The Impact of Gilt Yields on Pension Schemes

Gilt yields significantly affect the funding position of pension schemes such as the Pearl Scheme.

What are gilts?

Gilts are loans to the UK Government. The Government has to pay interest to the owner of a gilt as well as a final 'redemption' payment when the loan term ends. Gilts can be bought and sold (the new owner becoming entitled to the interest and loan repayments) and they are a very actively traded type of investment, especially for institutional investors like pension schemes or insurance companies.

Why do pension schemes invest in gilts?

Gilts are often seen as the lowest risk asset available in the UK investment marketplace, since it is expected that the UK Government is very unlikely to fail to pay its debts. Other investments like equities (i.e. shares in companies) are considered to be more risky, since companies can (and do) fail, leading to potential losses for investors. To compensate for this risk, investors hope to obtain higher investment returns from equities than those available from gilts. Whilst, on average, the return is expected to be higher from these more risky types of investment, the risk of suffering a loss is also greater, especially in the short term. In essence, gilts provide lower levels of investment return, but they provide those returns with greater certainty.

In practice, pension schemes invest in a mixture of different assets, including gilts and equities – the mix will depend on the circumstances of the scheme in question. The Pearl Scheme is no exception, with gilts currently making up roughly half of current assets, but, over the long term, the Trustee expects to move to a lower risk investment strategy which would very likely mean more gilts. This is because as the Scheme matures the Trustee would like to invest in assets which would provide more certain future investment returns as this should provide better security for members' benefits.

What do we mean by the yield on gilts?

The yield available on a gilt is a measure of the future investment return that can be expected to be received, based on the current market price of that gilt. If the price of a gilt rises, this means investors are willing to pay more to receive the interest and redemption payments. As they are making a higher initial investment to obtain the same future income, the expected future returns as a percentage of purchase price will be lower – in other words, the yield is lower. The key point is that as the prices of gilts rise the yields fall, and vice versa.

How is this different from interest rates?

The main difference between yields and "interest rates" is that whilst yield commonly refers to the market level of return the investor receives from a security like a gilt, interest rate generally refers to the interest charged by a lender such as a bank on a loan, or offered on a savings account.

The Bank of England sets its interest rates monthly and does so with the aim of providing stability to the UK economy (for example, it aims to keep inflation low to preserve the value of your money). Their decisions (and those of other banks) are not subject to the same market pressures affecting the returns on gilts which (like stock market prices) are changing constantly based on market sentiment, and hence you often see a difference between yields and interest rates, although gilt yields at short durations are linked with short-term interest rates.

How does this impact the funding of the Pearl Scheme?

When the actuary calculates the funding position of the Pearl Scheme, he assesses the level of assets the Scheme needs to pay the benefits of the members (often referred to as the 'liabilities'). This can then be compared to the actual level of the Scheme's assets to arrive at the funding level. If the assets of the Scheme are below the required level, there is a funding shortfall (i.e. the funding level is below 100% if the actual assets are below the liabilities of the Scheme).

To assess the liabilities a prudent assumption needs to be made about the return that will be earned on the assets which the Scheme will invest in. This means that any allowance for future investment returns should aim to under-estimate the likely returns to be achieved. For this purpose the Pearl Scheme Trustee and the Company have agreed that the allowance for future investment returns should be based on those achieved from gilts only, i.e. reflecting gilt yields. This approach is prudent because it does not take any advance credit for the higher returns that are hoped will be achieved from the other non-gilt assets that the Scheme invests in. It also reflects the long term aim of the Trustee to invest the Scheme's assets mostly in gilts at some point in the future.

(This approach to assessing the Scheme's liabilities is more prudent than that adopted by many other pension schemes which allow for higher investment returns than can be earned on gilts which leads to lower values being placed on the liabilities of those schemes.)

What happens when gilt yields change dramatically?

The recent sharp fall in gilt yields means that the liabilities of the Pearl Scheme have increased. Although the gilt assets of the Scheme have also increased in value, the Scheme invests in other assets which have not increased in value to the same extent. As a result this has meant that the funding position of the Scheme has got worse, because the increase in the liabilities of the Scheme has been greater than the increase in the value of the Scheme's assets. For example the change in gilt yields over the period from 30 June 2011 to 31 March 2012 has increased the Scheme's liabilities by around 15%.

However, members should always remember that the Scheme has to make payments for a very long time into the future and it is backed by contributions from the Company so it does not need to be overly concerned by short-term movements in the funding position.

It should also be recognised that any future increase in gilt yields would be expected to have the opposite effect – reducing the value of the Scheme's liabilities faster than the value of the assets and hence reducing the deficit.