Quarterly Investment Briefing
Quarter 2 2019

First Actuarial LLP

Regulated in the UK by the Institute and Faculty of Actuaries in respect of a range of investment business activities.
First Actuarial LLP is a limited liability partnership registered in England & Wales. Number OC348086.
Registered address: First Actuarial LLP, Mayesbrook House, Lawnswood Business Park, Leeds, LS16 6QY.

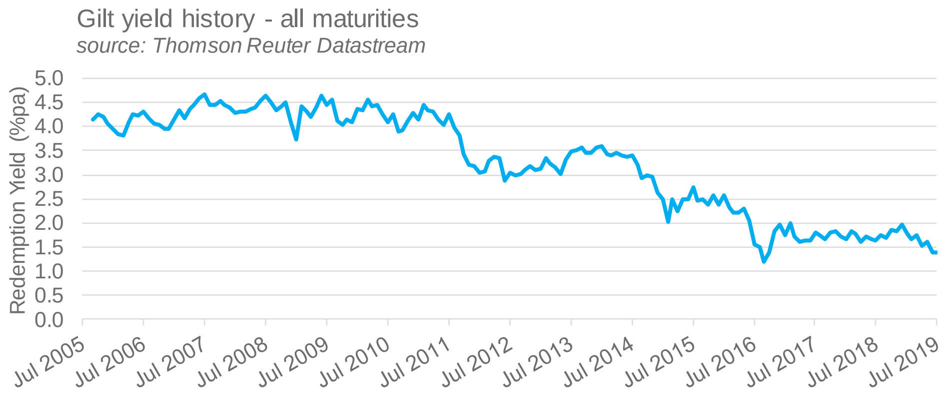
Borrowing cash to buy gilts: Is it sensible?

LDI funds offer an efficient means for pension schemes to gain exposure to the gilt market (to 'match' liabilities), without tying up too much money. In effect, LDI funds borrow cash[1] to buy gilts.

In light of the continued falls in gilt yields, we review whether the LDI approach of *borrowing cash to buy gilts* remains an appropriate approach for trustees seeking a long-term liability matching asset.

Note that this article is quite technical, but we hope that readers gain some insight into the factors we consider when advising on the complex area of LDI allocation.

Gilt yields



If held to maturity, a gilt provides a known series of future cashflows. These cashflows, along with the purchase price of the gilt, then determines the gilt's redemption yield[2].

The price paid for a gilt fluctuates and, as this happens, the redemption yield changes; if the price increases, a new investor will pay more for the known series of future cashflows and, hence, the redemption yield falls.

Gilt prices have risen significantly over recent weeks and redemption yields are now close to their historic low. However, redemption yields are only half the story when it comes to LDI funds.

To assess the potential merits of investing in LDI funds, we need to compare gilt redemption yields with the costs of borrowing both now and what it might reasonably be in the future.

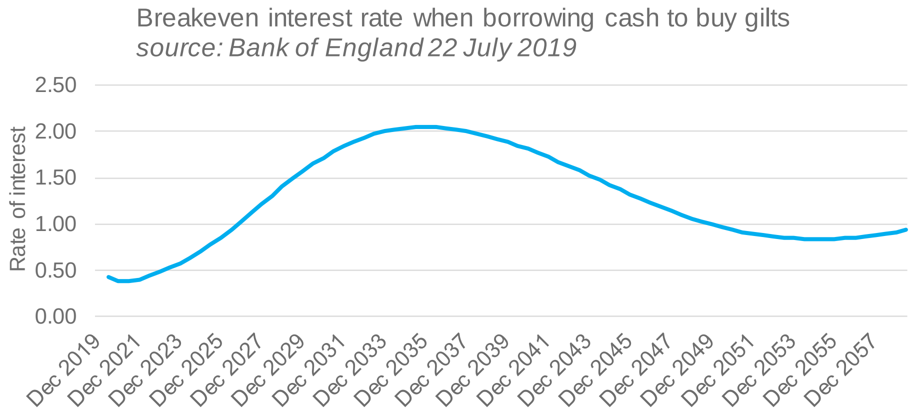
To help, we identify the interest rate on cash borrowed that would exactly accumulate to the return achieved on the gilt purchased (if the gilt were held to maturity).

[1] In practice this exposure is gained via derivatives or repo arrangements rather than borrowing directly.

[2] This concept is related to the internal rate of return calculation often used by businesses.

This "breakeven rate of interest[3]" is plotted below and shows how the market is "pricing-in" how interest rates progress over time.

Breakeven rate of interest



If, in practice, it is possible to borrow cash at a rate below the breakeven rate of interest, then the LDI approach will ultimately be profitable. The question to consider is then "Is what is priced-in reasonable?"

How high will interest rates go?

Back in June 2014 the Governor of the Bank of England, Mark Carney, told the BBC that household debt levels and a fundamentally altered financial system meant it was virtually impossible to raise interest rates much above 2.5% - a position which we have no reason to think has changed.

The breakeven rate of interest currently peaks at just over 2% and this seems reasonable to us.

However, beyond 20 years, the breakeven rate falls significantly and our view is that this reflects a distortion in the gilt market. There is a great deal of demand for gilts maturing beyond 20 years from pension schemes and insurers, but supply is limited. Consequently, prices for long-dated gilts are high (yields are low).

As an aside, although we consider long-dated gilts to be expensive, we don't think they'll get cheaper anytime soon. Pension scheme demand isn't going away and restricting supply helps keep the cost of government borrowing down.

