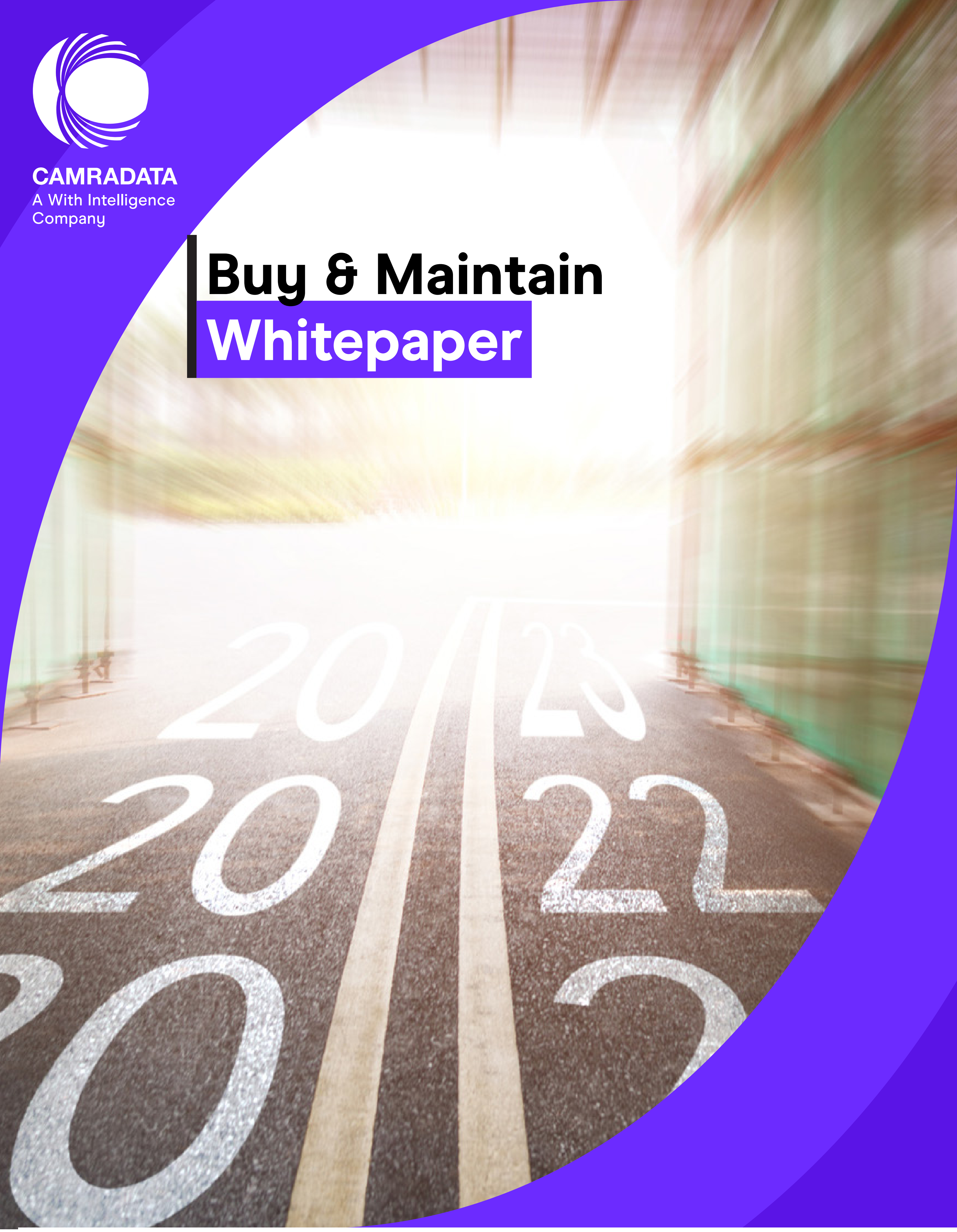
CAMRADATA
A With Intelligence Company

Buy & Maintain Whitepaper



Sponsored by

Invesco

MFS®

Clear and Independent Institutional Investment Analysis

We provide institutional investors, including pension funds, insurance companies and consultants, with data and analysis to assess, research and report on their investments. We are committed to fostering and nurturing strong, productive relationships across the institutional investment sector and are continually innovating new solutions to meet the industry's
complex needs.

We enable institutional investors, including pension funds, insurance companies and consultants, to conduct rigorous, evidence-based assessments of more than 5,000 investment products offered by over 700 asset managers.

Additionally, our software solutions enable insurance companies to produce consistent accounting, regulatory and audit-ready reports.

To discuss your requirements

+44 (0)20 7832 6517
info@camradata.com
LinkedIn
@camradata

camradata.com

Contents

Welcome to CAMRADATA's Buy & Maintain Whitepaper

Bonds and other fixed income instruments have been a mainstay in institutional investment portfolios for decades due to their typical risk profile and propensity to generate income.

But as the profile of the investors allocating to the strategy has changed, so has what they want from it and how it needs to perform.

As one of the largest holders of fixed income instruments, the needs of defined benefit pension schemes are high on the list of purveyors of funds of this type – and that landscape has shifted significantly over the past 10 years.

