Responsible fiduciary management in a period of market crisis: Our approach.

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DB Client Strategy Team
DB Sales and Client Team

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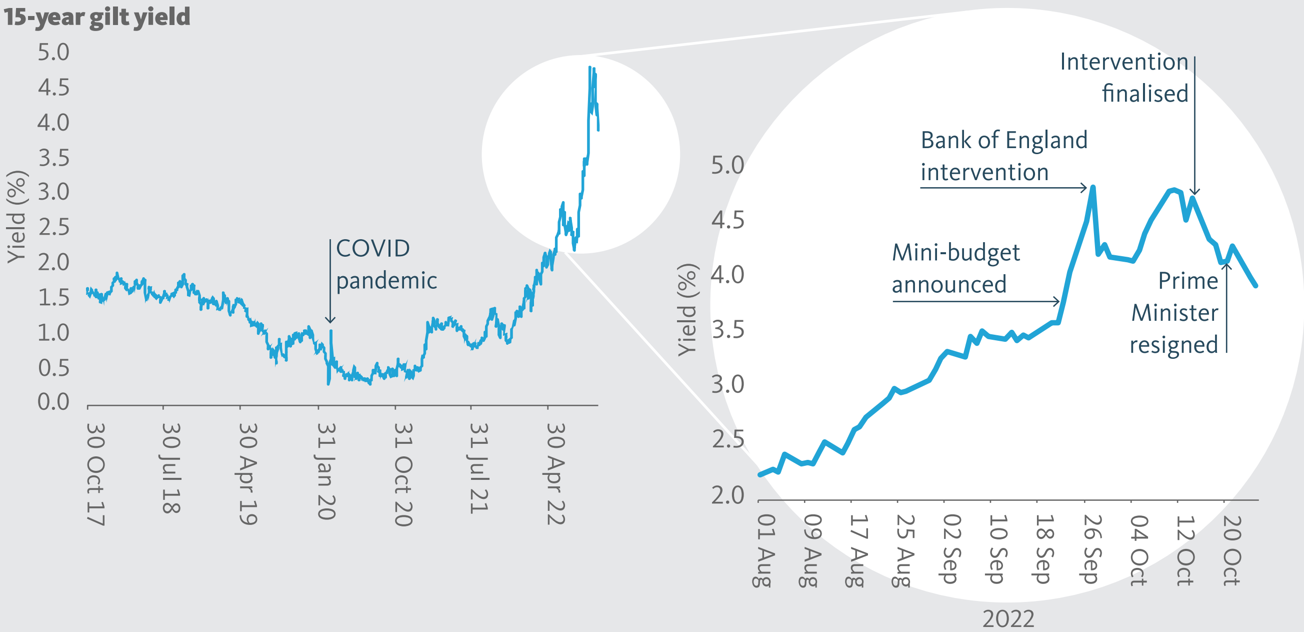
After a tumultuous month for defined benefit (DB) pension schemes, finally it seems as if the dust might settle. In the aftermath of what can only be described as a crisis, we reflect on what it means to be a good fiduciary manager, and what's next for the pensions industry.

The last few weeks have been something of a nightmare for UK trustees. Spearheaded by then Chancellor Kwasi Kwarteng, the Truss government's mini-budget sent shockwaves through the pensions industry when it was announced on 23 September. Unfunded tax cuts to the tune of £45B sparked a selloff in the gilt market, which took a toll on DB schemes.

Those exposed to highly levered liability-driven investment (LDI) funds were worst hit. Whilst such funds have long promised to match pension fund liabilities and deliver capital to close deficits, this model stalled as gilt yields rose at an unprecedented rate. The value of LDI funds with market levels of leverage fell so fast they could not be topped up in time, raising insolvency concerns. As collateral calls came flooding in, schemes were forced to sell down assets in a desperate rush for liquidity.

Whilst few analysts could have predicted the events that have unfolded over the last month or so, some schemes and their advisers were undoubtedly better placed than others. At SEI, we believe the policies, processes, and governance structures we had in place prior to the mini-budget announcement made all the difference.

Gilt yield rises: Covid-19 vs. the mini-budget announcement



Source: SEI, Bloomberg – Data from October 2017 to October 2022. Past performance does not predict future returns. Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Our approach to risk management and risk governance.

