LDI unveiled

Zuhair Mohammed separates the fact from the fiction following the recent gilt crisis and considers what's next for the future of LDI

In the wake of last year's 'mini-budget' in the UK, the gilt market was thrown into a frenzy that lasted for weeks. The Bank of England's intervention to restore stability to markets has prompted a wave of scrutiny and speculation about the role of liability-driven Investments (LDI).

Many defined benefit (DB) pension scheme trustees and investors were left wondering whether LDI was still a viable strategy for reducing interest rate and inflation risks. During a time that bears more than a passing resemblance to the opening of the last century with a pandemic, war and recession and a potential banking crisis looming, market volatility and turbulence seem to be the new normal.

But who should be blamed for the upheaval – LDI fund managers, pension scheme trustees adopting risky strategies, investment consultants or others? As blame is assigned for the upheaval, it's clear that in the eye of the storm, all parties did what they could to protect pension members and corporate sponsors from harm. And, ultimately, most schemes are now better funded. So, what lessons can we learn from the recent market turmoil?

The history of DB liabilities and LDI

For over two decades, DB pension scheme liabilities have been largely priced as government bonds, acting as the reserve currency for those liabilities. Whether that's the right approach, is something that merits its own (lengthy) article. In summary, it centres on the timeframe over which the scheme's health is assessed and what the trustees consider success.

Irrespective of the timeframe over which the pension scheme's health is assessed, if trustees and sponsors ideally want to transfer the liabilities to an insurer, then gilt-based funding is an objective measure. It can be traded with insurers and protects against unscrupulous sponsors walking away from pension scheme obligations. If, alternatively, you want to maximise the chance of all pensions being paid over the long term, on a measure that has a low dependency on the sponsor, then a diverse portfolio of low-risk corporate bonds and hybrid assets with return-seeking and liability hedging characteristics play a much more important role.

Accounting rules and financial economic theories argued that pension liabilities are like bonds. This pushed pension scheme regulation away from expected investment returns towards a bond-based valuation approach for liabilities. Consequently, we should consider risk from the perspective of the gilt-based reserve currency.

LDI takes that gilt-based approach one step further because most pension schemes cannot afford to invest only in government bonds. They minimised their risk, to the gilt-based reserve currency, by adopting leverage in their LDI portfolio and investing the rest of their portfolio in return-seeking assets, such as equities, corporate bonds, property and private market assets. LDI performed well through other periods of market turmoil and volatility, such as the 2008 Global Financial Crisis (GFC), Brexit and Covid.

In the aftermath of the GFC, the low interest rate environment prompted some schemes to gear LDI portfolios and invest in multiple complex illiquid strategies, all in pursuit of the elusive 'illiquidity premium'. This complex approach was marketed as cutting-edge thinking and appealed to some trustees. But, it was financial over-engineering, just in a different way. As an advisory firm that builds transparent portfolios

and generally avoids complexity for the sake of it, these were challenging times as we'd often get feedback from potential clients that other portfolios looked more 'sophisticated'.

Sadly, it's the pension schemes that went into 2022 with highly leveraged portfolios and sometimes with over 30 per cent invested in assets that could not be readily sold. We often caution our pension scheme clients against having high allocations to illiquid assets because, in similar times to the gilt crisis, it reduces the opportunities available to them when they need to act quickly.

LDI 2.0

At the time of writing, we are waiting for further joint guidance from various regulators. This will determine minimum levels of collateral "headroom" that needs to sit inside pooled funds for them to operate robustly.

One of the challenges with the gilt crisis was the size and speed of yield movements. Early indications imply that we should expect a minimum of 300bps of yield headroom (i.e. how much gilt yields can rise before the funds run out of money), with some managers already insisting on something closer to 400bps. This reduces the leverage and increases the portion of assets that pension schemes need to allocate to LDI to achieve a specified hedge ratio. While we strive to mitigate the last market stress, we should be mindful of the potential unintended consequences that could lead to new risks.

If the collateral buffers in pooled LDI funds or bespoke mandates are set too high, they will effectively force some pension schemes to choose between reducing interest rate and inflation protection or reducing their return targets. This places more costs on the sponsor or forces trustees to adopt a more bar-belled asset strategy: Lots of money in the LDI portfolio, coupled with a smaller but riskier growth portfolio.

What are we advising trustees and schemes to do?

Clients frequently ask us what the key takeaways should be from last year's gilt crisis. Fundamentally the market wasn't built for movements so swift and big as what we experienced.

The one in 20 risk keeps happening more often than the one in 20! Thoughtfully prepared risk models simply cannot identify every source of risk. Take the latest banking 'crises' – who would have thought we could be faced with a second liquidity squeeze within six months, but it's possible.

If you conclude, as we do, that it's not always possible to identify sources of risk, then structure the portfolio to be transparent and avoid over-engineering as it makes the portfolio incredibly vulnerable when similar events occur. To be clear, we use leverage and derivatives in the portfolios we advise, but only to the extent that it is necessary, to achieve the sometimes-competing demands. Given the uncertainties and volatile market conditions that still persist, it's really important that portfolios are resilient and ready for the next surprise around the corner.

We are reminded of the KISS (keep it simple, stupid) saying. By doing exactly that, only very few of our pension clients got forced out of liability hedges. That compares to some other portfolios that we've seen, where clients have suffered a loss of hedge protection.

In the wake of the gilt crisis, The Pensions Regulator recommended ten practical steps for DB scheme trustees and their advisers to follow to ensure that they keep their LDI portfolios resilient. From ensuring governance is robust to requesting an assessment of the liquidity of the assets that the schemes intend to use to make cash requests, these questions are all common-sense and we would encourage trustees to ensure they get the answers.

Where next?

After the gilt crises, most DB pension schemes are better funded. The exception being those that were over-engineered. The well-funded schemes have many more options and are grappling with:

- Surplus management – whether to secure liabilities to an insurer or as some sponsors wish, to use it to fund their DC contributions, where they have a joint DB-DC trust.
- The mortality outlook – consider whether the members' mortality assumptions is appropriately allowed for in insurer pricing. That will determine the best time to transact with an insurer but also affects whether you need to hedge 100 per cent of liability cashflows that were based on previous mortality assumptions.
- Keep an open-mind on end-game options – there are some sponsors who do not like the idea of passing over 'profits' to insurers and would prefer low risk portfolios while they run off their pension schemes over the long term. Under the draft new funding code, there's greater scrutiny on the strength of sponsors' covenants, therefore this has become more important.

Conclusion

LDI may have been mis-used and misunderstood by some but it has its place in helping UK DB pension schemes to be resilient. Many schemes have benefited from improved funding levels, bringing them closer to their end-game scenarios. Debates about how to manage risk better have begun and all market participants continue to play a key role in keeping their eyes on the prize; that is maximising the chances that DB pension members can retire well with the benefits that they have been promised, without making sponsors go bust.

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