Many maturing schemes, seeking either self-sufficient run off or an endgame of buy-out, want stable, income-earning assets that offer some certainty rather than shoot-the-lights-out, deficit-shrinking returns. Is a Buy & Maintain the strategy they need?

Once viewed as a strategy in the no-man's land between active and passively managed funds, Buy & Maintain often takes a long-term, quality-led approach to generate the stable cashflow that plugs into derisking models while paying benefits to members.

It also, handily, offers the type of assets insurers are happy to take on to manage a scheme to its natural close.

Additionally, this long-term, quality approach plays to the needs of defined contribution pension funds, which appreciate the promise of liquidity without having to execute frequent sales. Low trading costs and management fees are also attractive to long-term saving schemes where every basis point counts.

Irritants appear in the form of sustainability conditions, which increasingly need to be considered for every mandate. How can this strategy effectively meet stewardship requirements and, unless dictated at the point of issue, how can investors ensure their stated obligations to members are considered?

These requirements also change as regulation, stakeholder and any other number of demands emerge, meaning holdings may no longer fit a required template just months after purchase.

However, with a pool as deep and rich as global debt capital markets, do fund managers have a large enough opportunity set in which to work with issuers to create the instruments they need to futureproof their strategies and meet client objectives?

Meet the Team

Sean Thompson
Managing Director

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Sam Buttress
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

Orin Ferguson
Associate, Business Development

Buy & Maintain Roundtable

The CAMRADATA Buy & Maintain Roundtable took place in London in March 2023

Buy and maintain credit – a new dawn for an old favourite?

Buy & Maintain (B&M) strategies have played a significant role in pension fund allocations over the last decade, but what will be their role in the future? Furthermore, how did the LDI crisis affect the market, and can B&M be an ESG-friendly investment? CAMRADATA invited industry leaders to discuss the past, present and future of B&M.

As a traditionally passive, long-term investment, allocations to buy and maintain credit rarely make headlines, but it has been a significant underpinning for many pension scheme strategies for several years, though the scale of allocation varies widely between schemes.

"Buy and maintain credit first became popular about 10 years ago, and I'm a big fan of it," said Sasha Jain, Client Director at professional trustee and pension governance firm Vidett. "It's a great way to invest in credit, so a lot of clients that I had went into it back then, typically with allocations around 20% or more."

The key attractions of buy and maintain, according to our roundtable, are guaranteed cash flows, low risk to capital and, because of the low rate of churn in a buy and maintain portfolio, lower transaction costs.

"Allocations have been growing as schemes have looked to de-risk - it's considered a relatively low risk and return generating asset class and most schemes now have some allocation to buy and maintain," said Ben Gold, Head of Investment Advisory at XPS Pensions Group. "It varies from 10% to 50% plus, but 20% to 30%, on average. It is absolutely a core part of scheme's portfolios in the majority of cases now."

Luke Greenwood, Co-Head of Invesco Global Investment Grade for Invesco Fixed Income, agreed the trend was for rising allocations. "It's picked up in terms of the flows that we're seeing, because of the cash flow importance, and alleviating the trading costs associated with going into active funds and having to come in and out a lot to match cash flows."

Owen Murfin, Institutional Investment Manager at MFS Investment Manager, quickly raised another potential attraction on buy and maintain – it's potential in ESG investing.

"One area we're very interested in is the sustainability angle, because we think ESG becomes more material with longer timeframes, and obviously, the maturity of many of these buy and maintain assets is long," said Murfin. "To take a view on any credit for 30 years, you must have a strong view on ESG. But also, as funds derisk, they have more fixed income exposure and the need to report on sustainability measures are not just for equities, but fixed income too."

> ***"There are multi-investor pooled funds, many of which are evergreen, while others have target-end-date or maturing run-off style funds"***

Murfin believes it's likely buy and maintain will continue to be popular, as long as it is integrated with a robust sustainability framework.

Paul Whelan, Co-Head of Global Fixed Income Manager Research at Aon, was keen to explain that buy and maintain credit is not all the same and can be accessed by various different routes.

"There's an important distinction between how a client accesses buy and maintain as to its relative attractiveness," he said. "There are multi-investor pooled funds, many of which are evergreen, while others have target-end-date or maturing run-off style funds. Then for larger schemes, which have the governance budget and required minimum mandate size , there are segregated accounts which can be more

customised to their specific needs."

However, in the multi-investor pooled funds base, Whelan said fees were not materially cheaper than active credit.

"We think, net of those fees, active credit managers can be identified, that do outperform," Whelan said. "So, we have significant and growing amounts of credit investment by a typical large UK DB scheme, but for smaller clients that has not been via buy and maintain strategies."

The structure and strategic stage of a scheme can also determine whether buy and maintain is an attractive proposition. One example, according to Shola Salako, an Accredited Professional Trustee at Dalriada, is when a scheme is heading towards a buy-out. "It's a nice way to keep money while preparing to go towards buyout. You can just hold your money there, while you've got income coming in, and you don't have to worry about it," she said.

More generally, DB schemes find buy and maintain attractive because it helps increase certainty of return, said Gold. But he added defined contribution schemes could become more interested.

"One of the key things about buy and maintain is you're buying contractual cash flows, so it's about locking into a degree of certainty of return, so DB schemes are natural buyers as they go on a de-risking journey."

DC schemes are less interested in the strategy due to having less clearly defined liabilities.

