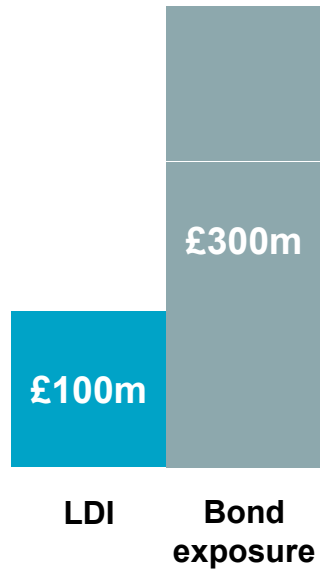
Accounting positions

Buyout targets

Alternative measures

# How does LDI work?

*The key is the use of leverage*

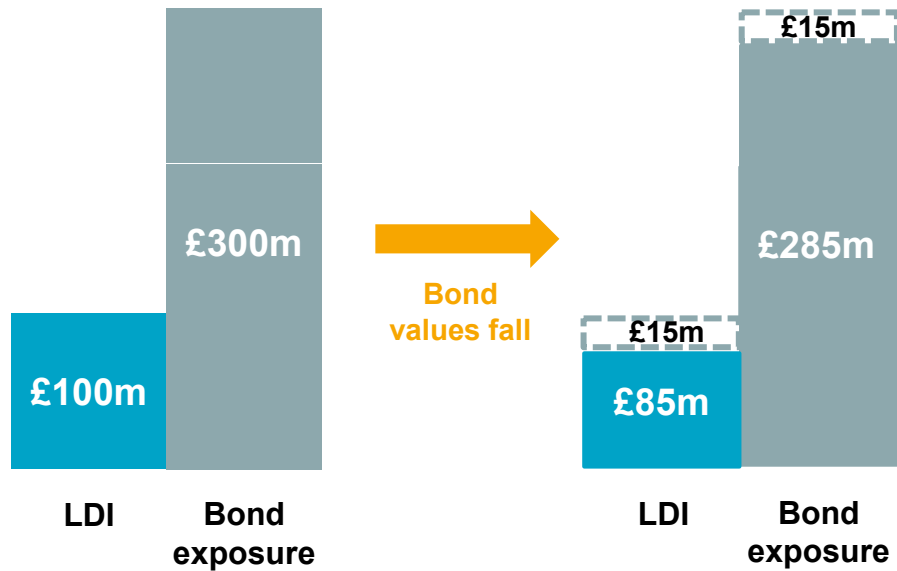


$$\text{Leverage} = \frac{300}{100} = 3x$$

Efficient risk management

# How does LDI work?

The key is the use of leverage



**Leverage**

$$\frac{300}{100} = 3x$$

**Leverage**

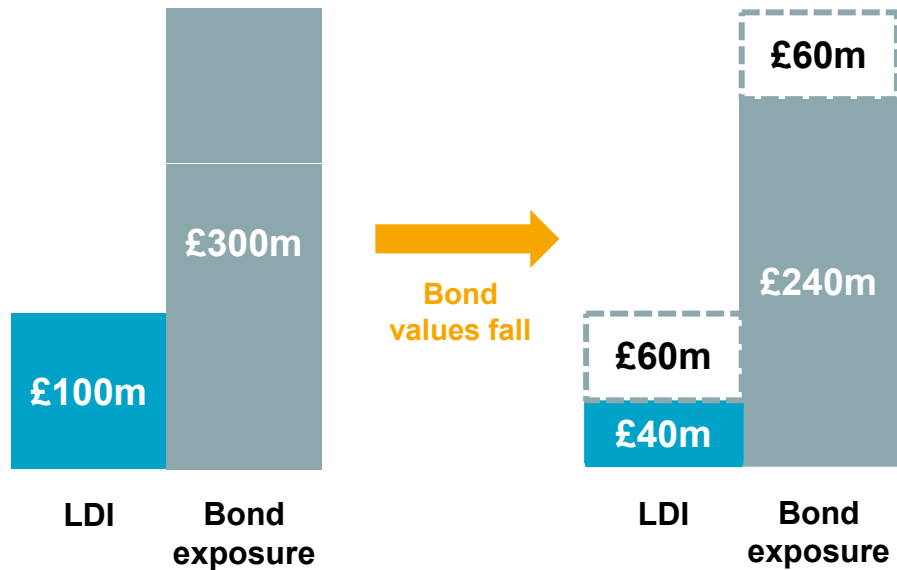
$$\frac{285}{85} = 3.35x$$

Efficient risk management

Leverage varies

# How does LDI work?

The key is the use of leverage



**Leverage**

$$\frac{300}{100} = 3x$$

