

Views from the LDI Desk

BlackRock®

Adding value in LDI hedges

Over recent years, market dynamics have shifted significantly. Rising issuance, together with a substantial change in investor demand, is creating a broad set of opportunities across fixed income markets. This paper explores these developments and highlights how they may translate into discretionary opportunities for clients within LDI portfolios in the UK market.

Changing landscape

The UK rates market has entered a phase where elevated issuance, evolving supply–demand dynamics and a changing investor base are creating a richer opportunity set for discretionary portfolio management. For LDI investors, this environment rewards a more active approach – one that looks beyond headline yields to identify relative value across gilts, inflation markets and high-quality spread assets.

Shifting supply–demand

In nominal markets, increased Gilt issuance across the curve along with a shift in the curve profile of issuance is driving greater dispersion in valuations, opening opportunities to add value through relative value positioning and maturity selection.

At the same time, shifts in the balance of supply and demand in the inflation market, driven by changes in Index-Linked Gilt issuance patterns and investor behaviour are creating dislocations in the relative pricing between RPI swaps and Index-Linked Gilts.

Schemes being better funded with larger allocations to government bonds and LDI along with using less leverage is creating an opportunity for investors to work their hedging assets harder and take advantage of opportunities.

This paper discusses many aspects of the UK market, the inefficiencies and how discretionary management can potentially capture some of these opportunities for LDI investors.

£310bn

Average Net Gilt issuance over the next 5 years and shortening of WAM having impact on Gilt curves

-10%

Reduction in Pension and Insurance Gilt ownership over last 5 years driving a shift to more yield sensitive investors

300%

Increase in average OAS of neighbouring government bonds (representing dispersion)

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Significant shifts in supply

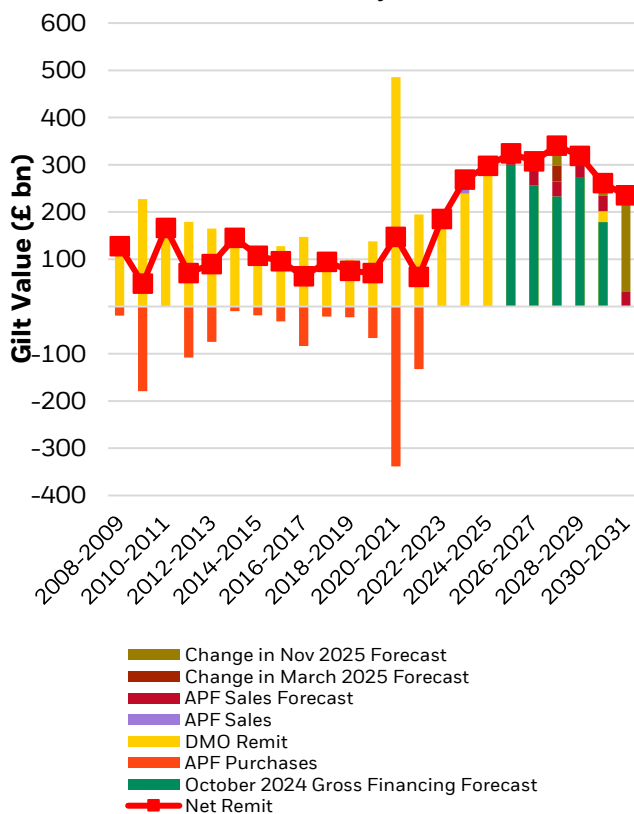
Over the last few years, we've seen a step-change in the overall amount supply of UK government bonds. This increase in issuance is driven by a range of factors such as the overhang from the COVID-19 pandemic, increased fiscal pressure, and a shift from the Bank of England of accommodative monetary policy to tightening.

In the autumn budget, Chancellor Reeves took steps to increase the Fiscal headroom through a combination of policy changes that look to increase tax revenues and curb spending. However, the net supply for Gilts remains high, and is expected to remain so over the next 5 years.

The volume of supply has heightened the need for policymakers and debt management offices to closely consider the market implications of their actions.

Net Gilt supply remains elevated

Gilt supply currently sits at c.£300bn p.a. and expected to remain at this level for the next 5 years



Forecasts may not come to pass. Source: BlackRock, DMO, OBR, BoE. Assumes updated pace of quantitative tightening allowing for passive and active sales.