Going into the crisis, we were in a better position than some of our competitors for two reasons:

1. We build bespoke client portfolios that are diversified ...

Rather than a one-size-fits-all approach, we build portfolios to achieve client-specific objectives. Diversification is key here—a client will typically have exposure to a variety of asset classes, currencies, investment styles, geographies, and managers.

Going into the crisis, the latter was particularly important. Where LDI hedges were being achieved through a pooled structure, we had typically exposed our clients to more than one manager. Having long advocated a more prudent use of leverage than many market participants, we had also incorporated credit as part of the overall hedging strategy, so that we'd have something to liquidate if we received a high volume of LDI capital calls.

... and sufficiently liquid

When designing a strategy, we consider the impact of—and interplay between—a variety of risk factors. We also stress-test portfolios against a range of scenarios.

Ahead of the mini-budget announcement, this meant that we had a good understanding of how large interest rate hikes could impact portfolio liquidity. Ultimately, we stress-tested our portfolios against severe liquidity events, and designed strategies that were sufficiently liquid to withstand a significant rise in gilt yields.

2. We have a governance structure in place to navigate extreme volatility

Our robust governance structure and experience handling past crises—from the 2008 global financial crisis to the more recent COVID-19 pandemic—stood us in good stead ahead of the mini-budget announcement.

We had working groups in place to discuss market movements and immediate capital calls, which meant our clients did not have to rely on their board of trustees for direction or instructions. When it came to formulating our firm-level view of the crisis, we could do so quickly and efficiently; we were also able to respond to client queries in a timely manner.

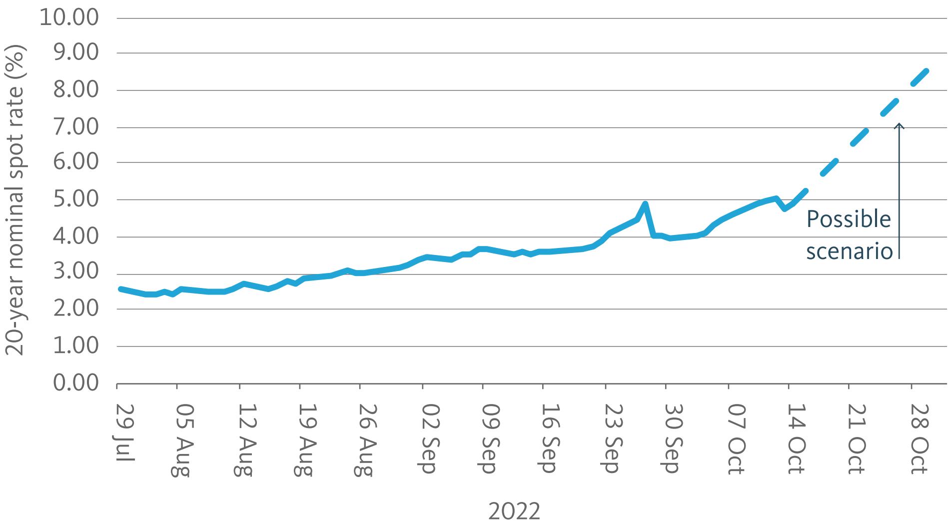
So, what was our response to the crisis?

Five days after the mini-budget announcement, the Bank of England (BoE) announced a £65B gilt purchasing programme designed to 'address dysfunction' in the market'.[1] Without this intervention, the BoE would later claim, many LDI funds would have been rendered insolvent.[2]

But there was a catch—the BoE's support would come to an end on 14 October. LDI funds were urged to delever over the period, and the Pensions Regulator called upon DB schemes to review their liquidity, liability hedging, and governance processes.

Rather than a solution then, the intervention bought the industry time—there was every possibility that after the BoE withdrew on 14 October, gilt yields would continue to rise at an unprecedented rate. And, if they did, that would have very real consequences. The worst-case scenario was almost unthinkable: Levered LDI funds could lose all their value, and more schemes would exhaust their liquid growth assets to meet capital calls. Sponsors would be under increased pressure to provide loans, with the risk of permanent capital impairment should LDI funds become insolvent, and the eventual loss of hedging capability.

