The Changing World Of LDI

The dynamics of the UK government bond market are changing dramatically, bringing significant implications for liability-driven investment strategies.

State Street's Jeremy Rideau and Van Lanschot Kempen's Nikesh Patel explored these issues at the Pensions and Lifetime Savings Association's conference in Manchester in October.

More than a year after liability-driven investment (LDI) strategies were thrown into turmoil by extraordinary gilt market volatility, defined benefit (DB) schemes are not yet out of the woods.

Industry experts speaking at the Pensions and Lifetime Savings Association (PLSA) annual conference in Manchester in October discussed several factors affecting UK government bond markets that could continue to cause issues for DB schemes for some time.

Jeremy Rideau, EMEA Head of LDI at State Street Global Advisors, outlined to delegates that the dynamics of the UK gilt market had changed fundamentally.

Then-chancellor Kwasi Kwarteng's radical 'mini-Budget', delivered in September 2022, sent sterling and gilt markets into a spiral and caused leveraged LDI strategies significant problems as schemes were forced to provide additional collateral, often at very short notice.

While volatility in the gilt market has fallen substantially, Rideau warned pension schemes they should still ensure they are prepared to handle a similar spike in volatility.

However, it is not just volatility that schemes should be monitoring, he added.

The Changing Nature of the Gilt Market

After 12 years of the Bank of England's quantitative easing programme — which involved the central bank buying £875bn worth of gilts between 2009 and 2021 according to official figures — the programme is now effectively in reverse.

"For a long time, the market got accustomed to the Bank of England purchasing a significant amount of gilts," Rideau said. "Now it is selling the gilts it bought as part of its quantitative easing programme — this is now quantitative tightening. The Debt Management Office [DMO] is also issuing new gilts into the market. We need to find the demand on the other side."

The Bank of England has been selling gilts back into the market since November 2022. As of the end of June this year, it had sold £26.5bn and planned to offload a further £7.1bn in the third quarter.[1]

The DMO, meanwhile, had issued more than £143bn worth of gilts (nominal value) since April this year as of 25 October 2023. It is expected to issue as much as £241bn by the end of the 2023–24 financial year.[2]

In addition, as Rideau explained at the PLSA conference, the current funding dynamic of UK private sector DB pension schemes is also playing a role in the gilt market.

According to the Pension Protection Fund's index of more than 5,100 private sector schemes, the aggregate funding level rose to 147.5% at the end of September 2023, representing a total surplus of £446.9bn over total liabilities.

As a result of this enviable position, many DB schemes are exploring insurance transactions including buyouts. Consultancy group LCP has estimated that the number of schemes approaching insurers for a buyout or buy-in quotation rose by 50% between 2022 and 2023 as trustee boards and sponsoring employers have sought to capitalise on improved funding levels.

As Rideau explained, when insurers take on new DB schemes, they often also become sellers of the gilts held by these schemes in order to adjust the portfolios to their own investment strategies.

This makes three major institutional sellers of UK government bonds — the Bank of England, the DMO, and insurance companies — and a changing landscape for one of the major traditional buyers, DB pension funds.

As Nikesh Patel, Chief Investment Officer at Van Lanschot Kempen, explained, international buyers may fill the demand gap to some extent, but this is unlikely to compensate for the other factors at play.

"If the government is no longer providing a credible fiscal policy, we are now reliant on overseas buyers looking at the relative value of gilts," he said. "They are not in any way going to favour the gilt market. If they see better value in European government bonds or US Treasuries, they will go there."

LDI's New Normal

All this means that pension funds employing LDI strategies need to address the potential for further volatility shocks in the government bond market.

Aside from reducing leverage — which most schemes and LDI managers have done — LDI users should look to review their management, State Street Global Advisors' Rideau said.

Trustees should ensure that they have an appropriate, robust collateral "waterfall" in place, Rideau said, which will give the pension fund access to the right amount of capital when needed.

