

The price is right? Gilt-y questions for UK pension funds

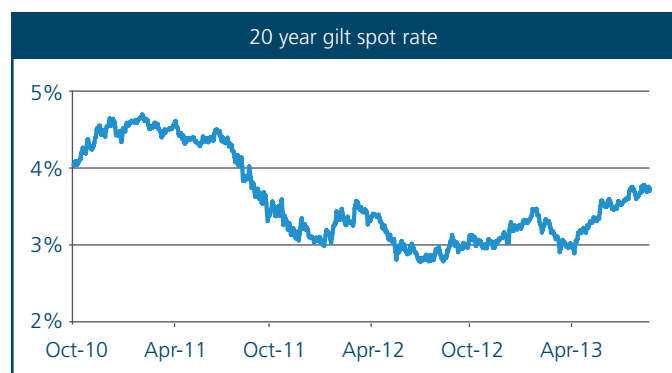
Over the past two years pension schemes have been faced with the challenge of gilt yields at record lows. Ever since Ben Bernanke, chairman of the Federal Reserve, stood up on 22 May 2013 and announced infinity, the never ending buying of bonds, didn't really apply to investment markets, gilt yields have been on the increase.

Is this the start of a sustained increase to "normal" levels of gilt yields following the quantitative easing (QE) experiment or just a mere blip on the long-term trend of low yields?

We are being a bit brave with this note by sticking our necks out and coming up with a forecast for long dated yields. We are being braver still and providing you with the tools for disagreeing with our estimate. Please be gentle in your disagreement.

Where have gilt yields reached?

As all trustees and sponsoring employers are aware yields, despite a recent increase, have fallen significantly over the past three years. This is highlighted in the graph below showing the evolution over this period of 20 year gilt spot rates. This was on the back of a fall in long dated gilt yields over the preceding two decades from highs in the late 1970s.



Source: Bank of England

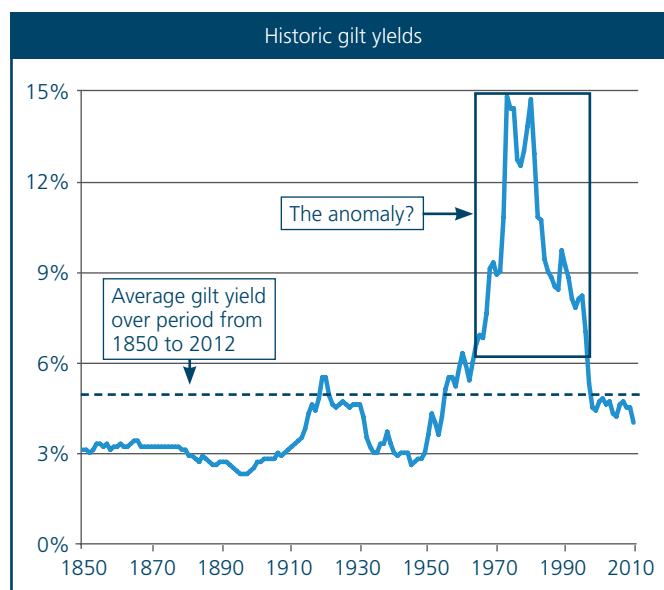
As a result the oft-heard cry from trustees and employers over the past five years has been:

1. yields are too low;
2. they must therefore rise in the future;
3. we therefore shouldn't buy any more bonds until this has happened (and indeed let's sell long dated bonds and move into cash).

At first sight this would appear a very rational conclusion to reach, why buy bonds when their yield is far lower, and the price far higher, than it has been over recent history.

Are yields too low? Is history any guide?

There are two possible reasons why this may not be the correct conclusion. First, just because the yield has fallen doesn't mean it cannot stay "low" for a long period of time, or indeed get lower. Second, we need to consider whether gilt yields are now "too low" or whether the anomaly was in the past when they were, with the benefit of hindsight, "too high".



Source: Bank of England

Let's examine whether gilt yields are indeed "too low". To do this it is appropriate to consider a slightly longer time horizon than just the last few years. The chart above shows yields going back over the last century and a half and suggests that perhaps the anomaly is from the late 1960's through to the early 1990's rather than the last 5 to 10 years.

