# There's more to diversified credit

**Jonathan Joiner and Toby Orpin explore whether diversified credit is more than just a growth asset for pension schemes**

We believe that diversified credit (or multi-strategy credit) has a number of uses in pension portfolios. As the name suggests, many people typically look at the strategy as a diversified way of accessing a broad spectrum of higher yielding credit assets. This can offer investors a more stable return profile than an equity-heavy strategy, to enable scheme de-risking without overly sacrificing return targets.

However, in this article we explore another use for diversified credit strategies: how allocating to diversified credit can help schemes manage their cashflow requirements without extending the timeframe for reaching their chosen endgame. We also touch upon the increased importance of integrating ESG (environmental, social and governance factors) into these strategies, not only to invest for a better future, but also to help drive investment value in this rapidly changing environment.

### Background: the CDI conundrum

As defined benefit pension schemes continue to mature, trustees are often faced with the challenge of balancing cashflow needs, return requirements and preparing for the endgame. This has raised cashflow driven investment (CDI) strategies as an increasingly important item on investment committee agendas.

Typically, a core component of CDI portfolios is investment in assets that deliver a defined set of cashflows with a relative degree of certainty. At the conservative end of the CDI spectrum, this can narrowly be defined as government and investment grade corporate bonds. But allocating only to these asset classes in pursuit of cashflows can create a challenge for pension schemes, even the very well-funded ones.

### Cashflow challenges: why IG credit may not be enough

The sharp recovery in asset prices from March 2020, coupled with the recent rise in yields in the opening months of 2021, will have been beneficial for most schemes' funding levels. Despite this, the majority of schemes' funding levels are not high enough to be able to fully cashflow-match with a portfolio just of gilts and public investment grade ('IG') credit. This has been made even harder by the fall in credit spreads, limiting the expected return a scheme can achieve from investment grade credit. The example well-funded scheme detailed in Figure 1 has switched its strategic asset allocation into buy and maintain (B&M) corporate bonds and LDI, and is running a very low risk portfolio on a buyout basis.

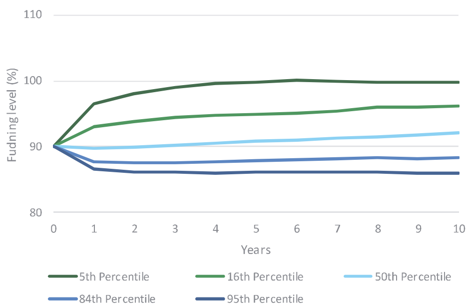
**Figure 1: Example well-funded scheme**


| | |
|---|---|
| Funding Level on gilts basis | 90% |
| Expected return | Gilts + 0.56% |
| Funding Level at Risk [1] | 3.2% |

*Source: LGIM as at 30 September 2020. For illustrative purposes only.*

The expected return for this portfolio is only 0.56 per cent over government bonds. As shown in Figure 2, it would take the scheme a significant amount of time to achieve full funding, despite its current strong position. Depending on the specific features of the scheme, retaining this portfolio allocation and expected return could be described as 'recklessly prudent'.

**Figure 2: Low-risk portfolio will take a long time to become fully funded**



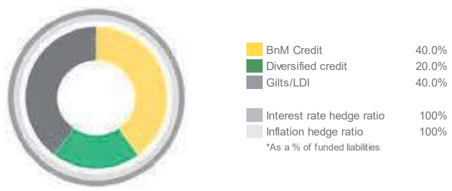

*Source: LGIM as at 31 December 2020.*

### How diversified credit can help

For pension schemes who are similarly looking to de-risk into a CDI strategy but require higher returns than offered by IG public credit markets and government bonds, we believe allocating to diversified credit can provide an attractive option. By diversifying credit exposure within your CDI portfolio to incorporate a greater range of asset classes, including emerging market and high-yield debt, it is possible to construct a portfolio which, for a relatively small increase in risk, could result in a significantly higher expected return.