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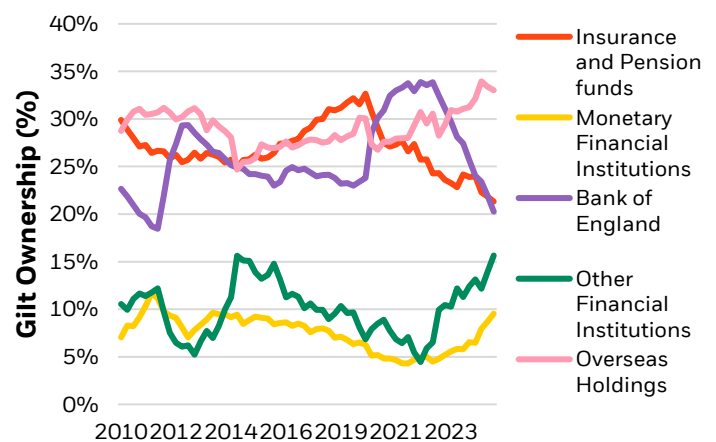
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Shifts in demand

We've also seen a significant shift in investor base for Gilts driving change in demand, historically Pension Schemes acted as structural buyer of Gilts, this is no longer the case with high funding and hedge ratios requiring little net demand. Instead, we've seen a transition to a more yield sensitive buyer base in overseas investors, hedge funds and other financial institutions.

Shifting buyer base

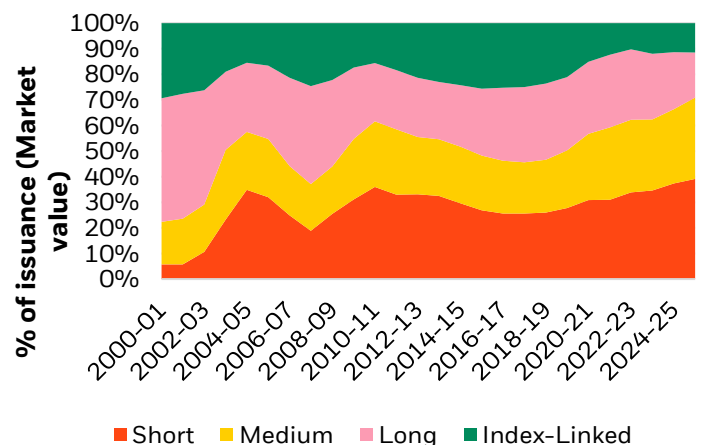
Move from Pensions to a range of other investors



This demand shift is driving a change in behaviour of the debt management office ('DMO'), who have been drastically reducing the amount of long-dated and Index-Linked supply in recent years, ensuring that issuance events continue to be well subscribed.

Shifting supply from the DMO

Shortening WAM and reduction in Linker allocation (%)



BlackRock, December 2025

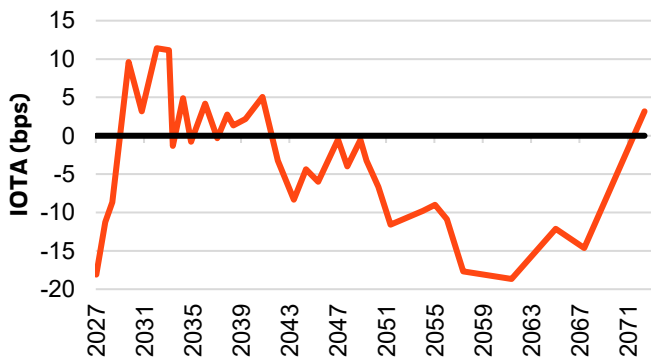
Impact on Inflation basis

Furthermore, we've seen a marked shift in the relative appeal of Index-Linked Gilts (or 'Linkers') from an insurer perspective, tight credit spreads coupled with wider Gilt asset-swap levels, have enhanced the return efficiency of Linkers from a solvency capital perspective.

This demand from insurers (and lack of long end supply) is having a significant impact on Inflation basis (the difference between Linker-implied inflation and swap-implied inflation).

Will Linkers continue to outperform?

