

# Investment Insights

## Gilt yields – is the answer still 4%?

Quarter Two - 2015

18 months ago we took a look at what was a reasonable yield for long-dated gilts. We concluded that a yield of perhaps around 4% was a fair assumption.

Since that date we appear to have been too optimistic on our outlook on gilt yields; long dated nominal yields have fallen to around 2.5%, with real yields around -1.0%, and the forward curve is pricing in only modest increases to those figures in the future.

We start by considering if we were too optimistic. We believe the answer is no, but, and there is often a but, we may have to wait longer to get there – some of the downside risks we highlighted in our original note may be playing out. Reader beware; this note therefore doesn't make particularly optimistic reading for those grappling with pension scheme deficits.

### Consideration for trustees

*It is the movement in long dated gilt yields that is the largest investment risk being run by the vast majority of UK pension schemes.*

It is the 'but' that forms the focus of this note; a focus on the structural imbalances that are prevalent in the gilt, and more so, the inflation market when you have the vast majority of pension schemes looking to de-risk into a very limited pool of assets.



### Consideration for trustees

*Readers should note that there are many other imbalances that could keep gilt yields lower, for example a global savings glut. The focus though for this note is on the imbalances caused by UK pension schemes.*

## Should we change our view of long dated yields?

The market is currently pricing in an increase in long dated gilt yields to only around 3%, with real yields 'forecast' to remain in negative territory.

In contrast the Office of Budget Responsibility (OBR) has recently forecast (2014 Fiscal Sustainability report) that gilt yields will revert to 4% over the next 3 years and to 5% over the subsequent decade. The difference between this and market implied pricing is huge – a price difference of around 30% for the gilt market. Who is right?

The long run OBR forecast is principally based upon their forecasts for the rate of increase in nominal GDP and assuming that gilt yields will be broadly in line (albeit around 0.5% p.a. above) the growth rate in nominal GDP. They assume long-run real GDP growth of 2.4% p.a. which is above the very long run historical growth rate of the UK, but in line with that over the past 20 years.

In particular they do not expect productivity growth to remain at the low levels seen over the last 5 years nor that demographic effects will have a significant dampening effect on growth; two of the risks we highlighted in our note 18 months ago.

We remain concerned that the OBR forecast may be biased to the upside and continue the note with our premise that a 4% yield on gilts, and by extension a real yield on index-linked gilts of around 0.5% (once you allow for the RPI/CPI 'wedge') is around 'fair value' from an economic perspective. Our rationale for this was set out in our paper from the third quarter of 2013, so we have not repeated it here. We go on to look at the market dynamics, in particular those of pension schemes, to examine whether it's reasonable to assume that such "fair value" will be reached. We start by considering the international perspective.

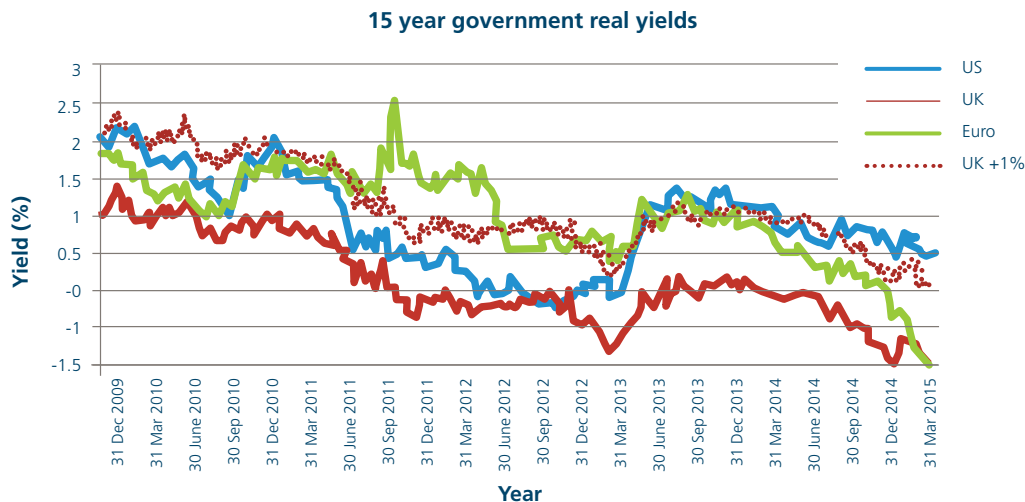


**Consideration for trustees**

*It is worth remembering that gilt yields have been below 3.5% for half the years since 1850.*