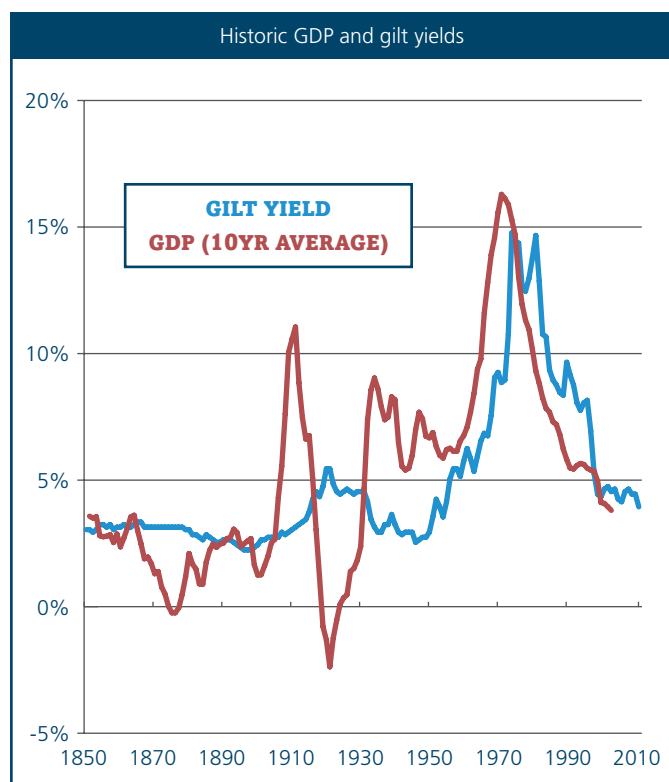
Therefore, if trustees are positioned for yield increases they may wish to temper their expectations if history is their only guide. Yields were only above 4%p.a. for roughly a quarter of years between 1850 and 1965. They remained above 4%p.a. from 1965 all the way through to 2010. Which period is normal and which is the anomaly?

What “should” long dated gilt yields be?

Something around 4.5%p.a. feels like a reasonable estimate to us. How do we get to that figure? Well, we can do it in a number of ways.

We could look at history as a starting point. This shows that historically UK longer dated gilt yields have averaged around 4.8%p.a. This includes the “anomalous” period of the 1970s, so is perhaps a little high for our estimate going forward.

From an economic theory perspective gilt rates “should” equate to the long run growth rate of the economy. The chart below shows this is broadly correct, focusing on nominal GDP growth compared to nominal yields.



Source: measuringworth.com

Looking forward, we therefore start with the, perhaps optimistic, view that the long run real growth rate of the economy remains at 2%p.a., in line with the historical average and will not be impacted by adverse demographics expected over the next 20/30 years. If we then assume that the Bank of England meets its inflation target of 2% CPI and allow for some differences between consumer prices, retail prices and the wider GDP deflator, we get our estimate of around 4.5%p.a. for gilt yields.

There is little credit risk associated with investing in gilts and gilts are generally very liquid, therefore we would not expect to get much in the way of additional yield to compensate for credit or liquidity risk. If we also assume no extra return is demanded for lending for longer periods of time then this suggests the long-term gilt yields should, on average, lie around this figure.

Build your own estimate of nominal gilt yields

Real GDP growth rate + future inflation + any risk premia
= estimate for nominal yields

Are we being too “optimistic”?

The above suggests pension funds should not expect a move to persistently higher yields than seen on average over the first 13 years of this century. This might seem rather downbeat. If forced to commit, we would say the above picture is actually overly optimistic. We comment below on why demand and supply forces may prevent us hitting this 4.5%p.a. level, but is the level itself unrealistic? There are three grounds on which we could be being overly optimistic:

1. The UK needs to develop a new growth model; North Sea Oil & Gas are in decline and the financial service sector has yet to reshape itself. As a result there could be many more years of restructuring ahead before we return to the 2%p.a. real growth rates seen historically;
2. We have assumed that the demographic changes facing the UK economy, in particular a reduction in the working proportion of the population, do not impact upon economic growth;
3. Inflation may not be as anticipated. Deleveraging is deflationary, slowing global growth is deflationary, Chinese rebalancing is deflationary (they arguably have their own credit bubble to deal with); the ECB seems to be pursuing deflationary policies. Countering all this is QE from the US, Japan and the UK. This has the potential to be inflationary in the future, but that is increasingly looking like it may be many years out.

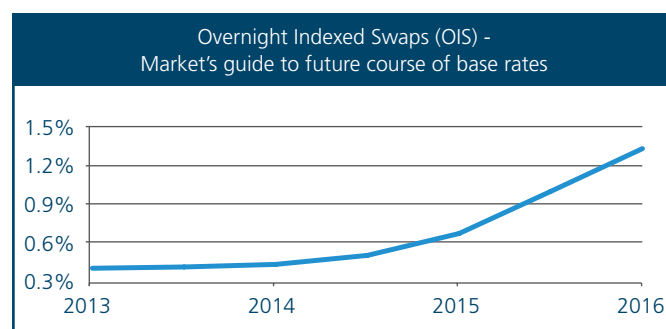
It could be that such a return to “normality” may be many years away and we should therefore assume lower GDP growth and set a long dated gilt yield target of perhaps 4%p.a. or lower in the medium-term.

When considering the impact of the “normal” level of yields clients should also consider the natural volatility around a level of yields. As a result, setting opportunistic triggers above the long run expected rate could still prove fruitful if you are able to wait and accept the risk in the meantime.

