Summary

- While data suggests DB schemes are not looking to overhaul their fixed income strategies, more weight is likely to be given to private debt, which can offer better returns while meeting cashflow needs – a theme DC schemes are also taking advantage of.
- Despite searching for better returns, rising inflation still raises questions about what sort of role fixed income should play in a DC scheme.
- In future for pension schemes, use of fixed income is likely to move away from its traditional role as a diversifier and income provider, and into a role that is much more outcome focused.
- Fixed income can also be used to meet ESG requirements.

What is driving trends in fixed income in pension funds?

Rising inflation and a wider range of products has created new trends in the world of fixed income investing in pension funds, and its role is likely to change in the future

Traditionally bonds have been used in pension funds primarily for diversification purposes. However, with UK inflation projected to rise above 4 per cent next year, and fixed income producing poor returns in the last year, questions have been raised about what role fixed income should play in a pension fund.

The last year has not been kind to bond investors – the UK gilt market, for example, produced total returns of -7.6 per cent in the year-to-date, according to data from Axa Investment Management. Despite this, a Mercer survey of 850 institutional investors, found defined benefit (DB) schemes have not changed their plans to continue adding to their fixed income and liability-driven investment portfolios. At the same time, 54 per cent of respondents were not planning to make changes to the defensive parts of their portfolio.

Some investors, though, are reassessing the role fixed income plays in their pension portfolios.

Law Debenture director, Alan Baker, says DB schemes are de-risking away from equities into safer assets and fixed income "in various guises".

"This trend has accelerated in the past year as there has been very positive outcomes for pension schemes linked to equity returns, so schemes are better funded than expected and increasingly focused on delivering cashflow to pay benefits," he explains.

The director says there is almost a "bewildering" range fixed income options to choose from, with the choice depending upon the level of income schemes are looking to achieve from their fixed income portfolio.

Private credit

While many DB schemes have no desire to move away from fixed income, one in five respondents to Mercer's research said they would consider moving into private debt for the income-producing part of their portfolio. Broadstone investment director, Crevan Begley, says private credit investment strategies are becoming increasing common among DB schemes.

"Low yields in public assets can make it difficult for DB schemes to balance excess return requirements and cashflow requirements," he explains. "Private credit asset classes can offer a way for investors to earn an excess return which meets the funding hurdle whilst also providing cashflows to meet benefit requirements."

At the same time, Begley says cashflow-driven fixed income strategies more broadly are becoming ever more popular among DB schemes. This comes as a result of better risk management from cashflow negative DB schemes, and a greater appreciation of the risks they face.

"Many investment managers now offer investment grade corporate credit strategies that not only pay ongoing coupon income back to investors but can also pay redemption proceeds from the

underlying bonds," he continues.

"Investment managers structure the maturities of the underlying bonds in each fund in a specific way as to create funds that are expected to deliver a particular cashflow profile back to the investor that matched their requirements."

He adds that he has also noticed currency plays, with some managers buying non-sterling bonds to help with country/sector diversification, or because they believe it offers an attractive yield.

Janus Henderson Investors EMEA global head of fixed income, Jim Cielinski, says he too has seen a shift to private assets, although typically from defined contribution (DC) schemes seeking higher yields.

"What we see is more of a move toward yield and income, so more high yield, more bank loans and more benchmark-agnostic types of strategies that are higher risk," he says. "I think that's just the return appetite. It's like every cycle – people run out of good returning options, so they start to stretch a little bit more.

"There is a move towards greater private assets… for many of these plans they don't need the liquidity, so if you're looking for yield and you can give up on liquidity, private debt and private markets have become a much bigger thing."

Inflation driving change

The UK's inflation rate – nearly at a nine-year high and set to rise still – is one of the fundamental factors that could change how fixed income is used within a pension scheme.

"A fund has liquidity needs and some income needs to minimise the downside protections and bonds would always feature in that. The big issue for everyone now is that, while bonds have provided diversification traditionally, what is the impact on the bond, and so on the outcome for members, now inflation is rising?" asks Independent Trustee Service director, Dinesh Visavadia.

Visavadia says a good outcome for scheme members is inflation plus X percent, with 'X' as defined by individual schemes, and that a bond could be a drag on that outcome.

Data from FE shows that among the main IA and ABI Pension bond sectors, only three – the ABI UK Index Linked Gilts, IA UK Index Linked Gilts and IA Sterling High Yield – are currently beating inflation, producing returns of 6.1 per cent, 5 per cent and 3.6 per cent respectively in the year-to-date. The other nine sectors are languishing at 2.8 per cent return or below, with the ABI Sterling Long Bond at the bottom of the pile, returning -5.8 per cent.

"It's a big challenge for trustees and master trusts to provide," Visavadia continues. "I chair the HSBC master trust and we're having these conversations quite regularly."

Despite the low returns, Association of Professional Pension Trustees trustee director, Martin Collins, argues fixed income is a simple way pension schemes can hedge against inflation.

"The best way to hedge inflation for most schemes is using index-linked gilts and these are commonly borrowed against using cheap repo finance so that the necessary hedging doesn't take up too much asset allocation," he explains.

"There are inflation linked alternatives such as infrastructure and property debt, but these typically don't offer great value for the hedging they bring and add unnecessary measurement complication to the process as you approach full hedging."

What's next for fixed income?

With an increasing number of fixed income products available to pension schemes, and changing and unusual macroeconomic conditions ahead, the role fixed income can play in a pension scheme is likely to continue to develop.

"We're trying to find a new role for fixed income and its role as a diversifier as well as an income provider, Cielinski continues. "I think it leads people away from the traditional asset class definitions and much more to an outcome and factor exposure kind of approach."

Another area fixed income is likely to feature in more is helping trustees meet ESG requirements. Visavadia points to the recently launched UK green gilt as something likely to become more popular within pensions.

"Green bonds from the government are really the way forward. We're going to hear a lot about it with COP26, so I'm really excited that we have this opportunity, and that the government is taking the lead of issuing green bonds," he says.

With that said, he noted that demand is high, and such a product is likely more suitable for a DC scheme, as young people are generally more interested in sustainable investing.

"Young people are the ones who care about the society we live in," he continues. "As for DB, there will be some pressure from the trustees, but it's less of an issue, in my opinion, as members are really just interested in getting their pensions paid, as opposed to thinking: 'how are those returns being sourced?'"

Similarly, Collins says ESG more broadly is likely to play a bigger role for fixed income in pension funds.

"The current growth in fixed income ideas seems predominantly in the space of ESG investing, particularly environmental," he says. "Some of this is marketing-led greenwashing and there are also some genuine opportunities.

"Within the UK there is a great deal of investment needed to finance the green revolution and pension funds can play a role in this. The challenge for investment managers is to craft credit funds in this space that deliver good returns with quantifiable and acceptable levels of risk."

Written by Hannah Godfrey, a freelance journalist

In association with

Janus Henderson INVESTORS