IOTA – measure of Inflation implied by Linkers vs Inflation Swaps has seen continued pressure (negative means Linkers are more expensive)



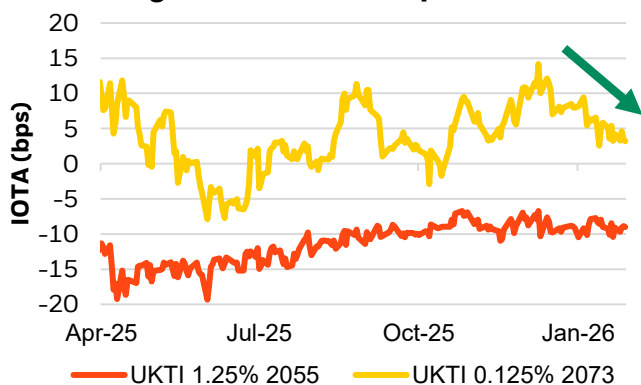
Source: BlackRock, January 2026

Where clients allow discretion, having the flexibility to act on these dislocations can generate meaningful incremental returns.

A recent example was the temporary cheapening of the ultra-long end of the linker curve, most notably the 2073s, which had materially underperformed nominals on an asset-swap basis. We took advantage of this by switching part of our long-dated conventional gilt exposure into the 2073 linker whilst removing the associated inflation exposure via inflation swaps.

This left discretionary portfolios with broadly unchanged real-rate and inflation-sensitivity profiles but allowed us to monetise the unusually wide inflation basis. As the basis subsequently normalised supported by stabilising LDI flows and continued long-end demand from insurers, the relative performance of the linker position contributed positively to returns.

Ultra long end Linker underperformance



Source: BlackRock, January 2026

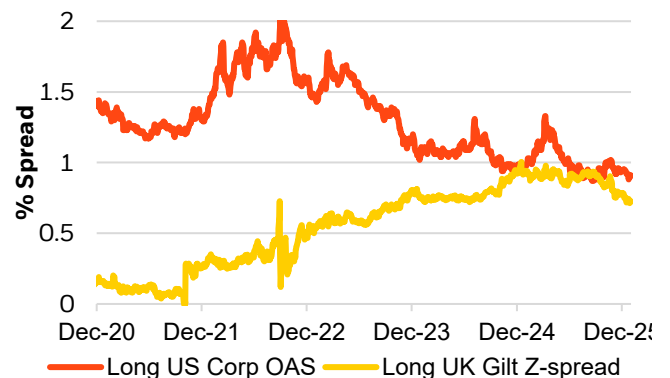
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Opportunities in Gilt and swap relative value

Another important area where discretionary LDI management can add value is in navigating the relative pricing between gilts and interest rate swaps. Over recent years, we have seen a persistent structural widening in UK gilt Z-spreads, a trend largely driven by elevated financing requirements and increased scrutiny over the sustainability of the UK's debt burden. As nominal gilt supply has remained high, investors have demanded greater compensation to hold government debt, causing gilts to cheapen relative to swaps.

At the same time, credit markets have moved in the opposite direction. Despite macro uncertainty, global investment-grade credit spreads have continued to grind tighter, leaving credit increasingly expensive when compared to Gilts. This divergence of credit tightening while gilt Z-spreads widen has created an environment where unhedged credit exposure has offered limited relative value, whereas gilts (adjusted for swap spreads) have provided more compelling dislocation-driven opportunities.

Widening in Z-Spreads for gilts while credit continued to tighten

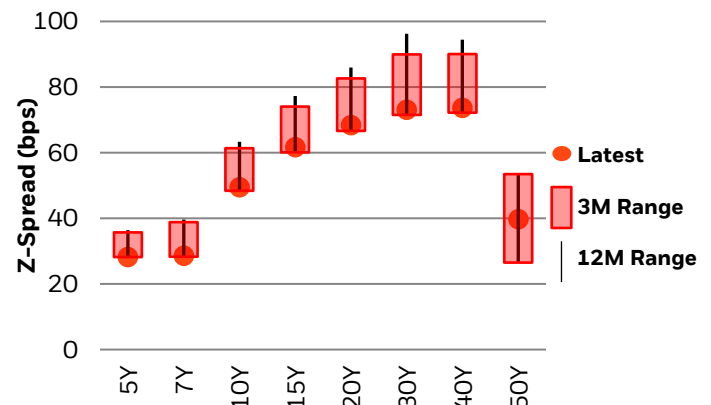


Sources: Bloomberg

Against this backdrop, opportunities continue to arise across the gilt curve. The past year has shown outperformance of gilts on a Z-spread basis, with continued volatility that create opportunities.

