momentum

Does your pension scheme have a clear framework for moving on from the gilts crisis?

Partnering with large institutional investors to help them achieve their goals

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Contents

Introduction

The gilts crisis in September and October 2022 resulted in an extreme "liquidity crunch" for many UK defined benefit pension schemes that had hedged liability-related risks using leveraged LDI.

The situation for many schemes has fundamentally shifted:

» The need to meet LDI collateral payments resulted in significant changes to investment portfolios, including the sale of liquid assets (such as corporate bonds) that many would view as forming part of the longer-term investment policy.

» The LDI industry has moved towards requiring a much larger pool of assets to be set aside in cash and gilts to meet potential collateral needs. This may mean that previous expected return targets can no longer be achieved.

» In some cases, significant improvements in funding positions mean that the timeframes to reach full funding on a low dependency basis or a solvency basis have come in considerably.

In light of these changes, now is the time for trustees to review whether their investment approach remains appropriate.

We believe that the key questions in the current environment are as follows:

1. Is the current objective still achievable?
2. What is an appropriate level of collateral resilience to target?
3. Are the cashflows covered and how should any surplus cashflow be reinvested?
4. Is the corporate bond allocation still fit for purpose?
5. What is the plan for dealing with illiquid assets?

We have developed a framework for our clients to address these challenges and have briefly summarised our approach in this short note.

Our Framework

STEP 1: Review your strategic objectives and key risks

STEP 2: Develop a collateral resilience framework

STEP 3: Review your cashflow position.

STEP 4: Re-think credit exposures

STEP 5: Have a plan for dealing with long-dated illiquid assets

STEP 1: *Review your strategic objectives and key risks*

We recommend that trustees review their current strategic objectives and time horizons to consider whether these remain appropriate. Most trustees will be required to think about this anyway as part of upcoming actuarial valuations once the new Funding Code comes into force (expected in October 2023), so getting a head start now would be worthwhile.

For some trustees, particularly those with lower levels of hedging, the long-term objective (such as low dependency or buyout) has moved a lot closer. On the other hand, many schemes need to accept a lower expected return than before the crisis (relative to gilts), with a greater part of the portfolio now required to be held in cash and gilts to support liability hedges in a world of lower leverage. Trustees should review what all these changes mean– some schemes are in a position to de-risk, while others need to accept that it may take longer to reach their objective than was previously anticipated.

Following the crisis, many trustees are asking the question "should we continue to use LDI?". Having considered this carefully, our answer in most cases is a resounding **"Yes!"** – albeit trustees will need to make sure that they have sufficient collateral to back this.

Gilts remain the primary risk-free asset to match liability obligations – given the long duration and inflation linkage of the liabilities. Pension schemes cannot afford to hold all their assets in gilts and LDI remains a useful tool in our view for managing liability risks and for managing the path to full funding. LDI facilitates a broader opportunity set for other assets (e.g. shorter maturity/floating rate assets). In the absence of LDI the focus would otherwise need to be on long duration, inflation linked assets which have historically been over-bid and are typically illiquid or an acceptance of far higher funding volatility over the period to achieving the objective.

The review should also challenge whether the long-term low risk portfolio previously identified remains appropriate. A key choice for many will be around how to hedge liabilities at that point (which should also inform the approach to hedging along the way):

	Advantages	Disadvantages
Hedge fully with leveraged LDI	» Accurate matching of liabilities	» Greater liquidity risks given use of leverage
Hedge fully with unleveraged, long-dated gilts (longer than the liabilities)	» Can achieve hedge without leverage	» "Curve risk", if medium- to long-term interest rates fall more than very long-term interest rates
Don't hedge fully	» Simple, and avoids leverage risk and curve risk	» Risk that interest rates fall

Our framework uses scenario analysis and stress testing to help trustees understand the balance of risks that are most appropriate to their circumstances. A simple Value at Risk analysis will not illustrate the dynamics at play here