So are yields going up? Let’s start with base rates

This is pretty unequivocal. Base rates have to rise given their current level. In the 300+ year history of the Bank of England we know base rates have never previously been below 2%p.a. The market has certainly priced in a rise in yields, with an expectation of the first rate rise in early 2015 and a gradual increase thereafter, only reaching around 1.5%p.a. three years from now.

However, even this gradual increase is at odds with the guidance proposed by the Bank of England who don’t expect rates to rise until 2016 if things run to plan and believe that the market is getting ahead of itself. We note that throughout the crisis the market has consistently been too early in predicting rate rises and retain some scepticism as to whether the first rate rise will be as soon as currently priced in.



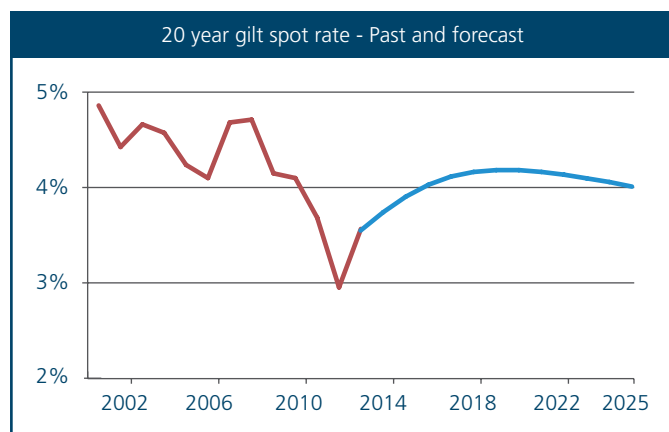
Source: Bloomberg

And what influences longer dated yields?

The future course of base rates will impact on longer dated yields. This is inevitable since arguably a 10 year gilt yield is the market's view on future base rates over that period. However, it is equally true that the further out you go the less impact movements in shorter rates have on yields. Whilst the Bank has a strong level of influence over short dated rates, the long end is governed more by longer-term structural views and institutional demand and supply.

We can see the dampening effect by considering the recent moves. Whilst the "benchmark" 10 year gilt rose by 1.5%p.a. in the four months since Bernanke's speech in May, long dated gilt yields (20 year duration), of greater interest to pension schemes, only rose by around 0.3%p.a. over that period.

It is worth noting that the market also views long-run gilt yields as increasing from current levels. The chart below plots the market's expected evolution of 20 year gilt yields into the future (blue line), alongside their historic levels (red line) over the past 12 years. They show, for example, that 20 year yields are expected to rise to around 4%p.a. over the next three years. It is crucial for trustees to factor in this expected improvement in yields when assessing any tactical positions. How much of your anticipated yield rise is already "priced in" to markets?



Source: Bank of England

Supply and demand should be another key factor in the market.

Supply must surely fall in the future as deficits are reduced, and indeed, depending on the outcome of the election, a surplus may emerge during the next parliament.

Against this is the possibility of the Bank of England selling the gilts it holds (at some as yet unspecified point) pushing up the level of "free float" in the market. It should be noted, that the level of debt, supply, has been historically a very poor indicator of the level of yields.

What about **demand**? Considering the various buyers in turn we believe that the role of pension funds within the gilt market may be set to grow:

- the Bank of England's role has slowed for now although they seem certain to play their role as buyer of last resort if needed;
- overseas buyers (the strongest buyers over the past 5 years after the Bank of England), may not have a similar appetite over the coming years; but
- pension funds (who have not been significant net buyers of gilts over the past five years) continue to mature and even at current yield levels some are able to increase gilt allocations due to strong equity returns or increased willingness from employers to remove pension scheme risk from their balance sheets.

Finally, regulatory pressure has been on the increase for many buyers; solvency II, central clearing and forced purchases by banks to name but a few. Regulatory pressure will surely be on the increase in the future if needed.

Ultimately, we feel demand for gilts remains healthy despite the level of yields.

So what does this mean for trustees?

With gilt yields at low levels compared to the last 20 years it is very easy to come to the conclusion that they must rise. We feel that the majority of any such immediate rises in yields may have already taken place or are already priced in (see the chart to the left).

None of this changes our view on absolute returns; over the short-term these look poor whichever way you cut it. If your focus is on maximising returns then gilts, especially conventional, remain an asset class to treat with caution.

The implications if you share our views are more significant for strategies targeting specific increases in yields and to ensure there are realistic expectations over when, or indeed if, these may be reached. We continue to encourage clients to focus first on affordability of gilt purchases for hedging liabilities, before trying to second guess markets.

Overall, we do not therefore feel that gilt prices can only move one-way from here and hence encourage clients to look for affordable opportunities, via the natural volatility in markets referred to earlier, to hedge their liability risk.

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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