Summary

- Fixed income – which includes bonds, gilts and other forms of debt – has long played an important role in pensions investing.
- It's likely that pension funds will be more drawn to investment-grade bonds rather than their high-yield equivalent, as they look for stability from the fixed-income elements of their portfolios.
- Historically, fixed income has provided stability when compared with equities. Recent economic conditions have made this less true – but some argue that the stabilising role will return in a higher-interest rate environment.
- Some argue that this area has not been as attractive as it is now, compared to equities, since the global financial crisis.

Asset class round up: Fixed income

In the first of a regular series providing asset classes overviews, Sandra Haurant explores the latest developments within fixed income

The basics

Fixed income is a broad term that covers investments that pay a fixed amount of income through, for example, dividends or interest payments. Capital invested is locked away for a set amount of time, and an income is paid until maturity, after which the capital is returned. Corporate bonds, government bonds or gilts are among the most common types, and the asset classes can be accessed directly or through fixed income exchange-traded funds (ETFs).

According to Aon partner and co-head of global fixed income manager, research, Paul Whelan: "Fixed income continues to be an ever-evolving, vast universe, which contains many heterogenous sub-asset classes. These sub asset classes range from highly liquid investments to illiquid investments, but serve to fulfil one or more of the following roles in investors allocations; liquidity, diversification, liability hedging, return seeking and capital preservation."

What's in it for pension funds?

Individual pension funds, says Whelan, have seen allocations to or from different areas of fixed income change and develop as their requirements evolve. "Particularly as funding levels have improved, we have seen clients increase their allocation to high quality, liquid credit instruments in both corporate bond and asset-backed securities, seeking modest excess returns whilst maintaining liquidity."

As for those looking for growth, he says: "We have seen pension funds diversify from public equity and diversified growth fund (DGF) allocations in particular, to multi-sector credit and less liquid fixed income strategies, including bank capital relief and direct lending strategies."

Traditionally, fixed income assets were considered to have a stabilising effect on a portfolio – but in recent years this has not always been the case. As DWS head of rates, fixed income EMEA, Oliver Eichmann, says: "When coupons or income are low, bonds are not able to provide stability in an environment of volatile rates and spreads."

However, this is now changing. "As coupons or yield levels have risen by two percentage points in many geographic areas," says Eichmann, "there is finally income in fixed-income portfolios to mitigate market risks or volatility especially from rates and spreads." As a result, he says: "Fixed-income portfolios should, after many years of low income, be in a position again to provide stability in investor portfolios going forward."

What are the challenges?

With such a broad spectrum of assets in the fixed income world, it's clear that specific areas will be facing different challenges. According to Eichmann, some of the biggest include "refinancing existing debt, or meeting funding needs in an environment of substantially higher rates; as well as economic slowdown and high commodity or input prices".

Some segments are more vulnerable than others, he adds, singling out high

net debt leverage (with low credit rating and especially high yield), emerging market sovereigns with high commodity exposure, debt issuers with large maturities in 2023, debt issuers from cyclical areas and debt issuers with high energy consumption as those who will be particularly at risk from the current difficult economic environment.

Pensions, then, are likely to lean towards the more stable sectors, says GIB Asset Management head of fixed income, Samantha Lamb: "If the current environment is to continue into 2023, then investors can expect investment grade credit to be favoured over high yield credit." She adds: "Given the high level of economic uncertainty and the higher rate environment resulting from inflationary pressures, we expect high-yield companies to be more exposed to refinancing risks and a weaker economy."

Arguably, few assets have escaped the turmoil of the markets over the past few years. And fixed income has been no exception. "A key characteristic of 2022 was the indiscriminate nature of the sell-off in credit markets," says Ninety One portfolio manager, Darpan Harar.

"Most credit asset classes have cheapened significantly, with spreads well above their 10-year averages. As a general theme, this has been most pronounced in the higher quality sectors of the market, such as investment grade and high-quality structured credit.

"It is very rare that we see corporate bond yields exceeding earnings yields that are available in equity markets, but that is currently the case in some key markets like the US. From a variety of angles, valuations are historically very compelling," Harar adds.

Indeed, the key question, Eichmann suggests, is not so much whether to re-enter or rebuild fixed income allocations, but when and how, with what are now decade-high yield levels across market segments. After all, the ground is still shifting underfoot, making it difficult to navigate reentry. "Central banks are not yet done with the monetary tightening, economies continue to slow and may enter recessionary territory in Q1 2023; while inflation also remains very high and is only expected to slow down to a still relatively high level in many monetary areas," Eichmann says. "Trustees and clients are interested in engaging with us to assess relative attractiveness of fixed income segments, ongoing risk factors and our return outlook for various markets."

What's next for fixed income?

Fixed income assets have long formed a major part of pension portfolios, and this is unlikely to change. But just now, there are some areas that are significantly more inviting than others, says Harar. Firstly, he suggests, like Lamb, that investment grade debt is a compelling segment of the market. Secondly, he says: "We like high-quality structured credit, which has underperformed this year and offers a significant cushion in the event of further credit stresses." What's more, he says, the fact that coupons in this sphere have floating rates means that this area is a lot more attractive – in an environment of high interest rate volatility, it makes sense to attempt to benefit from increases in rates.

"Finally, we like high-carry opportunities," Harar adds. "We believe that these will be the engine for credit returns, as they provide investors with a high and stable income source. That said, we believe it is important to remain dynamic in order to take advantage of current mispricing opportunities and to navigate the increasing dispersion we expect to see across the asset class as the cycle evolves."

Fixed income is also set to become a key part in environmental, social and governance (ESG) strategies, explains Whelan. "As allocations to fixed income have, typically, increased, we've also seen the asset class play a greater role in aligning to and helping achieve pension funds responsible investment and ESG objectives," he says. "We have observed a marked improvement in ESG integration and awareness across fixed income products, as well as a growth in products and solutions seeking to achieve an impact objective without impairing the risk-return characteristics of such strategies."

The focus on these solutions has been varied, but Whelan cites assisting the climate transition required – for example net-zero and Paris-aligned strategies, as well as positive alignment to the UN Sustainable Development Goals, as key areas.

After a tricky time, Harar suggests that a selective approach will allow investors to benefit from a more positive run in this area. "We can expect a much more diverse picture in 2023," he says, "as investors start to discriminate between the winners and losers in a challenging economic climate."

And while the mantra may not quite be 'the only way is up' for fixed income as a whole. there is certainly room for optimism in the right areas, says Lamb: "Despite volatility, in our opinion, credit has not been this attractive compared to equities since the global financial crisis."

"The challenge this year has been that inflation variability has been the issue, leading to interest rate increases, weaker government bonds, and (via consequent expectations for weaker growth) falls in equity prices and higher risk components of global bond markets," says Payden & Rygel's managing director (London), Nigel Jenkins. "Whilst inflation volatility may be a bigger issue on average over the next 10 years than it has been over the past 20, for the most part we think it will once again be economic growth expectations that will be the dominant factor. And in that environment, fixed income assets should again provide stability in a balanced portfolio allocation."