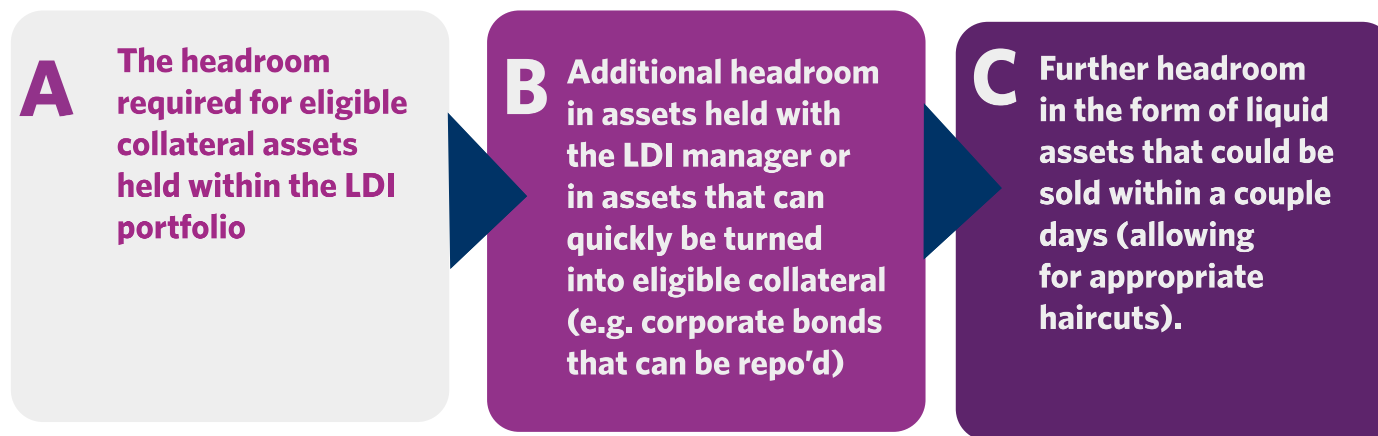
STEP 2: *Develop a collateral resilience framework*

Where trustees use leveraged LDI, it is critical to ensure that the scheme can withstand a significant spike in gilt yields. The consensus appears to have coalesced around holding eligible collateral assets (cash and gilts) sufficient to sustain a rise in yields of around 3%-5%.

Conditions have stabilised somewhat and systemic risk in the LDI sector has been significantly reduced due to reduced levels of leverage, and a better-informed Bank of England.

But schemes are by no means out of the woods yet. Gilt market technicals and liquidity remain very challenged, and there are plausible scenarios which could lead to renewed stress in gilt markets.

We continue to advise our clients to take a cautious stance and we would not view 5% of collateral resilience overall as being sufficiently "safe" to avoid potentially very bad outcomes. We have developed a collateral resilience framework for our clients based on three different yield rise thresholds:



We are reporting regularly to our clients on this basis and the framework is being used to guide key decisions on:

- The pace of increasing / rebuilding hedges
- The pace of adding back to high quality credit assets
- Preferences for physical investment grade corporate bonds / credit default swaps / asset-backed securities
- The need for any further asset sales / reinvestment of surplus cashflows

STEP 3: *Review your cashflow position*

Given the extent to which investment portfolios have changed, cashflow positions may be very different to what had been planned. We have helped our clients to assess their projected cashflow position over a ten-year time horizon to:

- Ensure cashflows are covered over the period until full funding has been achieved on a low dependency basis.
- Set up cashflow generating portfolios to plug any near-term shortfalls – rather than relying on the LDI portfolio as the "piggy bank".
- Consider options for accelerating the distribution of cashflows from the assets – e.g. moving segregated portfolios from an "evergreen" to a maturing approach.
- Develop a plan for reinvestment of any surplus cashflows – e.g. how quickly this would allow hedging to be increased.

Ilustrative client analysis based on data sourced from scheme actuary and investment managers.

STEP 4: *Re-think credit exposures*

Many schemes sold down holdings in investment grade corporate bonds and high-quality asset-backed securities to support their hedging programmes. We view these assets as being an important part of a long-term low risk portfolio and many investors will be looking to rebuild these allocations.

Now is a good time to re-assess the merits of different approaches to accessing credit spreads and to agree where to focus on rebuilding first.

Prior to the gilts crisis, the decision as to which credit assets to hold was largely based on achieving "credit spread" efficiently. Going forward there are additional considerations:

Impact on collateral

During the crisis, our clients benefited from the use of corporate bond repo as an efficient way of meeting collateral payments. This meant being able to release cash from corporate bond holdings using repo rather than selling assets (at an inopportune time). This would favour corporate bonds which are easier to repo than asset-backed securities.

Credit default swaps (CDS) typically provide a lower credit spread than physical corporate bonds but are "collateral efficient". With lower transaction costs than a physical approach, this is the least disruptive way to add credit spread exposure into portfolios whilst retaining high levels of collateral resilience. We have helped our clients to build buy & hold single name CDS portfolios to benefit from active security selection, but CDS indices are also available.

