Is now the time? Targeting your return and cashflow objectives with Buy and Maintain Credit

As LGPS funds find themselves better funded than ever, this paper sets out why we believe de-risking into Buy & Maintain Credit could offer potential opportunities for LGPS funds to simultaneously achieve attractive investment grade credit returns at the same time as generating cashflows. At LGIM we have extensive experience in this area, including now [celebrating 10 years of our pooled Buy & Maintain Credits funds].

James Sparshott,
Head of Strategic Client Team

John Southall,
Head of Solutions Research

Nambassa Nakatudde,
Solutions Strategy Manager

2024 LGPS client case study:
Investing £750m into our pooled L&G Future World Net Zero Buy & Maintain Fund

- Large, well-funded scheme restructuring their assets
- New asset allocation includes de-risking through reduction in equity exposure
  - ✓ LGIM pooled fund chosen targets scheme's risk and return objectives and provides access to a broad and diversified fixed income universe
  - ✓ Leverages the 10-year track record of our range of pooled B&M credit funds
  - ✓ Built-in ESG through incorporation of temperature and SDG alignment

Case study shown for illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.

Where are LGPS now?

LGPS funding levels, like those of many private sector UK DB schemes, have reached record highs. Isio's 'LGPS Low-Risk Funding Index' estimates that the average funding position for LGPS funds in England and Wales has risen to 110% funded, as of 31 May 2024 – with 59 of the 87 funds having funding levels greater than 100%[1].

Unlike most private sector UK DB schemes, LGPS funds are open and expected to 'run on' indefinitely. These circumstances influence optimal investment decisions. Many LGPS funds are now able to de-risk, and some will seek out contractual cashflow-generating assets such as fixed income for this purpose. But what fixed income asset allocation and strategy could be most appropriate?

Diversification into a broad fixed income universe

A Buy & Maintain (B&M) strategy is a well-trodden path for private sector DB pension schemes de-risking as an alternative to strategies managed against sterling investment grade (IG) benchmarks. This is because there are inherent sector and issuer concentration issues with these benchmarks; namely, the large banking and government-related exposure.

A benchmark-agnostic B&M approach breaks the association with benchmarks that are constructed around lending to the most indebted entities. As with LGPS funds, the investment time horizon of B&M is long, turnover is low, and there is an emphasis on security selection resulting from fundamental credit analysis which aligns to LGPS expectations of running on indefinitely. Indeed, this is similar to the £86bn annuity[2] portfolios which LGIM manages for Legal & General insured DB pension schemes.

Historically, B&M portfolios have tended to concentrate on the developed investment grade market. However, there is a broader universe which includes securitised credit, global high yield, emerging market debt and subordinated debt (e.g. corporate hybrids), which could all play a role alongside traditional investment grade credit. The extent to which we use these assets depends upon the level of returns and risk appetite being targeted. Given their long-term horizon, we believe this broad opportunity universe could be particularly suitable for LGPS fund investments into B&M.

1. https://www.isio.com/insights/lgps-ew-low-risk-funding-index-31-may-2024-results/

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

2. As at 31 December, Legal & General Group PLC Preliminary Management Report 2023, 6 March 2024 - https://group.legalandgeneral.com/media/rorj3amk/2023-full-year-results-full-press-release-and-analyst-pack.pdf

Below we show the standard deviation and credit spread of several fixed income sub-asset classes, in addition to a time series of their relative credit spreads.

Chart 1 – Risk and return[3]

