The evolution of pension fixed income: Where are the opportunities now?

Georgie Lee looks at the role fixed income can play today, given the current environment

Summary
• There has been significant exposure to fixed income in pension portfolios over the past decade.
• Pension scheme funding positions may improve during high inflation.
• The income element is now coming back to fixed income.
• Market volatility for bonds is creating an entry point that pension fund investors have been looking for.

There has been a significant increase in levels of fixed income exposure in pension portfolios over the past decade. Contractual cashflows and secure income are attractive to pension investors and trustees, particularly those managing default risk who want clarity around the amount being paid out to pensioners.

As investors began looking beyond the sterling corporate bond market to find returns, trustees were tasked with weighing up the merits of diversification, against foreign currency risk. Large pension funds were more inclined to hold US and European bond investments, with or without hedging rates or currency, Dalriada Trustees director, David Fogarty, tells *Pensions Age*.

According to Fogarty, the UK approach to tackling narrowing credit spreads after the financial crisis was to look beyond standard AA bonds, and into high yield multi-asset credit and private debt. "This obviously has its challenges," says Fogarty. "Investment consultants have been active in pursuing those different strategies and there has been a significant explosion in the number of products available in this space.

"We have been living in a very benign credit environment up until three months ago, and so those risks have paid off. There have been very limited defaults, even throughout Covid-19. But there might be pain to come. If we go into a recession, corporates will default, and various bonds will default."

The return of income

Inflation is climbing to rates not seen in 40 years and hit 9 per cent in April. The price of energy and tradeable goods is also rapidly increasing. The UK labour market is tightening, with the number of vacancies now outpacing the number of unemployed, while consumer confidence has plunged to record lows, sparking concerns around slowing growth.

According to MFS Investment Management managing director for UK & Ireland institutional sales, Kelly Tran, all eyes are on central banks and how much they can reasonably raise interest rates. Tran says this is an important moment for maturing defined benefit pension funds, which tend to be natural buyers of fixed income.

As these pension funds mature and de-risk, they tend to move into fixed income, says Tran, buying gilts and corporate bonds which have historically meant buying into an expensive and low/negative yields asset class.

Until recently, many investors struggled to find the "income" element in bonds when looking for income assets for their portfolios. The amount of negative-yielding debt globally rose to a peak of $18 trillion in 2020 (according to Bloomberg). But in the space of just over a year, it reduced to $4 trillion in light of the current market sell-off, which can only be encouraging for an asset class that investors are drawn to, amongst other reasons, for the positive income stream it offers.

"That income element is now coming back to fixed income," says Tran. "And that has not happened in a long time. While inflation is still a concern for pension funds, it depends on how high it rises. A scheme's funding position could potentially improve in a period of high inflation. This is because rising inflation, from already high levels, may have only a limited impact on liabilities due to caps on pension increases and deferred revaluation.

Tran explains that as gilt yields are

likely to increase as the market adjusts to sustained higher inflation, it can reduce pension liabilities, depending on a scheme's hedging strategy. She adds that government bonds are currently yielding 1.9 per cent, levels not seen since 2015.

"Fixed income is now a cheaper asset class for pension schemes as they de-risk. This is a pivotal moment as market volatility for bonds is creating an entry point that pension fund investors have been looking for."

Pension funds have always used fixed income, both for liability matching and return-seeking. According to WTW global head of credit and manager research, Kate Hollis, UK pension funds have for years hedged rates and inflation exposure via LDI funds, and that has not changed. She explains that from this perspective, rate and inflation movements should not impact them directly. "However, the pandemic fundamentally changed the shape of the economy," she says. "The path out of this on a global basis is very different from country to country and from industry to industry. The Ukraine war has had enormous effects on the price of energy, food, and potentially, the supply of food. All these things need to be factored in when you are looking at credit."

According to Hollis, as inflation rises in developed economies, credits previously able to pass price rises on to customers are no longer able to. "This will have knock-on effects for credit qualities across all sectors," she says.

Another factor to consider, according to Hollis, is that high yield credits have, for a while, been easily able to refinance themselves. Now, it will become more difficult, as highly-leveraged companies struggling to refinance their debt enter tricky waters. On the consumer credit side, the fact that consumers are now being squeezed means some consumer credit may also become riskier.

Advantages for DB and DC schemes

There has been an evolution in markets over the last few years, with investors now viewing fixed income as a safe growth asset, and pension funds using it as a matching asset.

According to Broadstone head of investment consulting, Marc Devereux, the majority of closed DB schemes now chasing end game or runoff are targeting lower-risk investment.

"The direction of travel is relatively clear," he says, "that schemes will aim to increase their allocations to lower-risk fixed income assets, and in particular investment grade corporate bonds". The focus on high quality and predictable cashflows from these assets, he adds, and the link to insurer pricing for potential buyouts, means that demand for these assets is likely to increase.

Devereux explains alternative forms of high yielding fixed income will increasingly feature as part of a diversified portfolio.

Though the size and governance budget of a scheme will be a factor here, allocations to fixed income can be structured as part of a multi-asset credit strategy, or "tailored with several strategies" by specialist managers, he says. For schemes with longer investment time horizons, there could also be a shift towards illiquid private credit covering direct lending, property, and infrastructure.

"The risk-return profile of these assets can be attractive relative to more liquid fixed income markets. We continue to see investment managers expanding their solutions, and in particular opening up access for smaller clients to invest," says Devereux.

According to Buck chief investment officer, Carl Hitchman, DB investors have been increasingly looking to buy and maintain credibility as an asset class for the flexibility they provide in deviating from benchmark allocations amid inflationary concerns.

As yields began to rise this year, and credit spreads widened, pension schemes that were not fully hedged found there were benefits for their funding level, he says. "There may be an opportunity for schemes to potentially de-risk by switching out of some of the growth assets into fixed income. We see this as potentially attractive, not only for reducing risk but because it changes the dynamics of some pension funds."

He explains that cashflow-driven investment is used as a province for well-funded schemes that can afford to switch into gilts and credit. But in current market conditions, for schemes that still have a way to go on their journey plan and need growth assets, they can invest in buy and maintain credit strategies to match cashflows in the next five or 10 years.

"Those funds can leave their residual growth assets to carry out their function and exploit the upside volatility without worrying so much about downside risk. This provides a lot more flexibility," says Hitchman. "Whilst the current environment is clearly very uncertain, because of the sad events going on around the world, it is throwing up some potential opportunities."

He adds that while both equities and credit currently look risky, the reality is, that there are opportunities for pension funds to do things to "lock in an improved funding position".

According to Hitchman, in the DC space, a lot of funds will have been structured to have 25 per cent cash and a large allocation to long-dated bonds.

Since pension freedoms came into being, more and more people have been using the drawdown option. For pension funds that have not changed their default strategy and still have long-dated bonds in their portfolio, they may want to re-examine their position as rates continue to rise, he says.

Written by Georgie Lee, a freelance journalist

In association with