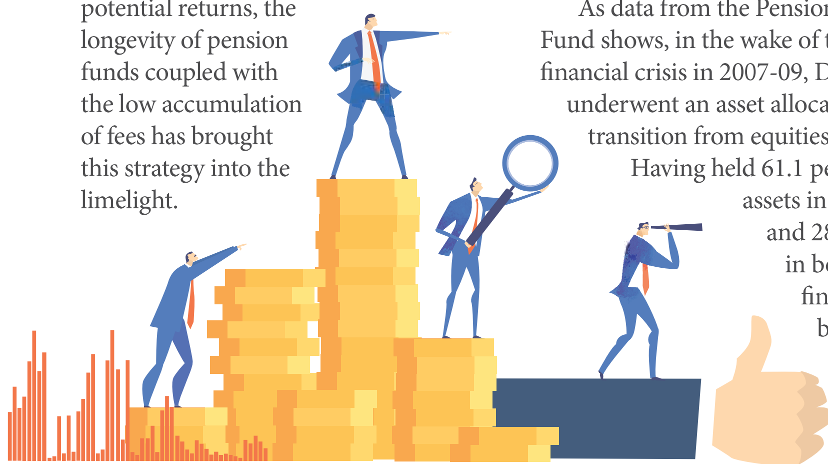
Summary
• Buy and maintain strategies are designed to reduce the amount of trading, lowering costs for investors and clients. The low-yield environment, the longevity of pension funds and the low accumulation of fees has brought this strategy into the limelight.
• There are several ways pension scheme clients in the UK utilise buy and maintain bond mandates, such as a 'maturing' buy and maintain mandate as part of a cashflow-driven investing solution, alignment to a typical insurance buy-in or buyout pricing structure, or as an alternative, diversifying investment option.
• With low bond yields and momentum building for ESG investment, buy and maintain strategies are anticipated to become a core strategy for maturing DB schemes.

B&M bargain: How buy and maintain strategies are stacking up in DB portfolios

With markets dominated by low yields, long-term and low-cost strategies are aiming to deliver for DB portfolios, finds Tom Higgins

The changing economic landscape has brought buy and maintain approaches to the fore of pension fund managers' attentions, as considerations move beyond the traditional siloed approach to bond investing.

Buy and maintain strategies are designed to reduce the amount of trading that occurs, which in turn lowers costs for investors and clients. At a time when a low-yield environment is draining potential returns, the longevity of pension funds coupled with the low accumulation of fees has brought this strategy into the limelight.



Back in fashion

Premier Investment Consulting head of investment consulting, Mark Hodgson, says that the popularity of buy and maintain bond strategies has been boosted by economic factors as well as the changing nature of pension schemes.

"Bonds have played a major role in pension fund portfolios since the 1970s, but over time strategies evolved to be dominated by equities and latterly by diversified growth funds," he says.

As data from the Pension Protection Fund shows, in the wake of the global financial crisis in 2007-09, DB funds underwent an asset allocation transition from equities to bonds. Having held 61.1 per cent of assets in equities and 28.3 per cent in bonds pre-financial crisis, by 2017 the roles had switched. Allocations shifted to 29 per cent and 55.7 per cent, respectively.

It was a move that proved to be cost-effective. Analysis from AXA Investment Managers has found that an actively managed investment-grade credit strategy with a turnover of around 75 per cent per annum could expect to incur transaction costs of 0.4 per cent. A passively managed strategy that accumulates 20 per cent annual turnover will incur transaction costs of 0.1 per cent.

A buy and maintain approach that, outside of reinvestment, experiences no turnover, can anticipate generating transaction costs of only 0.05 per cent in a year.

Maintaining control

Aon partner, Paul Whelan, says that there are several ways pension scheme clients in the UK utilise buy and maintain bond mandates.

Some will choose a 'decaying' or 'maturing' buy and maintain mandate as part of a cashflow-driven investing solution. These are designed to meet member cashflow obligations while earning a higher expected return than pure gilts or interest rate swaps.

Alternatively, managers such strategies can be aligned to a typical insurance buy-in or buyout pricing structure for schemes focused on insurance transactions.

A third use of buy and maintain is as an "alternative, diversifying investment option to clients with 'evergreen' credit exposure who may not wish to invest in full active credit strategies, but do not want to invest in a passive market-cap-weighted alternative", Whelan explains.

