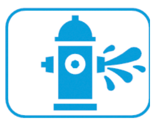
12 months later…

LDI and investment strategy considerations for a post gilt-crisis world

A year on from the 2022 gilt crisis, and a lot has changed in the DB and LDI marketplace. Now the dust has settled, this article highlights what trustees should be thinking of when considering their LDI allocations. Funding ratios are generally better than they were 18 months ago, and decent progress has been made rebalancing away from illiquid and to liquid assets. Additionally, it feels like the market has reached a steady state in terms of regulatory guidance and provider service offerings, meaning that now is a sensible time to reassess the appropriateness of one's LDI arrangements.

We have repeatedly been referring to headroom, liquidity, and governance to signpost the three key areas that trustees should focus on:

Headroom – Defined as the rate rise a portfolio can absorb before remedial action is required. There are several things to consider here. The first is a straightforward regulatory hygiene check. Regulatory bodies have guided towards minimum headroom levels of 2.5% to 3.0% (defined as the rate rise a portfolio could absorb before full asset exhaustion), trustees should verify that their LDI provider's approach is compliant with this guidance. Secondly, the LDI portfolio/fund will have a certain level of in-built day-to-day headroom before action is required to top up collateral. Trustees should be aware of what this is and fully understand the unique rebalancing process operated by their chosen provider. The devil is in the detail, and approaches differ between providers. Finally, trustees should determine what level of headroom they wish to accommodate with their non-LDI collateral assets. This will be scheme specific and linked to growth asset liquidity, governance, and return requirements etc. Your LDI provider should be able to offer detailed reporting, analysis, and input to help inform this decision making.



Liquidity – Any collateral waterfall asset or supplementary collateral MUST be sufficiently liquid, both day-to-day and in a crisis. As a minimum, this means daily traded and with short settlement cycles. Additionally, trustees should consider exit costs and whether such costs could increase in times of market stress. Price volatility is also relevant. Generally, assets with more stable values are more attractive as market timing risk is reduced. This has been steering investors towards short-dated global corporate bonds, diversified growth funds and absolute return strategies.

Governance – What model do the trustees wish to employ for instructing trades and moving money around to top up LDI collateral pools? The general trend is towards delegation. Even schemes with meaningful governance budgets, who were able to meet capital calls during the crisis are seeking to delegate this activity to reduce risk. The broadly accepted solution it to pre-agree what assets will be sold and in what order and to delegate this within a rules-based framework to someone operationally set-up to implement such activity day-to-day, such as the LDI manager, a fiduciary manager or the scheme's adviser.

What does all this mean for investment implementation?

- More pension schemes are **allocating to adjacent liquid asset strategies with their LDI manager**, to facilitate automatic rebalancing of leverage when required. Whilst pure investment capability and credentials remain important, the settlement cycle, exit costs and level of leverage rebalancing automation the manager can offer are becoming increasingly important.
- **Full integration of credit and LDI allocations** is attractive where possible. Apart from the obvious accuracy benefits of the LDI manager accounting for the credit accurately and in real time, there are some proven benefits should the credit need to be sold to top up the collateral pool. Firstly, it may be possible to avoid selling credit altogether by using maturity proceeds or by borrowing using credit repo. Secondly, where credit must be sold it can be done in a nuanced way, minimising the amount of credit that is sold and the impact of any sales on the remaining portfolio.
- Emergence of **demand for implementation manager solutions.** There has been a dawning realisation of a middle ground between full delegation via a fiduciary manager and the traditional advisory model. This involves the trustees continuing to take advice from a traditional adviser and owning the strategic and manager selection decisions, but then delegating the implementation of these decisions to a third party. Another way of describing it is as fiduciary management but without the advice. Such a solution ensures the right people are undertaking the right tasks. i.e. a market practitioner

takes responsibility for a lot of the operational tasks, freeing up bandwidth for the trustees to focus on strategic decision making.

- **Short-dated credit is gaining a march on longer dated cashflow matching portfolios.** Two things have driven this. Firstly, shorter dated credit is better suited as supplementary collateral. It is more liquid, less volatile and contributes less to hedging than longer dated credit. Secondly, improvements in funding ratio place schemes closer to buyout than previously anticipated. Shorter dated credit is better suited to near- and medium-term buyout aspirations as it is easier to sell at the point of transition to an insurer.
- **Greater focus on end-game objectives.** Improved funding ratios have focused minds on whether run-on or an insurance solution is the desired outcome. This has led to an awareness that the insurance market is capacity constrained and so schemes need to make themselves as attractive as possible to a potential insurance suitor. In some instances, this requires meaningful work on data and liability management. Buy-ins have taken a bit of a back seat. Lower LDI leverage levels post gilt crisis mean that buy-ins can put an unjustifiable additional strain on the remaining scheme assets.
- **Dynamic LDI has returned to the fore.** Dynamic LDI involves biasing the liability hedge to the cheaper of gilts and swaps and systematically switching between them to add-value. Several things have combined to remind investors of the attractiveness of such an approach:
  - Increased market volatility has created more value-add switching opportunities.
  - Excess gilt supply versus demand has led gilts to underperform swaps, making pure gilt-based hedging less attractive.
  - The gilt crisis increased awareness of the flexibility benefits of a multi-asset hedging strategy.
  - Improved funding ratios and therefore proximity to buyout has reminded trustees that incorporating swaps in the hedging portfolio reduces basis risk relative to insurance pricing.

In summary, a lot has changed within the LDI market in the past 12 months, and now is a good time to reassess your LDI arrangements to ensure you are best placed to meet your scheme's objectives over the coming years.

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