# Eleon Capital Management Ltd.

## - MARKET OUTLOOK -

EDITION 1/2022

## NET ASSESMENT

OCTOBER 2022

At the time of writing this net assessment, I am sure that every investor is by now aware of the devastating impact that the gilt market had on the UK pension fund liability-driven investment (LDI) strategies following the mini-budget presented by the new UK Chancellor, only to be 'bailed out' by the Bank of England a couple of days later.

To understand how this situation regarding LDI came about, it is important to realise that historically pension funds (given their long-term liabilities) viewed investing from the long-term perspective, i.e. they estimated both their labilities (both in duration and amount) and prospective long-term returns and assessed the funds surplus or deficit. However, the introduction of mark-to-market for pension fund accounting introduced a high level of volatility in company accounts on an annual basis since asset prices often vary widely irrespective of fundamentals causing pension funds to swing wildly into deficits or surpluses over time. Such volatility puts immense pressure on pension fund trustees to reduce this volatility. Herein came the investment consultants with the introduction of LDI strategies. Initially, this involved mapping a pension fund's liabilities over time and creating a fixed-income portfolio of assets whose coupon and redemption payments matched the liabilities to a high degree. Naturally, many pension funds found insufficient assets to cover their liabilities and corporates were reluctant to fund those deficits. So, what did the consultants recommend? In essence, they leveraged the pension fund portfolios by introducing derivative instruments designed to match those liabilities and use the assets as collateral. As gilt prices tanked, pension funds, in the past week, were faced with margin calls against those derivative contracts, which could only be met by selling some of their gilts and as the prices of those gilts fell further due to forced selling, it created a death spiral that almost bankrupted the UK pension fund industry. The addition of derivatives was the detonator; all it took was a "market event" to trigger it.

It is challenging to identify where system stresses will appear in advance. Following periods of rising asset prices, low asset price volatility, high liquidity and money supply, deteriorating lending standards, high investor optimism, and low investor risk aversion, all being reinforced by low-interest rates, stable and low inflation, quantitative easing, consumer stimulus from governments, accommodative central banks, excesses that can endanger the financial system and hence the real-world economy will begin to develop. Once these conditions and/or measures are removed or are no longer valid, they will start to expose the weaknesses (both known and usually unknown) slowly but gradually, as witnessed in 2007/2008 as money market funds 'broke the buck', Bear Sterns had to be bought and Lehman subsequently imploded. It further reinforces that investors do not focus on fundamentals but instead overemphasize the role of central banks, particularly the FEB to drive their investment strategies or save them from poor investing decisions. It also highlights that investing is a long-term activity that needs long-term solutions (the rest is speculation) and that are no miracle solutions in investing without taking undue/higher risks (albeit they are exposed over time).

While it is almost certain that short-duration T-Bills (treasury bills) or equivalents will have their value eroded due to inflation, similarly and most likely, the same fate is anticipated for fixed-interest securities. While it is also almost certain that the economic cycle and inflation will significantly strain company earnings, over the long term, a collection of good businesses will do well, especially if bought at reasonable prices.

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*Strong Roots, Sustainable Growth*

**Eleon Capital Management Ltd.**

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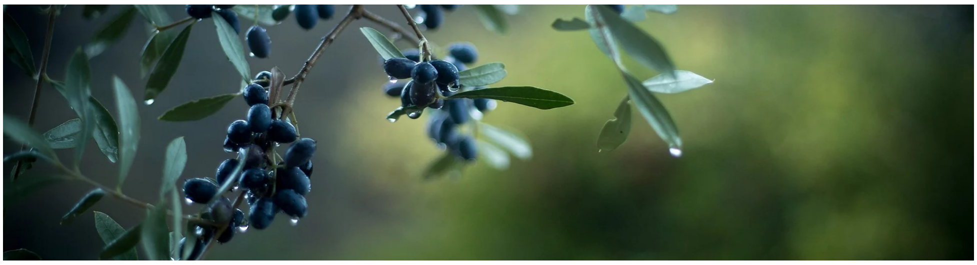



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