



Growing old with fixed income

▶ Jack Gray chats to 20-20 Trustees trustee director, Martin Collins, about the impact Covid-19 may have on fixed-income investment and the vital role it could play in a more ESG-conscious investment environment



▶ What role do fixed-income investments play in a portfolio?

It is the dominant asset class for the most mature pension schemes, and as a scheme matures it tends to take up an increasing proportion of a scheme's assets because it contains the lowest-risk asset classes, which are the most suitable investment for more mature schemes. Most fixed-income assets are relatively low returning but low risk, but there are some quite funky ones that are more equity-like in nature, like private debt.

The other thing within the fixed-income universe is you have very liquid investments like gilts and some forms of corporate credit, and some very illiquid assets like private debt. Illiquid assets are expensive to sell if you have to in a hurry, so those types of fixed income are less suitable for schemes approaching a buyout or buy-in.

Most pension schemes are getting really mature now, so most are at the stage where it is a big part of what they do. It includes liability-driven investment (LDI), which is one type of fixed-income investment. Most schemes have got some LDI now and a lot of schemes have got a lot. There are not many schemes that do not use it at all. If you go back 30 years when schemes were

much less mature, schemes might have a 10 per cent allocation to credit and a tiny amount in gilts, but now it is not uncommon for it to be 50 per cent.

▶ Does fixed-income investment vary depending on scheme size?

The type of fixed income used will not vary much by scheme size. Generally, managers have got good at providing most asset classes to smaller schemes through collective investment. Most can do anything for smaller schemes often in a different form. For things like LDI they would use something that is a bit clunkier and less tailored whilst doing the same job. Some of the niche, high-returning assets are only made available to very big schemes or fiduciary managers but generally allocation does not tend to depend on scheme size.

▶ Defined benefit (DB) schemes in the UK have seen their funding position improve so far this year. How much of this can be attributed to bond performance?

performance?

Generally, it has been a good time for return-seeking assets. There are two reasons why this has happened. Equity markets have had a good run, which impacts credit only a little. Also, bond yields have been rising. Gilts have been falling in price, which means for many schemes that hold a lot of gilts, counter-intuitively, that is often good news, because it means the cost of doing more hedging has fallen. Generally, you buy gilts as part of your hedging strategy to lock down risk and once you have got them, you never sell them. If the price of continuing to hedge more gets cheaper, that is good news. So there are not any schemes out there regretting what they have done, unless they did a big hedging programme last year, which would have been very bad timing with hindsight.

The improvement in the funding position also means that schemes that have not hedged have been helped enormously. For those types of schemes, if they are not on the LDI bandwagon already, it is a very good time to start.





▶ What impact did Covid-19 have on fixed income and what is the general direction of travel?

The most interesting part of fixed-income investment, other than hedging, is credit. Credit is lending money to people and, when you are doing that, what affects your returns mostly is avoiding the dud investments where you lose the money you lent to people. When hiring credit managers, you are most focused on risk management and finding managers who avoid bad investments. That is what is most impactful. You lend money and have a fixed-rate return on that. You will achieve that return unless the person you are lending money to defaults.

The pandemic has obviously been a massive economic shock, but company insolvencies have been much lower than expected because of the government's support packages. Initially, we thought that credit would be badly impacted and there would be mass failures, particularly in some industries like airlines, but actually government relief has meant we have had very low insolvencies. There is a theory that perhaps when the government relief packages wear off some time in the next few months, it could be a very bad time for credit. It is possible the impact has just been deferred. It is the kind of thing where the credit managers have not really been tested yet by the pandemic and we will find out who will get hurt probably over the next six months. Those issues are stored up for when company defaults start occurring.

It will be a test of general good principles of risk management. Risk management is so important in credit investment, it is the principal thing you are looking at. If your managers have invested 50 per cent of the portfolio in aviation credit and the holiday sector, they will probably get absolutely caned at point in the next year. But they should not have done that. One of the things it shows is that managers cannot predict everything that is going to happen, so expect some bad news, but hopefully you have picked managers that have good risk management credentials and have minimised that damage when it comes.

▶ Were lessons learnt from the 2008 financial crash?

The trouble with these crises is that, if you are doing risk management in the rear-view mirror, you are protecting against what happened in the past rather than what will happen in the future. It is very easy to judge people with hindsight but obviously no-one saw Covid-19 coming. If you go back 10 years, it was on the risk radar but it was one of 20 things, so it was not thought of as a probable event. The danger is you invest nothing at all if you go too far with a risk approach.

▶ How well are fixed-income investments adapting to a world that more conscious of environmental, social and governance (ESG) factors?

There is going to be a genuine opportunity with so much investment in infrastructure, like renewable energy, so it

will be a natural marriage for the higher-returning credit investments for pension schemes. The government is starting to think about how it can promote that kind of investment to pension schemes as part of its green recovery. There are natural investments there. Thinking about risk management, you want to think about going into those sectors prudently and avoiding concentration. Generally, they are going to be illiquid investments, so if you are coming up to buy-in or buyout then too much in illiquid investments is not good because you may have to sell it at a loss to get out.

The other thing that has been an issue since the growth in interest in green investment is greenwashing. It is the process of managers, when they are marketing investments, making them sound green when they are not really. So there is a danger of that. But I think there are going to be some good green opportunities. I mean good in two senses: in terms of an increasing desire to be using pension scheme money for good, but also to get good returns. It is not just going to be an ethical conscience premium that you pay, there will be some good opportunities.

▶ Do you see the introduction of the UK's first Sovereign Green Bond having much impact?

It is a leadership thing. In itself it will not be material, but it is an interesting act of leadership to set the direction of travel. That is to be applauded.

▶ Written by Jack Gray