How did gilts take us so close to catastrophe?

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Here is something you don’t really understand. It will increase your returns while reducing the risk”. This, in a nutshell, is the cause of last week’s near-catastrophe in the gilts market. As a piece of financial prestigidation, Liability Driven Investing (LDI) is right up there with the raft of other initials which somehow offer this beguiling prospect. Against the super-smart bankers and fund managers who peddle this stuff, the part-time pension trustees don’t stand a chance.

Well, not quite all of them. Some had been reluctant to drink the bankers’ Koolaid, even when their fund manager urged them to do so. Take, for example, the Universities Superannuation Scheme (USS), with over £80bn under management, managing the pensions for half a million employees in higher education. You would not expect the vice-chancellors of Oxford and Cambridge, plus the president of Imperial College, to see the potential for disaster in a proposal from the chief executive of their scheme to bet heavily on LDI. In February this year, they did exactly that.

So what is behind the mystery initials? At its simplest, a pension fund is a collection of contributions made over the years by employers and employees, invested to produce returns to pay the pensions as they fall due. In recent years, the ultra-low yield on government bonds caused the funds’ managers to worry about meeting their obligations. The City boffins had the answer: juice the returns. This involved borrowing to buy programmes involving bets on future movements of interest rates, derivatives that Warren Buffet memorably once described as “instruments of mass financial destruction”.

In normal circumstances, the prices move in predictable ways which allow the risks to be measured and balanced. In abnormal circumstances, such as the reaction to last week's banana republic Budget of unfunded tax cuts, it all goes horribly wrong. The markets took fright at the uncosted liability, Government stocks fell heavily, and the purveyors of LDI instruments demanded more cash as collateral to compensate. The pension funds had to sell whatever they could to raise it, which meant holdings of government stock. This drove down prices further.

The damage to conventional bond prices was dramatic. That to index-linked bonds where returns are geared to UK inflation was near-catastrophic. These are supposed to provide protection against inflation, but it provided no protection last week when there were effectively no buyers. Some index-linked stocks almost halved in a day.

To avoid catastrophe, the Bank of England pledged to pour £65bn into buying bonds, reversing the policy it had declared only days earlier. It really had no choice. The Financial Times article explaining the crisis was headlined: "The better mousetrap that almost broke the UK." The Bank's intervention stopped the rot, but the support lasts only until October 14, and the damage to the credibility of UK government debt may be permanent, meaning more expensive borrowing.

Which brings us to the USS. The plan from Bill Galvin, the chief executive, was to raise the proportion of the fund in LDI assets (primarily index-linked gilts) from 35 per cent to 52 per cent, and to increase the leverage from 17 per cent to 37 per cent. In response the trio – Louise Richardson, Stephen Toope and Alice Gast – concluded: “We do not believe that the case for further purchase of inflation-linked bonds has been made and we believe the increase in leverage may introduce potentially significant risks into the scheme in a period of high market volatility.”

This was, remember, last February, a time that looks like tranquil stability compared to last week’s earthquake, from three people who would not claim to be experts in managing complex financial instruments. They could see the danger in a way that their fund manager could not, by applying the best test of any clever plan – *cui bono?*

We are dealing with billions of pounds here, so even a sliver of commission is a very large sum. Just as the butcher sells meat to make a profit not because he loves you, the derivative salesman acts in his own interest – and such is the scale of rewards that he may never need sell you anything again. Your risk, his reward.

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