"But I think the DC the exposure to buy and maintain might grow," said Gold. "Or, more accurately, exposure to credit will grow because we're seeing more DC schemes coming to maturity. As we see a maturing of population in DC, we'll see more exposure to credit."

Looking even further out, Greenwood suggested buy and maintain may have a role in post-retirement.

"Buy and maintain is more akin to an annuity," he said. "You could see it being offered to retail clients. For cohorts who are more DC than DB, maybe it's an alternative to an annuity, because they would be getting a cash flow that matches their expected needs."

But while the long-term trend may be clear, short-term events have also forced a rethink. As Jain pointed out: "Things have changed recently, particularly with the LDI crisis."

The impact of the LDI crisis on buy and maintain

On this rather unexpected event in 2022, our roundtable discussion identified a conundrum in how buy and maintain is regarded. As the name suggests, buy and maintain credit holdings are not intended to be highly traded assets, one of its potential values can be its low transaction rate, which translates into lower costs.

But in the LDI crisis, as long gilts crashed and schemes had to quickly source liquidity, credit holdings theoretically earmarked as buy and maintain became quickly saleable assets."The gilt crisis led in the very short term to flows away from buy and maintain, because there were lots of schemes that simply

> ***" Schemes now better understand the need to not look at a particular part of their portfolio in isolation but to see all their assets in the round. It showed the importance of having clarity of roles for specific things in a portfolio."***

needed access to any source of liquidity," said Gold. "And away from buy and maintain, because there were lots of schemes that simply needed access to any source of liquidity," said Gold. "And whilst buy and maintain is not an asset most pension schemes want to sell - it was relatively liquid. In the post- September period, we saw lots of schemes, selling simply to raise liquidity as quickly as possible, knowing full well that they would be buying them back as soon as the opportunity arose."

This, Gold added, meant many schemes were currently still reassessing their credit holdings, but planning to buy back into buy and maintain. "There is probably an appetite to buy more buy and maintain credit, because it has taken schemes a little while to work out their position post-crisis. So, there is an overhang that I think it will take some time to come through," he said.

Whelan, meanwhile, pointed out the LDI crisis could have been much worse and, reflecting on potentially bigger risks, may have led many schemes to think hard about whether buy and maintain credit was something they would never need to liquidate before achieving their "end game" objective.

"One thing that lessened the impact of the crisis was that it was a UK crisis and limited. But if there had been a similar environment to say the global onset of COVID in February and March 2020, it could have been a very different story as to how much of this credit could be liquidated. That's brought more caution into how people think about buy and maintain," Whelan said.

Salako agreed that the LDI crisis would and should prompt reflection.

"It was a real shock to the system," she said. "I remember, at the time, the scramble for liquidity, and it wasn't comfortable as a trustee. You just don't want to be in that position again. One needs to manage risks and weigh the opportunities that may be available."

Gold said schemes now better understand the need to not look at a particular part of their portfolio in isolation but to see all their assets in the round. It showed the importance of having clarity of roles for specific things in a portfolio.

"If you take buy and maintain specifically, the need to access liquidity in the gilts crisis was clearly very important and front of people's minds. Buy and maintain was not where you wanted to take your money from, despite it being fairly liquid, because it contributes to hedging, and so selling it to top up your LDI made restoring hedging even more complicated," he said.

However, being clear on the role of assets could be good news for managers running the strategy.

"There's a role for buy and maintain and it's now even clearer than it was, that you really don't want your buy and maintain to be a source of secondary collateral unless you absolutely have to," said Gold. "You need other sources clearly defined in your portfolio that you're going to tap into first."

Whelan argued the need for a 'holistic' approach to portfolios was a vital lesson of the LDI crisis.

"One of the things that has changed about how clients and advisors think is looking more holistically, rather than, we've got a hedging pot over here, and that's its own little part, then we've got equities here and so on. People are looking far more holistically at that picture," he said.

"It's important to always test: 'Why am I holding this allocation? Should I be holding more of it? Should I be holding less of it as situations evolve?' It must be done holistically, not just in isolation," Whelan said.

Salako echoed the sentiment: "One of the things that we learned during the LDI situation was we had to look at everything holistically. Where before you might have looked at it as different pots, you now look at the whole. And you now ask a lot more questions."

Buy and sustain?

As well as agreeing that buy and maintain assets needed to be seen in the context of the entire portfolio for liquidity purposes, our roundtable contributors agreed they also needed to be seen in the full context of ESG concerns.

explaining that he regarded the issue through three streams that partly hinged on the articles of the EU's Sustainable Finance Disclosure Regulation. "Article eight is where they're sitting with our pooled products at the moment. It has what we've termed sustainability safeguards or exclusions on tobacco, thermal coal and others. That's a benchmark exclusionary light approach for our pooled funds."

Is the next step net zero?

"We think net zero lends itself very well to buy and maintain, because it's about transition," said Greenwood." It's not about just excluding everything. It's about looking at, where can we make money, at the same time as helping and encouraging the companies to do the right thing."

Murfin at MFS argued there was a further dimension to the ESG balance in buy and maintain credit because of default risk. "It's always going to be a balance, because you can't have defaults. You cannot compromise," he said.

"When it comes to balancing things, we need to buy names that we really like, fundamentally, there's no way around that. It's an annuity-type product, and you want the cash flow that comes through to be paid. That has to be one of the most important starting points," he said.

