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# LDI & the Gilts Market

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Clients that have followed the team's thinking over many decades are familiar with some of the key principles that drive our investment philosophy. Often these principles are drawn from famous thinkers and practitioners in the field of finance and economics. A good example is the exhortation to "avoid the permanent impairment of capital," that is the centrepiece of Ben Graham's book, "The Intelligent Investor." Required reading for those who invest and the foundation on which Warren Buffett built his fortune and Berkshire Hathaway.

Another component of the Tacit catechism of investment is the idea that, "Every generation discovers the magic of leverage," best expressed by the economist and US policymaker J K Galbraith in his short, but again essential, "The Great Crash," which looks at the combination of innocence, cupidity and stupidity that led to the US Depression via the 1929 stockmarket collapse. As Galbraith never tired of pointing out, leverage works in both directions; it juices returns magnificently in the upturn and wreaks untrammelled destruction of capital in the downturn.

The third pillar of our approach stems from Paul Volcker's assertion, when he was Chairman of the Federal Reserve, that the "only useful innovation in finance in his lifetime was the introduction of the ATM," the hole in the wall.

What he meant by that was that finance does not lend, as it were, itself to innovation and that at bottom all financial innovation boils down to different types of debt laced with differing degrees of leverage, either borrowed in cash or derived from the markets in financial derivatives; the weapons of financial mass destruction as Mr Buffett famously describes them.

One of the endlessly fascinating aspects of finance is the capacity of markets to introduce risk even into the safest and least risk tolerant of financial enterprises. The events of the last week or two in the arcane world of LDI or "Liability Driven Investment," is yet another example. The totally unexpected impact of the ill-advised mini-budget was to blow-up real yields, sink the gilts market, expose a serious fault-line in the provision of pensions, and force the Bank of England to intervene in its function of lender of last resort.

The more lasting consequence of the "event" is that low-cost mortgages are now a footnote in economic history and the standard variable rate is over 6%, leaving many mortgagees with payments 2 or 3 times higher than previously expected or budgeted.

The irony is that LDI in its infancy was designed to mitigate and reduce risks. What became its undoing was the long, long decline in interest rates that came to such an abrupt halt a week or so ago.

The idea behind LDI is that the liabilities associated with an investment are carefully analysed, projected forward under "realistic" assumptions, and then matched with a series of appropriate assets that exhibit the appropriate levels of risk, tested under various scenarios. It is a perfectly valid approach that we have adopted in times past, and it concentrates the mind of the investor on assessing and evaluating the risk/reward trade-offs of competing strategies over specific time frames.

One example might be to look at a client at age 70, for example, and match their income needs to their "demographic," say age 85, with a series of bonds that mature every year, on a specific day, to their 85$^{th}$ birthday. The surplus might then be invested in a more volatile, stockmarket environment, over an extended timeframe with the proceeds used for further income, care, or inheritance.

That is one example of liability-driven investment but the big defined-benefit schemes, that are largely closed to future pensioners but largely underpin current pensioners, have the same problem. How do they match existing specific, current liabilities with security and at the same time meet future unknown liabilities securely?

The problem is simply this: if my investment rate is declining then the cost of a given stream of future income is higher, forcing me to invest more in safe but lower and lower yielding instruments.

The difficulty with that approach is that I have a reducing amount of capital available to me with which to tackle the longer-term liabilities of my total portfolio.

In the case of our example retiree above, the cost of securing her income with certainty as interest rates (and gilt yields fell) became prohibitively expensive and we were forced to abandon the strategy some time ago.

This is a distortion in financial markets that is a direct consequence of Quantitative Easing and has nothing to do with the mini-budget, except to say the budget lit the blue touch paper and exposed a hitherto unappreciated systemic risk running through LDI investments.

That unappreciated risk was the use of "leverage." In attempting to juice returns and offset the rising amount of capital needed to be set-aside to secure current liabilities, as the long downtrend in interest rates extended to nearly forty years, the use of derivatives (synthetic leverage) expanded.

The world of derivatives is unlike the normal financial markets in that return trade-offs are fixed, leveraged and open-ended, all at the same time. Each counterparty to a derivative has a very explicit exposure to one of those risks. The risk is managed using a deposit known in the trade as "margin." Derivatives exchanges don't go bust; counterparties occasionally do but that risk is managed because the exchanges require that sufficient margin is posted by the investor, at each daily close, to cover the combined profit and losses of all market participants.

The leverage or debt derivatives that were used by funds to maximise their returns on the smaller pool of assets securing their long-run liabilities were secured on the very gilts underpinning their short-term liabilities.

When the mini-budget turned forty years of interest rate declines on their head and sparked a very sharp and immediate spike in interest rates, "leveraged" LDI investors had to post more margin, which meant a deluge of selling in their most liquid assets, the gilts they were using to meet their near-term liabilities.

Result: a leveraged doom-loop in the safest asset you can buy.

The Bank of England stepped in, and the panic is now over but it marks a sea-change in the path of interest rates and is yet another reminder that the untutored combination of leverage and financial innovation can indeed, lead to the permanent impairment of capital.