**Leverage**

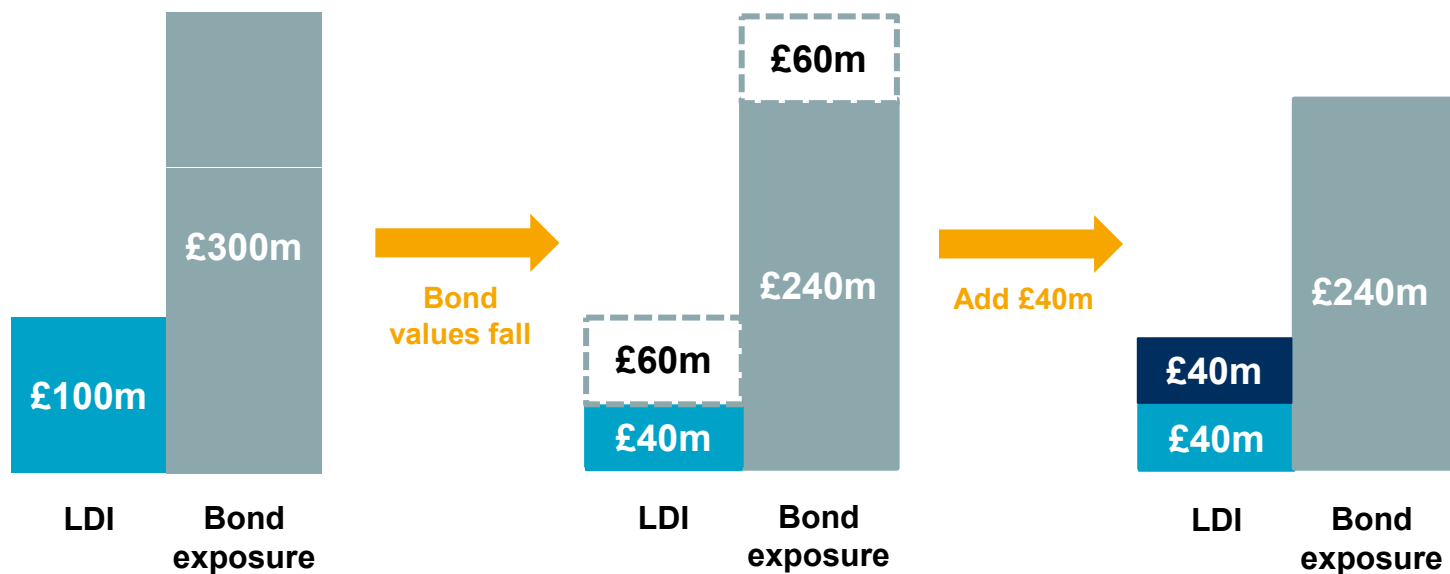
$$\frac{240}{40} = 6x$$

Efficient risk management

Leverage varies

# How does LDI work?

The key is the use of leverage



**Leverage**

$$\frac{300}{100} = 3x$$

**Leverage**

$$\frac{240}{40} = 6x$$

**Leverage**

$$\frac{240}{80} = 3x$$

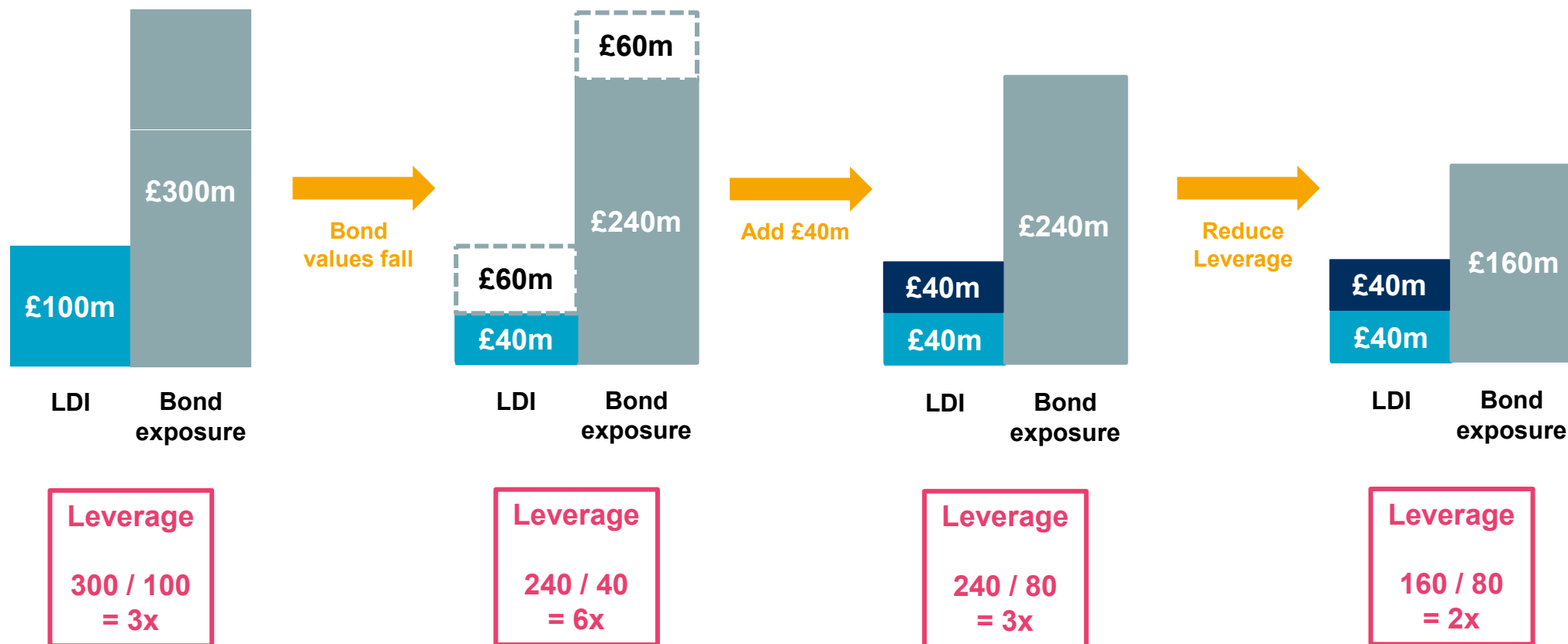
Efficient risk management

Leverage varies

Rebalancing processes

# How does LDI work?

The key is the use of leverage



Efficient risk management

Leverage varies

Rebalancing processes

New normal?



*What should schemes that  
use LDI do now?*



# A critical strategic decision to take

*Seek returns, or hedge risks?*

## Typical LDI strategy

Target returns: cash +2.5%  
Liability hedging: 100%  
Target LDI leverage: 3x

Before September 2022

After September 2022

## Option 1: prioritise returns

Target returns: cash +2.5%  
Liability hedging: 60%  
Target LDI leverage: 2x

## Option 2: prioritise hedging

Target returns: cash +1.5%  
Liability hedging: 100%  
Target LDI leverage: 2x





# *If you want to preserve liability hedging*

*Act quickly, and carefully*

Rebalancing

Wider asset  
liquidity

Hedging targets

Speed over  
precision?

Cashflow

Don't maintain at  
all costs!