Sustainability works in partnership with the overall strategy, according to Murfin – but "it can't be the tail wagging the dog".

"Otherwise, you might end up with uncompetitive yields, or, worse still, a default, while still bragging that your sustainability statistics are really great."

Sustainability statistics were themselves an issue for our roundtable contributors. Murfin said it was extremely difficult to gain diversification across the credit universe by applying the most available metrics such as the Transition Pathway Initiative (TPI) or Science Based Targets Initiative (SBTi).

"If you look at data alone, it's pretty impossible to have coverage of the universe," he said. "If you take TPI, or SBTi, the coverage is pretty low. So, if you wanted to rubber stamp it through that medium, either you have to get a very concentrated portfolio and reduce the universe, or you need to incorporate some sort of proprietary measure."

Getting up to 70% or 80% coverage of a buy and maintain universe using Article eight or Article Nine criteria may be possible, according to Murfin. "

But 100% coverage? That's pretty tough."

Greenwood argued that while climate and wider ESG issues were heading in the right direction, there was also a subjective human dimension to getting ESG right.

"The biggest challenge is getting people to trust that what we're doing is in their best interests, longer term but it does take time and it's about transition for all these things," he said. "Metals, miners, the oil and gas sector - there is no sustainable future without those industries, so you can't exclude them. But even if you look at the oil and gas sector, many are the biggest advocates and users of carbon capture and storage technologies. So, you have to look beneath the surface of just 'safe sector' allocations or exclusions, or how we should be thinking about it. It's about good research, good engagement, and having a sound process."

The roundtable also agreed in whose trust needed to be earned – younger investors, who are more attuned to ESG issues. Here discussion again returned to the distinctions between scheme types. DB schemes that typically have older members are n m,facing less pressure from members, but DC schemes, which typically have a lower age profile of members, are facing more.

Given the expectation that DC schemes are likely to become more interested in buy and maintain as they approach maturity, they are also likely to require that those buy and maintain credit assets have a strong ESG profile.

"DB members are generally an older cohort, whereas the DC ones are much younger and they're definitely much more engaged about environmental sustainability. So, they will ask the question, and you will be challenged, and they will come to you with questions that you hadn't even thought about," said Salako.

Roundtable Participants

Luke Greenwood

Co-Head of Invesco Global Investment Grade for Invesco Fixed Income

Personal Profile

Luke is Co-Head of Invesco Global Investment Grade for Invesco Fixed Income (IFI) based in London. Luke is IFI's lead portfolio manager for Global Buy and Maintain IG credit strategies, Euro Short Term Bond Fund and the UK Investment Grade Bond Fund in conjunction with a number of other actively managed strategies.

Luke is a senior portfolio manager and a key contributor to asset allocation decisions for European and UK investment grade credit across the Invesco Fixed Income platform.

Luke joined Invesco in 2000 and became a member of the IFI team in 2004 when he focused initially on the UK, Canadian and Japanese government bond markets before turning to specialise in credit markets. His extensive experience in the global corporate bond markets stems from his credit research responsibilities covering the UK banking, European auto and defence sectors and portfolio management of a diverse array of credit funds ranging from short duration to total return.

Luke has over 25 years of experience in financial markets. Originally from Australia, he began his career at Westpac and subsequently, State Street in Sydney before moving to the UK. Luke holds an Executive MBA from City, University of London, Bayes Business School.

Company Profile

Invesco is one of the world's leading independent global investment firms, solely focused on investment management. With 8,600 employees worldwide as of 31 December 2022, the firm directs all of its intellectual capital, global strength and operational stability toward helping investors achieve their long-term financial objectives.

By delivering the combined power of the firm's distinctive investment management capabilities, Invesco provides a wide range of investment strategies and vehicles to retail and institutional clients around the world.

On the ground in more than 25 countries, the firm is global in reach yet local in presence and its processes are disciplined yet can be delivered in customised ways. All of which distinctively positions Invesco to keep pace with clients' evolving investment needs worldwide.

Invesco

Owen Murfin, CFA

Institutional Investment Manager

Personal Profile

Owen Murfin, CFA, is an investment officer and institutional fixed income portfolio manager at MFS Investment Management® (MFS®). He is a member of the MFS Global Fixed Income portfolio management team. In this capacity, he participates in portfolio strategy discussions, customizes portfolios to client objectives and guidelines and communicates portfolio investment strategy and positioning. He is based in London.

Prior to joining MFS in 2017, Owen served as managing director and global fixed income portfolio manager at BlackRock for 15 years. Before that, he worked as an associate and global fixed income portfolio manager at Goldman Sachs Asset Management for five years.

Owen earned a Bachelor of Science degree with first class honors from University College London. He holds the Chartered Financial Analyst designation.

Our portfolio managers are supported by our entire team of investment professionals in nine worldwide offices. The team employs a proprietary investment process to build better insights for our clients. The core principles of our approach are integrated research, global collaboration and active risk management.

Company Profile

In 1924, MFS launched the first US open-end mutual fund, opening the door to the markets for millions of everyday investors. Today, as a full-service global investment manager serving financial advisors, intermediaries and institutional clients, MFS still serves a single purpose: to create long-term value by allocating capital responsibly. Supported by a culture of shared values and collaboration, our teams of diverse thinkers actively debate ideas and assess material risks to uncover what we believe are the best investment opportunities in the market.