In principle, buying an expensive asset and subsequently selling it for a high price is not in itself an unreasonable strategy to follow. It might lead to a similar result as sale/purchase at a fair price.

[3] You may also have heard us talk about the market implied progression of base rates. This is the same thing.

Whilst the distortion as plotted appears dramatic, for many pension schemes the effect is however relatively modest; the bulk of their liabilities will have been paid before the drop in rates.

We've estimated for instance that, for a typical pension scheme, with an average term until benefits are paid of 20 years, the yield of their gilt portfolio would be around 0.2% pa higher if the breakeven curve remained at its high point at longer durations.

How quickly will interest rates rise?

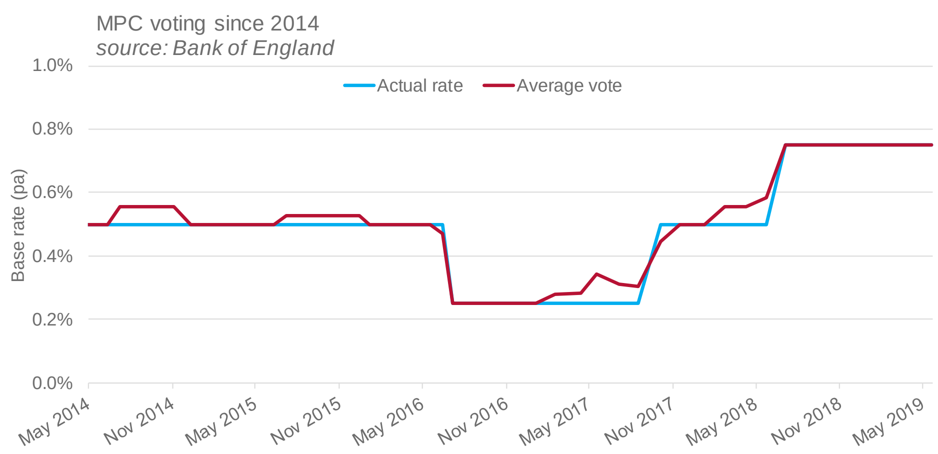
As the Bank of England's Monetary Policy Committee (MPC) set base levels of interest rates, it is worth looking at what the bank has done and said recently.

In his interview in 2014, Mark Carney went on to state that "when we raise interest rates we expect to do so in a gradual and limited fashion." By August of that year, the first rate rise looked imminent and two of the MPC voted for rates to rise to 0.75%.

However, since then the Bank of England's plans to raise interest rates were blown off course.

UK economic growth fell from 2.9% to 2.2% from 2014 to 2015 and the Bank held rates low to help stimulate the economy.

Then, in response to the Brexit vote and concerns over its impact on economic growth, rates were cut to 0.25%.



Rates were however raised in November 2017 and again in August 2018, in both cases the rate rises were clearly signalled by the split voting of the MPC in the run up to the rise; the red line in the chart above shows the average of their votes.

Since the rate rise in August 2018, the MPC has been unanimous in its decision to keep rates at 0.75%. Furthermore, there is currently market speculation that rates will be cut in the US and Europe due to economic uncertainty. The UK may well follow suit in light of Brexit uncertainty.

Indeed, one member of the MPC, Gertjan Vlieghe, recently made the follow comments (at a speech at Thompson Reuters).

"On balance, I think it is more likely that I would move to cut [the] bank rate towards the effective lower bound of close to 0% in the event of a no-deal [Brexit] scenario."

He went on to say that even with a smooth Brexit, he envisaged that it would be a year before interest rates were raised to 1% and two years before they hit 1.25%. By 2022, depending on the state of the global economy, he said they might still only be 1.75%.

In that context breakeven interest rates could look low if you expect a smooth Brexit and a growing global economy. However, if you expect a disorderly Brexit and an economic slowdown breakeven interest rates could look high.

Sadly, such is the level of uncertainly in the UK at the moment, it is impossible to know which of these eventualities will materialise.

One thing is for sure though; while gilt yields are at historic lows, there is the potential for yields to get much lower.

If the MPC cuts interest rates to the Eurozone level of zero, we could feasibly see gilt yields align with German bond yields and move into negative territory.

Is borrowing cash to buy gilts still a sensible thing to do?

LDI remains a useful and capital efficient risk reduction tool. However, investors do need to take into account the supply and demand distortions in the gilt market that particularly impact on long dated gilts. Given this, our best estimate is that cash rates of interest will exceed the yield available on a typical gilt portfolio by around 0.2% pa over the very long term.

Having said this, there is a great deal of uncertainty as to future interest rates. For instance, a ‘No Deal' Brexit and poor economic growth could trigger a return to a sustained period of near zero interest rates. In such circumstances the strategy employed by LDI funds of borrowing cash to buy gilts could be very profitable indeed. This is not the only possible outcome though as inflation may increase due to a weakening of sterling e.g. which may lead to pressure for the Monetary Policy Committee to increase rates.

Leveraged exposure to gilts can also help pension schemes manage short term volatility of their funding position. In turn this can allow them to accept volatility and risk elsewhere, by for instance investing in equities. That is, returns on capital that would otherwise have been ‘tied up’ in risk reduction investments should also be taken into account.

Our view is therefore that the risk reduction and capital efficiency benefits of LDI funds continue to make their use worthwhile.