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Fixed income focus:

Expanding horizons

Andrew Swan, director of fixed income, M&G Investments

Investing across the full credit spectrum

Andrew Swan explains why pension fund trustees are widening their fixed income allocations to include private debt assets

Pension schemes will usually have extensive holdings of public market securities, typically conventional and index-linked government bonds, as well as investment-grade corporate bonds. Public debt assets have the potential to offer excellent value opportunities and are generally liquid; however, pension schemes' need for income sources above government debt rates – which are extremely low – has prompted many trustees to consider allocating to private debt assets in order to generate higher risk-adjusted returns.

Together, publically quoted and privately sourced credit instruments can form the building blocks of portfolios that can be tailored to schemes' requirements to achieve their desired outcomes.

Investing for cashflows

UK pension schemes are now seeking to structure their asset portfolios to generate cashflows that more closely reflect the profile of their liabilities, while at the same time diversifying away from the volatility and uncertainty of more traditional asset classes.

Specifically, private assets can help schemes gain exposure to long-dated, contractual cashflows – whether fixed, floating or inflation-linked – that are well suited for longer-term liability matching purposes as well as delivering pension payouts as they fall due.

Private debt: A premium for illiquidity and better protection for investors

As the yields available in public markets have continued to compress, investment consultants in the UK have steadily looked to private debt in search of higher returns – recommending their clients consider an allocation to private debt as part of a diversified portfolio. As many schemes are still below target allocations, there is still more to be done to facilitate greater investment in private and illiquid debt.

Part of this may be due to the fact that private and illiquid assets are typically less well known and can be esoteric in nature, so investors may be less comfortable investing in them. While most private loans are illiquid, meaning they will normally be held by investors to maturity, the exception is European leveraged loans, where an active secondary market exists.

Short-term liquidity may not be a primary concern for pension schemes, given the long-term nature of the liabilities they face, but scheme trustees need to be aware of how private and illiquid assets will fit in their portfolios as individual holdings have different liquidity profiles.

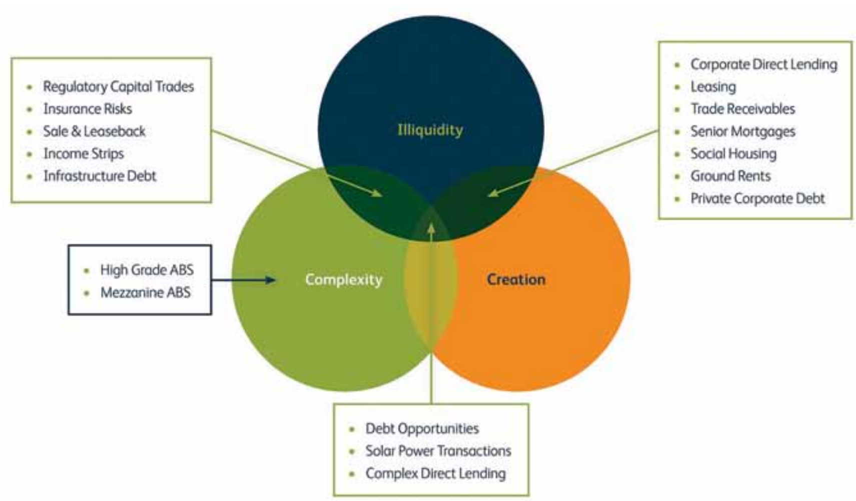
Reassuringly, private debt assets will ordinarily pay a premium over similarly-rated public bonds to compensate investors for their lack of secondary trading and ability to sell at a good price at any time. This is often referred to as an 'illiquidity premium'.

The opportunities in the private debt universe span a diverse range of maturities and risk/return profiles. As such, an investor will often need the resources and expertise in place to identify and source potential investments, conduct due diligence and analysis to understand the credit risk upfront, and perform ongoing credit monitoring. Consequently, these assets may justifiably command a return premium reflecting the additional complexity involved. Complexity can arise in situations where a borrower is distressed or whether the size, type or geography of an asset makes it harder for investors to understand or value.