We believe that incorporating ESG into our investment process is integral to skilled asset management and an essential part of our ability to achieve our clients' objectives. Our goal is for ESG considerations to impact our investment decision-making process in every instance that such factors could materially affect the long-term value of an issuer. Facilitated by our robust ESG integration framework, carefully considered proxy voting policies and thoughtful issuer engagement, we are entirely convinced that this approach improves our ability to achieve our clients' objectives and fulfil our fiduciary duty.

MFS®

Roundtable Participants

Paul Whelan

Co-Head of Global Fixed Income Manager Research

Shola Salako

Accredited Professional Trustee

Personal Profile

Paul is Co-Head of Global Fixed Income Manager research at Aon, based in the UK. He is responsible for covering the full spectrum of fixed income asset classes. Paul is an active member of the UK Fixed Income Views team, working to expand the breadth of the team's output, formulating appropriate scheme hedging levels and informing the advice we give to clients on managing their liabilities. Paul also works closely with Aon's global fiduciary business, Delegated Consulting Services, shaping market-leading fixed income solutions covering liability hedging and return seeking opportunities. Paul represents the UK manager research team on the UK Content Committee team helping drive forwards the creation and marketing of innovative new ideas to the UK client base and beyond.

Paul joined Aon in November 2012 after more than 10 years in asset management with Aviva Investors, Henderson and UBS. He has worked in the strategy setting and management of fixed income portfolios for his entire career managing a variety of long-only and absolute return mandates across the fixed income universe. Paul holds a 1st Class Honours degree in Economics from the University of Bath. Paul is a CFA charterholder.

Personal Profile

An accredited Professional Pension Trustee, knowledgeable pensions professional with a consistent track record of achieving outstanding results. Shola works on Trustee boards as both a co-trustee and Chair of Trustee. Shola uses her experience to tackle issues on a broad range of schemes in an inclusive and collaborative way. She looks for pragmatic solutions to complex pension issues, working with employers, co trustees and advisers to find the best way forward.

Prior to joining Dalriada Shola has over 25 years' experience managing pension schemes and running trustee boards. She was a Pension Fund Manager for a large multinational with the main scheme having £1.3BN AUM.

She is a Fellow of the Pensions Management Institute (PMI).

AON

Dalriada. A better way

Sasha Jain

Client Director

Personal Profile

Sasha has over 20 years' investment experience and began her career in asset management with roles at Merrill Lynch Investment Managers (now BlackRock) and PIMCO. She spent 15 years as an investment consultant at Mercer Ltd, specialising in medium to large defined benefit pension schemes of varying complexity.

Sasha has extensive experience of working with trustee boards and corporate stakeholders on a wide range of pension and investment related issues, including journey planning and investment strategy, de-risking, buy-ins and buy-outs and defined contribution and AVC arrangements.

Ben Gold

Head of Investment Advisory

Personal Profile

Ben sits on the Executive Committee of XPS Pensions Group, the leading pension consulting and administration business focussed on addressing the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis as well as administrating pensions for over 1 million members.

He is the Head of Investment Advisory at XPS and has over 25 years of advisory experience in the sector, advising employers and schemes with assets ranging from£150m to £7bn. He has all-round expertise in helping schemes and employers navigate investment objectives, strategies, and risk management.

Moderator

Elizabeth Pfeuti
Chief Client Officer

Personal Profile

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.


Invesco
For professional investors only
Sustainable income.
For the long run.
Invesco's Net Zero Global Buy & Maintain Credit Strategy aims to harvest a sustainable stream of income from high quality bonds.
With credit and ESG analysed jointly and rigorously, our team seek to minimise turnover costs and optimise risk and cashflow over the long run.
To learn more, scan the QR code or visit invesco.com/netzero
For UK institutional investors.
Capital at risk

From farming to hunting and back again

Finding income doesn't have to be so risky anymore

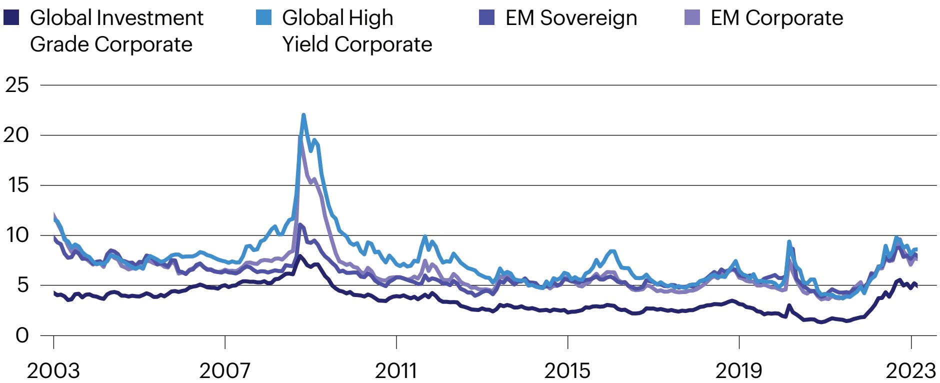
Bond investing used to be like farming: buy a portfolio of relatively high quality securities, tend to it, and harvest the coupons over a multi-year horizon.

