The problem with credit indices

The UK institutional client base is reliant on fixed income securities to meet its long-term requirement for stable, long-term, income-generating assets. Often, that reliance extends to securities of traditional fixed income indices. This brings a series of risks into play.

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Indices are not perfectly constructed, relying on periodic rebalancing rules which leave them open to concentration risk – across issuers, sectors and countries. For long-term investors, who require diversified sources of cashflows to aim for portfolio stability and seek to protect against potential impairments, this can be a major problem.
This paper considers the problems that passive investors can face due to falling credit quality and issuer-specific risks before explaining how these drawbacks can be overcome to protect client portfolios.

Falling credit quality

Recent years have seen a decrease in the average credit quality of indices; the ultra-low interest rate environment since 2015 likely provided corporate treasurers with a strong incentive to increase the overall level of indebtedness in capital structures. This has resulted in a drop in the average credit quality of issuers, driving a large increase in the BBB component of credit indices. The COVID-19 crisis has served to accelerate that trend. In the most liquid markets, BBBs now typically account for more than 50% of the investable universe in investment grade (IG) credit indices:

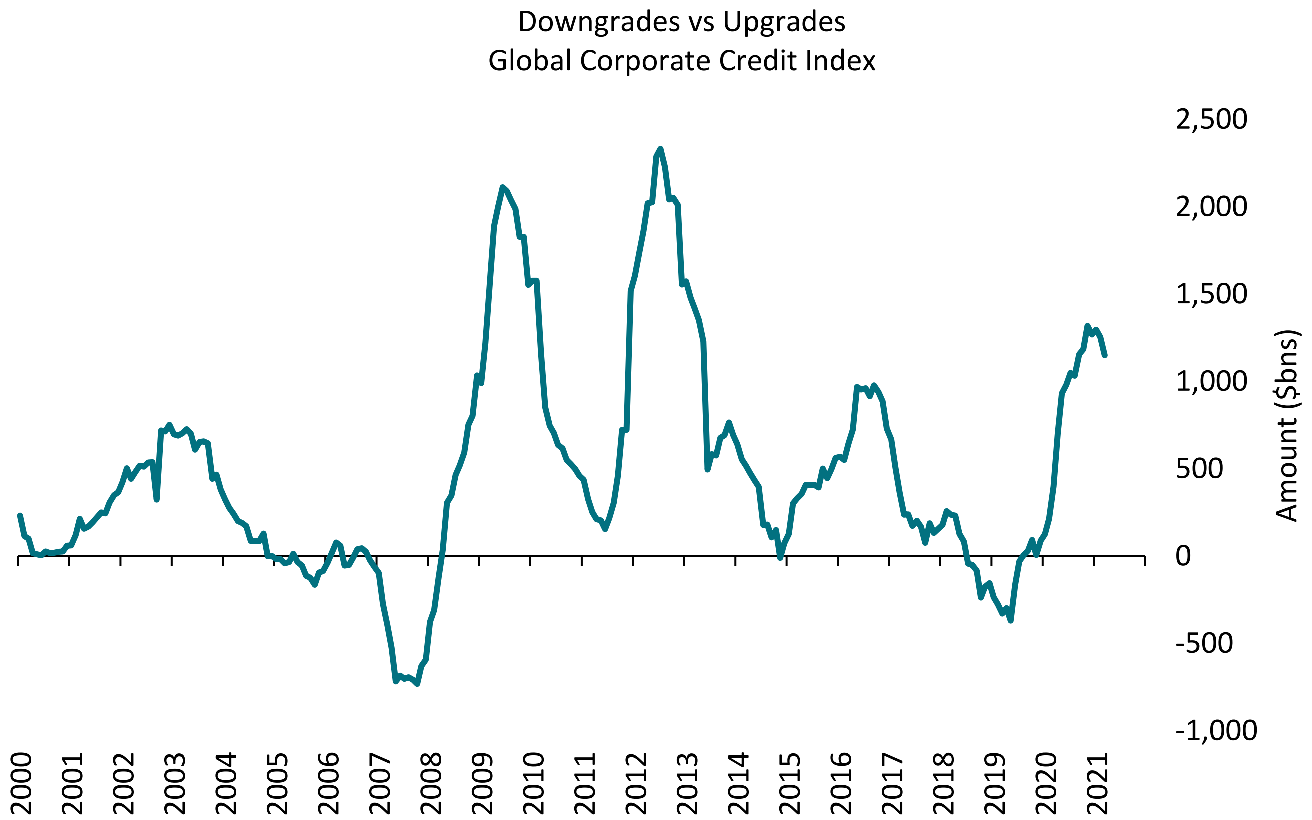
Figure 1: Triple-B credits on the rise

	% BBB rated debt		
Index	Jan 2015	Dec 2020	Change
ICE BofA Sterling Corporate (UR00)	40.2%	50.2%	+8.0%
ICE BofA Euro Corporate Index (ER00)	41.7%	51.0%	+9.3%
ICE BofA US Corporate Index (C0A0)	44.1%	50.7%	+6.6%

Source: Inter Continental Exchange. AXA IM.

Since the start of the pandemic, ratings agencies have downgraded over $1.1trn of corporate issues across global credit indices:

Figure 2: Shift in downgrades vs upgrades



Source: Inter Continental Exchange. Global Corporate Index (G0BC) as of November 2020

This rating action has been issuer and sector specific, exacerbating the existing problem of issuer and sector concentrations, as BBB issuers have moved downward and out of the IG universe, and A-rated bonds have migrated towards BBB.

