DIVERSIFIED CREDIT: INCOME IN A LOW-INCOME WORLD

These are difficult times for defined benefit (DB) pension schemes. Many of them are maturing and cashflow negativity is increasing. A lack of a sufficient and regular cash income stream is at the heart of the problem. Interest rates have been anchored at historically low levels for more than a decade.

This has seen many final salary schemes having to take more risk to generate the income they need to pay their members' pensions. Yet moving into riskier assets could be an issue if the sponsor is looking to hand their responsibilities to an insurer before the end of the decade.

But could investing in a diversified credit fund provide maturing DB schemes with the income that they need and still appeal to an insurer?

***portfolio institutional* spoke to Legal & General Investment Management (LGIM) to find out.**

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DIVERSIFIED CREDIT: A WORLD OF OPPORTUNITY

Diversified credit could prove to be the antidote for investors concerned by the depressed returns and spreads offered by investment-grade credit issued in the developed world.
To take a closer look at what investors could gain from adopting a strategy that can invest in investment grade, high yield and emerging market credit, *portfolio institutional* spoke to two members of Legal & General Investment Management's active fixed income team.

THE PANEL

Matthew Rees
Head of global bond strategies in LGIM's active fixed income team

Madeleine King
Co-head of investment grade in LGIM's active fixed income team

What is diversified credit?

Matthew Rees: Diversified credit is an allocation to the whole global credit opportunity set. It is a combination of traditional investment grade, high yield and emerging market credit.

It is looking to access higher returns and credit spreads than you get in what are currently quite tight investment grade markets, but are still good high-quality bonds.

For example, despite being called emerging markets, 50% of bonds issued in the developing world are investment grade with the other half being high yield. So, many of the bonds we invest in will have investment grade characteristics and are from quality issuers.

How would you expect a diversified credit portfolio to behave compared to an equity portfolio?

Rees: One of the benefits of diversified credit is that its global diversification helps to smooth out volatility levels in different types of the market as, obviously, volatility levels are much, much higher in equity than in credit.

There is an upside there, but we are talking about bonds rather than equity. So, the upside is not a 25% to 30% return, it is the upside you get from good, high coupons.

Another benefit is that the level of risk and the level of drawdowns are, on average, lower in a diversified credit portfolio than for equities over time. What we are trying to offer investors is a good level of certainty of income and certainty of returns that you would traditionally get from fixed income, but with the higher returns you can get from being diversified.

How are investors using diversified credit?

Rees: That is an interesting question because many of our traditional pension scheme clients are looking towards their endgame. They are looking to de-risk some of their equity allocations, but still maintain an element of good growth within their portfolios to get the yield they need to pay their pensions.

That is why this part of the credit market is a good way to diversify and reduce the risk you get in high equity allocations, but to give an enhanced level of yield. The risks will be lower over time. These are bonds not equities, but diversified credit provides an element of growth.

So, there is an element of de-risking high equity allocations, but it is also for those in their endgame to sweat their bond assets a bit harder to get more return than you traditionally would, particularly with the compression of yields and spreads at the moment in traditional investment grade. For example, the sterling benchmark yield is pretty low at 1.5% for a duration of almost eight years. Whereas the diversified credit fund has a four-year

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Matthew Rees, LGIM

duration and a 4% total yield because there are emerging market and high yield elements.

It is a good diversifier for investors who have traditionally relied on investment grade. It gives a good material boost to their bond portfolio.

The other point is cashflow. They pay a higher coupon than normal mainstream developed market bonds, so the cashflow can help schemes who are struggling to pay their pension obligations.

What advantages are there to allocating between credit asset classes rather than investing directly in the underlying sleeve?

Rees: This is where we really add value. The team I represent like to have an overview of different markets, so we can dynamically allocate between investment grade or emerging markets depending on where we see the right fit – and the return profile is better. That is a benefit we have in looking at asset allocators across the global credit market.