Nominal Gilts asset swaps

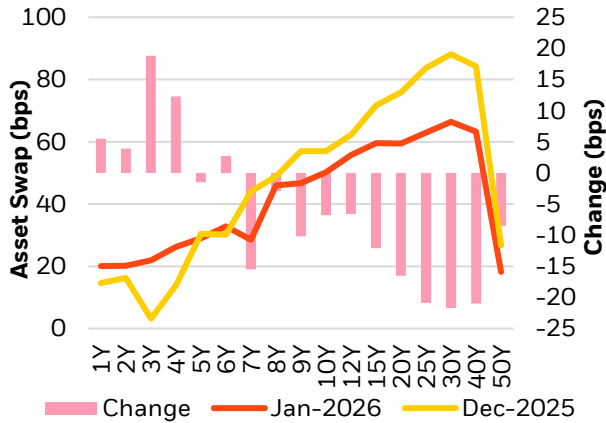
Supply and demand driving structural shifts in Z-spreads across the curve



Source: BlackRock, January 2026

The DMO's shift in issuance has left the long end relatively under-supplied, while strong convexity demand continues to support valuations. As a result, long-end asset-swap levels now reflect a more balanced mix of demand-supply dynamics and the embedded political risk premium. In this environment, we prefer to lean with the move trading these spreads from the long side rather than fading them, allowing us to capture incremental value through targeted discretionary RV positions.

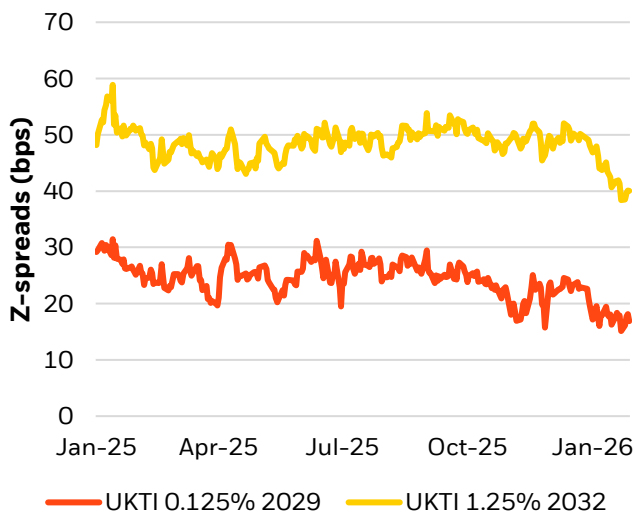
Nominal asset swaps shifts in curve shape



Sources: Bloomberg

In the linker asset-swap space, we held a long position in short-dated tenors. Over the last year, these front-end linker asset-swap levels remained very stable, even when the broader market experienced volatility. Steep real-yield curves mean the carry (return earned through the passage of time) in this part of the curve remains strong amid low volatility and as a result the trade generated steady, reliable returns. It's a good example of how choosing stable, high-carry parts of the market can add consistent alpha in an LDI portfolio.

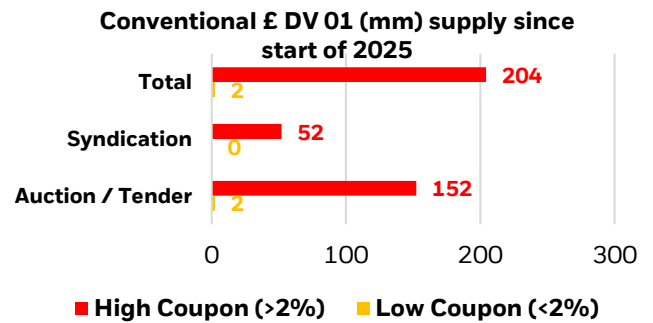
Front end Linker Asset Swaps



Sources: Bloomberg, BlackRock

Increased dispersion amongst individual Gilts

Over the past year we have seen a notable increase in dispersion across the gilt market, particularly when comparing bonds with similar maturities and structural characteristics. A key driver has been the changing composition of supply: since the start of 2025, issuance has been heavily skewed toward high-coupon conventional gilts, with DV01 supply materially larger than in low-coupon lines (as shown in the chart)