For the UK pension fund industry, which is particularly reliant on the higher quality, 10+ year and 15+ year A-AAA indices, this presents a serious challenge and comes at a time when there is increasing demand for high quality, long-dated assets – plans are increasingly putting cashflow-generating solutions in place, and there are an increased number of investors chasing less available, high-quality assets. The ability to source these rare assets remains key to achieving portfolio goals.

Issuer-specific risk

Over the last two years, we have seen a number of high-profile issuers downgraded and exit the high-quality sterling indices. The largest downgraded issuers are listed below:

Figure 3: Major names are seeing downgrades[1]

		Index weight - pre exit: ICE BofA AAA-A Sterling Non-Gilt:			
Issuer	Class	10+	15+	Index exit	Issue cited
General Electric	Senior + Subordinated	2.40%	2.38%	Oct/Nov 18	Idiosyncratic risk
Heathrow Funding	Senior - Class A	2.30%	2.04%	April 20	Covid-19
HSBC	Subordinated - LT2	2.49%	2.79%	May 20	Idiosyncratic & Covid-19
National Grid	Senior	1.01%	0.97%	March 21*	Idiosyncratic risk
At risk					Current ratings
EDF	Senior	6.51%	6.31%	N/A**	BBB+ A-(-ve) A-(-ve)

*For illustrative purposes only. Source: Inter Continental Exchange. AXA IM as of March 2021. *At the time of writing, UK utility National Grid suffered a downgrade to BBB+ and is scheduled to leave A-AAA indices at the end of March. ** EDF is considered at risk of exit should one of its remaining A ratings suffer a downgrade.*

In sterling corporate credit, where the top 10 issuers (out of 120) already account for close to a third of the index market value, fixed income investors are now facing the possibility that Électricité de France (EDF), the second-largest issuer, may lose one of its two remaining A- ratings. The French energy company is already rated BBB+ by S&P and is on negative outlook at both Moody's and Fitch. This would have the effect of leaving investors reliant on an increasingly concentrated asset class (see Figure 4 below).

Investors who are passively following a benchmark approach will have to navigate potentially challenging index transitions. We saw an example of this in April and May 2020, when index-tracking investors found themselves unable to efficiently transact credit that had suffered rating downgrades. They lobbied fixed income index providers seeking to waive the usual month-end index-rebalancing rules[2].

The table overleaf illustrates this issuer concentration problem in the 15+ A-AAA index, with the resulting simulated weights of the largest 20 issuers, should EDF be downgraded and exit the index.