More importantly, the governance is much easier for our clients. They do not have to invest in multiple funds and then workout how and when to move them. They can invest in one fund with one manager who they can have discussions with. That process is a lot similar for clients trying to earn better returns.

What do you look for when deciding the asset allocation in a diversified strategy?

Rees: Particularly with some of the higher risk characteristics compared to normal investment grade, we consider the prism of valuation, technicals and credit quality. When valuation is appealing in one market, say, emerging market valuations are cheaper than high yield or investment grade, it can sway us towards it. We then look to credit quality. When we have concerns over credit quality it overrides valuation, that is where we retreat to more defensive characteristics.

The technicals are also important. They show how strong the demand is for various asset classes. That is where we use our experts in emerging markets and high yield to see how strong the technicals are because that can help in terms of where we will dynamically asset allocate between different parts of the fund.

We would love to have perfect information and perfect data on all companies, but that is not to say that we do not have enough to reach an assessment on them.

Madeleine King, LGIM

These are bonds not equities, so is it harder to report on their ESG performance?

Madeleine King: It can be harder, but as much as the data is not as uniform or as good as it could be across fixed income, especially in emerging markets and high yield, it is not as though it is not available.

We would love to have perfect information and perfect data on all companies, but that is not to say we do not have enough to reach an assessment on them. At a minimum, we know what companies do, we know where they get their revenues from and that tells us a lot about their environmental, social and governance profile.

You are using the UN's Sustainable Development Goals as a key metric for measuring the ESG profile of your portfolios. How does that work?

King: We wanted to create something for our clients who want us to go beyond ESG integration. In all our portfolios, clients already expect us to integrate ESG into our investment decisions, but here we are trying to think about how we are making an impact. So, looking beyond pure ESG integration.

We thought that the Sustainable Development Goals were a good lens to think about impact because they are a globally recognised framework. Even though they were historically developed for countries,

a lot of companies and investors are starting to look at them. They are a widespread and well understood set of goals.

They tick all the main boxes in terms of what we want an ESG portfolio to achieve. So, the focus on the environment and on the social element is high. We felt they were the right framework.

The way we thought about that was essentially for every company we want to assess the way they do business – so the practices they carry out – as well as assess their underlying products and services. Does the fundamental nature of that business align to one of the Sustainable Development Goals or not? That is different to the historical way that the market has thought about ESG.

It sounds all very good but what does it mean for someone investing in your diversified credit portfolios?

King: It means that a client has an easy way to hold us to account. We have said this is how we are going to manage the portfolio from an ESG point of view, that we have a specific objective in terms of alignment to one or more of the Sustainable Development Goals and can report against those and measure the portfolio against a benchmark. We can essentially prove to a client that we are doing what we say we are on ESG.

Do the Sustainable Development Goals' alignment scores help with the wider investment framework when it comes to decision making?

King: The Sustainable Development Goals framework is useful not just for constructing these portfolios, but also for our wider engagement.

So, where we have a company that is perhaps borderline in being in our positive SDG category, or is at risk of falling into a negative category, that can create a good opportunity to talk to companies and explain where they need to get to in order to meet the thresholds that we would like to see from them.

Rees: In terms of how our investment framework brings returns for clients, the pricing impact of SDG and ESG alignment is increasing. We are seeing that with new funds coming out, like our own, but more so that as investors focus on the ESG element, it is having a price impact on the market. But based on the SDG, a broader opportunity set is much more important as well.

We will be ahead of the pack, particularly through our engagement process, because we will be able to influence company behaviour. And that investment framework we have provides us with an opportunity to monetise us being ahead of the pack.

Positive returns will accrue to investors who understand early the pricing impact of positive and negative alignment with the Sustainable Development Goals. An example is the European investors' approach towards tobacco. Four or five years ago when I was running a Euro fund, the harmful impact of tobacco was not yet fully priced into spreads. Today, a lot of European investors are not willing to hold tobacco at all and that negative technical has now been priced into the Euro market. We saw this coming and took advantage of it. That is an important part of where the engagement and investment framework come together.