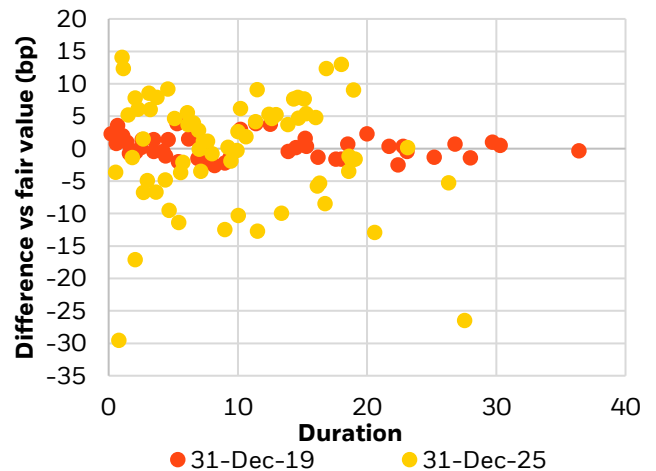


Sources: DMO, BlackRock

These dynamics are further amplified by behavioural factors among holders of low-coupon gilts, where the pull-to-par effect can create tax-efficient outcomes for some investors. This can lead to persistent richness in certain low-coupon bonds even when neighbouring gilts offer more attractive valuation metrics. The result is a wider distribution of relative value outcomes: while historically the average deviation from fair value was around 2–3bps, today we see levels closer to 9bps, reflecting a more dislocated market environment.

The relative value scatter chart illustrates how this dispersion has widened over time—with a far broader range of deviations at similar durations compared with earlier periods pre-covid and pre the regime change in rates.

Dispersion in gilt yields



Sources: Bloomberg, BlackRock

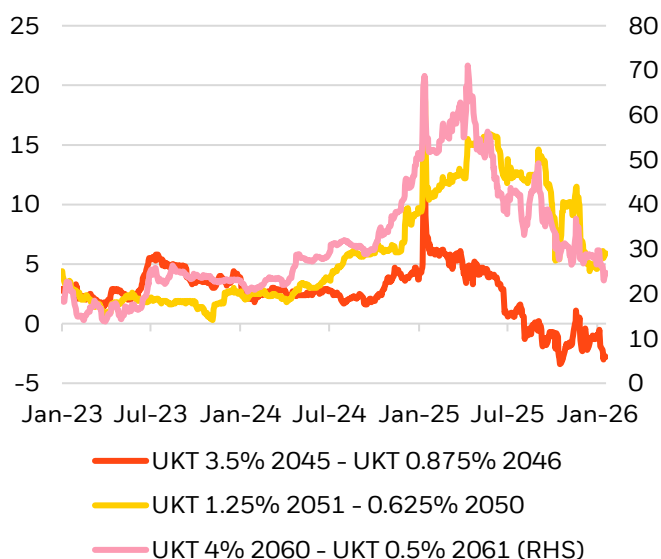
For discretionary LDI managers, these conditions present ongoing opportunities to generate incremental returns by switching between mispriced bonds and their more efficient neighbours. In an environment where dispersion is rising and supply is unevenly distributed, the ability to rotate between high- and low-coupon lines, or between rich and cheap issues of similar duration, can consistently add a few basis points of performance that would otherwise be left on the table.

This imbalance has created persistent valuation gaps as the market absorbs differing liquidity profiles and differing investor preferences across the curve.

Low/ high coupon bond switch example

An example of exploiting curve-adjacent dispersion is our position **long UKT 4% 2060 versus UKT 0.5% 2061**. These two gilts sit next to each other on the curve with near-identical duration, yet the low-coupon 2061 has often traded rich due to structural demand and tax-driven pull-to-par effects, while the higher-coupon 2060 has tended to appear cheap. As the chart shows, the spread between the two has moved sharply over time, creating opportunities to capture value as the relationship normalises. This switch has been a reliable source of relative-value with minimal directional rate risk.

High coupon vs Low Coupon Gilt Yield Spreads



Sources: BlackRock, January 2026

Key takeaways for LDI Investors

1. The size of LDI allocations for pension schemes has grown considerably over the last 5 years as a function of funding levels and portfolio de-risking.
2. We believe that the current market environment provides ample opportunities for Pensions Scheme's to work these assets harder and potentially generate modest returns within a risk-controlled framework;
3. Continued dispersion in markets driven by increased supply and shifts in the profile of supply are creating opportunities to capture value for LDI investors.
4. Changing behaviour of the investor base shifting from a structural demand base in DB pension schemes to one that is more yield sensitive
5. Continued political risk in the UK with upcoming local elections, and the shifting geopolitical environment could create further opportunities

If you would like to learn more about these themes or how they could be applied within your LDI portfolio, please reach out to your usual Client PM contact.

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