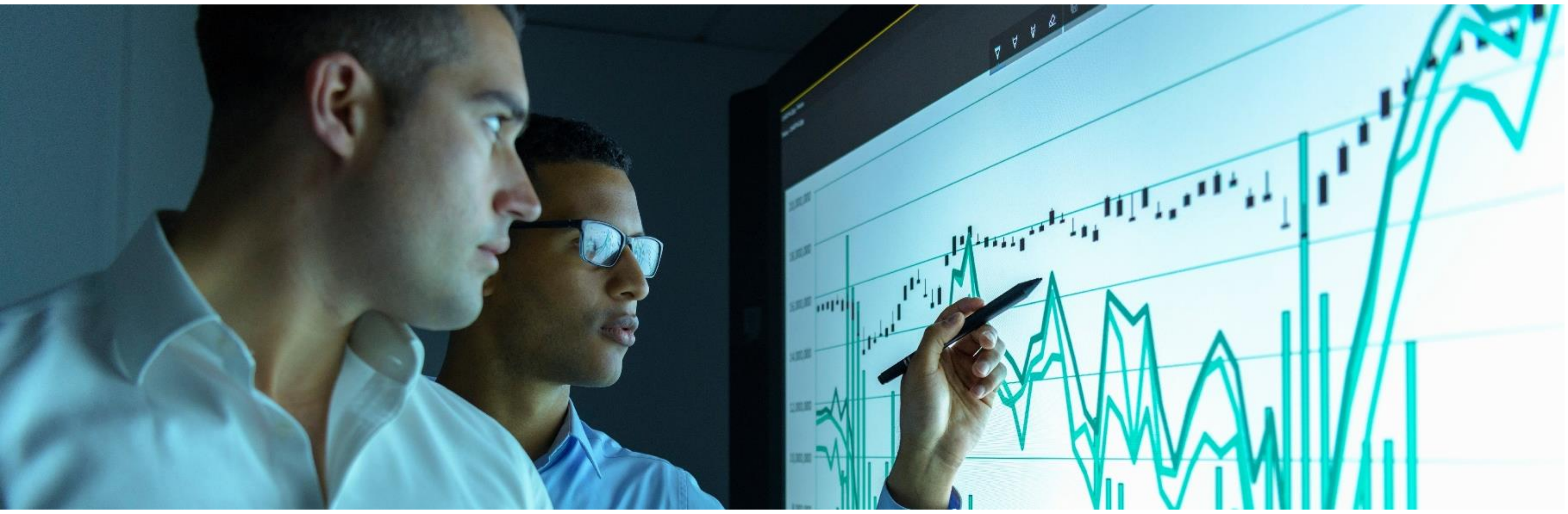
Traditional credit indices: the problems … continued



Rob Price, Senior Credit Portfolio Manager

In our April 2021 note, "The problem with credit indices", we highlighted the drawbacks of traditional fixed income indices and, importantly, the impact that the reduction in credit quality was having on the high-quality sector of the market. These drawbacks could negatively impact performance for those investors, including UK Defined Benefit and Defined Contribution pension schemes, that passively track these indices.

Our note focused on long-dated AAA-AA-A indices (10yr+ and 15yr+ maturity)[1] which are still commonly found in UK pension scheme mandates, and highlighted the reduction in diversification and over-concentration they had experienced following numerous high profile downgrades over the preceding year. Names such as Heathrow, HSBC and National Grid all left these indices, having together made up over 5% of the index weight before their downgrades.

While we didn't have a crystal ball, we did signpost the risk of the highest-weighted corporate issuer in the index (c.6% index weight) – Électricité de France (EDF). The risk of the potential downgrade was material as EDF was both a meaningful weight in the index and had a precarious A- credit rating – being just one notch above the rating (BBB) that would knock it out of these high quality indices.

The event has now materialised. On 17 January 2022 a Fitch downgrade to BBB+ meant this name is no longer eligible for such high-quality AAA-AA-A rated indices. As a result, at the end of January, EDF will have to be removed from the indices, and from portfolios by those investors who track the indices passively.

