INFOCUS

Investor Thinking

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For pension schemes

SWEATING YOUR MATCHING ASSETS: BLENDING LDI AND BUY AND MAINTAIN CREDIT

When investing in credit, the typical motivation for pension schemes is to achieve a good balance between using these assets to manage risks and sleep well at night and 'sweating' these assets for higher return. In this note our Liability Driven Investment (LDI) and Fixed Income teams consider the rationale for investing in credit, look at an approach which can help enhance the return from credit assets, and show that by blending LDI with a buy and maintain credit strategy the assets can be made to sweat even harder while still avoiding sleepless nights.

Investing in credit

For the majority of UK pension schemes, an allocation to credit forms an important part of their overall investment strategy. Currently, the average UK pension scheme has allocated 19%[1] of their total portfolio to credit and this is expected to increase as schemes continue to reduce their allocation to riskier growth assets and increase their allocation to bonds as part of a de-risking journey towards self-sufficiency and/or buy out.

When investing in credit, pension schemes typically seek to achieve the following benefits:

Rationale	Explanation
Generate a return above government bonds	Schemes are seeking to capture the credit spread, i.e. the excess return over government bond yields. This spread reflects the additional credit risk that is being taken and the lower liquidity in these bonds. Current UK credit spreads are 1.3%, representing 44% of the total yield on a credit portfolio. Historically these spreads have ranged from 0.5% to 4.8% over the last 15 years, sometimes representing more than 70% of the total yield.[2]
Better diversification	An investment in credit offers risk and return characteristics that are different from growth assets and government bonds, and has historically exhibited lower correlation with these asset classes. This gives credit investors the opportunity to increase the diversification of their portfolio and capture different return opportunities.
Manage liability risks	The expected regular cashflows from credit, together with the fact that UK corporate bonds change in value in part to reflect movements in UK interest rates, means that credit assets can reduce a scheme's interest rate risk versus its liabilities. Whilst these characteristics are not typically the main drivers for investing in credit, they can shape the duration and the regional allocation of the credit portfolio.

[1] Mercer European Asset Allocation Survey, 2015.
[2] AXA IM & Merrill Lynch, from 31 January 2000 to 31 August 2015. Current spreads as based on the BofA Merrill Lynch Sterling Corporate Index, which as of 31 August 2015 has a duration of 7.8 years and an average rating of A+.

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Blending credit and LDI

Where a scheme implements an LDI strategy alongside the credit assets, strategic allocations to credit can focus on the first two outcomes (return generation and diversification), leaving the LDI strategy to focus on managing liability risks. The use of leverage within an LDI strategy and the fact that the sole focus of this portfolio is liability risk management means that:

- Significantly more hedging can be achieved,
- Inflation risk can be hedged in addition to interest rate risk, and
- More bespoke matching to a scheme's own liabilities can be achieved.

In addition, by taking any duration and liability risk management responsibility away from the credit assets, the credit portfolio can be optimised to achieve a better risk adjusted return and can be further diversified to capture opportunities outside of the domestic market.

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Maximising risk adjusted return generation

Current fixed income market conditions support the case for constructing a credit portfolio that is focused on the parts of the market that deliver the best yield per unit of risk.

When yields are low, pension schemes need to be mindful of volatility, the asymmetric return profile of credit investing, and the cost of managing a credit portfolio. The challenge for investors is to build a portfolio that offers the best risk-adjusted return for the lowest cost, which tends to point towards a diversified portfolio that has low levels of turnover and transaction costs. This approach is also suited to the structurally lower level of liquidity that is evident in investment grade credit markets today.

Opportunities for active credit managers to capture 'alpha' within the investment grade market have been reduced by the compression of spreads in the last two to three years. Looking ahead, the ability to increase the yield on portfolios of investment grade credit appears to be limited. Thus, the focus should be on getting the credit assessment right, minimising turnover, and seeking exposure to those parts of the credit market that provide the best risk-adjusted yield. The strategy should not blindly follow an index but should look to harvest the maximum amount of yield available in the investment grade credit market in the most cost-effective manner. This type of credit strategy, often referred to as a 'buy and maintain' credit strategy, is expected to deliver predictable cashflows over the long-term and avoid unwanted return erosion caused by credit-related losses, transaction costs, and outsized management fees.

As illustrated in Figure 1, the UK, US and Euro credit curves are currently relatively steep at the short end (below 15 years) and flat at the long end. Given these conditions, a credit investor who is managing liability risks separately in an LDI portfolio might consider constructing a buy and maintain credit portfolio that is focused between the 5 to 15 year section of the credit curve - capturing the higher spread, benefiting from the roll down effect, and avoiding the longer dated end where the risk-adjusted return is lower and the fundamental outlook for all issuers is less predictable.