20-year nominal spot rate



Source: SEI and Bloomberg, as at 7 October 2022. Data from July to October 2022. Based on yield movement predictions from SEI. Period used to illustrate yield movement ahead of the BoE withdrawl and as a comparison. 4% increase of yield movement is based on calculations within SEI.

[1] Sir John Cunliffe to Rt Hon Mel Stride MP, 5 October 2022, https://committees.parliament.uk/publications/30136/documents/174584/default/.

[2] Alex Janiaud, "Some LDI investments 'worth zero' without BoE intervention," Pensions Expert, 6 October 2022, https://www.pensions-expert.com/DB-Derisking/Some-LDI-investments-worth-zero-without-BoE-intervention?ct=true.

With the clock ticking, our first priority was to try and safeguard client assets ahead of the 14 October deadline. We reviewed client financials, hedging levels, and approved trading activity on a case-by-case basis, and established a firm-level response to the liquidity risks plaguing the LDI market.

Establishing even more conservative leverage limits

Soon after the BoE announced its intervention, we established new leverage limits at the LDI fund, segregated account, and client level. Whilst segregated LDI clients tended to have lower levels of leverage going into the crisis—and were, therefore, more resilient to extreme market events by design—we reduced limits here, nonetheless. In short, the level of leverage we were comfortable with decreased by a factor of two across the board. We also decided to buy only physicals or LDI products with reduced leverage. This was to help prevent against tail liquidity risk after the BoE's withdrawal.

Suspending the purchase of highly levered LDI funds

Approaching the 14 October deadline, we became increasingly concerned by a lack of transparency from our LDI managers. Some managers only revealed exposure levels days after the fact, whilst contract notes for certain trades were slow to materialise and pricing issues persisted. We also heard of LDI managers in the wider market who were resorting to net asset value (NAV) calculation methods we considered non-standard and, in some cases, these managers were suspending NAV publication altogether.

Against this backdrop, tracking the holdings of LDI funds was challenging, which in turn meant determining appropriate hedging levels was challenging. For at least the first three weeks of October, it was impossible to know where hedge ratios sat in real time.

In the face of acute uncertainty, we made the prudent decision to stop topping up LDI funds. These funds, we believed, were at real risk of insolvency following the BoE's withdrawal. We could not risk clients meeting capital calls to the detriment of their liquid growth assets, particularly when they might end up with no LDI exposure and no hedging thereafter.

And whilst the impact of the LDI crisis has varied client by client, our commitment to responsible fiduciary management has remained constant.

Where are we now and what's next?

The fact that the worst-case scenario didn't materialise is, of course, a relief. With a change in government, the mini-budget was abandoned, and so far, the gilt market looks to have recovered somewhat. Where 20-year yields stood at 5% just weeks ago, they have since fallen to 3.8%. [3]

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As we think about next steps, it is important to realise that the last few weeks have brought about a paradigm shift. We have been open and transparent in our communication with clients, helping them understand the decisions we have made on their behalf. This needs to continue over the coming weeks and months. Gone are the days when schemes could demand high growth and high levels of hedging—now they must choose between the two. Client investment strategies will need revisiting as a result.

The industry, too, we believe must change. If the BoE had not intervened, many highly levered LDI funds would have faced insolvency, which for some DB pension schemes could have been catastrophic. Such an event also had the potential to erode a scheme's growth assets, perhaps irrevocably.

Rather than a blip then, recent events should be viewed as game-changing, and a reason to reconsider the construction of LDI strategies moving forward. Hedging at all costs is at best naive, and at worst poses an extreme risk to the viability of certain pension schemes. As the Work and Pensions Committee (WPC) launches its inquiry—which focuses, in part, on the regulatory oversight afforded to pension schemes using LDI strategies[4] —many commentators are rightly questioning the industry's fixation with gilt-based discount rates. We believe this is a discussion that needs to be had, and we hope to see a more balanced approach to hedging emerge.

[3] As at 9 November 2022.

[4] Sophie Smith, "WPC launches inquiry following gilt market volatility," Pensions Age, 24 October 2022, https://www.pensionsage.com/pa/WPC-launches-inquiry-following-gilt-market-volatility.php.

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