The future of fixed income investment

Many UK pension funds have switched money from equities into fixed income in recent years, while still demanding strong outperformance. Richard Dyson, Client Director, Aberdeen Asset Management, explains how fixed income fund managers can match assets to liabilities while still delivering high performance, and how local authority pension schemes can access this capability, despite restrictions on investing directly in derivatives.

A greater awareness by pension funds over recent years of the relative position of their assets to their liabilities has brought about an increase in the overall level of investment in fixed income, and in particular a move to higher weightings in longer dated bonds. Given the historical and expected returns from bonds relative to other asset classes, in particular equities, the commonly held view is that a higher bond weighting comes at the expense of overall investment returns.

At Aberdeen Asset Management, we believe that it is possible for schemes to achieve a closer match between their assets and liabilities, which typically requires an increase in longer dated assets, whilst at the same time obtaining higher investment returns relative to the benchmark from fixed income investment strategies. The most efficient way of achieving this is by managing each of these two requirements separately, separating "alpha", or investment outperformance, and "beta", or market risk.

Developments in the market have provided managers with a wider range of tools with which to manage portfolios. Although derivatives have been around for many years, the tax status of UK pension funds investing in one particular type of derivative, known as swaps, was only recently clarified in 2003. Swaps have transformed the opportunities for fund managers to manage pension funds more efficiently. In particular, they offer the scope for pension funds to better match their assets to liabilities than normal indices allow.

Whilst some pension schemes have chosen either liability matching strategies or higher outperformance strategies, it is possible to access both of these options from a single fund manager who has the ability to use derivatives as well as having the resources to deliver outperformance using a range of specialist investment teams.

At Aberdeen we have been managing segregated accounts on this basis for a number of years and can boast a five-year track record in higher outperformance fixed income mandates. Now, with the advent of pooled liability matching funds, similar solutions are becoming more widely available to smaller clients, as well as to those, like local authorities, who have restrictions on the direct holding of derivatives.

Alpha sources: interest rate, currency and credit strategies

Rather than simply increasing risk in an effort to achieve higher returns in today's low yield and low volatility environment, fixed income fund managers are turning to a broader range of alpha sources that can enhance performance, in addition to traditional investments in domestic government bonds and investment grade company bonds. Typically, fund managers have looked to add value through duration positions, currency positions and by choosing the right corporate bonds. So in terms of alpha sources, how exactly has the opportunity set changed for fixed income managers?

In the area of interest rates and currencies, fund managers now have the ability to put on 'two-way' positions. When managing against a traditional UK fixed income benchmark (conventional and index linked gilts and credit) the opportunity to add value in global bonds and currencies is one-sided. This is because exposure to overseas bonds and currencies can only be taken when they are expected to outperform the UK. But, because they are either not in the benchmarks, or allocations are small when they are, the opportunities to be underweight these assets when UK assets are expected to outperform or to place relative value trades between overseas markets are limited and it is not possible to add value when UK bonds and sterling are strong.

By allocating risk to interest rate and currency overlay strategies, these constraints disappear because we can go short as well as long markets. Overweight and underweight positions in international bond markets and currencies can be implemented irrespective of the underlying benchmark. For example, fund managers can now put on positions that involve Dollar versus Yen and actually have no bearing at all about the outlook for Sterling.

Fixed income managers can also access a broader opportunity set in credit by looking at the global marketplace rather than just at Sterling denominated issues. Such an approach increases the number of potential investment opportunities dramatically. Other solutions include using sub-investment grade issues, comprising both government and corporate debt.

Since starting to use these strategies, Aberdeen has achieved superior excess returns without taking excessive risks and as a result our information ratios have been consistently high. But how do we address the other side of the equation – beta matching?

Beta matching – addressing market risk

Of course, the value of pension fund liabilities is linked to UK bonds rather than overseas bonds. Through the use of derivatives such as interest rate swaps and currency forwards, it is possible to hedge out the overseas interest rate and currency exposure implied by our alpha generating strategies, creating in its place a UK interest rate exposure and yet preserving the excess returns. This is a technique known as "porting" or "portable alpha". Whilst this approach may be new to many

UK pension funds, it has been employed successfully by investors for many years.

Implementing portable alpha strategies requires expertise in the derivatives marketplace, including the ability to negotiate special contracts with counterparties on behalf of clients, as well as the skill to execute transactions and manage margin payments. At Aberdeen we have a dedicated team who between them traded over £34billion in interest rate swaps, over £33billion of exchange traded bond futures and over £55billion in forward currency contracts during 2005.

How can such techniques be used by local authority pension funds, given that they are governed by the regulations of the Local Government Pension Scheme? We believe that local authorities are able to invest indirectly in derivatives – in particular, interest rate and inflation swaps – via pooled funds. The development of pooled funds that offer a portable alpha strategy is therefore an opportunity for local authorities to gain access to the same range of investment solutions as corporate schemes.

A pooled approach to accessing swaps

Aberdeen launched a range of dedicated pooled funds – the Fixed Income Alpha Funds range – in March 2006. This series enables clients to aim for a higher level of outperformance over their stated benchmark as well as offering them the flexibility of customizing the interest rate sensitivity, or duration, of their assets – typically bringing it more closely into line with the liabilities.

The range has proved particularly popular with institutional clients searching for a pooled fund rather than a segregated portfolio solution. Because they provide access to swap overlay strategies through a pooled fund wrapper, the funds are also equally appropriate for those clients who have restrictions on the direct holding of derivatives, especially local authorities.

Each feeder fund in the Fixed Income Alpha Funds range offers clients access to the alpha returns combined with different target durations. Aberdeen works with the client and their consultant to agree which funds from the range will best match the client's liability profile or desired duration. The flexibility of this approach enables schemes to adopt a longer duration position for their assets, often much closer to their liabilities. We have already seen particular demand for our two 50-year maturity funds, reflecting this opportunity, as well as a lack of sufficient supply of ultra long dated bonds. Inflation protection strategies can also be accommodated through inflation swap feeder funds.

“ The market for fixed income management will continue to become more and more demanding ”

A further benefit for schemes in addition to providing the tools to help them match pension assets to liabilities today is the flexibility available from the Fixed Income Alpha Funds range, which allows a scheme to alter its investment profile as liabilities change over time – quickly, easily and cost-effectively.

The future of fixed income investing

The market for fixed income management will continue to become more and more demanding. Clients are setting increasingly aggressive outperformance targets, but they still want to maintain the link between their assets and liabilities. The most efficient way of addressing these requirements is by using a range of different investment ideas, as well as portfolio management techniques that offer flexibility to the client. Pooled funds allow access to such solutions for investors who previously were unable to participate because of regulatory restrictions.

At Aberdeen Asset Management we are excited by the challenges that these developments present, and believe that we have the necessary resources and ability to meet clients' requirements.

by Richard Dyson, Client Director
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