In all our portfolios, clients already expect us to integrate ESG into our investment decisions, but here we are trying to think about how we are making an impact.

Madeleine King, LGIM

Pension schemes are looking to de-risk some of their equity allocations, but still maintain an element of good growth within their portfolios to get the yield they need to pay their pensions.

Matthew Rees, LGIM

DIVERSIFIED CREDIT: SHORTENING THE TIME TO ENDGAME?

We believe diversified credit (or multi-strategy credit) can be much more than just a growth asset class. It could help pension schemes to meet their endgame sooner whilst also providing cashflows. As the name suggests, many people typically look at diversified credit as a way of accessing a broad spectrum of higher yielding credit assets. This can offer investors a more stable return profile than an equity-heavy strategy, to enable scheme de-risking without overly sacrificing return targets.

However, in this article we explore another use for diversified credit strategies: how allocating to diversified credit can help schemes manage their cashflow requirements whilst also shortening their timeframe for reaching their chosen endgame. We also touch upon the increased importance of integrating ESG (environmental, social and governance) into these strategies, not only to invest for a better future, but also to help drive investment value in this rapidly changing environment.

Background: the CDI conundrum

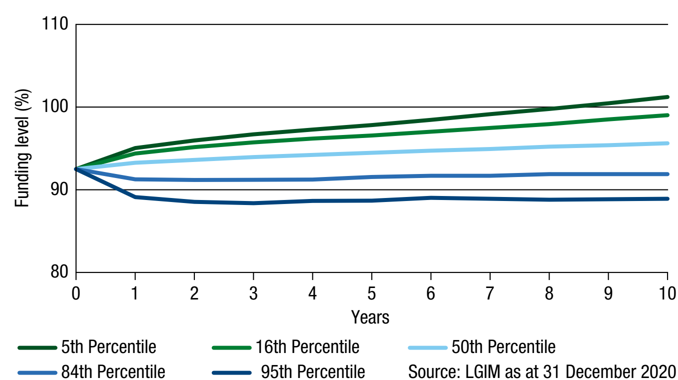
As defined benefit pension schemes continue to mature, trustees are often faced with the challenge of balancing cashflow needs, return requirements and preparing for the endgame. This has raised cashflow-driven investment (CDI) strategies as an increasingly important item on investment committee agendas.

Typically, a core component of CDI portfolios is investment in assets that deliver a defined set of cashflows with a relative degree of certainty. At the conservative end of the CDI spectrum, this can narrowly be defined as government and investment grade corporate bonds. But allocating only to these asset classes in pursuit of cashflows can create a challenge for pension schemes, even the very well-funded ones.

Cashflow challenges: why IG credit may not be enough

The sharp recovery in asset prices from March 2020, coupled with the recent rise in yields in the opening months of 2021, will have been beneficial for most schemes' funding levels. Despite this, the majority of schemes' funding levels are not high enough to be able to fully cashflow-match with a portfolio just of gilts and public investment grade (IG) credit. This has been made even harder by the fall in credit spreads, limiting the expected return a scheme can achieve from credit. A well-funded scheme, for example, has switched its strategic asset allocation into buy and maintain (B&M) corporate bonds and LDI is running a very low risk portfolio on a buy-out basis.

The expected return for this portfolio is only 0.56% over government bonds. As shown in Figure 1, it would take the scheme a significant amount of time to achieve full funding, despite its current strong position. Depending on the specific features of the scheme, retaining this portfolio allocation and expected return could be described as 'recklessly prudent'.

