A fixed role?

Lynn Strongin Dodds considers the role of fixed income within pension fund portfolios during the turbulent economic landscape

Summary

- The focus in fixed income is on high-quality bonds and liquidity.
- Pension schemes can be more selective as funding levels have improved.
- LDI and insurance rules limit illiquid credit but there are opportunities in private debt and multi-asset credit.

There is no doubt that fixed income has had a tumultuous ride over the past few years but 2023 has been hailed as the year of the bond comeback. However, the asset class has always been a firm fixture in pension fund portfolios. The difference today is an altered macro-economic picture and reappearance of geopolitical risk, which has made schemes look at different opportunity sets.

Mini-Budget impact

Surprisingly, perhaps not that much has changed in terms of fixed-income asset allocation over the past year, despite the mini-Budget from former Prime Minister, Liz Truss, which wreaked havoc on the markets. The latest *Purple Book* from the Pension Fund Protection showed index-linked bonds still accounted for the biggest proportion of total fixed income holdings at 47.8 per cent in 2022, followed by corporate bonds at 30.2 per cent and government fixed interest bonds at 22 per cent.

This year pension funds may tweak their bond holdings with a greater emphasis on liquidity and high-quality bonds. They have more breathing room because their coffers are in much better shape than in the past. Although rising interest rates can be challenging, on the whole they are positive for schemes as they reduce the size of future liabilities. This has put many DB schemes into an aggregate surplus and many companies have or are thinking of transferring their pensions funds over to the insurance sector in the shape of a buyout.

Analysis from XPS Pensions Group found that the aggregate funding level of UK pension schemes increased over February to 105 per cent. It said that the rise in gilt yields of 0.39 percentage points, to the highest levels seen since October's market turmoil, led to a decrease in the value of liabilities. In number terms, this translated into the accumulation of around £30 billion against long-term funding targets.

Last year, the outlook was not that bright as pension funds were caught by surprise by the impact of the unleashing of £45 billion of unfunded tax cut in the Truss mini-Budget. This triggered a massive sell off in government bonds. Spreads on 30-year gilts jumped by more than 100 basis points in a week to the highest levels in four decades, while liability-driven investing (LDI) funds sold a staggering £23 billion of gilts in three weeks. The Bank of England was forced to intervene and restore order to the market.

"By and large, UK DB schemes have seen improvements in funding levels where liabilities have fallen in value by more than assets last year and growth assets have had a reasonable start to 2023," says Mercer UK head of intellectual capital, James Brundrett.

New attractions

He adds that this has led to further de-risking into defensive and matching assets, such as investment-grade credit and UK government bonds. In fact, as the year has progressed, US and European investment-grade bonds are looking more attractive as a result of the pricing shifts that occurred during the banking crisis in March. They proved their resilience after the collapse of Silicon Valley Bank and the government engineered takeover of Credit Suisse.

This was not the case with lower-quality, high-yield bonds, where smaller issuers and private companies have fewer manoeuvres to employ if the underlying business encounters problems.

"The fact that real yields on index-linked gilts yields are in positive territory is of some comfort," he adds. "Also, there is an appetite for liquid credit, whether to help support collateral for liability hedging or to prepare for transitioning to an insurance company as many schemes can now afford to transact."

Pension funds are also now being required to hold more liquid assets as an operational buffer due to the LDI debacle last year. The Pensions Regulator (TPR) and Financial Conduct Authority recently issued guidance that said processes should be in place for meeting 'cash calls' if the buffer drops too low and this could be implemented by, for example, using a single fund, a pre-specified portfolio, or a waterfall of funds to raise cash.

TPR said when determining which assets to use, trustees should consider timeframes and be clear on the process of selling the assets, which could be delegated to an LDI manager, investment platform or fiduciary manager. It also said while LDI can help manage volatile funding deficits and support a scheme's journey to buyout, it also "requires you to maintain a certain level of liquidity to meet collateral calls, which may impact your ability to invest in illiquid assets".

In addition, insurance regulation can also act as a barrier. "In general, we are seeing pension funds move away from return-seeking assets and more to liability matching as they increasingly have an eye on buyout pricing," says WTW global head of credit manager research, Kate Hollis. Since the funding levels have improved the expected time to buyout has become shorter."

However, she adds: "Insurance companies are constrained by Solvency II, and it is difficult to predict which illiquid credit strategy each insurance company might invest in. Investment grade is more suitable if pension funds want to build a portfolio that will be accepted in specie by as wide a range of insurance companies as possible."

Lane Clark & Peacock has predicted that this year's buy-in and buyout volumes will break the £44 million record set in 2019, with high demand for both following an average around 15 per cent improvement in the buyout funding positions of DB schemes over the last year. It noted that pricing will continue to be attractive for schemes that are properly prepared.

Invesco portfolio manager, Derek Steeden, believes "many schemes no longer need LDI and can therefore run a much simpler strategy using inflation-linked bonds and long-dated credit, which offer both a yield above government bonds and hedging characteristics."

He recommends a global approach because the UK long-dated credit market is not big enough to absorb the demand.

"We invest buy & maintain credit portfolios globally, although we do take into account currency and monetary policy risks. For example, the Federal Reserve typically changes rates much quicker than for example the European Central Bank, which has been more measured. We look at dollar, euro and sterling markets in these portfolios," Steeden explains.

Looking ahead

Despite the restrictions, illiquid credit should not be off the table, especially if buyout is not the ultimate destination. As Steeden points out, it is not the end goal for all pension funds.

"There is a large dispersion of scheme situations – large, underfunded or open schemes want or need to continue to manage assets on a self-sufficiency basis and will use the opportunities in private credit such as infrastructure debt to target higher returns," he adds.

Brundrett also notes that outside of investment grade and sovereign bond markets, the banking failures, as well as the prospect of recession later this year and consequently market volatility, are presenting some interesting opportunities.

"Currently these may by in Additional Tier 1 banking debt (AT1s), but we think nimble strategies that are positioned to take advantage of dislocations will perform well and are proving popular with clients," he adds. "Such strategies include multi-asset credit and credit opportunity strategies in the private markets and the hedge fund space."

He also sees multi-asset credit (MAC) being attractive propositions. These funds invest across the sub investment-grade credit spectrum including high yield, bank loans, emerging market debt, convertibles and securitised assets (and AT1 debt).

"Whilst defaults are likely to increase as companies continue to face tough conditions, markets have been quick to price this in (with the yield on US high yield almost reaching 9 per cent last year) and we believe good MAC managers are well placed to navigate choppy waters and take advantage of volatility given the nimbleness of these strategies," he adds. "The current high inflation and rising interest environment is also favouring floating rate debt such as the bank loan element to MAC strategies."

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