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.

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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.

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Background: the CDI conundrum

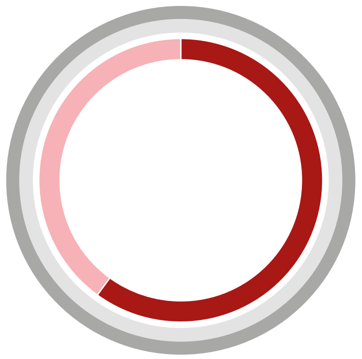
As defined benefit pension schemes continue to mature, trustees are often faced with the challenge of balancing cashflow needs, return requirements and preparing for the endgame. This has raised cashflow driven investment (CDI) strategies as an increasingly important item on investment committee agendas.

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. The example well-funded scheme detailed in Figure 1 has switched its strategic asset allocation into buy and maintain (B&M) corporate bonds and LDI, and is running a very low risk portfolio on a buy-out basis.

Figure 1: Example well-funded scheme



- B&M credit - 60%
- Gilts LDI - 40%
- Interest rate hedge ratio - 100%
- Inflation hedge ratio - 100%

As % of funded liabilities

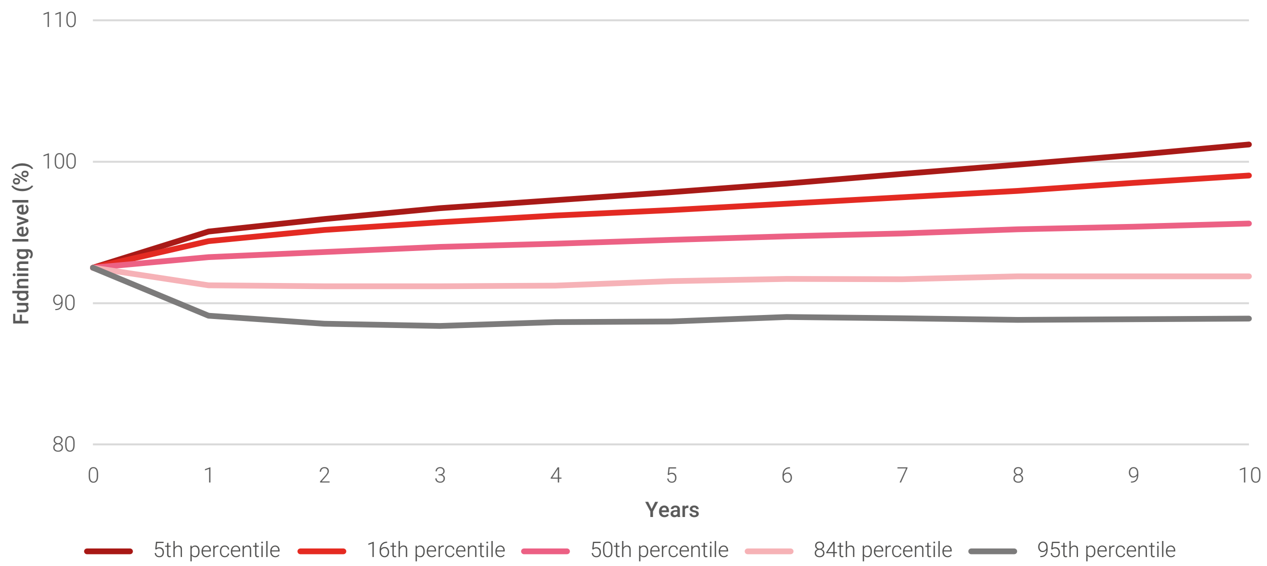
Funding level on gilts basis	95%
Expected return	Gilts + 0.56%
Funding level at risk[1]	3.2%

Source: LGIM as at 31 December 2020. For illustrative purposes only. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

[1]Defined as the amount the scheme's funding level could worsen in a 1 in 20 downside scenario over 1 year on a buy-out basis. As at 31st December 2020

The expected return for this portfolio is only 0.56% over government bonds. As shown in Figure 2, 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'.

Figure 2: Low-risk portfolio will take a long time to become fully funded



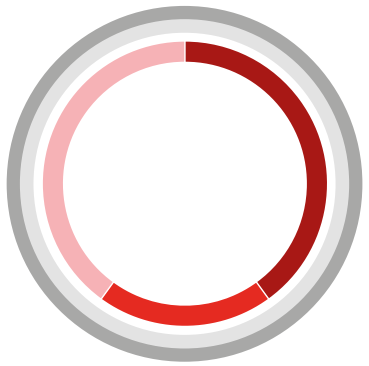
Source: LGIM as at 31 December 2020. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

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. In Figure 3, 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.