As a result, there are two issues for passive investors in these indices:

1) they will be forced sellers of the EDF bonds at the exact time that they have fallen in price, and
2) they will be forced to recycle the proceeds into the remainder of the now more concentrated index

[1] UN79, UN78 ICE BofA 10+ and 15+ AAA-A Sterling Non-Gilt index

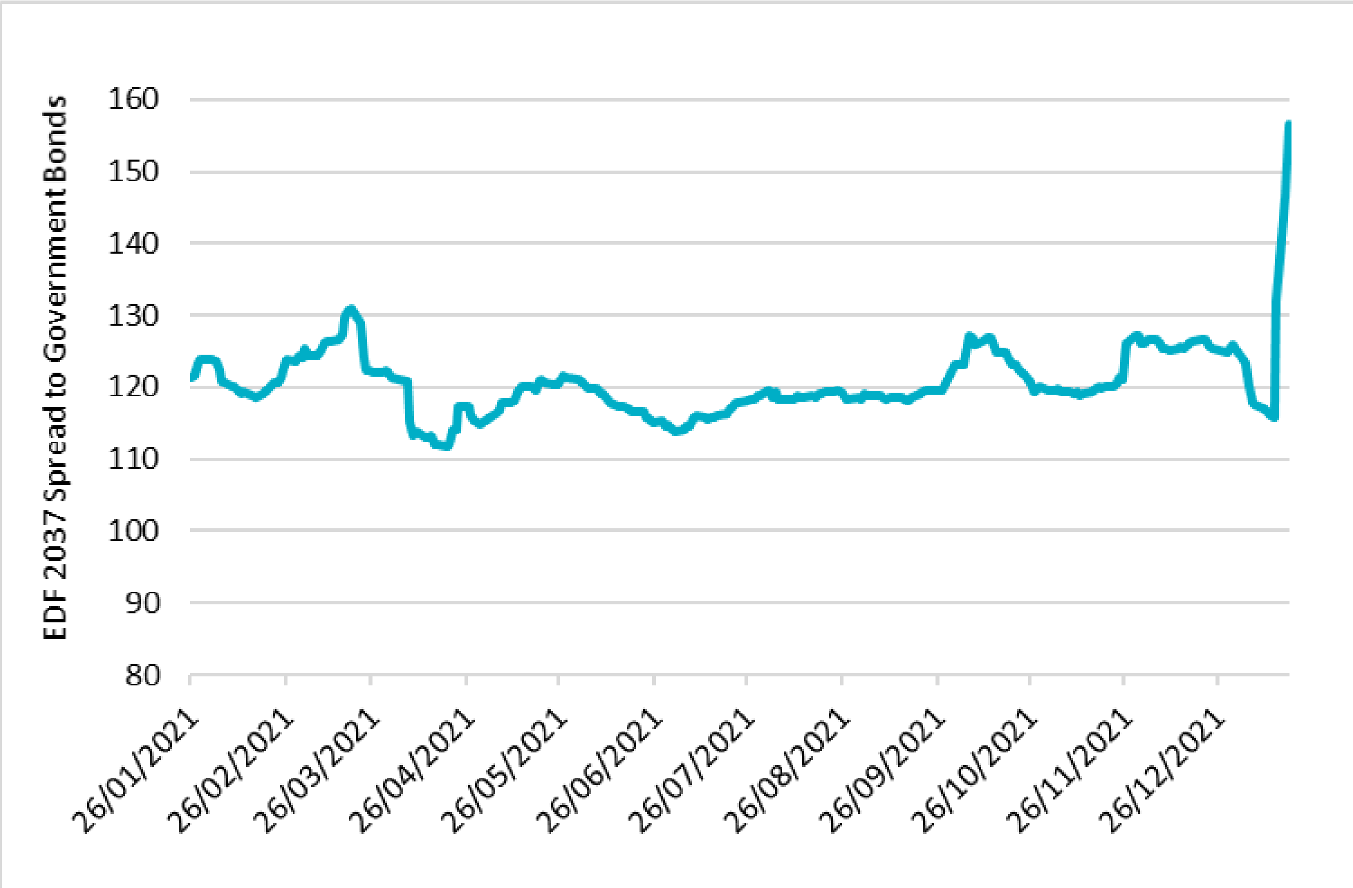
We explore these aspects in further detail below, along with potential opportunities for investors to avoid such problems going forward.

