LOOMIS | SAYLES

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LDI in the Crosshairs

Volatility in the UK gilt market dominated headlines last week. For UK pension schemes, the sudden spike in gilt yields was acutely painful.

Many plans were under pressure to raise cash quickly to meet margin calls on the derivative overlays used in their LDI portfolios.

Bank of England intervention has relieved the pressure for the moment, but there could still be challenges ahead for these pension schemes.

Many US plan sponsors that use derivatives are likely considering how to avoid a similar fate. Here, we'll lay out key differences in the UK and US pension markets, how we believe US plans should think about derivatives, and possible implications for their investment strategies going forward.

RESEARCH & PERSPECTIVES

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Structural Differences

First, it's important to recognize structural differences between the UK and US pension markets. UK pensions are generally further along in their de-risking life cycle, with higher allocations to LDI assets and greater use of derivatives (and leverage) compared to US peers. Further, overlays for US plans are typically implemented via a separate account structure rather than the more pervasive pooled funds managed by a concentrated group of managers in the UK market. Nonetheless, for those US plan sponsors currently using or planning to use derivatives, it is worth exploring the considerations.

Liquidity is Key

We believe one of the most critical aspects of building LDI portfolios that utilize derivatives is to ensure there is sufficient liquidity to meet potential collateral calls. Plan sponsors using a highly levered strategy may run into issues if the underlying collateral is invested in securities that are illiquid or experience stress at the exact time there are margin calls coming from the synthetic exposure. This is the so-called "doom loop" recently seen in the UK, which forced plans to sell assets (including long-duration securities) to meet margin calls, further exacerbating market stress and rate rises.

So what would "sufficient" mean? Prior to the turmoil in the UK, it appears many UK LDI pooled funds were using a threshold of roughly 150-200 basis points in rate rises before collateral issues would arise.[i] Unfortunately, gilt yields have increased approximately 360 basis points year-to-date, with roughly 120 basis points coming last week. For funds running with up to seven turns of leverage and a duration of 50 years, the losses have been severe and the scramble for cash has been very difficult. Some of these funds are currently down more than 90% year-to-date, with only government intervention to credit for avoiding potential ruin.[ii] We expect these events to prompt a reassessment of risk models.

In the US, it is uncommon for plans to use leverage at this magnitude in their LDI portfolios. Many plans use derivatives in a completion management framework that focuses primarily on hedging key rate exposures across the curve, with perhaps some small amount of leverage. Plans using higher leverage are typically attempting to increase their interest rate hedge ratio (e.g., from 40% to 50%) in a capital-efficient way while seeking to preserve allocations to return-seeking assets. While these plans may be more exposed to a potential margin call in a rate shock environment, they may be able to tolerate a temporary drop in their interest rate hedge ratio (i.e., close out their derivative positions) given that the bulk of their overall funding ratio volatility is likely to be driven by return-seeking assets.

[i] *Source: reuters.com/markets/europe/why-are-britains-pension-schemes-dumping-gilts-2022-09-28/*

[ii] *Source: Bloomberg, data as of 1 October 2022.*

There is the risk of a potential snap back in rates—but again, plans with a longer time horizon may consider this a lesser evil than being a forced seller. Even in the face of a severe Treasury rate shock, we believe the US would be unlikely to experience the same pension-driven systemic turmoil as the UK because US plans typically implement derivatives on an idiosyncratic basis, not using pooled funds.

While the recent stress is very real for many UK plans, we do not think plan sponsors should lose sight of the fact that rising yields generally lead to better plan health due to the significant drop in liabilities. Margin calls are largely a near-term cash problem; they are challenging but still quite different from a solvency problem. It is also important to note that US plans on the whole have not appeared to experience stress running overlay strategies during 2022 with long-term Treasury yields higher by approximately 200 bps (albeit a much less extreme rate of increase than the UK experienced last week). While the term "LDI" is certainly in the crosshairs, the majority of US LDI portfolios use tried and true long-duration physical bonds, which typically remain unaffected by margin issues.

Derivatives Still a Useful Tool

Going forward, we expect more scrutiny from plan sponsors around derivative strategies, and we believe this could be a good thing. We continue to believe they are a useful tool for hedging liabilities if implemented thoughtfully and with a reasonable amount of leverage. Determining the appropriate levels of leverage will vary for each client based on plan-specific factors and risk tolerances. It is critical to ensure there is real-time monitoring on positioning so there is potential opportunity to replenish collateral gradually in advance of extreme rate spikes (though this is not always possible). Nevertheless, if an extreme rate spike were to arise, we believe plan sponsors should have a strategy in place to help manage it, which could entail tapping other liquid assets in the portfolio or, as mentioned previously, temporarily allowing a lower interest rate hedge ratio to ease the margin stress. We recommend working with your LDI partners to determine an appropriate structure for your plan.

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