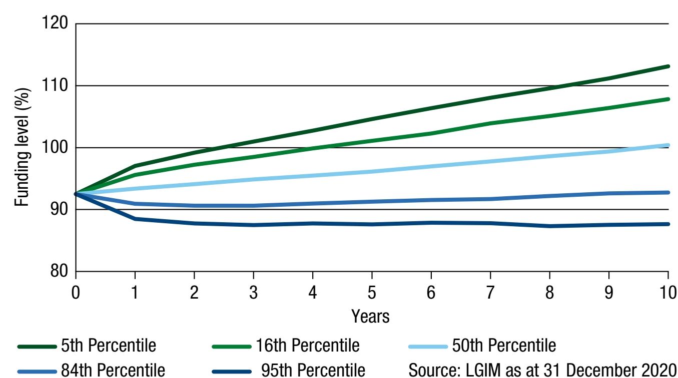


How diversified credit can help

For pension schemes who are similarly looking to de-risk into a CDI strategy but require higher returns than offered by IG public credit markets and government bonds, we believe allocating to diversified credit can provide an attractive option. By diversifying credit exposure within your CDI portfolio to incorporate a greater range of asset classes, including emerging market and high yield debt, it is possible to construct a portfolio which, for a relatively small increase in risk, could result in a significantly higher expected return, whilst retaining the cashflow properties.

To illustrate, we return to the example scheme. The scheme has reallocated 20% of the B&M credit holdings to a diversified credit mandate. This causes the expected return over government bonds to double.

The funding level at risk on a buy-out basis increases, but only marginally so. This is in part due to the positive correlation (c.0.45) of diversified credit with investment grade credit, and therefore with buy-out prices. The result can be seen in Figure 2, where the scheme is now expected to achieve full funding in 10 years' time. In addition, the higher return means that the absolute downside risk is broadly similar over the longer term.



Source: LGIM as at 31 December 2020

When we build diversified credit portfolios, our focus is on constructing a relatively balanced exposure to the higher yielding part of the credit universe, by picking the best bonds using our credit research capabilities. This ensures that we are not over-exposed to any single part of the credit market at the wrong time. However, at the same time, this positions the portfolio to gain exposure to the higher yields on offer in aggregate. We also dynamically shift portfolios and aim to benefit from market movements and seek to protect against risks where possible.

Responsible investment

The longer time horizon of CDI portfolios increases the focus on long term prospects for companies, placing a heavy emphasis on responsible investment and sustainability considerations. This increases the importance of measuring the environmental, social and governance (ESG) impact of investment decisions aim to minimise negative impacts and to work with companies to encourage and develop positive practices that can lead to more sustainable outcomes.

One approach is to align our portfolios with the UN's Sustainable Development Goals (SDGs). We believe that the UN SDGs create a 'blueprint' for a more sustainable world. They provide a useful structure for measuring the impact of investment portfolios on the environment and on society, and they also enable investors to focus their engagement efforts on acknowledged themes of importance for companies and governments, and to align their activities with other significant stakeholders around the world.

Integrating the UN SDGs

How can this be achieved in practice? A key element is ESG analysis being integrated directly into the fund management process. This requires research to incorporate a focus on 'financially material' risks and opportunities stemming from ESG factors (i.e. they have the potential to affect a company's financial or operating performance).

On top of this, to fully align a strategy with the UN SDGs, we have created a proprietary framework to score companies on each of the SDGs using a -1 to +1 scale. If we deem a company to be negatively aligned on any of the SDGs it will score a -1 and will be excluded from a portfolio. The reverse is true with positively aligned companies, they would score a +1 and we would look to have an increased exposure to these names. In our SDG portfolios we measure the overall alignment of the fund versus the benchmark and look to achieve higher overall alignment to SDGs.

To assess each company's alignment with the SDGs, an investor needs to look at both business practices and revenues from products. Our analysis uses quantitative assessment and qualitative analysis as we recognise that data on ESG, while improving, may not capture all the important factors and features that should be taken into account.

Conclusion

We believe that diversified credit is one of the important options that schemes can look to consider to try to reduce the time to their chosen endgame, offering the potential opportunity for generating return, providing stable cashflows, and integrating ESG. We advocate that it is considered as part of a holistic approach, potentially working alongside other portfolio elements such as, private credit markets, investment grade credit and other cashflow distributing assets to enable schemes to meet their requirements.

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