Summary

- Fixed income offers huge variation from both the public and private sectors, such as government and corporate bonds and asset-backed securities.
- The asset class has been on a 'roller-coaster ride' during the first half of the year and has been impacted by Covid-19.
- However, looking over the long term, allocation to fixed income has increased significantly over the past 16 years.
- Current opportunities range from multi-asset credit mandates, taxable municipal bonds in the US, real assets, index-linked bonds to asset-backed securities.

A bumpy ride

Like most asset classes, fixed income has been impacted by coronavirus, so where are the current opportunities? Natalie Tuck reports

"Fixed income assets have gone through a roller-coaster ride in the first half of this year," says Insight Investment fixed income specialist, Isabelle Meyer. Like most asset classes, fixed income has not been immune to the financial impact Covid-19 has had on most of the sector.

Fixed-income markets include huge variation of securities from both the public and private sectors, explains MFS Investment Management institutional fixed income portfolio manager, Owen Murfin. This includes bonds from state and regional governments, corporations, and some physical assets such as hotels or receivables from credit card loans – the latter two are known as asset-backed or structured.

Impact of Covid-19

Due to such a varying degree of offerings, fixed income has seen different impacts as a result of Covid-19. For example, Meyer says that global investment-grade (IG) credit saw the biggest sell-off since the global financial crisis with unprecedented speed and little chance to react.

TwentyFour Asset Management head of institutional business, Alistair Wilson, also notes that within fixed income, the pandemic has seen central banks "slashing interest rates as they attempt to steer their economies through a deep recession".

"Given our macro outlook, we believe bond investors will be faced with an ultra-low yield environment for much of the next decade, with income once again a scarce commodity. With rates set to remain at low levels for some time to come, in our view government bonds will be of more limited use to fixed income investors going forward," he says.

LCP partner, Dan Mikulskis, notes that for a short period of time in April and May of this year, Covid-19 related stresses caused the yields available on corporate bonds to increase. He says some schemes were able to take advantage of this, but this was short-lived and the support from central banks has pushed these spreads low again.

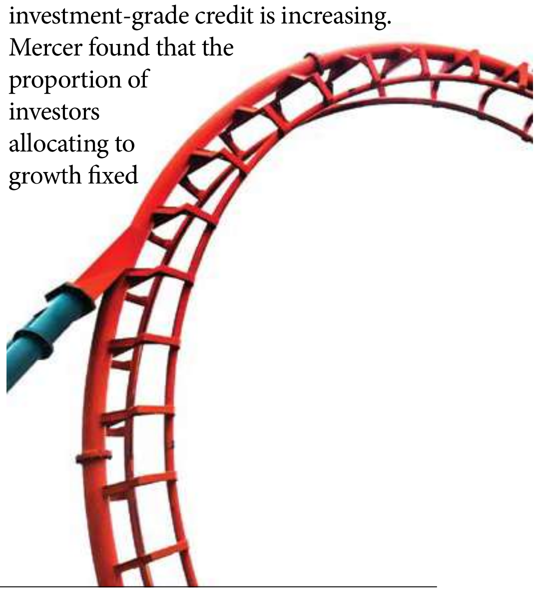
In addition, Meyer notes that the high-yield market has seen several "fallen angels", which were all centered around the autos, oil and retail sectors. Mikulskis adds that this has increased default worries in these sectors, whereas others continue to strengthen but offer lower returns.

On a more positive note, policy response from global governments and easing of lockdown has helped markets in general recover, and "we are almost back to pre-Covid levels," Meyer notes. Wilson is in agreement, noting that the "swift response" from central banks and governments has helped markets recover strongly.

A steep incline

Coronavirus aside, looking over a long-term period, fixed income is on the rise; Mercer's *European Asset Allocation Insights 2020* report reveals that allocation to bonds has increased from 34 per cent in 2004 to 55 per cent in 2020. This year, 76 per cent is allocated to government bonds, whilst 24 per cent is invested in corporate bonds.

In addition, the report reveals that growth fixed income, which includes strategies expected to generate returns in excess of government bonds and investment-grade credit is increasing. Mercer found that the proportion of investors allocating to growth fixed



income stands at 47 per cent in 2020, compared to 37 per cent in 2019.

Within that, multi-asset credit rose from 16 per cent to 22 per cent of total assets invested, high yield from 10 per cent to 21 per cent, emerging market debt from 18 per cent to 28 per cent, absolute return from 16 per cent to 21 per cent, private debt from 11 per cent to 16 per cent and secured finance from 4 per cent to 7 per cent.

"You can see from this there has been a massive switch to contractual income for most schemes, particularly in the private sector, and this makes sense as they mature. We would expect this trend to continue as schemes move assets from equity markets over time," Wilson says.

The appeal, he says, is that fixed income can provide pension schemes with a reliable stream of income for meeting their long-term liabilities. "Historic exposure to equity markets were driven by expected long-term returns but these tend to be more volatile and we are, of course, in a scenario where equity income is coming under increasing threat."

Current opportunities

Currently we're at a "critical juncture", says Cambridge Associates head of European pensions, Alex Koriath. He notes that pension schemes could face scenarios ranging from deflation, a benign reflationary growth to the dreaded stagflation.

"Consequently future return opportunities in fixed income will be different in divergent scenarios and a diversified allocation should be the focus for pension schemes. We also think that despite already low real yields, index linked bonds or other real assets may prove useful in a higher inflation scenario."

Mikulskis sees opportunities in multi-class credit mandates: "For investors looking for higher returns in fixed income we have been allocating to multi-class credit mandates, which can go anywhere for opportunities including lower-grade companies and emerging markets.

"We have also made allocations to asset-backed securities (for example bonds backed by mortgages or loans to smaller companies). These can offer more value as they are less readily traded."

For those schemes that want to match liabilities, Wilson says that traditional government bonds currently provide very limited income, and particularly with expected high levels of issuance, we may even see more volatility associated with them in future years.

"An investor could instead look to move down the risk spectrum into investment grade and then high yield and emerging markets. Asset-backed securities, often a very misunderstood asset class post the global financial crisis, themselves provide a very wide spectrum of risk opportunities and often at a premium to other areas of the bond world due to – what we prefer to call – the analysis premium."

In addition, Murfin says there are a number of sectors that can still offer compelling yields relative to their risk. "Examples include areas like taxable municipal bonds in the US and certain parts of emerging market bonds and structured bond market. We have also been encouraged by moves in Europe towards greater fiscal integration and remain positively positioned in European periphery bonds."

For DB schemes that are focused on future cash flows, AXA Investment Managers head of portfolio solutions, Sebastien Proffit, believes that corporate bonds "satisfy all the pre-requisites for reliable cashflow generation".

"They offer a predictable cashflow profile with no floating payments, along with duration exposure and a premium over government bonds. This, in addition to their relatively liquidity and flexible nature, forms a compelling argument for pension schemes consider corporate bonds as the fundamental building block within their cashflow-driven strategy."

Written by Natalie Tuck