Learning lessons from the 2022 liquidity crisis

The extreme volatility in gilt yields in the second half of 2022 will force trustees to re-examine their hedging programmes. CDI has been found wanting

From September to October 2022, inflation-linked gilt yields rose nearly 2 per cent, twice, each in the space of a week. This volatility was the result of an unprecedented sell-off by pension schemes who lacked liquidity to support their liability hedges after inflation sparked a wave of panic.

Markets have recovered, but the volatility has caused lasting impact to many schemes and forced trustees to re-evaluate their liability hedging programmes.

What went wrong?

Schemes that struggled in September and October generally combined too much leverage with too little liquidity in their matching portfolios. Many of these schemes moved a material proportion of their interest rate hedges out of gilts and into higher yielding, less liquid credit and infrastructure securities using an increasingly popular hedge framework known as cashflow-driven investing (CDI).

There is nothing inherently wrong with CDI: A fully-funded scheme with a hedgeable liability can take a literal approach to CDI and simply match bonds with future cashflows. Because everything is aligned, trustees can take comfort that interest rate risk is fully hedged and that assets are designed to become liquid at exactly the right time.

However, UK funding is more complicated:

- In general, UK pensions are well funded on a 'technical provisions' basis. To maintain this, scheme assets need to earn excess returns to keep pace with liabilities.
- UK liabilities are complex, most cannot be hedged with a static portfolio of bonds.

The dual objectives of full hedging and excess return generation have forced Trustees away from pure CDI into something much riskier. Moving out of gilts degrades the quality of the hedge and reduces liquidity, while adding leverage to create a full hedge ratio increases the need for liquidity – creating conflict.

Leverage, investment risk, and illiquidity have historically been a dangerous combination and schemes paid the price.

2022 crisis!

Interest rates had risen steadily throughout 2022 and the surge accelerated in late September. As yields rose, schemes began to accumulate losses on their matching portfolios. As losses mounted, schemes received cash demands on short notice, they were not prepared. Many schemes were forced out of their hedges to avoid insolvency.

Schemes with high hedge ratios and limited liquidity fared worst. CDI is not the only culprit in the crisis, but the tendency towards illiquidity in CDI portfolios caused significant problems.

What can we learn?

The recent crisis highlights weaknesses in typical matching portfolios:

- Cashflow matching ties up capital and leaves little room for growth assets or liquidity reserves
- Illiquid LDI can be prohibitively expensive to sell on short notice
- Leverage increases the potential need for additional liquidity
- Rebalancing cashflow-driven strategies can be a burden

Trustees will use the lessons from 2022 to review and strengthen hedging programmes. Schemes should take a hard look at their return-focused CDI programmes and consider expanding to a broader definition of liability hedging, which is commonly called liability-driven investing (or LDI). We highlight the key differences below:

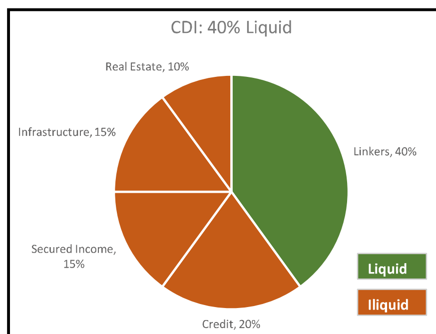
CDI	LDI
Seeks to meticulously buy a bond to match every cashflow	Aligns to the sensitivities of the liability as rates and inflation changes
Seeks to minimise the need for cashflow management	Willing to reinvest income or sell liquid assets if it makes economic sense to do so
Prioritises investments that provide both hedging and return generation	Separate growth assets from matching assets to improve the outcomes for both
Seeks returns from more risky and less liquid hedges	Hedge with liquid capital efficient gilts/ linkers and earn returns from a separate growth portfolio

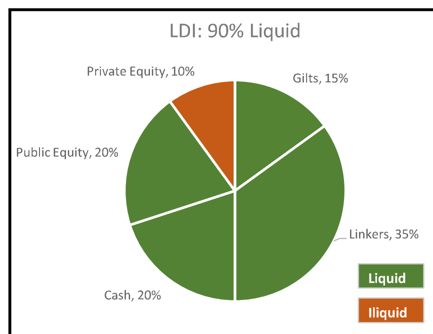
During the crisis, the most successful schemes had large pools of cash and significant additional liquidity buffers.

Strengths of full LDI

Fully utilising LDI requires more work and often works best with a fiduciary manager who has the tools to advise, oversee, and manage cashflows and hedge overlays. LDI captures most if not all of concepts behind and benefits of CDI while avoiding the blunt singular matching framework of just cashflow.

While the concepts are the same, LDI generally leads to significant differences in the asset allocation. Below is a comparison of typical portfolios in each framework:





In conclusion, comparing the two portfolios:

Link to liability: Both portfolios match the liability with bond-like investments linked to the maturity and indexation liabilities.	Tie
Precision: Inflation-linked gilts are more closely linked to indexed cashflows than infrastructure debt and a liquid bond portfolio can be rebalanced between gilts and linkers as inflation changes.	Winner: LDI
Return potential: Is higher for the LDI portfolio as excess returns can be sourced from anywhere and are not required to come from matching assets.	Winner: LDI
Liquidity: The LDI portfolio has more liquidity as all hedges are liquid, public market growth assets are more liquid than typical CDI return generators. This efficiency leaves room to dedicate an allocation to high confidence illiquid alternative investments like private equity.	Winner: LDI

Ironically, although CDI is often chosen for its direct focus on matching, liquidity, and excess performance, moving away from direct cashflow matching to a broader LDI framework can lead to significant improvement on all fronts.

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