[1] Stock shown for illustrative purposes only and should not be considered as advice or a recommendation for an investment strategy.
[2] https://www.institutionalassetmanager.co.uk/2020/09/14/289567/credit-downgrades-present-serious-challenges-uk-pension-funds-says-axa-im

Figure 4: Measuring the impact of an EDF exit

Issuer	Current weight (%)	Simulated weight, if EDF downgraded (%)
European Investment Bank	6.86	7.32
Électricité de France	*6.31*	-
GlaxoSmithKline Capital	3.66	3.91
Pfizer	2.58	2.75
LCR Finance	2.54	2.71
The Wellcome Trust	2.32	2.47
Clarion Funding	2.22	2.37
Affordable Housing Finance	2.16	2.31
SNCF Réseau	2.12	2.26
Housing Finance Corp	2.08	2.22
London & Quadrant Housing Trust	1.97	2.10
Aspire Defence Finance	1.91	2.04
Transport for London	1.87	2.00
Berkshire Hathaway Finance	1.85	1.98
Engie	1.79	1.91
Notting Hill Genesis	1.59	1.70
Sanctuary Capital	1.54	1.64
Citigroup	1.52	1.62
Motability	1.51	1.61
KfW	1.47	1.57

Source: AXA IM simulation based on ICE BofA index data as of 23 March 2021. For illustrative purposes only. This forecast should not be relied upon and does not constitute a representation or guarantee as to future outcomes.

How can investors manage concentration risk?

When building our fixed income portfolios, we aim to diversify cash flows across issuers, sectors and geographic sources of earnings, while drawing on research into key environmental, social and governance (ESG) factors.

Issuers: No one issuer should be a single large driver of fund returns. To achieve this, we cap the size of issuers based on their credit quality, rather than in reference to their index weights. This helps avoid the situation where we are lending the most units of risk to the most indebted issuers, which are most heavily represented in the indices. We also need to be mindful that mergers or acquisitions can further increase an issuer's debt concentration.

Sectors: No one sector should be overly dominant in the fund. For example, the real estate sector makes up over 29% of the ICE BofA AAA-A Sterling Non-Gilt 15+ index – far too high a concentration, we believe, given the dynamics of the UK economy and the credit rating linkage to the sovereign. We aim to cap sector exposures well below this – typically closer to 10%.

Geographic source of earnings: An overly large reliance on cash flows generated by solely UK-focused entities leaves portfolios more exposed to idiosyncratic country risk – be that political or economic. The international representation of bond indices can allow an investor to source assets backed by international cash flows, without having to take non-sterling currency risk. For those investors willing and able to manage non-sterling assets, the ability to diversify cash flows increases significantly by adding US dollar and euro-denominated assets.

ESG considerations: We believe issuers with higher ESG quality are potentially less likely to migrate downwards in credit quality, and likely to move more slowly if they do. Poor governance especially can lead to rapid downgrades of multiple rating notches which can result in much trickier and more costly index transitions. A comprehensive internal assessment of management and controls should allow for discrimination between issuers. Separately, a focus on sector-specific ESG issues – for example, reduced future value of assets previously considered "strategic", such as oil reserves – highlights the importance of sectoral diversification and sector limits.

Seeking to protect clients

The reduction in average credit quality over the last five years was accelerated by the COVID-19 crisis during 2020. This has left high-quality assets in shorter supply at a time when demand for them is rising. This creates increased concentration risk for those investors who had planned to rely on passive alignment with credit indices. In this new environment, nuanced and intricate challenges emerge through large fixed income index rebalancings when issuers are downgraded.

Careful management of credit allocations seeks to mitigate the risks discussed here. At AXA IM we believe that a deep and targeted focus on diversification, allied with an ESG-integrated assessment of fundamental credit quality, can potentially allow more balanced and responsive portfolio construction. Our goal is to ensure investors are insulated from some of those avoidable negative biases of fixed income indices.