To illustrate, we return to the example scheme. In Figure 3, the scheme has

**Figure 3: Allocating to diversified credit**



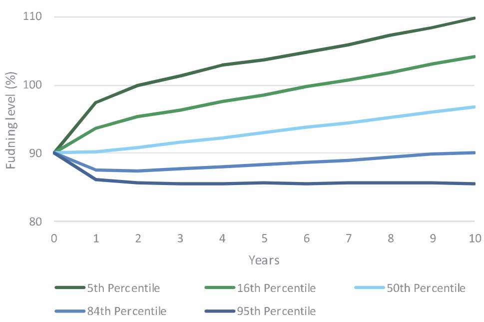

| | |
|---|---|
| Funding Level on gilts basis | 90% |
| Expected return | Gilts + 1.23% |
| Funding Level at Risk [2] | 4.0% |

*Source: LGIM as at 30 September 2020.*

reallocated 20 per cent of the B&M credit holdings to a diversified credit mandate. This causes the expected return over government bonds to double.

The funding level at risk on a buyout basis increases, but only marginally so. This is in part due to the good correlation (c.0.45) of diversified credit with investment grade credit, and therefore with buyout prices. The result can be seen in Figure 4, where the

**Figure 4: Achieves full funding within 10 years**




*Source: LGIM as at 31 December 2020.*

scheme is now expected to achieve full funding in 10 years' time. In addition, the higher return means that the absolute downside risk becomes lower over the longer term.

When we build diversified credit portfolios, our focus is on constructing a relatively balanced exposure to the higher yielding part of the credit universe using our credit research capabilities. This ensures that we are not over-exposed to any single part of the credit market at the wrong time. However, at the same time, this positions the portfolio to aim to gain exposure from the higher yields on offer in aggregate. We also dynamically shift portfolios and aim to benefit from market movements and seek to protect against risks where possible.

**Responsible investment**

The longer time horizon of CDI portfolios increases the focus on longer term prospects for companies, placing a heavy emphasis on responsible investment and sustainability considerations. This increases the importance of measuring the ESG impact of investment decisions to minimise any negative effects and to work with companies to encourage and develop positive practices that can lead to more sustainable outcomes.

One approach to assist in achieving this is to align our portfolios with the UN's Sustainable Development Goals ('SDGs'). We believe that the UN SDGs create a 'blueprint' for a more sustainable world. They provide a useful structure for measuring the impact of investment portfolios on the environment and on society, and they also enable investors to focus their engagement efforts on acknowledged themes of importance for companies and governments, and to align their activities with other significant stakeholders around the world.

**Integrating the UN SDGs**

How can this be achieved in practice? A key element is ESG analysis being integrated directly into the fund management process. This requires research to incorporate a focus on 'financially material' risks and opportunities stemming from ESG factors (i.e. they have the potential to affect a company's financial or operating performance). To align with the UN SDGs, investors will need to ensure there is no exposure to companies that are 'negatively aligned' when it comes to the SDGs.

To assess each company's alignment with the SDGs, an investor needs to look at both business practices and revenues from products.

Our proprietary framework uses ESG indicators and maps these onto the appropriate SDGs. This allows us to ascertain whether a company is positively or negatively aligned with SDGs. Our analysis requires both quantitative assessment and qualitative analysis as we recognise that data on ESG, while improving, may not capture all the important factors and features that should be taken into account.

**Conclusion**

Diversified credit is not the only potential solution for pension schemes looking to meet their cashflow requirements without extending the time horizon for their journey to endgame – it can be part of a holistic approach, working alongside other portfolio elements (such as, for example, an allocation to private credit markets, which tend to have a higher illiquidity premium) to enable schemes to meet their cashflow requirements without significantly extending their timeframe for reaching endgame. We believe that diversified credit is one of the important options that schemes can look to consider, offering both the potential opportunity for generating stable cashflows, and integrating ESG.

**Written by LGIM senior solutions strategy manager, Jonathan Joiner, and head of global fixed income distribution, Toby Orpin**



[1] **Defined as the amount the scheme's funding level could worsen in a 1 in 20 downside scenario over 1 year on a buyout basis. As at 31st December 2020**
[2] **Defined as the amount the scheme's funding level could worsen in a 1 in 20 downside scenario over 1 year on a buyout basis. As at 31 December 2020**