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Thought Leadership

Pension funds and index-linked gilts: a supply/demand mismatch made in hell

A severe supply/demand imbalance means that pension funds waiting for index-linked gilt yields to rise to "attractive" levels are fighting a losing battle.

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– UK private sector defined benefit schemes already own an estimated 80% of the long-dated index-linked gilt market and potential demand is almost five times the size of the market.

– Supply is expected to remain high, and is likely to increase the market by around a third over the next five years, but this will not come close to matching demand.

– Other sources of inflation protection exist, but can only bring partial relief.

– Pension funds waiting for index-linked gilt yields to rise to "attractive" levels are fighting a losing battle. The imbalance is structural and yields are likely to remain depressed relative to economic fundamentals for the foreseeable future.

– A combination of a liability driven investment programme and a structured and disciplined flight path focusing on reducing risk when funding levels permit, is likely to represent the best course of action for most pension funds.

Long-dated index-linked gilts: the value proposition

Given the long-dated inflation-linked nature of their liabilities, a key benefit that pension funds gain from investing in long-dated index-linked gilts is management of liability risk and funding level volatility.

The index-linked gilt market was launched in the early 1980s to meet this specific need, with ownership initially restricted to pension funds or similar institutions writing pension business.

From a pension scheme perspective, "value" comes from risk mitigation, not return generation. This has important implications for the dynamics of this market.

Pension funds already dominate the long-dated index-linked gilt market

As is well known, UK private sector defined benefit pension funds are in (very) long term terminal decline.

According to statistics in the latest Purple Book from the Pensions Regulator, only 13% of private sector defined benefit schemes remain open to new members and around two thirds are now closed to future accrual.

As schemes have matured, the focus has shifted. Pension funds everywhere have attempted to de-risk in order to manage funding level volatility. Allocations to equities have slumped while allocations to bonds have soared.

The trend of increased allocation to bonds shows no signs of slowing down and this journey has much further to go.

Average asset allocation - UK private sector pension funds

Source: The Pensions Regulator Purple Book 2015, as at 31 March 2015

Data from the latest Purple Book indicates that, as at 31 March 2015, private sector pension funds had around 48% of their assets invested in bonds, of which 42% was invested in index-linked gilts.

This equates to around 20% of their overall portfolios, or around £260 billion in aggregate using 31 March 2015 asset values. Given that pension scheme liabilities can stretch decades into the future, this is likely to be concentrated in the long-dated part of the market.

In contrast, the over 15-year index-linked gilt market was valued at a little more than £317 billion at that time (£338 billion in June 2016), indicating that pension scheme holdings amounted to over 80% of the total – they dominate the market...

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