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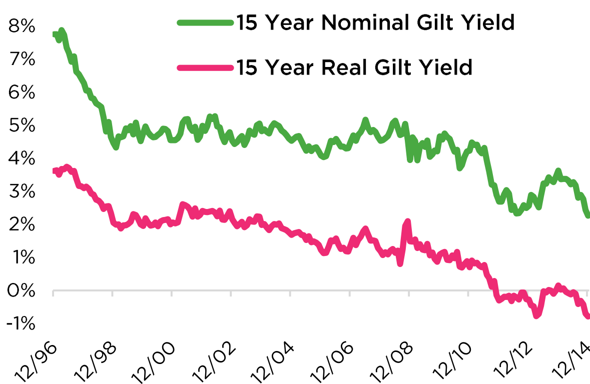
GILTS YIELDS AND PENSION DEFICITS

'Interest rating' times for pension scheme funding

Yields on long dated gilts went through the floor in Q4 2014. This was bad news for defined benefit pension schemes. In this paper, we comment on the outlook for interest rates and options for managing interest rate risk.

1 What has happened to interest rates?

After rallying over the second half of 2013, the downward trend in interest rates continued over 2014. By 31 December 2014, benchmark 15 year fixed and real gilt yields had fallen to just 2.2% and -0.8% per annum respectively - both new historic lows!



Source: Bank of America Merrill Lynch, January 2015

2 What's the impact and what can we do?

Falling interest rates mean larger deficits and employer contributions. This happens because on almost all valuation measures, the actuary's discount rate is either directly or indirectly linked to gilt yields.

Put simply, falling interest rates are bad news for pension schemes. We recommend that sponsors and trustees:

1. **Prepare themselves for large deficits and difficult funding negotiations - especially if they have 31 December 2014 valuation dates.**

2. **Build up their understanding of investment risks and consider hedging interest and inflation risks.**

3 "But yields are at historic lows. Everybody expects them to increase and isn't it better to de-risk then?"

This rationale is typically used to maintain the status quo and at first sight seems perfectly sensible. However, before brushing aside de-risking, trustees and sponsors should consider:

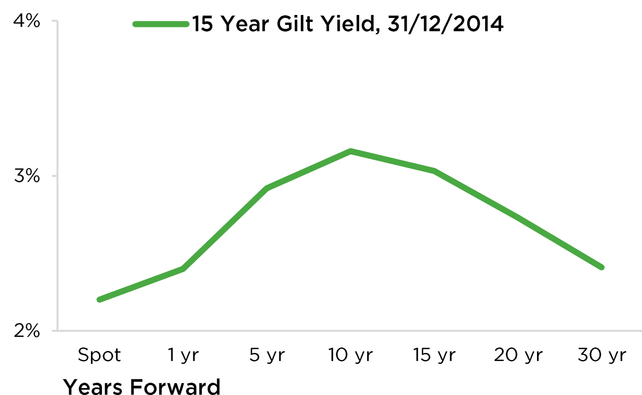
Market Expectations

Economists, investors, financial journalists, actuaries and trustees all analyse central bank announcements to predict the next movement to interest rates.

Everyone now believes that interest rates will rise – it's just a matter of when and by how much. However, if 'everybody believes' rates will rise, then surely this is already priced into current yield curves?

The argument for deferring de-risking is only valid if trustees and sponsors believe interest rates will rise by more and faster than 'everybody' already expects.

An indication of the markets view of the path of long term gilt yields can be found by examining the forward yield curve in the chart below. This implies that markets expect 15 year gilt yields to rise from 2.2% in December 2014 to 3.2% in 2024:



Source: BlackRock, January 2015

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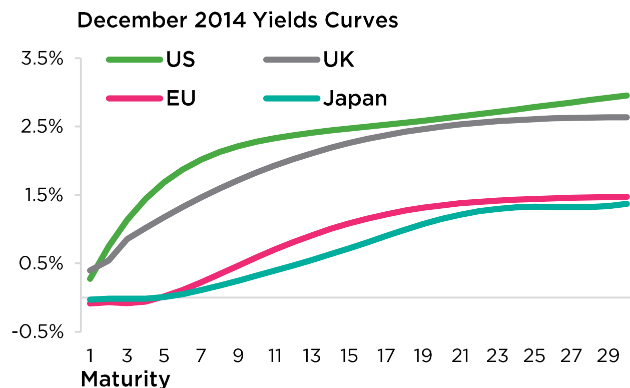
Our View

Our own view is that the market has this wrong – it always does! We believe confidence in the global economy and economic normality will eventually return, and when this happens interest rates could rise higher than expected - with 15 year gilt yields perhaps as high as 4%.

However, this is a long term view and we also believe there is considerable uncertainty as to interest rate movements in the short to medium term. Ageing populations, a declining ratio of working to total populations, pension schemes buying long-dated gilts, central bank policies, the risk of deflation in the EU, uncertainty over global economy and political risk could all act to keep interest rates low.

Moreover, although low, UK interest rates are still above those in other developed countries such as the EU Area and Japan, and over the short to medium term, we believe interest rates will remain low or even fall further:



Source: Bank of America Merrill Lynch, January 2015

4 "We still think interest rates are very low..."

Very well! We still recommend a good understanding of interest and inflation risks and the tools for managing these. In addition, we recommend monitoring scheme finances and interest rates to make sure de-risking opportunities are not missed.

Schemes already holding gilts could get this protection using interest rate swaps and leveraged gilts instead. This will free up assets which could be invested in growth.

Trustees and sponsors who believe gilt yields will rise may also believe inflation will do the same. In that case, be on the lookout for inflation hedging opportunities if breakeven gilt inflation is thought to be lower than historic RPI inflation.

In summary, we believe a better understanding of interest and inflation risk, and how this can be reduced and managed, would benefit all trustees and sponsors. Even those with firm views on the future path of interest rates.

If you would like to discuss this please contact your usual BROADSTONE adviser or:

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