The graphic below illustrates how particular strategies derive their excess returns relative to traditional market returns.

Private debt asset classes are secured (private placements are unsecured but rank alongside banks) and mostly senior

Where do returns come from?



Source: M&G Investments, June 2017

in the capital structure. This means that if an investment does not perform as expected, then the owners of these assets are first in line to be repaid, ahead of unsecured debt holders, thereby affording more downside protection compared to other similarly-rated fixed income instruments.

Structural protections are as important as sound security selection. Private debt assets can often provide security over assets and typically incorporate attractive features, such as strong covenants that can offer added downside protection and enhance potential recovery values in the case of default. This often relies on the strength of the negotiation between the lender and borrower when structuring a deal or creating an asset, to ensure investors are adequately protected.

Key points to remember:

• Illiquid and private credit assets can perform a variety of different investment roles in the portfolios of long-term institutional investors. Considerations for building portfolios extend beyond returns and include seniority in the capital structure, security and the type of coupon – fixed, floating or inflation-linked.

• Potential outcomes can include growth, steady contractual income, diversification from bond portfolios and greater structural protections to mitigate the risk of losses in case of default or credit deterioration.

• Markets are constantly evolving and the best opportunities are often found in non-standard, complex and underserved markets, which require a high degree of expertise and experience to navigate.

• Discipline, patience and flexibility are crucial in the development of credit portfolios. Investors must avoid being a forced buyer to ensure that value is prioritised over asset availability.

• Access to assets is vital to provide sufficient choice to be able to be highly selective, and required well-developed networks of issuers and market intermediaries from which to source new investment opportunities.

Building flexible credit portfolios

Fixed income investment strategies are evolving in response to structural changes in the industry, offering hold-to-maturity investments managed for their coupon income that can use income-generating assets from both public and private markets to help local authority pension schemes deliver the predictable, scheduled and secure cashflows they require.

Private debt has been growing in size and relevance, and competition for opportunities has intensified in certain sectors. As markets continue to evolve and provide new opportunities, it is important to invest where risk is best rewarded i.e. in areas of the market where you can still find excess returns.

To illustrate, we have summarised an example where we have provided bank replacement finance to a privately-owned UK company to support its long-term objectives. In addition, we managed to secure favourable terms and security on behalf of underlying investors.

Investment example: UK trust and corporate services provider

We participated in a £22.7 million debt financing deal to a leading international fiduciary, management and administration service provider. The company also benefits from recurring, long-term revenue streams, low customer attrition as well as a diverse client base, product offering and geographical presence.

The deal followed a period of sustained growth for the business and is intended to support management efforts to deliver its growth ambitions in the years to come.

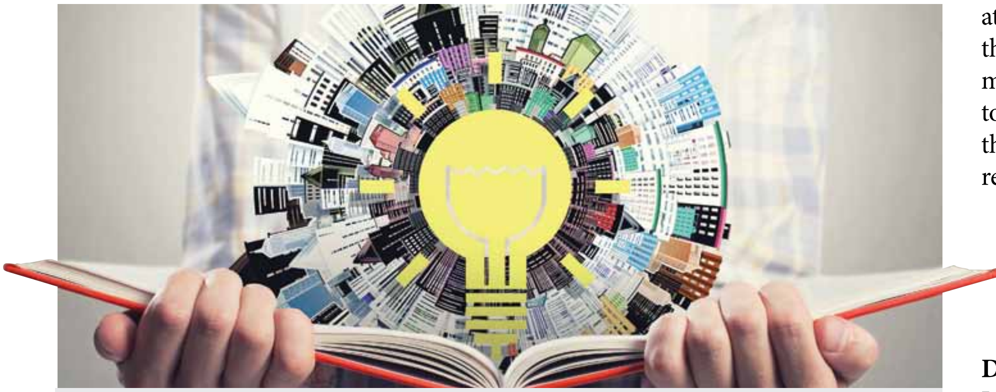
Furthermore, with the investment paying a floating interest rate in excess of a short-term reference rate – in this case Libor – investors are able to capture an additional return premium above similarly-rated public bonds, simply by going private side.

