Trustee toolkit downloadable

An introduction to investment

Case example 4 of 5: Supply and demand

Here you can find out about the effects of supply and demand on the gilts market.

This case example is linked to the tutorial **Capital markets and economic cycles**.

The Pensions Regulator

The UK gilt market

If we created a line chart of yield percentages for the UK Government gilt market for the period of October 2005 to January 2006, we would see that in October 2005 the UK gilt market had a yield percentage of just over 1.2%, but by January 2006 the yield percentage had dropped to 0.5%.

Yields went down a lot?

They certainly did. In May 2006 the yield on 10-year index linked gilts was just under 1.25%. The yield on 50-year gilts was just 0.38%, which was well below the UK long-term average gilt yield of about 3%.

Why were the yields so low?

When the price of gilts goes up, the yield goes down. The demand for gilts far outstripped supply for a number of different reasons, and this caused the price of gilts to rise. These reasons included an increased demand from defined benefit (DB) pension schemes and a reluctance on the part of the government to release new issues.

Why the demand from pension schemes?

By 2005, many DB pension schemes had recognised that their equity investments had underperformed against their targets by a wide margin. Trustees had become acutely aware of the risks in equities. At the same time, liabilities had increased because of reduced mortality rates and low interest rates, not to mention low gilt yields. Trustees wanted more security in their investments, not least because of the demands of the regulator, and of the Pension Protection Fund when setting its levy.

How much did the fall in gilt yields matter to pension schemes?

A very great deal. Gilts became very expensive and, although the income would be secure when the liabilities fell due, it would have been bought at a very high price. As you have seen, when gilt prices are high, gilt yields are low. However, gilt yields are a major component in measuring DB pension scheme liabilities. So, when gilt yields are low, liabilities go up.

You have now reached the end of this case example.