Summary
- A popular alternative approach to fixed-income investment has been increasing allocations to private debt.
- Liability-driven investment (LDI) strategies continue to be popular as schemes seek to ensure their investment portfolios moves in line with liabilities.
- For those schemes that require some extra return, multi-asset credit strategies have also surged in popularity, while asset-backed securities (ABS) are appealing for schemes willing to take on a more complex fixed-income arrangement.
- Implementing environmental, social and governance (ESG) investment themes into fixed-income investment is considered a priority for the sector.

Is now the time for DB to go green?

Tom Higgins investigates whether low yields are fuelling new trends in fixed-income investing for defined benefit schemes

Bond investors have an unenviable job. In the past decade since the global financial crisis, getting a consistent and secure income from bonds has been increasingly difficult, leading defined benefit (DB) schemes to search for new approaches to meet liabilities.

As a measure intended to stem the consequences of the financial crisis, quantitative easing (QE) served to improve liquidity in financial markets and preserve the immediate ability of banks to serve their clients. However, the unintended side effects of QE have had a detrimental impact on the financial viability of pension investors, leading to pension schemes being forced to alter asset allocations and find new approaches.

In 2019, research from consultancy CREATE-Research, published by Amundi, found that over half of the 153 European pension schemes surveyed believed that QE had undermined the financial viability and prospects of pension plans.

The Covid-19 pandemic prompted the deployment of similar monetary policy tools, further increasing the pressure on bond allocations and prompting more schemes to shift their attention to alternative approaches.

Taking on private debt

One of the most popular alternative approaches has been private debt. Allocations to this broad and diverse sector have become more prevalent in pension fund portfolios as schemes seek out returns and yield.

Aided by the withdrawal of traditional lenders such as banks from private credit markets, 16 per cent of European pension funds had an allocation to the asset class at the end of 2020, according to Schroders, compared to just 2 per cent in 2013.

Willis Towers Watson head of manager research, Chris Redmond, says the increased interest has come from schemes needing to "diversify their credit portfolios and take advantage of the return and income pick-up found in illiquid strategies".

"With DB pension funds increasingly in the 'cashflow negative' phase of their lives, and consequently with a greater focus on income generation, a diversified private debt allocation can form a valuable part of a holistic solution to cashflow needs," Redmond explains.

In recent months, large UK public pension pools such as London CIV, Border to Coast and Brunel Pension Partnership have all begun instigating private-debt arrangements in an effort to access the 'illiquidity premium'.

Redmond says that the first steps in allocating to private debt are typically into middle-market direct lending. However, many pension schemes are also "embracing the broad options available in the asset class across collateral types", he adds.

Ross Trustees director, Pavan Bhardwaj, agrees on the benefits of a greater emphasis on private debt allocations.

"Pension funds are long-term investors, able to invest 'through the cycle', thereby taking advantage of the illiquidity premium, which other investors may not wish to, or be able to, access," he says.

The approach, Bhardwaj says, helps form 'cashflow aware' strategies for those funds requiring reliable income but also a yield more than that available from liquid credit strategies.

Fixing fixed income

Underpinning any fixed-income allocation is a market suffering from low interest rates, making any area of the asset class less than straightforward.

Bhardwaj highlights the continued popularity of liability-driven investment (LDI) strategies as schemes seek to ensure their investment portfolios move in line with liabilities.

"As funding levels have improved, schemes have gradually been able to increase hedge levels in order to offset movements in funding levels, which derive from changes in government bond yields as well as expected rates of inflation," he says.

Elsewhere, buy-and-maintain credit strategies are also growing in popularity among trustees, Bhardwaj says. Income from these portfolios can be matched to pension payments and other cash outflows, which can negate "the need to sell assets at inopportune moments", he adds.

For those schemes that require some extra return, multi-asset credit strategies have also surged in popularity due to their ability to provide a "relatively easy way for trustees to access less liquid and/ or less creditworthy assets in a diversified manner", Bhardwaj says.

Asset-backed securities (ABS) can also appeal to those schemes willing to take on a more complex fixed-income arrangement. These are typically bonds secured against an underlying pool of assets that generate income, and can give investors additional diversification from core bond holdings.

Putting the DB in ESG

Unsurprisingly, environmental, social and governance (ESG) investment themes are gaining traction rapidly in bond markets. Almost all pension scheme trustees surveyed for a recent River & Mercantile and Pensions Management Institute report said they believed ESG integration should be a priority for the sector.

Premier Investment Consulting head of investment consulting, Mark Hodgson, sees the shift towards sustainability as "one of the biggest trends in fixed-income investing", with UK pension funds increasingly paying close attention to, and investing in, green and sustainable bonds.

"Pension funds, with influence from regulators, are being pushed towards ESG and carbon-neutral strategies, and are encouraged to be better custodians of the assets they invest in," he says.

The introduction of regulation and guidance such as the EU Green Bond Standard (EU GBS) has provided shape and direction to a sector that is anticipated to surge in the coming years.

The EU GBS, a voluntary set of standards for green bond issuers, is aligned with the wider EU sustainable finance taxonomy. Under the framework, bond issuers must provide details on the important aspects of how proceeds from the bonds will be used. It also includes non-mandatory reporting measures on climate change mitigation, sustainable use of resources and a transition to a 'circular economy'.

Redmond says demand for green and sustainable bonds currently outstrips supply, and "increasing issuance will help to balance this dynamic by increasing liquidity, reducing sector concentration and pushing green principles into the mainstream".

However, the trend is not without shortcomings. Increased issuance "is a positive development", says Hodgson, but there are potential unintended consequences. With the increased number of issuers, and the huge demand for green bonds, these assets may not always be what they seem.

Beyond the risk of greenwashing, ESG complexities arise because schemes' views on sustainability are rarely universal.

Hodgson says: "It is important to avoid using your own moral compass on a portfolio, attaching values that aren't aligned across all scheme members but to ensure that asset managers are including ESG as factor being considered when investing.

"Pension schemes must be comfortable with such realities. Sustainable bond investing will rightly increase, but allocation decisions are not simple."

A recent NN Investment Partners poll of institutional investors found that concerns about the financial returns of green bonds were the biggest barrier to their uptake.

Nearly half (44 per cent) of respondents said that worries about an inferior return on their investment was the leading inhibitor of green bond uptake, followed by fear of greenwashing (38 per cent) and insufficient market capacity (19 per cent).

However, the survey found that investors were still willing to incorporate green bonds into their allocations. Almost two-thirds (63 per cent) said they would incorporate green bonds into an 'impact bucket' – a separate allocation from standard bonds.

Only 20 per cent of respondents said that they would use them to replace corporate bonds and 17 per cent to replace government bonds.

There are also the practical issues associated with green and sustainable bonds. Unlike equities, bondholders do not get an annual meeting at which to hold the investee company board to account, limiting the impact bondholders may be able to exert.

However, as decarbonisation efforts heighten in intensity, the green bond market will mature and will inevitably play a greater role in DB portfolio allocations.

As bond investors continue the hunt for reliable sources of income amid a sluggish market, new approaches and trends will continue to emerge. The success and proliferation of green bonds will remain a hotly discussed topic, and but whether the implementation and success of schemes match the demand and ambition of investors remains to be seen.

Written by Tom Higgins, a freelance journalist