Sourcing investment opportunities across the full credit spectrum

There are a range of assets available that pension schemes can access on a standalone basis, or as a multi asset-approach. Trustees want robust strategies in an uncertain environment, but also high returns that will improve their funding levels. We believe a multi-asset credit approach is best to ensure sufficient diversification and wide opportunity set to maximise returns. This way, portfolios can be adapted to specific risk/return needs and assets can be added over time to diversify the portfolio further.

For long-term institutional investors, including pension schemes, working together with a partner that has the ability to source a variety of high-quality assets across the full credit spectrum can realise the benefits from a wider range of opportunities than would otherwise have been possible.

Written by Andrew Swan, director of fixed income, M&G Investments



Summary

• A typical multi-asset strategy will lead fund managers to invest in a combination of asset classes, such as cash, equities, bonds, property and alternative investment.
• These strategies can reduce the most important risk: that investors do not meet their return requirements.
• It has been stressed that it is more crucial to have a strong multi-asset offering in the DC industry than for DB pensions. UK, Italy and the Netherlands are all expected to have the strongest multi-asset demand.
• Multi-asset credit investing is becoming more popular enabling pension funds to carry out tactical and dynamic asset allocations within fixed income in order to profit from a broad range of opportunities, mitigate risk and manage interest-rate duration.

Broadening opportunities

Andrew Williams explains how multi-asset strategies are helping pension fund managers to diversify investment risks and opportunities, particularly within credit portfolios

In recent years, a growing number of pension funds have adopted multi-asset investment strategies as a diversification method and hopefully to maximise returns. This approach can be used across asset classes, or within a specific spectrum, such as credit, which we explore in this article.

Combination of asset classes

As Investment Quorum chief investment officer Peter Lowman, explains, a typical multi-asset strategy will lead fund managers to invest in a combination of asset classes, such as cash, equities, bonds, property and alternative investments.

"Generally, a multi-asset strategy investment contains more than one asset class, therefore creating a wider portfolio of assets and thus spreading the risk for clients," he says.

Elsewhere, M&G Investments global head of institutional distribution Ominder Dhillon reveals that, although there are a wide variety of multi-asset strategies, they ultimately all seek to "take advantage of the fact that different asset classes behave in different ways at different times". By not putting all their eggs in one basket, he argues that multi-asset strategies are therefore able to "reduce the most important risk: that investors do not meet their return requirements".

"At the same time they enable investors to take advantage of the lack of correlation between different asset classes in the short term," he adds.

Diversification benefits

In Lowman's view, the key advantage of multi-asset investing is that it enables highly-skilled professional fund managers to decide the asset allocation of the portfolio, taking into consideration important issues such as the global economy, the political backdrop, research capabilities, meeting company management, a ridged investment strategy – and "perhaps most importantly have the daily benefits of being able to enter and exit the markets quickly and efficiently".

Meanwhile, Dhillon points out that some multi-asset strategies also enable managers to make dynamic active allocation decisions, which provides investors with the diversification benefits of holding a mix of asset classes, while simultaneously allowing exposure to attractive assets when the opportunity arises.

"Most importantly, they can avoid unattractive assets when valuations do not compensate you for risk. For example, M&G's range of 'episode' multi-asset funds seek to hold a mix of assets that look attractive from a long-run value perspective, but will also be prepared to alter that mix in response to short-term volatility caused by investor fear or greed," he says.

"They also acknowledge that correlations between asset classes are not static; you cannot always rely on bonds to perform when equities are weak for example, and being able to shift allocations as these patterns change can be highly valuable," he adds.

For Dhillon, another advantage of multi-asset strategies is that, because of their larger size and greater analytical resources, they are able to gain access to areas of the market that are harder to own directly for smaller investors, which he believes can further help improve diversification and ultimately, returns.