### Are UK index-linked gilts relatively expensive?

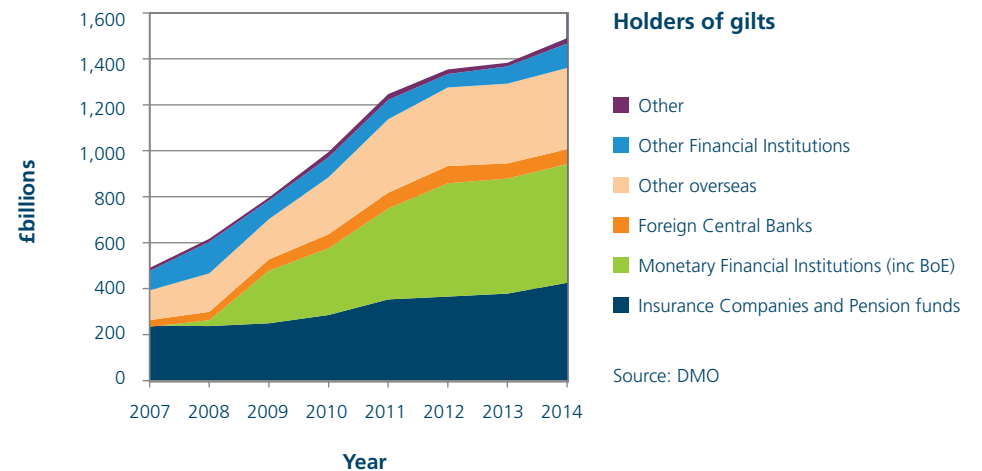
It is often argued that the buying of index-linked gilts by UK pension schemes has forced down the yield below its 'fair value' and that it therefore doesn't make sense for UK schemes to buy any more. The chart below shows the real yield available on UK, US and European Government linkers.



Source: Bank of America Merrill Lynch

At first sight this actually seems to support the view that UK real yields have been forced artificially lower, as UK real yields (red line) have consistently provided a lower real yield. However, care needs to be taken here as UK linkers pay out relative to RPI rather than CPI and if we take the CPI/RPI difference at 1%, for ease of argument, we see by the dotted red line that the yield available on UK linkers has not been structurally lower than the US, or European issuance, when compared consistently.

Our view is that the behaviour of UK pension schemes has not been the dominant force in determining the level of yields. To put it another way – over the past 5 years it's not been UK pension schemes buying the new gilts coming to the market; it's been overseas investors and the Bank of England as shown by the chart below:



Going forward pension schemes may well reassert themselves as a dominant force in the gilt market; to see why we consider their relative size below.

### How much demand is there?

According to the 2014 Purple Book, as at 31 March 2014 the buy-out cost of UK defined benefit (DB) pension schemes' liabilities stood at £1.7trillion. Many schemes (32%) are closed to future accrual. However, even for those that are closed, the value of the existing benefits is still expected to grow over the next couple of decades as schemes mature and more of the accrued benefits come into payment. Of the £1.7trillion of total liabilities a large proportion will be linked to inflation, whether it is CPI or RPI. Perhaps around £1 - 1.25trillion of the total liabilities are inflation-linked.

## What is the available supply?

For the vast majority of schemes the main hedging instrument is the gilt market, but is this big enough? No. The total gilt market at 31 March 2015 stood at £1.8 trillion, with the Bank of England holding £375bn of this and unlikely to sell anytime soon.

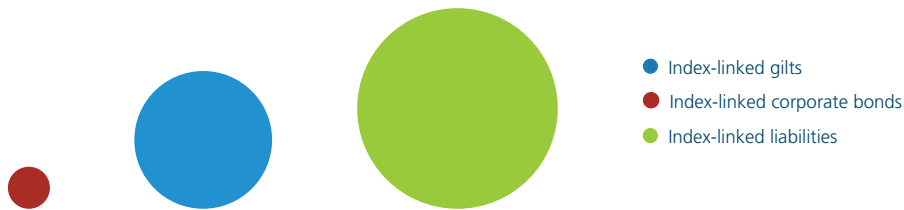


### Consideration for trustees

*The index-linked gilt market is small - even if pension schemes were able to hold the entire market, this would leave more than half of inflation-linked liabilities unhedged*

This shortfall in supply is a feature that, if anything, is likely to get worse not better in the future. The chart below shows the size of the current inflation-linked UK DB pension scheme liabilities against the size of the index-linked gilt and UK corporate bond market.

Relative size of index-linked markets



Source: DMO, Bank of America Merrill Lynch

Looking forward it is going to be a number of years before the size of DB inflation-linked liabilities starts to fall.

In contrast the level of issuance of UK gilts is expected to fall considerably from the levels seen in recent years as the government is forecast to move into a position of a primary surplus. Given the economy is expected to grow in size this still allows the gilt market to grow in absolute terms, but it will take many years for this to catch up with the size of pension liabilities.