"If you are willing to be patient and farm the portfolio, you can have reasonable confidence in achieving yields to maturity"

The Global Financial Crisis of 2008 changed that as more than a decade of low or negative central bank policy rates forced investors to adapt. A more active, hunting approach was needed to find real returns in the bond market, and this brought with it a greater degree of risk. Achieving returns over 3% generally required some allocation to sub-investment grade and / or emerging market bonds. These brought with them periodic waves of default, as we saw for example in 2015-2016 in the energy sector and 2021-2022 in Chinese real estate. While decent total returns could be earned with the hunting approach, they were rarely smooth and often below initial expectations.

The developments over 2022 have reopened the door for the farming approach, however. As central banks have raised interest rates at the fastest pace in 40 years, we find ourselves with a more generous level of yield in the bond markets. If we look at the yield to worst on the global investment grade corporate index, we see that, not only is it at the highest level since 2009, but it is also around the prevailing levels for high yield and emerging market debt for much of the 2014-2021 period.

Yield to worst on selected asset classes (%)

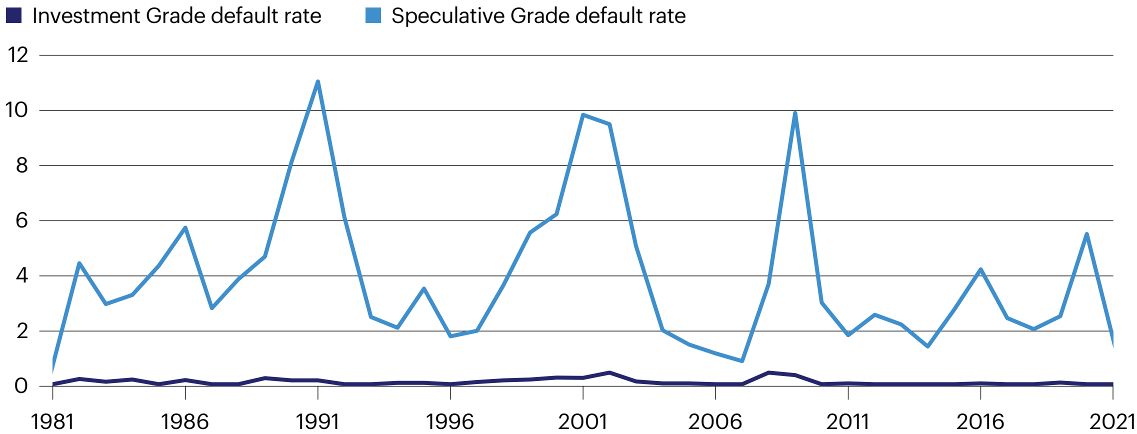


Source: Bloomberg to March 2023. Indices used: Bloomberg Global Aggregate Corporate, Global High Yield Corporate, EM Sovereign (USD), EM Corporate (USD). An investment cannot be made in an index. Past performance does not predict future returns.

Matthew Chaldecott,CFA
Senior Client Portfolio Manager, Invesco Fixed Income

The added advantage for investment grade is that the prospects of realising those yields are much higher now. If we look at historical default rates, the highest annual rate for global investment grade corporates was just 0.4% in 2002 and 2008, while for high yield it has historically been 10% or more.

Annual default rates (%)



Source: S&P 2021 Annual Global Corporate Default and Rating Transition Study. Past performance does not predict future returns.

This suggests that the probability of realising permanent capital losses in an investment grade portfolio is low, though there will likely be some volatility in mark-to-market performance as the level of yields fluctuates.

Nevertheless, if you are willing to be patient and farm the portfolio, you can have reasonable confidence in achieving yields to maturity, particularly when combined with issuer diversification and investment decisions underpinned by robust bottom-up credit analysis.

As bond markets are anticipating further rate hikes by most major central banks, yields are currently highest for shorter maturities. If we consider a 3- or 5-year investment grade corporate portfolio, the index yield to worst is 4.5-5%[1], while the effective duration is three years. At Invesco, we can further optimise a portfolio for potential returns, thanks to our proprietary Vision analytics system.

The chief risks for mark-to-market performance are 1) inflation remains stubbornly high and further rate hikes become necessary – this would be mitigated by the short duration and "pull to par" effect, which allows the opportunity to reinvest the proceeds at more attractive yields at maturity; 2) further worries over the banking sector prompt spreads to widen, not just within financials but more broadly given tightening credit conditions – again this would be mitigated by a short duration, high credit quality portfolio for which diligent credit research and diversification would help reduce the chances of capital impairment. The shorter maturity focus also increases research visibility and should reduce the need for subsequent portfolio turnover.

Overall, we view current conditions as favourable for investment grade corporate bonds, particularly in the shorter maturity space, which offer the chance to harvest yields previously reserved for high yield and emerging markets, but with lower credit and interest rate risk.

[1] Based on the ICE BofA ML 3-5y US Corporate (C2A0) and Global Corporate (G2BC) indices. Source: Bloomberg, end-March 2023.


