

### Summary

- Many traditional areas of pension fund investment income, such as toll roads, office space and airports, have been negatively affected by the Covid-19 pandemic, although some areas, such as supermarkets, have fared well.
- The Covid-19 pandemic has increased the importance of pension funds allocating to income assets, due to inflation likely becoming more of an issue. Cashflow-driven investing is also likely to increase.
- Government bonds and well-diversified investment grade corporate bonds are recommended to provide steady income, along with asset classes such as infrastructure debt, real estate debt and private credit.
- Defined benefit pension schemes may have an increasing role to play in rebuilding society post-Covid, through their patient pools of capital marrying well with companies seeking long-term funding.

# Securing income in a new world

## Laura Blows considers where pension funds can turn to for secure income investments in the wake of Covid-19

The Covid-19 pandemic has turned many societal norms, such as going on holiday or even into the office, on their head. It has also changed investment sector 'standards', with pension funds having to focus on new opportunities to receive a steady income.

Many assets that were previously expected to be low risk, secure and stable are perhaps now in question following the pandemic, Dalriada Trustees professional trustee, David Fogarty, warns.

### Covid-19 impact

Fogarty gives the examples of investments in airports or tolled motorways – “will user numbers return at the level required to make the commitments or will some of these businesses need to be restructured”?

He notes that the pandemic has been particularly punishing to travel and leisure sector, as well as related sectors such as automobiles and airplanes, “with re-rating of these businesses higher defaults are likely”, Fogarty adds.

Investment in long-lease property may also be affected, as the amount of office space required may change materially as a result of changing working patterns, he warns.

Across real assets there has been significant dispersion in performance, Redington investment consulting practice director, Mette Hansen, finds. She agrees that demand-based infrastructure assets such as airports and roads have performed the worst, “whereas assets with contracted cashflows such as renewables have remained online and maintained cashflows”.

“Sectors that rely on physical footfall or operational assets, such as hotels and leisure are also struggling to pay rents, and there remains a big question mark about when things will get back to some sort of normality,” Hansen says. In contrast, there are sectors that have thrived, she notes, “such as supermarkets and industrial/logistics, which are likely to have maintained their value”.

Legal & General Investment Management senior investment specialist, private credit, Amie Stow, also

finds that, from a credit perspective, the effect of Covid has been sector and borrower specific. “Within real estate debt, for example, we have seen continued performance of logistics and distribution, healthcare and residential together with the resilience of primary office space, which are underpinned by high-quality tenants. At the other end of the spectrum, temporary office spaces, hotels and shopping centres have fared less well,” she explains.

These regular sources of income always been an important feature for defined benefit (DB) pension schemes, because they have pensions to pay,” BlackRock head of EMEA pensions, multi-asset strategies and solutions team, Sarju Mehta, says. “It is also probably safe to say that the more mature plans get, the more income will feature as an important aspect of the way a strategic asset allocation is designed.”

### Changes

The Covid-19 pandemic has increased this importance of pension funds allocating to income assets, due to inflation being more likely to become ‘centre stage’ and “on average, between 50-70 per cent of a pension scheme liabilities are linked to inflation”, Mehta says.

This growing attention on inflation will occur due to expected higher global production costs, he explains, as deglobalisation and the remapping of

supply chains will be accelerated by the post Covid-19 desire to achieve greater resilience against a range of potential shocks.

Major central banks are evolving their policy frameworks and explicitly intend to let inflation overshoot their targets, Mehta adds. “We see a risk to the nominal anchor – major central banks losing grip of inflation expectations relative to their target levels – without proper policy guardrails and a clear exit strategy from current stimulus measures,” he warns.

This higher inflation regime, combined with a maturing pension membership base, means income assets that provide either explicit or implicit inflation-linkage will become much more important for pension scheme investors, Mehta says. “The obvious choice is inflation-linked government bonds, which we advocate in portfolios. In addition, private markets offer opportunities to structure investments with explicit inflation-linkage, such as through rent payments on property.”

According to Hansen, Covid-19 is most likely to have affected the importance of income for schemes that are mature with meaningful pensioner payments, but still under-funded so they receive high sponsor contributions.

“Schemes in this situation will need to weigh up the temporary cashflow requirements against the need to continue to generate a high enough return to close the funding gap,” she says.

“One solution could be to tilt into higher-yield credit, whether public or private, which will allow income generation under a higher returning asset strategy. Although it is worth noting that attempts to ‘cashflow match’ for less well-funded schemes is often less efficient, given that such schemes are likely to run highly leveraged LDI portfolios where collateral calls will easily overshadow any income-generated cashflows.”

## Future

Overall, Hansen suggests that the

safest place to find predictable income continues to be a portfolio of government bonds and well-diversified investment grade corporate bonds.

“These assets have historically constituted the core of UK DB pension scheme income portfolios, and we expect this to continue to be the case. If schemes specifically need longer-dated higher yield income then the residential sector, particularly social housing or shared ownership, might be of interest given the resilience of income and the severe shortage of affordable housing,” she adds.

Mehta recommends pension funds look to private market assets, classes such as infrastructure debt, real-estate debt and private credit, to find new sources of sure, predictable income. According to Mehta, these asset classes offer a number of benefits to pension funds looking for income, including higher yields than public assets with equivalent credit risk, genuine diversification of income sources, through access to new parts of the economy, such as new infrastructure projects, and flexibility to structure the terms of the investment to suit the pension fund’s needs.

However, “with interest rates being so low, finding assets that deliver income to the level needed by pension funds is no easy task”, Stow warns. Schemes are now increasingly supplementing a core credit building block with real assets such as private debt, property and infrastructure, she finds. “In our view, rates will remain ‘lower for longer’ over the medium term as the global economy recovers from Covid-19, which should cause pension investors to continue to favour a cashflow-driven investment strategy,” Stow adds.

“Income is important to pension funds but the quality of the income is more important than the timing - the Covid-19 crisis is likely to refocus pension funds on this point,” Fogarty says.

“More generally, Covid-19 has arguably awakened more urgency around ESG-driven investing and that

will naturally lead to a re-rating of those assets deemed less committed to such principles.”

Looking further ahead, Stow warns that it is impossible to know at this stage the long-term effects of Covid-19 and to what extent people’s work and leisure habits will have permanently changed.

Therefore, “we advocate that pension funds are adequately diversified across asset classes which offer reliable income streams such as infrastructure debt, private corporate debt and real estate debt”, she says.

“These ‘secure income assets’ can be particularly valuable during times of uncertainty as they can deliver better downside protection, attractive valuations and a depth of universe that is not available in the public market. However, careful credit selection is required, to ensure portfolios can deliver stable cashflows that ultimately help pay pensions.”

Ultimately, pension schemes as investors may have a vital part of funding the world in the aftermath of Covid-19.

“We believe defined benefit pension schemes have an increasing role to play in rebuilding society post-Covid,” Stow says.

“These patient pools of capital marry well with companies seeking long-term funding, many of whom are engaged in revitalising the UK economy by investing in new infrastructure projects, helping to refinance upcoming debt maturities or providing additional debt funding where needed.

“Pension capital could ultimately drive a return to growth through investing in these secure income type assets, whilst also offering the potential benefit of helping schemes achieve required funding levels without taking excess risk.”

Written by Laura Blows

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