Maximising diversification

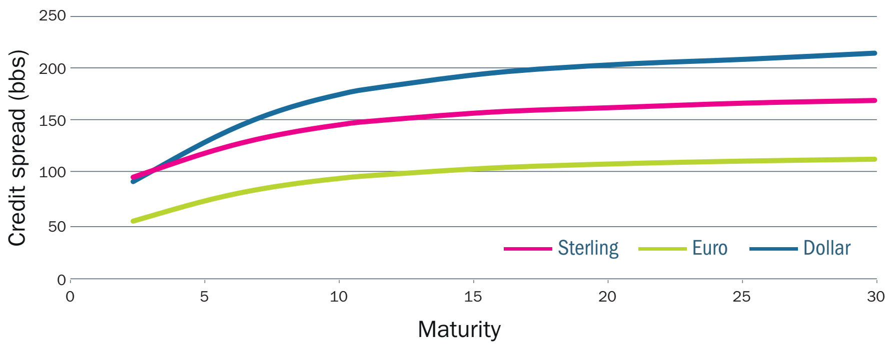
The other benefit of not using the credit assets to manage liability risks is that pension schemes do not need to limit their holdings to domestic credit. Instead, schemes might consider implementing a global credit mandate and using the LDI portfolio to hedge any unwanted interest rate or currency risk.

While the UK market makes up less than 7% of the global credit market, the average UK pension scheme has currently allocated 90% of their credit portfolio to domestic markets. Just as UK pension schemes have moved away from UK equities toward global equities, a similar diversification trend might be observed for credit allocations in the future if the duration and rate exposure can be managed through the LDI portfolio.

A global credit mandate provides the opportunity for greater diversification across regions and sectors. The number of issuers in the global market is six times larger than the number of UK issuers. Relative to a domestic UK credit strategy, a global mandate also offers greater liquidity. The liquidity of the USD market, as measured through metrics such as traded volume, new issue activity, and transaction cost, is much better than the UK market.

Recent regulatory change in the insurance and banking sectors (Solvency II and Basel III) also mean that UK insurance companies are likely to increase their allocation to Sterling credit away from global credit. Pension schemes are not subject to these regulatory hurdles and can therefore take advantage of the diversification benefits of global credit while avoiding the likely increased supply and demand imbalance in Sterling credit markets.

Figure 1: Credit spread curve (non-Financial)



Source: Iboxx/UBS Delta, as of 31 August 2015.

Importantly, a global credit mandate also offers the potential for higher expected return. As illustrated in Figure 1, the USD market currently offers a higher pick-up in spread relative to the UK market. Furthermore, the differences in the shapes of the credit curves allow the portfolio to be invested in the parts of the market that offer the best return for the level of risk.

A better outcome with the same assets

Whilst operating parallel credit and LDI portfolios can provide the return and diversification benefits outlined above, there are a number of additional risk/return benefits that can be achieved if the LDI and credit portfolios are managed in the same fund by the same investment manager.
In particular:

- Better capital efficiency - the amount of assets held in the LDI portfolio to protect against future movements in interest rate and inflation can be reduced. This means that more of the portfolio can be invested in credit with a corresponding higher expected return.

- Better cashflow management – where schemes are using cashflows from their investments to pay pensions, ongoing communication between the credit and LDI managers means that cash holdings, reinvestment into and sales of corporate bonds can be managed more efficiently to reduce overall cost.

- Improved transition efficiency - given that the LDI strategy is likely to evolve over time, whether through increased hedging as triggers are hit or through restructuring to generate cash or meet collateral requirements, it is important that the credit strategy is managed in close coordination to allow for efficient transition and management between the two components as needed.

[3] Mercer European Asset Allocation Survey, 2015.

Practical implementation

When creating a blended LDI and buy and maintain credit strategy, pension schemes will need to decide from where the assets are sourced from.

Where existing gilt holdings are used to fund an LDI portfolio and existing credit to fund the buy and maintain credit portfolio, this would typically not have an impact on the scheme's overall expected return. In fact, because of the potential for leverage in the LDI portfolio, the same amount of hedging can be achieved with a lower allocation to LDI. This would allow for more assets to be invested in credit, thus providing the opportunity to capture a higher overall expected return.

Alternatively, where a scheme has a small allocation to gilts, passive equity holdings could be used to fund the LDI portfolio. Equity exposure could be replicated within the LDI portfolio using derivative instruments such as equity futures or total return swaps. Whilst this increases complexity, this structure leaves the expected return unchanged. A further advantage of this approach is that within the LDI portfolio derivative strategies can be used to provide insurance against falling equity markets – an additional risk management strategy that can contribute to a good night's sleep. In isolation this insurance would be expected to reduce the expected return on assets, however the overall return target can be maintained if some of the upside potential from equities is sacrificed in order to pay for this downside protection.

Conclusion

Given the investment characteristics of credit, it is likely that pension schemes will increasingly rely on these assets for return above gilts and for the opportunity to reduce risk through diversification. These benefits could be amplified if an LDI strategy is implemented alongside the credit strategy, taking on the liability risk management responsibilities. Likewise, better outcomes can be achieved if this strategy has greater flexibility to seek opportunities in global credit markets to improve diversification and capture the best yield per unit of risk over the long-term.

As pension schemes continue to balance the need for return against the need to manage liability risks, blending LDI with a buy and maintain credit strategy could help to 'sweat' matching assets harder while trustees enjoy fewer sleepless nights.

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