Fixed income investing for defined outcomes

Sherilee Mace
Institutional Business Development Director
Insight Investment

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Local authority pension funds face myriad challenges. Austerity is increasing pressure on contributions and, as funds mature, cash flow risk management is becoming a priority. Every pension fund aims to cover both short-term liability payments and meet long-term commitments. A fund that plans ahead and preserves some allocation to long-term return-seeking assets can be more certain of achieving those goals. However, when net cash flow is neutral or negative there is a new imperative: timing.

If cash flows are insufficient to meet current liabilities, a fund may be forced to sell its return-seeking assets at an untimely moment. Being a forced seller at the wrong time will impair a pension fund's ability to meet future obligations. This would have the same effect as raising the long-term return target of the fund, because the pool of return-seeking assets will have been shrunk by the forced sales.

This is a problem that is confronting many pension funds and their advisers. By definition, fixed income assets offer predictable cash flows, and will have a significant role to play in meeting this challenge. Liability matching offers the simplest answer, but most funds do not enjoy surpluses. Added to these concerns is the market backdrop. US base rates may be at the start of a rising cycle, which could presage a wider process of policy normalisation in the UK and Europe and herald the end of the long post-financial crisis bull market in bonds.

After a long period of positive returns as yields have fallen, bond investors now face potentially higher risk and lower returns. If bond yields rise more than is already priced by markets, the capital element of fixed income investments will fall in value. In spite of this, we believe there are there are potential current opportunities for bond portfolios to both deliver risk-managed cash flow and generate positive returns.

There are three ways to capture this potential: hold carefully selected long duration assets to maturity; buy high quality, but less mainstream and liquid, assets; and, finally, to free the manager from investment constraints and allow them to invest with an absolute return objective.

Duration premium

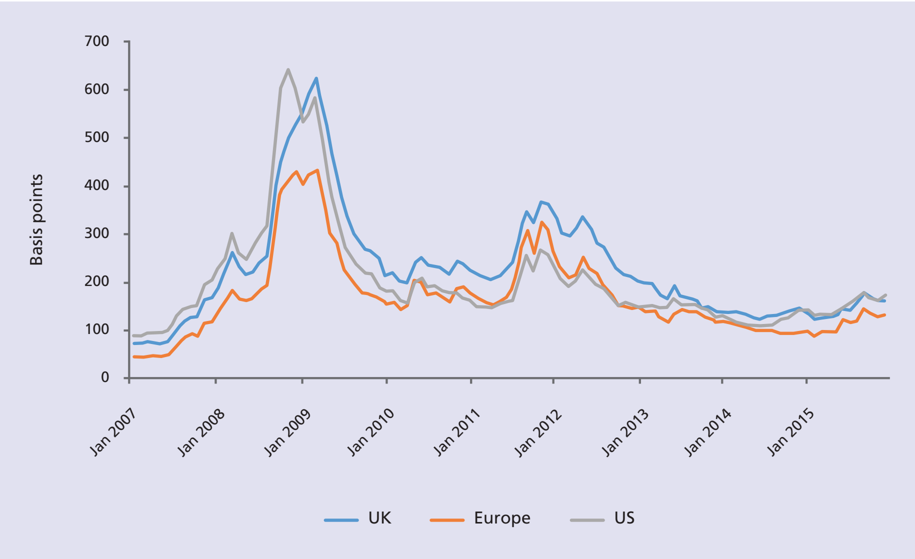
A longer duration asset will typically offer a higher yield than a similarly-rated bond with a short maturity. The investment logic is simple. Bonds pay out at a par, so the shorter the duration the more certainty there is over the financial soundness of the credit and the higher the likelihood the investor will receive all of their interest payments and capital. The longer the duration the greater the uncertainty, hence investors are typically paid a premium.

For investors seeking exposure to credit, a buy and maintain approach can be tailored to meet their yield, maturity and credit quality requirements. We believe buy and maintain credit portfolios are superior to passive fixed income investing because they incorporate bottom-up analysis at the portfolio construction phase, which seeks to avoid material credit events such as downgrades and default. The "maintain" element aims to minimise unnecessary trading due to index rebalancing, keeping costs under tight control.

Illiquidity / complexity premium

Though there has been a recent increase in investment grade credit spreads as the cycle reaches a more mature phase, particularly in the US, spreads are still relatively low (Figure 1). Investors looking to maintain attractive returns are generally faced with the equally

