The pensions/gilts relationship

Summary
• Gilts and pensions go back a long way – they have an interdependent relationship, with pensions historically owning the bulk of gilts, and gilts historically making up a large proportion of schemes' asset allocations.
• The 2022 mini-Budget caused anything but mini problems, driving up yields and shaking up schemes to reveal vulnerabilities in the liability-driven investment practice.
• Prior to the crisis, allocations to gilts had already been slowing.
• These may yet slow further, as the shape of, especially DB, pensions continues to change.
• But the long-term relationship between gilts and pensions looks set to continue into the future, as gilts provide a useful hedging tool for pensions.

UK government bonds – or gilts – have long played an integral part in pension strategies. We look at the place they hold in today's evolving industry, and the effects of the 2022 gilt crisis on pensions

Back to bond basics
'Gilts' is the name given to UK government bonds. They are called gilts because they traditionally offer gold-standard security (the risk of default being vanishingly small), and because, once upon a time, they were printed on paper that was literally gilt-edged.

UK gilts are issued by the Debt Management Office (DMO) on behalf of HM Treasury and are listed on the London Stock Exchange. Like corporate and other government bonds, gilts are effectively a loan to the issuer; investors lend money to the government, and in return receive interest on their investment.

There are two kinds of UK gilts, conventional and index-linked. DMO defines the former as "a liability of the government under which it guarantees to pay the holder of the gilt a fixed cash payment (coupon) every six months until the maturity date, at which point the holder receives the final coupon payment and the return of the principal".

Index-linked gilts, on the other hand, offer "semi-annual coupon payments and the principal repayment are adjusted in line with the UK Retail Prices Index (RPI) with a lag". Coupons and the principal paid on redemption of index-linked gilts are adjusted to take into account inflation since the issuance of the gilt.

Gilts have long played an important part in pensions, and vice versa. According to Bloomberg Intelligence, just over 20 years ago, almost two-thirds (65 per cent) of all gilts were owned by pension schemes and insurers. However, as the shapes of pension schemes change and defined benefit (DB) schemes move towards their endgames, approaches are changing. Bloomberg Intelligence says the proportion of gilts owned by pensions has now fallen to below a quarter (24 per cent).

Mini-Budget, maxi impact
While gilts have long had a reputation for providing stability, the market faced a rocky patch in September 2022. The so-called mini-Budget announced under then (briefly) Prime Minister, Liz Truss, and her chancellor, Kwazi Kwarteng, shook the markets, provoking a run on sterling, along with dramatic volatility in the UK gilt market. Gilt yields soared, and pensions with liability-driven investment (LDI) portfolios felt the strain.

As a report by J.P. Morgan, published in May 2023, put it: "In less than three days in September 2022, 30-year UK gilt yields rose more than 1.60 per cent. For UK DB pension schemes, the size and unprecedented speed of this increase created a perfect storm – since these schemes typically manage their liquidity based on bond yields rising by 1 per cent over a period of a week or more."

Commenting on the events, J.P. Morgan's head of sales for trading services, Eileen Herlihy, said: "The magnitude of this market move went well beyond the contingency plans that most institutions had in place. They had to quickly generate appropriate collateral to meet sizable margin calls on interest rate swap and FX forward positions." Indeed, some schemes were even obliged to sell off gilts to generate that cash.

Reflection and restoration

If the 2022 crisis exposed a level of vulnerability in certain pensions schemes, it also led schemes to take a long and careful look at their situations, says Schroders head of LDI solutions management, Phil Howard. He says: "In the past 18 months, there's been a great deal of reflection on the LDI arrangements that schemes had in place during the gilts crisis, how these arrangements performed and whether they remain fit for purpose. This topic is polarising and the outcomes schemes experienced vary."

Long-term relationship

While the gilt market, and the economy as a whole, underwent an undeniably wobbly time in 2022, there has nonetheless been an element of stability to be found in the relationship between pensions and gilts. Short-term strategies may have called for a quick rethink, but in the longer term, there is still a firm place reserved for gilts in pension scheme strategies.

Columbia Threadneedle Investment managing director, head of solutions CPM, Simon Bentley, says: "The role of gilts has not materially changed within pension scheme investment strategies since the 2022 gilt crisis," In fact, he says: "They remain core to schemes' liability hedging strategies and with the increase in long-dated yields that occurred in the 12 months following the crisis, we have seen lots of schemes top-up hedging allocations to capitalise on both increased funding ratios and more attractive yields."

And while the Pension Protection Fund's *Purple Book* does show that allocation to gilts has fallen – according to the latest edition, DB holdings in gilts went down by around £230 billion from March 2020 and the same month in 2023 – this appears to be down to underperformance of gilts compared with other asset classes, because of their long duration profile and the increase in yields since the start of 2022.

> **"Gilts are likely to remain a core allocation for liability hedging reasons"**

Indeed, BlackRock head of EMEA LDI research, Phil Smith, says reductions in gilt allocations are "more a function of the mechanical performance effects". He adds: "We do see pension schemes increasingly de-risking from growth assets into spread generating assets such as corporate bonds and securitised assets, but typically this is not at the expense of gilts."

Gilt-edged future?

A combination of evolving needs, particularly for DB pensions, and shifts in UK gilt yields means that changes were already occurring before the big 2022 bump in the road. According to the Office for National Statistics (ONS), holdings in both long-term conventional and index-linked gilts fell by over 10 per cent for private and public sector DB and hybrid pension schemes from 31 March 2022 to 30 June 2022. Between March and September 2023, direct holdings in central government bonds and cash equivalents fell by £38 billion (10 per cent) and £9 billion (13 per cent) respectively.

Some anticipate that the flow of capital into gilts from UK pension schemes will continue to slow – arguing that those schemes that are already well-hedged have less of a need for them, while others may well be pursuing buyout. But there is also an expectation that the duration of gilts will shift, potentially creating greater appetite. In March, the DMO announced it would offer £265 billion in government bonds for the 2024/25, up from £232 billion in the 2023/34, the second highest issuance on record (the highest being during the pandemic), and the greater proportion of those are short and medium duration.

And, Bentley says, other industry movements might create a different emphasis for pensions, but fundamentally gilts will remain a useful, even essential, tool. "There has been a lot of talk of schemes shifting their long-term objective to 'run-on' to target a surplus which can be shared amongst stakeholders," he says. "Even if we see a meaningful industry shift in this direction, gilts are likely to remain a core allocation for liability hedging reasons. Where schemes target a surplus, we anticipate them retaining a high hedge ratio via gilts and/or swaps and seeking incremental excess returns in a risk-controlled manner through allocations to credit-like assets."

There may have been some rifts, and there may be more ahead, but it seems that pensions and gilts will continue to need each other. "Looking forward, we anticipate pension schemes maintaining high hedge levels and therefore gilts continuing to be a significant and core holding within pension portfolios," says Bentley.