INFLATION
VOLATILITY
LIQUIDITY
UNCERTAINTY
DURATION
RISK
FIXED INCOME
RISING RATES
SURVIVE OR THRIVE?
Do more than survive. Our active fixed income approach strives to help you make the most of changing bond markets.
Do more at mfs.com/active360
MFS®
ACTIVE 360°
52051.2

Time to Rethink Pension Scheme Asset Allocations

" In our view, this means UK institutional asset allocations may shift towards increased proportions of fixed income, lower illiquidity and a greater focus on sustainability"

Authors:

Owen Murfin, CFA
Fixed Income
Institutional
Portfolio Manager

Kelly Tran
Managing Director, UK & Ireland
Institutional Sales

2022 was a difficult year for some UK pension schemes, with the LDI liquidity crisis causing many trustees to scramble for liquidity to meet margin calls. However, on the brighter side, rising gilt yields have generally improved funding levels despite lower asset values across equity and fixed income. The result is that schemes need fewer assets to meet the significantly lower level of liabilities, allowing them to further reduce risk in their portfolios.

Key takeaways for schemes in regard to the LDI crisis include paying attention to liquidity and reviewing asset allocations.1 Looking ahead, we see two major questions for trustees, sponsors and their advisors:

- Given the improved funding position, what will future asset allocations look like?
- How do UK regulatory requirements to address climate risks and reach net zero factor into portfolios?

While the answers will depend on the desired endgame for schemes — insurance-based solutions or self- sufficiency — we believe there are some shared goals, such as de-risking while meeting net zero objectives.

In our view, this means UK institutional asset allocations may shift towards increased proportions of fixed income, lower illiquidity and a greater focus on sustainability.

Impact of improved funding levels on asset allocation

Schemes using leveraged LDI faced severe issues during the crisis due to the short, sharp rises in gilt yields. Despite this story making national and international headlines, what is overlooked is that, overall, schemes are in an improved funding position due to the rise in yields.

Longer term, these reduced liabilities will require a smaller pool of assets to pay out benefits as they come due. What might improved funding levels and the ability to hedge interest rate risk at better levels today mean for asset allocations going forward?

We now see schemes getting closer to the buy in or buy out stage and in a better position to reach self- sufficiency. In the case of an insurer-based solution, this means schemes and sponsors should start positioning portfolios to be attractive to insurers, which we view as containing higher fixed income allocations and lower private asset exposure.

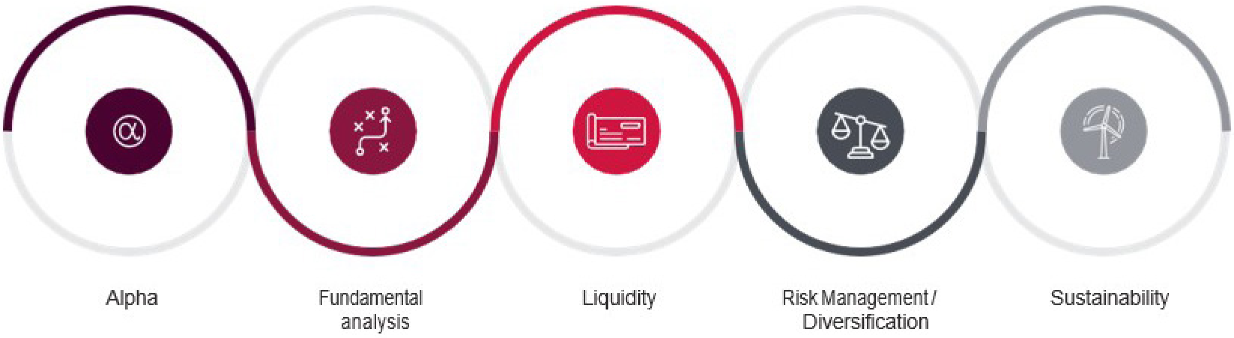
Now is a good time for schemes and their advisors to reset and consider what this future state could be. As the industry reflects on the LDI crisis, schemes may wish to assess whether they had the right liquidity risk management and liquidity asset pool, and how much risk to take as the funding backdrop improves.

Meeting climate regulations while managing portfolios

Whilst asset allocation decisions appear relatively straightforward, how can schemes factor the UK's net zero ambitions into their de-risking plans? Does net zero pose a challenge to building a portfolio that is attractive to insurers who also have net zero objectives?

In our view, strategies like, 'buy and maintain credit' will become ever more appealing from a de-risking perspective; however, aligning fixed income investment goals with net zero commitments can pose challenges due to balancing conflicting priorities. Careful consideration will be required to find the right balance of risk, return, liquidity and sustainability.

Aligning fixed income investment goals with net zero commitments can pose challenges



De-risking and influencing real-world carbon emissions

Is it possible for schemes to de-risk portfolios while meeting real-world climate targets? We have been working with clients to design a solution that meets their requirements, considering net zero alignment ambitions alongside return and risk management objectives.

We see buy and maintain credit as an ongoing portfolio that can meet a client's need for steady returns without a specific time frame. We also see buy and maintain helping clients meet their net zero goals because as an active manager we can build fixed income portfolios based around client's risk and return as well as environmental, social and governance (ESG) parameters. We believe ESG factors impact the ability of a company to pay its coupons and principal maturities over the long term and in a timely manner, making them an extremely important part of our credit analysis.

To meet these risk, return and net zero goals, it's the client that specifies the parameters before we run a proprietary quantitative framework over the vast universe of fixed income securities to filter down to a more dedicated and concentrated portfolio. This becomes the starting point for our fundamental analysis by portfolio managers and credit analysts.