Contribution to hedging

Corporate bonds contribute to interest rate hedging, which is more important now that LDI leverage is lower. By contrast, CDS and asset-backed securities are floating rate assets that don't contribute to the hedge.

STEP 5: *Have a plan for dealing with long-dated illiquid assets*

Many pension schemes have benefited significantly from illiquid, private market assets (such as private debt and long lease property). These provide attractive predictable cashflows and have offered a better yield than could be achieved on public assets. However, percentage allocations to these illiquid assets have risen, as liquid assets were sold to meet LDI collateral calls.

Trustees should review what their target allocation is to illiquid assets (particularly where the time horizon has changed, as discussed under Step 1). If the ultimate objective is buyout, then the focus should increasingly be on liquid assets as you approach this goal.

- For schemes that expect to buy out in the next ten years, have a plan for selling down long-term illiquid assets such as property and infrastructure and start to monitor any secondary market opportunities. Closed-ended funds (such as private debt) will run off naturally over time but re-think any planned top-up commitments.
- For schemes planning to buy out in the next five years or so, consideration should also be given to growth asset allocations such as equities. These are long-term investments and five years is arguably too short a holding period.

Contact Us

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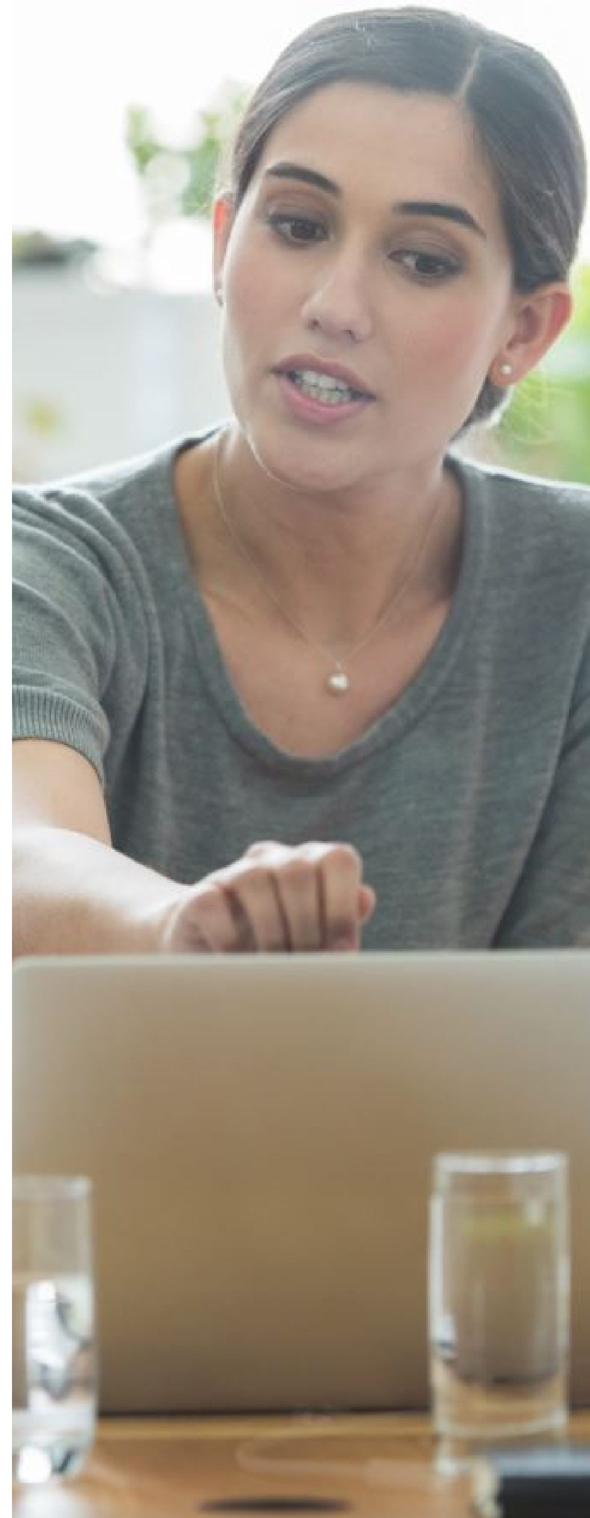

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