Core strategic holding

Generally speaking, Dhillon thinks that diversified growth funds (DGFs) – investment strategies designed to deliver returns comparable to equities in the long-run, but with less risk, by investing across a wide range of asset classes – are a "good example" of multi-asset strategies that are "increasingly popular, particularly with pension funds that have to meet growing liabilities but have a greater focus on short-term volatility".

"DGFs are often used by pension schemes as a core strategic holding to deliver growth, helping to close funding gaps in a single solution that is relatively easier for trustees and their advisers to monitor," he says.

Over the next few years, Cerulli Associates associate director Justina Deveikyte expects multi-asset investment strategies to experience the strongest demand from both DB and DC pensions – but stresses that it is more crucial to have a strong multi-asset offering in the DC industry than for DB pensions.

"The asset manager respondents to Cerulli's *2017 European Institutional Dynamics* asset manager survey expect the strongest multi-asset demand in the UK, Italy, and the Netherlands," she says.

"We believe that established, branded managers with scale are best placed to win business in the UK DC market. Most UK asset managers have chosen to sell default components rather than provide the whole default solution," she adds.

Lowman also believes that multi-asset class product investment will continue to meaningfully accommodate clients finding it difficult to obtain the 'correct level' of diversification – and "can be more cost effective, especially for clients with small sums of money to invest on a regular basis".

"I think the skill in multi-asset class investing is to match up the clients' requirements and level of risk appetite to the correct product, as there are many to choose from, including those that offer both growth and income strategies, which can be useful if a client is seeking income distribution," he adds.

Multi-asset credit investing

One class of multi-asset strategy that has become increasingly popular in recent years is multi-asset credit (MAC) investing, which enables pension funds to carry out tactical and dynamic asset allocations within fixed income in order to profit from a broad range of opportunities, mitigate risk and manage interest rate duration. As CQS head of long-only multi asset credit Craig Scordellis explains, MAC strategies seek to capitalise on the 'most compelling' individual credit opportunities and capture relative value opportunities between different credit asset classes and across geographic regions over time.

"To achieve this, MAC investing requires deep fundamental research and agile portfolio management ... and offers access to a broad investment opportunity set within credit," he says.

"With exposure to the full spectrum of issuers and asset types, the multi-asset manager can select attractive investment opportunities across different credit asset classes and regions and be nimble in rotating between them," Scordellis adds.

He argues that, in the prevailing macroeconomic environment, with lower interest rates, potentially high inflation, central bank activity and sporadically high asset price volatility, it is a challenge to maintain reasonable expected returns while moderating volatility.

"Alternative credit enables portfolios to reduce volatility and de-risk, relative to equities, while maintaining attractive risk-adjusted expected returns relative to government and investment-grade bond markets. Alternative credit also enables portfolios to generate income, reducing the requirement to fund liability cashflows from capital. Furthermore, in an environment of lower growth for longer, credit should be generally attractive, certainly relative to equities," he says.

Capturing opportunities

Scordellis adds that MAC offers a "broader opportunity set than traditional single strategy vanilla credit, with access to a wider range of issuers and asset sectors". As a result, he argues that a MAC portfolio can maximise bottom-up driven fundamental credit research to mitigate risks associated with single strategy credit portfolios and capture opportunities that present themselves.

One example Scordellis cites is that, in the latter half of 2015, the US high-yield market experienced a substantial price correction, resulting in investors losing over 7 per cent in a six-month period, largely attributable to energy-related issuers in US high yield, which as an industry represented a "substantial portion of the US high-yield market".

"With the flexibility to invest in multiple sectors and not tracking a broad index but targeting an absolute return, a MAC portfolio has the ability to avoid a substantial portion of an individual sector, such as energy. It can therefore potentially avoid such a drawdown or the volatility associated with its price correction and ultimate rise in defaults," he says.

"MAC investing can also be fully flexible so that solutions can be tailored to sit alongside and complement existing investment allocations. It is however vital that a nimble and active multi-sector portfolio management approach, with skill in fundamental credit selection and robust risk management, is adopted to take advantage of opportunities, mitigate risks and secure solid through-the-cycle returns and provide downside protection," Scordellis adds.

Written by Andrew Williams, a freelance journalist