Figure 1: Investment grade corporate bond spreads remain low



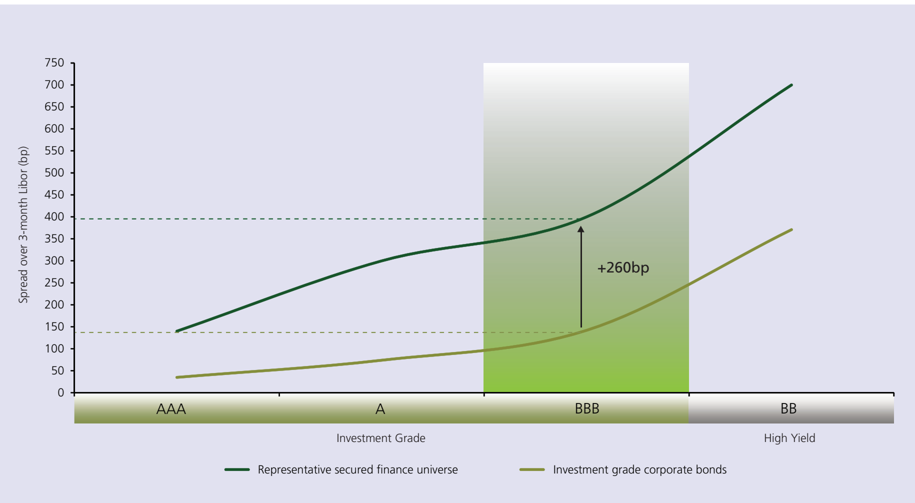
Source: Bloomberg as of 31 December, 2015

unpalatable choices of reducing credit quality (buying high yield) or raising leverage, via strategies such as risk parity.

Less liquid or more complex investments could be considered an attractive alternative. Investors can pick up a significant premium over investment grade credit whilst retaining a portfolio with high credit quality (Figure 2). In addition to relative illiquidity, the excess yield can be explained by the under-researched nature of the assets, as well as a shortage of the expertise required to understand the mechanics of investing in this area of fixed income.

Secured finance assets are credit investments secured against other assets, such as residential mortgages, commercial real estate and corporate loans. Because they are secured against collateral, the ratio of return to expected default probability is materially higher than that of standard corporate bonds. Secured finance investments are also typically floating rate in nature, so income should increase when interest rates rise.

Figure 2: Risk/reward from investment grade secured finance vs. comparable bonds



Source: Insight Investment as at 31 December 2015. The spreads shown are for illustrative purposes only.

Skill premium

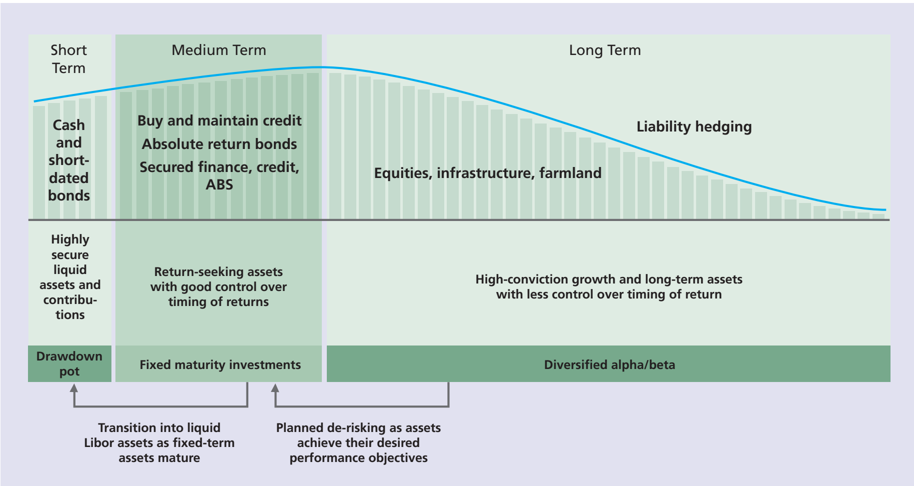
Absolute return approaches enable managers with skill to express their investment views precisely by looking at both long and short opportunities in an unfettered, non-benchmark constrained, way. The key tenets of Insight's investment process are diversification and precision. We include only those elements of market risk that are considered attractive and aim to eliminate unintended and unrewarded risks.

Long only investing only captures manager skill in one direction: their ability to find attractive investment opportunities. Adding the freedom to short unattractive investments adds a significant source of potential opportunity and return. Properly managed absolute return strategies should also seek to preserve capital and avoid drawdowns by giving the manager flexibility to hold cash.

Cash flow risk management

As local authority pension funds mature, planning a framework for cash flow risk management should be a priority. One component of an effective cash flow risk management plan is the creation of a "drawdown pot" consisting of highly liquid, short-dated assets: largely money market instruments, cash and short-dated bonds. When the fund is required to pay income to retirees, it can draw from this pot. For example, a pension fund may set aside a drawdown pot to cover the next five years of payments.

Figure 3: A holistic approach to meeting the income needs of pension funds



Source: Insight Investment. For illustrative purposes only.

Over time this drawdown pot can be added to. This is where assets with fixed maturity dates are valuable. If a pension fund has a high level of confidence that assets will mature and generate a certain amount of cash each year it can be confident that its drawdown pot will be replenished. With these building blocks in place a pension fund can invest in assets for the long term with greater confidence that it will not be forced to sell them to meet cash requirements.

If long-term assets achieve or exceed their targets, they can be sold to reinvest in medium-term assets with fixed maturities. Long-term assets could, over time, be converted to the fixed maturity assets designed to generate cash for the drawdown pot. This process can retain the upside generated by long-term assets while reducing exposure to volatility (Figure 3).

This planned approach to cash flow risk management with its emphasis on income generation and capital security in a fixed income allocation, enhances the overall portfolio. Long-term, return-generating assets can be ring-fenced and allowed to do the job that they were originally bought for, rather than being sold to meet an urgent requirement for income.