## Are there alternative sources of protection – particularly inflation-linked?

The starkest shortfall is in the inflation-linked part of the market. Are there alternative supplies of inflation protection in the market so that schemes can hedge their inflation-linked liabilities? It would be even better if they didn't carry the 'cost' associated with hedging through index-linked gilts.

One option is the index-linked corporate bond market. However, as can be seen from the chart to the left, this is very small being valued at around £35bn. Clearly credit risk is introduced when investing here and there are a limited number of suppliers.

Of course many pension schemes have been hedging using derivatives rather than purchasing physical assets. However, this doesn't produce new, limitless supply (particularly in the current regulatory environment where banks are unwilling and often unable to create that outright supply). In fact it's even more expensive to hedge through swaps than gilts at present.

Another source may be property or infrastructure type assets. Here the income streams are frequently inflation-linked but there is a significant mark to market risk on the value of the assets creating volatility on the balance sheet that may be unwelcome for schemes.

If a secondary annuity market comes to fruition could this be a potential source of inflation-linked assets? Any such market is a number of years from functioning and likely to be at older maturities than pension scheme liabilities so we don't feel this will be of significant benefit.

In summary, there are some small potential sources of inflation protection available. But they are all imperfect, small or fundamentally linked back to the gilt market.



### Consideration for trustees

*In the absence of a huge increase in the issuance of UK gilts, and in particular, index-linked gilts, we see these structural imbalances between the demand and supply persisting for many years to come.*

## What about the annuity market?

So far, we have looked at how schemes would look to reduce the level of risk themselves. Ultimately many schemes have a goal of going a step further and passing the liabilities to an insurance company. Does this help with the shortfall in matching assets highlighted above?

2014 was a record year for bulk annuity deals with a total of £13billion being transacted. Over the past 8 years the average annual level of deals has been around £6billion per annum. Against total liabilities of around £1.7trillion it is clear that a step change is required if there is to be any meaningful dent in liabilities sat on companies' balance sheets. Is this possible?

It is often said that insurers are only able to write a certain amount of business due to capital constraints. However, in practice they may be able to respond relatively quickly in the event that there was pension scheme demand – ultimately if the insurer's capital was not able to respond to the increase in demand the business could still be written; it's just that the price would increase and in effect the schemes themselves would have to provide the capital.

However, there is one area of the market that will undoubtedly be constrained if there was a big rush to buy-out and that is 'administration'. Each buy-out deal takes a certain amount of time and work, requiring personnel at the insurer. If demand was high then insurers in such a scenario will be able to cherry pick the schemes that they wanted to work with; it is likely that smaller schemes would lose out in such a scenario as insurers may focus limited resources on the larger deals. Schemes with unusual benefits or poor data may also suffer.



### Consideration for trustees

*If pricing is under pressure for schemes to de-risk internally; the same pricing pressure is going to be evident in the annuity market.*

All of this says to us that the annuity market is there as a final stage for schemes looking to de-risk. However, it has the same demand and supply pressures as the do-it-yourself markets. Fundamentally the insurers are fishing in the same asset pool as pension schemes.

## Conclusions

Pension schemes for many years have felt gilt yields have been too low to extend the level of protection. In that time yields have continued their fall. We are now at the stage where the vast majority of the £1.7trillion of UK pension scheme liabilities are saying:

- we wish to reach full funding on a buy-out or self-sufficiency basis;
- we are looking to do this over the next 10-20 years;
- at which point we'll be invested in low risk assets, predominantly gilts (especially if going down the buy-out route);
- but we do not want to further hedge liabilities at low yields;
- **and we will therefore wait for better opportunities to de-risk.**

It is the latter part that is key – if all are waiting for better yields will they materialise? This seems very questionable to us and therefore the above objectives are just not possible for all to achieve.

Yes, short-term opportunities will always present themselves due to other factors, for example the UK election may throw up a surprise result, but our view on gilts remains much as it was 18 months ago:

- 'Low' yields are here for a reason and can be expected to remain below the levels seen in the first decade of the 21st century. Therefore, a target or fair value yield of around 4% seems plausible;
- However, various market dynamics may mean that even this 'low' yield of 4% is not reached on a sustained basis in the short to medium-term.

Many schemes have put trigger mechanisms in place to try to do this; far fewer have actually traded those triggers. Are they set at realistic levels?

Finally, and at the risk of introducing a new concept into a conclusion; we also feel that schemes should reassess if their objectives are correct:

- is reducing short-term volatility in funding the correct course of action?
- is buy-out or self-sufficiency the right target?

For most these will be and will require hedging liability risk as described above. For some it will not be; for those they may well be able to deal with their pension liability at a lower long-term cost. The implication though will be a bumpier ride along the way with a longer tail to the liability on the sponsor's balance sheet.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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