Figure 3: Allocating to diversified credit



- B&M credit - 40%
- Diversified credit - 20%
- Gilts/LDI - 40%
- Interest rate hedge ratio - 100%
- Inflation hedge ratio - 100%

As % of funded liabilities

Funding level on gilts basis	95%
Expected return	Gilts + 1.23%
Funding level at risk[2]	4.0%

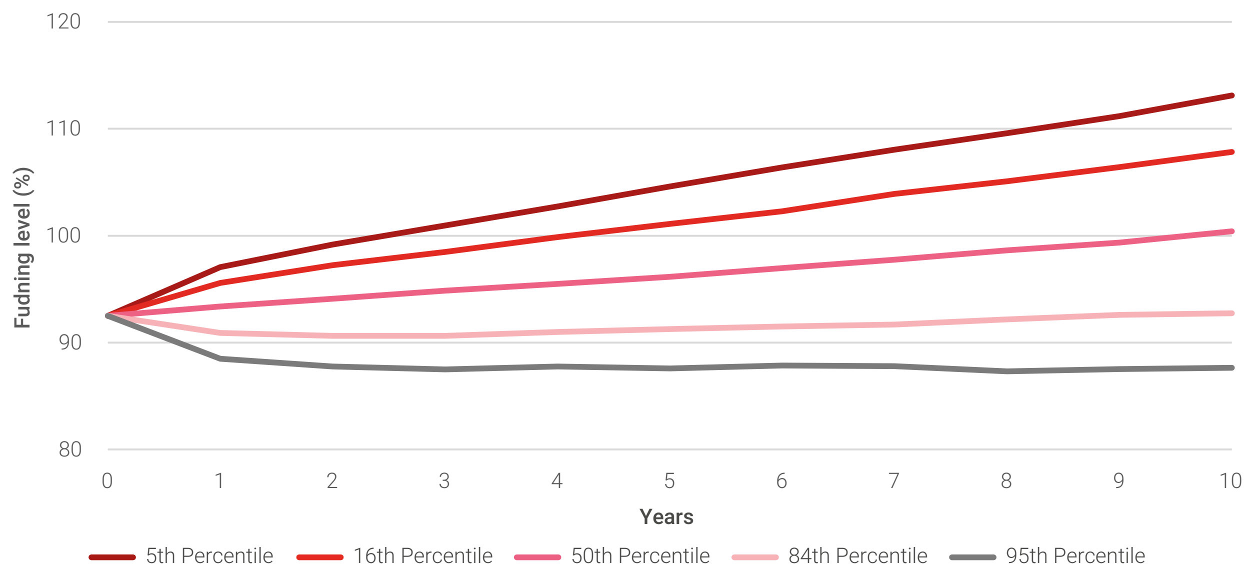
Source: LGIM as at 31 December 2020. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

[2]Defined as the amount the scheme's funding level could worsen in a 1 in 20 downside scenario over 1 year on a buy-out basis. As at 31 December 2020

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 4, 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.

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.

Figure 4: Achieves full funding within 10 years



Source: LGIM as at 31 December 2020. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

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. An example framework for this is shown in figure 5. Our analysis uses both 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.

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Figure 5: Example framework for assessing company alignment for SDGs

Products

- Analysing revenue streams for UN SDG alignment
- Screening for involvement in controversial products

Sustainable products

Revenue streams aligned to one or more SDGs, e.g. ≥5% of revenues generated from renewable electricity generation.

-1 0 +1

Controversial products

Revenue exposure to controversial product categories, e.g. any revenues generated from tobacco.

-1 0 +1

Practices

- Analysing company practices aligned to UN SDGs
- Screening for companies involved in controversies

Sustainable practices

e.g. ≥50% of raw materials used are made of recycled or re-used material.

-1 0 +1

Controversial practices - performance

e.g. zero women on the board; zero female executives; zero women in senior management.

-1 0 +1

Controversial practices - incidents UNGC* violation and severe controversies

The involvement in severe scandals results in a -1 score or caps. The overall score at 0 (prevents the company from being considered positively aligned).

-1 0 +1

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.

*United Nations Global Compact

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