Investment de-risking – when is the right time to hedge interest rate risk?

Introduction

The use of liability driven investments ("LDI") has increased over the last few years. Rising liabilities due to falling gilt yields has led to greater emphasis on hedging interest rate risk and the increased availability of pooled LDI funds has enabled small to medium sized pension schemes to use leveraged solutions.

However, given that gilt yields remain close to historic lows, trustees and sponsors are spending more time asking themselves the following questions: when to increase hedge ratios; how to increase hedge ratios; and how much to increase hedge ratios.

Why hedge now?

Many pension schemes have had low hedge ratios, which has left them exposed to changing interest rates and inflation expectations, a risk that could be argued is not rewarded. Some rise in interest rates is already priced into the market, however, it is not inconceivable that the path of interest rates could be lower and slower than current market expectations, leading to a further rise in the value of pension scheme liabilities.

There is a supply/demand imbalance of gilts, with issuance currently expected to be lower than demand. Insurance companies and pension schemes have traditionally been the largest holder of gilts, but the increase in demand from overseas investors and the fact that the Bank of England hold a large proportion, has led to yields being pinned down at the long end of the curve. Indeed, index-linked gilts syndications have been heavily oversubscribed over the last few years.

Given the current government's pledge to reduce borrowing in the next few years, the supply problem is unlikely to go away. Adding in the fact that pension schemes are going to be increasing hedge ratios, this leads one to conclude that the supply/demand imbalance is going to keep yields pinned at low levels.

Why wait?

Gilt yields have fallen considerably over the last few years, which has led to a large rise in the value placed on pension scheme liabilities. Trustees and/or sponsors may wish to continue to take interest rate risk in the belief that interest rates will rise. If interest rates do rise faster than currently priced in then funding levels are likely to improve.

There is also the opportunity cost and regret risk of increasing hedge ratios and then seeing interest rates rise. Given the current level of yields, many now believe that interest rate risk is rewarded and that there is greater upside than downside.

Striking a balance

The case for hedging or not hedging is not a simple decision and it is difficult to predict which direction interest rates are going to go. Therefore it is important for trustees and sponsors to be as objective as possible and consider individually the different factors that go into setting a hedge ratio.

In order to make a decision, the initial starting point should be the market neutral hedge ratio which is defined as either fully hedging the level of liabilities (lock into the deficit) or fully hedging the level of assets (lock into the funding level). A market neutral hedge ratio is absent of any market views.

Trustees should then consider what their optimal hedge ratio is, which takes into account a number of factors:

- Sponsor covenant
- Current funding position and expected return
- Market views and risk appetite
- Risk optimisation
- Diversification and available tools

So when is the right time to hedge interest rate risk? There is no right or wrong answer but it depends on the individual circumstances of the pension scheme and views of trustees and sponsor. Trustees should be encouraged to consider what factors are important to them when deciding on when to hedge, how to hedge and how much to hedge.

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