Despite the breadth of approaches used, the core benefit remains a low overall cost of ownership due to minimal transaction charges.

Cashflow goals

Mercer principal, Lewis Emmons, says that the "main advantage" of the

approach is that "it can target a specific outcome, such as delivering a set of cashflows".

"With standard approaches, the return profile is often dominated by the characteristics of the benchmark, even for active managers," he says.

Hodgson adds that the popularity of buy and maintain is representative of the advantages it offers in the current economic climate. Record low yields from investment grade bonds and sovereign securities have characterised the sector for the past few years, meaning returns are more easily eroded by costs.

"In a low-interest rate, low return environment, transaction costs have had an outsized impact on returns," Hodgson explains. "Active buy and maintain strategies, where turnover is low, have proved popular as a good way of reducing the impact."

MFS Investment Management head of global consultant relations, Maddi Forrester, says that a key perk of the approach centres on the "downgrade and default" experience, which should be "far lower than a broader universe of bonds" while still offering similar returns.

Forrester says: "This stems from the focus a successful buy and maintain manager will place on anticipating credit deterioration and assessing the ability of issuers to service their debt over the time frame of the mandate."

Additionally, the strategy can give an investor more certainty on returns, which can provide comfort and reassurance in the "current changing inflationary environment", explains Forrester.

"As many bonds are held to maturity, the initial yield of the portfolio at construction should give a strong indication of potential future returns."

As Whelan highlights, buy and maintain strategies invest primarily in investment-grade corporate bonds, a familiar asset class to many trustees. Not only does this improve the understanding of the strategy, but it makes it simpler to implement with skills and expertise being transferable from other bond strategies. It also fits well with many pension schemes' risk profiles.

For pension schemes that can invest in segregated mandates, the large universe of available bonds allows a skilled fund manager the ability to closely match the scheme's expected cashflows.

While this offers a huge range of choice, schemes must be prepared to go global to improve diversification.

As Hodgson says: "There just aren't enough UK bonds, especially across sectors, to support pension fund investments, so schemes must look globally."

Looking beyond the UK market and going global makes it "relatively easy to incorporate responsible investment or ESG objectives – for example, a transition towards a net-zero carbon footprint by a certain future date", says Whelan.

"However, global indices have significant exposure to the energy sector, and so schemes keen to avoid this need to think differently," he adds.

Buy, maintain, change

Buy and maintain strategies may be constructed on the premise of hands-off and hold, but that does not mean that the approach is immune to the shifting investment trends seen in the wider financial landscape. The momentum behind environmental, social and governance (ESG) investing themes – and in particular carbon neutrality – has led to changes in the bond market and allocations, catalysed by investor demand and regulatory pressure.

One key enabling factor for this, Forrester says, is the ability for buy and maintain strategies to be built to meet the bespoke requirements of each scheme. As a result, the approach can be sculpted to include specific ESG preferences as well as "providing schemes with the opportunity to engage on these themes to influence change over the long term".

As the world adapts to the new realities brought about by the pandemic, a long-term approach is essential for investors to be able to consider change in a way that anticipates future risks.

Forrester anticipates that it may become increasingly crucial to have a "strong focus on credit research and security selection" within buy and maintain strategies as the longer-term impact of Covid-19 on company operating models becomes clearer.

Emmons adds that future concerns on cashflow security may centre on the mix of sterling and non-sterling-denominated bonds – a consequence of limited bond offerings from within the UK.

"How non-sterling bonds may be hedged to create a known or reliable sterling-based payout profile will be an important aspect of the management of buy and maintain portfolios," Emmons says. He adds that, for some portfolios, current hedging practices for non-sterling bonds do not deliver the certainty that schemes will require in the future.

Buy and maintain strategies are just one approach to meeting the requirements of a DB pension fund. But in the current environment, with low bond yields and momentum building for ESG investment, buy and maintain is anticipated to become a core strategy for maturing DB schemes.

While "it is not a panacea", says Hodgson, its role within a well-diversified portfolio tailored to a scheme's individual liabilities and needs has considerable upside.

If transaction costs continue to have a significant impact on returns, and return rates remain low, then those who have implemented a buy and maintain strategy will be able to reap the rewards.

Written by Tom Higgins, a freelance journalist

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