# *Wider investment considerations*

*Act quickly, and carefully*

Currency

Credit market  
opportunities

Illiquid asset  
opportunities

Real assets

De-risking

## *Poll*

- Do you think LDI, possibly in a modified form, still has a role in pension scheme strategies?
- Yes
- No
- Don't know

## *Poll Results*

- Do you think LDI, possibly in a modified form, still has a role in pension scheme strategies?
- Yes – 89.1%
- No – 2%
- Don't know – 8.9%

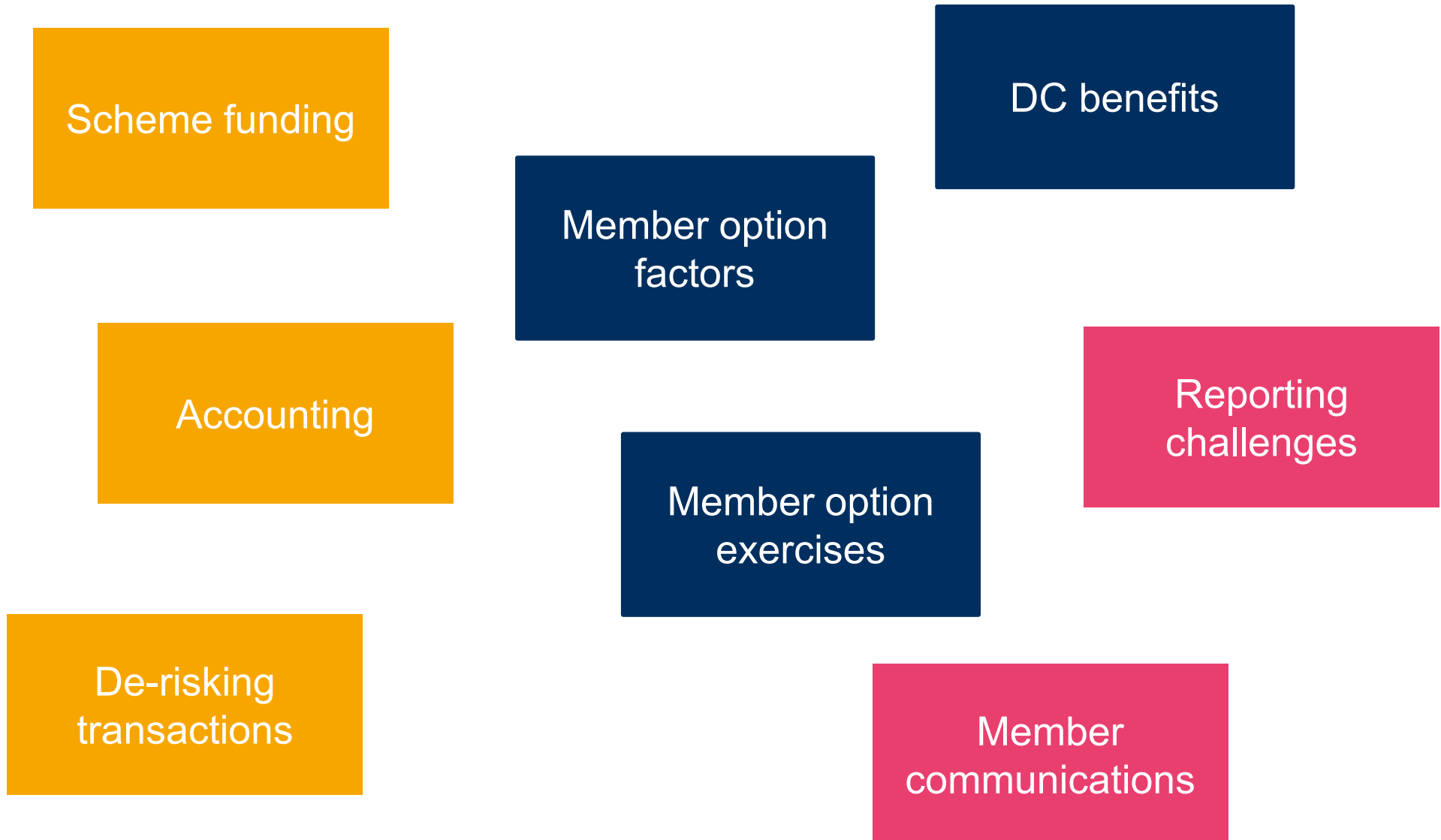


*What else needs  
considering?*



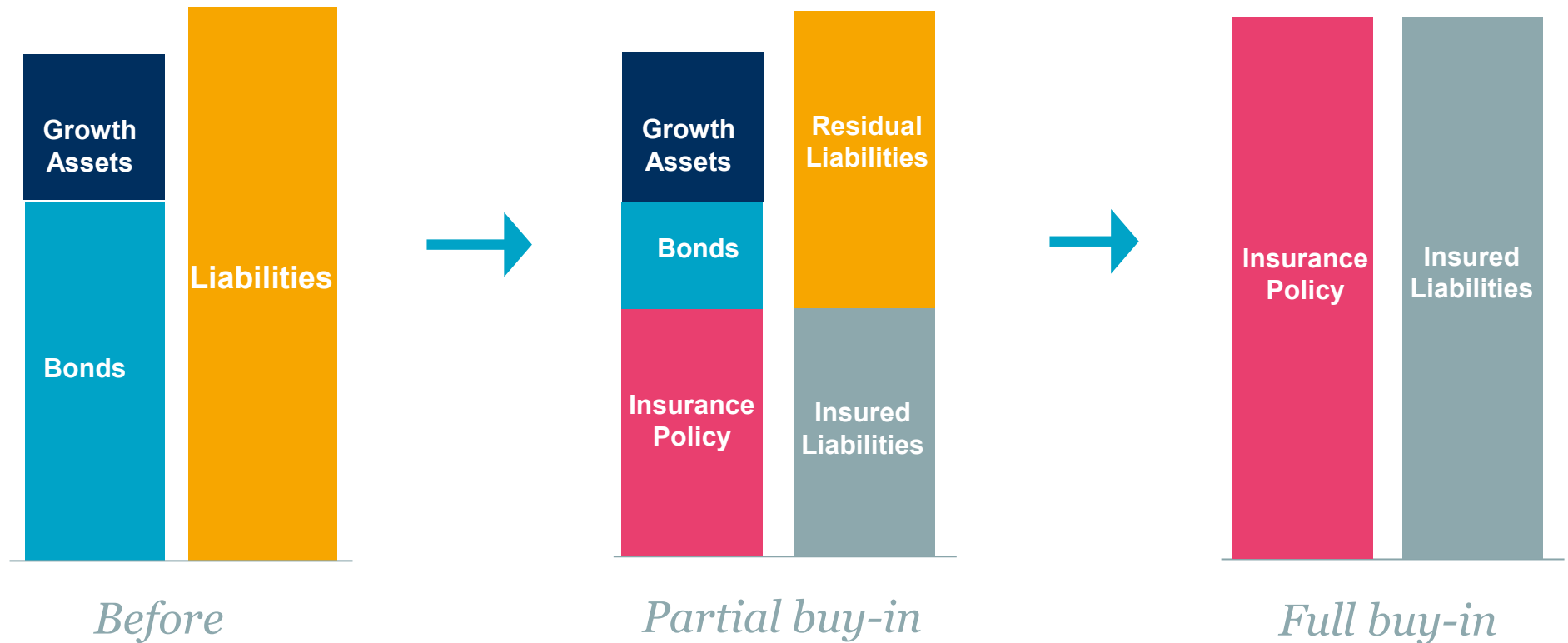
# Other matters to consider

*Much to work through, some more urgent than others*



# Overview of buy-ins and buy-outs

*Partial buy-in transactions need to consider liquidity constraints*



Increased liquidity constraints?

Potentially more affordable?

# *Questions & Answers*





## Takeaways and actions



Schemes with LDI need to take decisions 'in the eye of the storm'.



All schemes (and non-UK pension scheme investors) need to consider opportunities.



Once the dust has settled, review journey plans, funding and investment strategies (and lots else).

# Our team

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