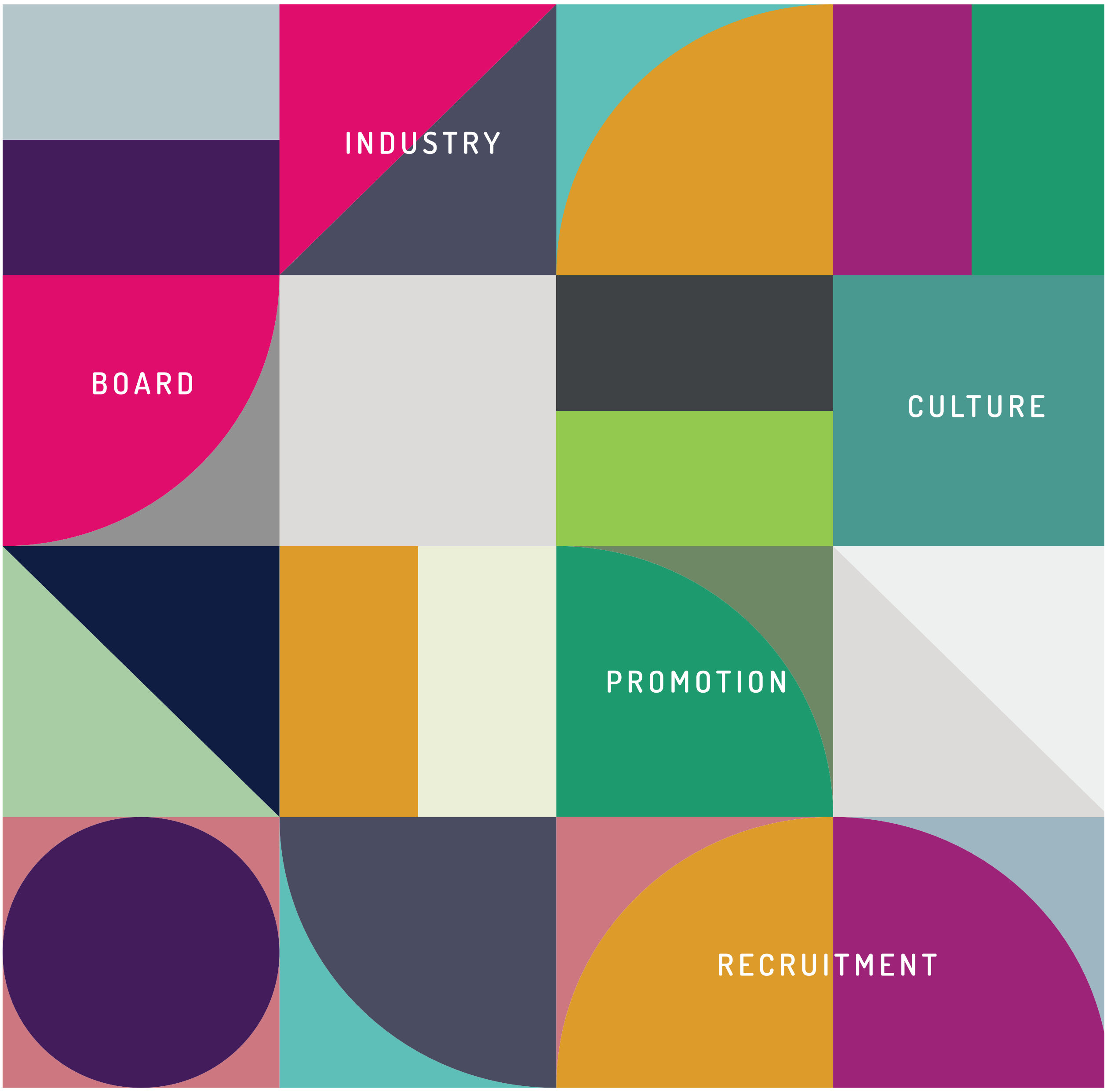
Our proposed solution uses a combination of ESG data and metrics (Transition Pathway Initiative, Science- Based Targets Initiatives) as well as our proprietary SFDR Article 8 criteria and fundamental research ratings. Through monitoring and on-going engagement with portfolio companies, we strive to improve the overall net zero alignment of the proposed portfolios.

Is there a silver lining?

Although the health of the UK economy has deteriorated, UK pension schemes are doing better due to rising gilt yields. Looking ahead, this presents an opportunity to de-risk portfolios to meet long-term objectives.

In our view, this will result in increased fixed income allocations, lower illiquidity and a greater focus on sustainability. That's why we believe now is the time for schemes to reconsider asset allocations and consider buy and maintain strategies that can incorporate net zero ambitions. We believe that we can align our strong global credit capabilities with enhanced ESG Integration to meet a range of client objectives.

For more information about MFS' Buy and Maintain capability, please contact Kelly Tran, Managing Director – Institutional, via ktran@mfs.com.


INDUSTRY
BOARD
CULTURE
PROMOTION
RECRUITMENT

Important Notice

CAMRADATA
With Intelligence
One London Wall
London
EC2Y 5EA

+44 (0)20 7832 6500
camradata.com

Join us on LinkedIn