Gilts: To buy or not to buy, that is the question

Sam Roberts explains why gilts are still an attractive investment holding for pension schemes

Maybe I wasn't watching closely enough before, but I've recently noticed some respected commentators wanting UK defined benefit pension schemes to reverse the trend of buying UK government bonds (gilts), or at least to not buy any more. Liability-driven investment (LDI) seems to come in for particular criticism. Instead, so the argument goes, pension scheme money should be invested in growth assets such as equities, property and infrastructure to earn a higher investment return, receive a higher yield, and take the pressure off sponsoring employers' rising pension contributions. That way, UK businesses can reinvest more in themselves and pension schemes can invest in the future of the UK and the global economy. I can definitely see the attraction!

So why am I sceptical?

What this non-gilt approach seems to ignore is that trustees' time horizons and risk appetites are rarely as long or as large as assumed. There are five main reasons that persuade me to continue to talk to my clients about the benefits of investing in gilts (and LDI in particular):

Trustees should target a bulk annuity, which moves with gilt prices. Trustees' ultimate objective is to pay all members' benefits in full. The most reliable way to do this is by purchasing a bulk annuity, even if the current high cost of a bulk annuity means that we need to rely on some higher expected risky investment returns over the medium term to achieve it. Bulk annuity prices move broadly in line with gilt prices rather than equities, property or infrastructure, because insurers need to consider all the different risks and they have one chance to get the price right.

The reliance on the employer should be reduced. The strength of an employer's support for the scheme, and its ability to absorb the scheme's investment risk if there is a market shock, is difficult to measure at the best of times. But both the employer's support and the investment risk can change quickly, unpredictably, and undermine the health of the scheme at the same time (eg in an economic recession). If an employer is no longer solvent then the bulk annuity cost at that time will directly and immediately determine what proportion of their benefits members will get – in a flash, the trustees' time horizon has gone from many years to zero. Even if an employer remains solvent, the employer's available cash could be severely limited forcing the trustees to adjust their asset allocation and crystallise what could have been a temporary investment loss. The trustees' ability to provide members' benefits in full could also be severely damaged (as lower employer contributions and lower expected investment returns).

Regulatory changes are moving in this direction. Despite Brexit, and maybe because of BHS and Tata Steel, regulatory changes (eg IORP II) may push trustees to disclose and manage their risks more akin to how insurers manage their annuity books. Targeting a bulk annuity (see above) and buying gilts/LDI should be consistent with this.

I'd expect employers to be sympathetic. Most employers understand the impact of pension scheme risks on their accounts, and would prefer to remove these often large non-core business risks as soon as it's affordable to do so. Trustees should not be scared to start this conversation.

LDI helps not hinders. LDI allows schemes to invest in both gilts and growth assets at the same time. By introducing LDI, trustees can typically maintain their expected investment return (avoiding any immediate increase in the employer's contributions) and reduce the volatility of the deficit. It's not magic fairy dust, it's sensible risk management with an eye on the liabilities.

I'm always looking for ways to help my clients to challenge the status quo and find better ways of doing things, but I'm yet to be convinced that avoiding gilts/LDI is one of these such opportunities.

Written by Sam Roberts, head of investment consulting, Cartwright Group

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