"Rates have shown that they can be incredibly volatile, and this could happen again," he continued. "Don't be complacent and think lower leverage is the answer — it isn't. Leverage equals risk, and it will always remain that way."

Van Lanschot Kempen's Patel emphasised that the new era of LDI was "not just about improving what you have".

He continued: "We have decided that pooled LDI has a fundamental problem. Even if you make it as good as you can make it, it still leaves massive amounts of risk on the table — which is unnecessary — compared to a segregated solution. We have moved to segregated accounts for all of our clients."

This has allowed Van Lanschot Kempen and its clients to have more control over their LDI portfolios. As Patel explained, closer relationships and better data and technology has helped the fiduciary manager access LDI data in near-real time.

“We don’t want to be in a position in the future when there is a crisis and we can’t communicate to our clients exactly what their position is at the moment they call,” Patel said. “That is probably the biggest change [in the past 18 months], that openness and transparency of data.”

A New Approach to Collateral?

With the dynamics of the gilt market changing, Rideau suggested that trustee boards should look to diversify their sources of collateral to reduce the likelihood of a volatility spike significantly affecting their investment portfolios.

“All pension schemes for a long time have had diversified investment portfolios,” he said. “But how many of them choose to source their leverage from an asset class other than gilts? Most put all their eggs in one basket, so when the gilt market falls you have a problem.”

Diversifying sources of collateral to facilitate leverage was “relatively straightforward”, Rideau said. Schemes should consider equities as they can be “incredibly simple and liquid”, making them easy to use for leverage. US dollar and euro-denominated credit markets could also be an option for some schemes.

Rideau also warned against over-reliance on corporate bond repos as a source of collateral, as this is not a deep enough market to support large amounts of borrowing.

He added: “It’s a great idea, but from an operational standpoint and from a financial standpoint, it is very complex. It can be useful as an option in the toolkit for larger pension schemes, but it is not a systemic answer to sourcing collateral in times of need.”

Journey Plans: New Challenges and Solutions

One of the most positive side effects of recent gilt market movements has been the drastically improved funding positions of many DB schemes.

However, this has presented trustee boards with a new challenge. Journey plans have changed significantly as pension funds have found themselves hitting funding targets years ahead of schedule.

As Van Lanschot Kempen’s Patel detailed at the PLSA conference, this presents a significant problem for schemes that have invested in illiquid assets on the assumption that they have several years left before they need to cash them in.

“What could have been a buyout a long time away is now [achievable] within a year or two,” Patel explained. “Schemes are no longer holding these illiquid assets for a five-year period, they need to be able to get rid of them in one or two years.

“You need a rational and easily executed plan for illiquid assets. Can you monetise them? Can you sell them at a good price now or later? If you can sell them at a good price, start putting in place broker relationships to access that price.”

Preparing for the Next Shock

“I think we are starting from a far better place than where we were,” said Patel. “We have already got higher yields and we have withstood those. There is enough collateral headroom for another 350 basis points [of rate rises] from here, across most pension schemes.

“It would need to be a much bigger crisis than before to create as much damage [as last year], but it could certainly happen again.”

Rideau added that trustees should not be lulled into thinking that market movements of 20–40 basis points in a day are not possible more regularly in the future. He also emphasised that schemes need to be flexible and able to respond, in case the path of yields starts to change. Different economic outcomes, such as a recession or ‘soft landing’, could lead to a change in investor attitudes towards gilts relative to other markets.

Endnotes

1 Source: Speech by Dave Ramsden, deputy governor for markets and banking at the Bank of England, delivered on 19 July 2023. Link: https://bis.org/review/r230724a.pdf.

2 Source: Financial Times, ‘UK gilt market returns to normal as ‘idiot premium’ subsides’, published 17 April 2023. Link: https://ft.com/content/3e7cbab5-7ac1-450a-8bb3-26ca9ce6c456.

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* Pensions & Investments Research Center, as of December 31, 2022.
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