Impact 1 - Not the best time to sell

Selling bonds as they drop out of the maturity bucket of an index is never ideal for investors. However, selling bonds due to downgrades is a cause of more concern for investors as highlighted in our April 2021 note.

Figure 1 shows the spread over government bonds of the 2037 maturity EDF bond, one of five EDF bonds within the 10yr+ index, following negative news on the name and subsequent Fitch downgrade. Following the news, spreads widened c.40bps between 13 and 18 January[2], which accounts to a performance in the region of -6% for investors in this bond. Bear in mind that EDF issues bonds in the Sterling market out to the year 2114 that will also be included within these indices, and the performance of these bonds will be significantly worse than the 2037 EDF bond. The negative impact of trading costs for investors when selling the bonds also needs to be considered alongside the negative bond performance.

Figure 1: EDF 2037 – spread to government bonds (26 January 2021 to 18 January 2022)



Source: AXA IM, Bloomberg, 20 January 2021

[2] Source: Bloomberg

Impact 2 – Where will you re-invest?

First, investors will also have to pay to trade the c.6% of re-investment required – there is no way around this.

Second, in our April 2021 note, our view was that the trend in index changes would only continue – as bonds' maturities reduce and further downgrades occur. The result would be fewer issuers within the 10yr+ and 15yr+ iterations of the index. Fewer names would lead to lower diversification and higher concentration into those remaining positions. This could have a direct impact on clients' credit portfolio performance and risk profile.

Since April 2021, the number of names within the index has actually increased, as GBP supply has been strong with new issuers to the long-dated GBP market. 13 new names have been added to these indices (10 yr+) more than offsetting the three bonds to leave the index (all due to maturity considerations rather than downgrades).

However, the re-investment will only increase the existing biases and over-concentrations in the resulting index. For example, it will lead to a further increase to the largest issuer within the index, EIB. In addition, the index will now have over 50% exposed to two sectors - real estate (largely housing associations) and quasi-sovereigns (which offer limited spread), as illustrated in Figures 2 and 3 below.

Figure 2: Top 5 Index weightings – impact of EDF downgrade

Issuers	April 2021	January 2022	End January 2022 (ex EDF)
European Investment Bank (EIB)	7.1%	6.9%	7.3%
Électricité de France(EDF)	*6.7%*	*6.1%*	*0.0%*
GlaxoSmithKline Capital	4.1%	4.0%	4.3%
KfW	2.7%	2.5%	2.7%
Walmart	2.2%	2.1%	2.3%

Source: Inter Continental Exchange UN79, ICE BofA 10+ AAA-A Sterling Non-Gilt index. AXA IM.

Figure 3: Index sector weightings – impact of EDF downgrade

Sectors	April 2021	January 2022	End January 2022 (ex EDF)
Real Estate	23.5%	26.1%	27.8%
Quasi-Sovereign	20.6%	21.1%	22.5%
Utility	*10.9%*	*10.0%*	*4.2%*
Other sectors	*45.0%*	*42.8%*	*45.5%*

Source: Inter Continental Exchange UN79, ICE BofA 10+ AAA-A Sterling Non-Gilt index. AXA IM.

So where does this leave investors? They will have paid to exit their EDF positions at an inopportune time *and* paid to re-invest in a more concentrated index.

How can investors avoid this in the future?

We believe a Buy and Maintain credit strategy overcomes the issues raised above. To start, having a flexible approach to downgrades means that Buy and Maintain investors are never forced sellers and if they do wish to exit a name, they can choose their timing, helping avoid locking in depressed prices. Importantly, they can also monitor and manage concentrations within their portfolios, both to single names and sectoral biases, to deliver a more resilient and balanced exposure to the credit market.

Investors in Buy and Maintain credit strategy can receive the same high-quality, GBP-focussed credit exposure, without the structural flaws of passively tacking indices.

The value of investments, and the income from them, can fall as well as rise and investors may not get back the amount originally invested.

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