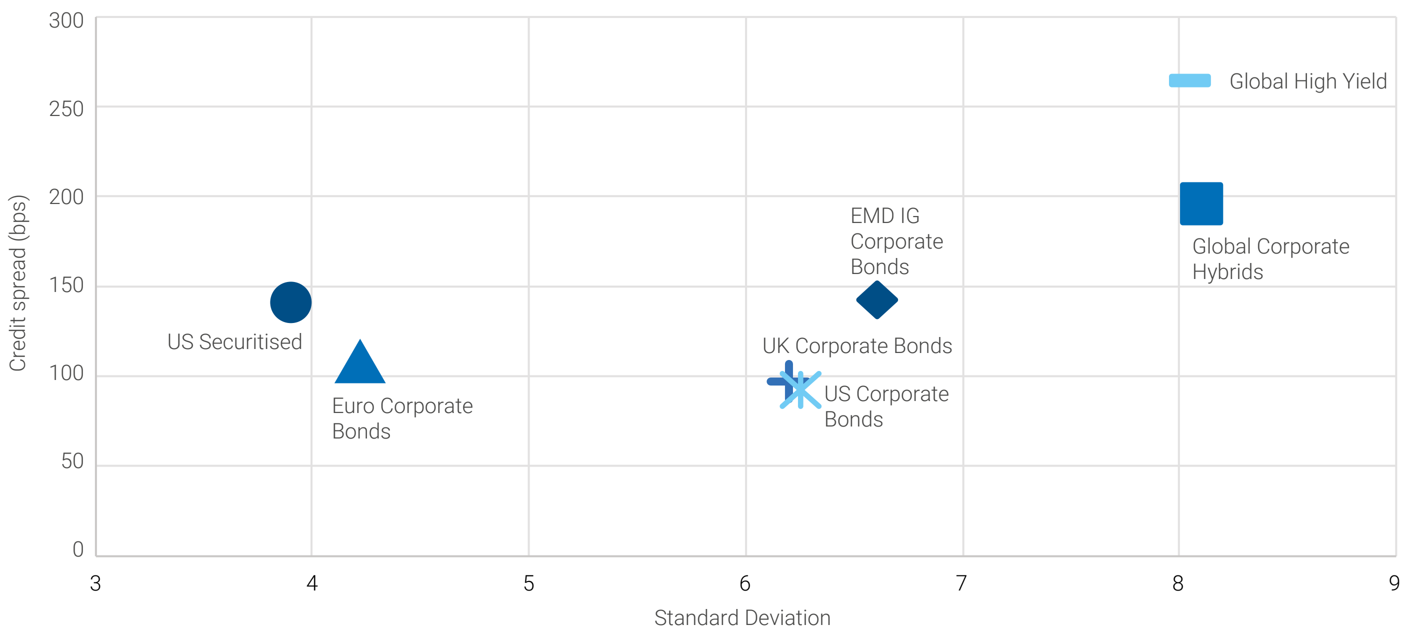
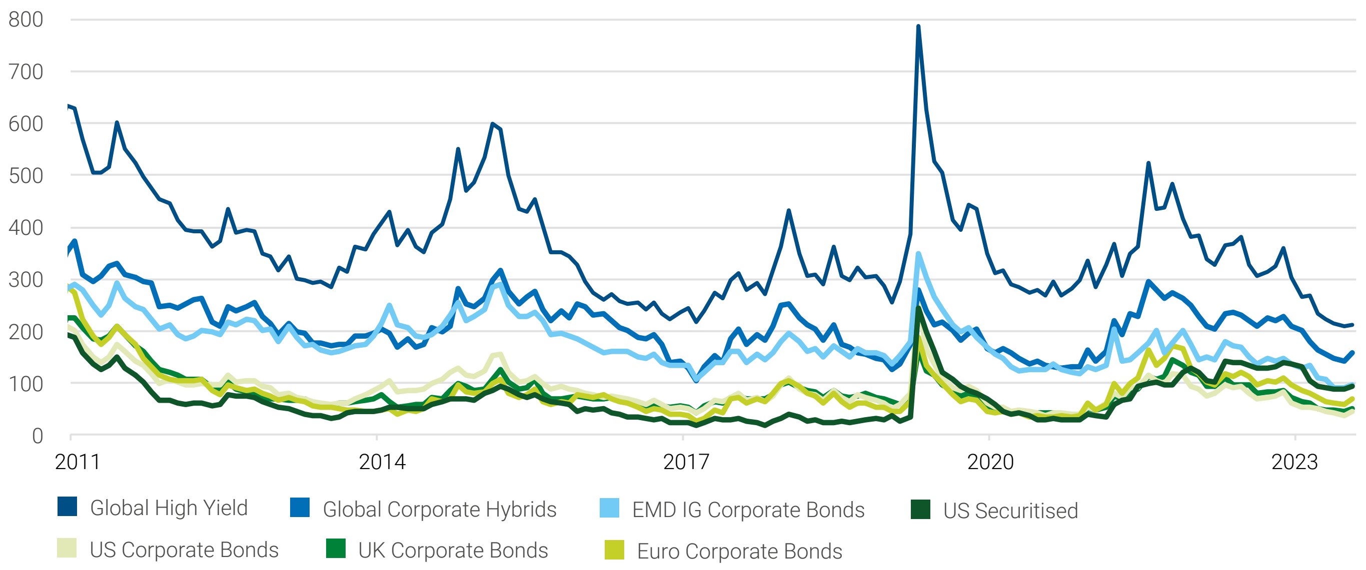


Chart 2 – Spread time series[4]



3. As at 31 May 2024 - Source: Bloomberg
4. Source: Bloomberg

Key risk: The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

US securitised credit

Securitised products are bonds backed by the cashflows of a dedicated pool of financial assets (for example, loans, leases and lines of credit). The market is large, diverse, and mature.

Mortgage-backed securities are around 85% of the securitised market* and include various parts of the real estate market such as residential (RMBS) and commercial mortgage loans (CMBS). The remainder of the market includes the likes of auto, credit card and student loans (ABS).

At LGIM we've been investing in this market for over 15 years. LGIM B&M portfolios favour bonds with a high level of seniority where there is an excess of demonstrable collateral provided by underlying assets.

* Source: BofA as at 30 September 2023

Global corporate hybrids

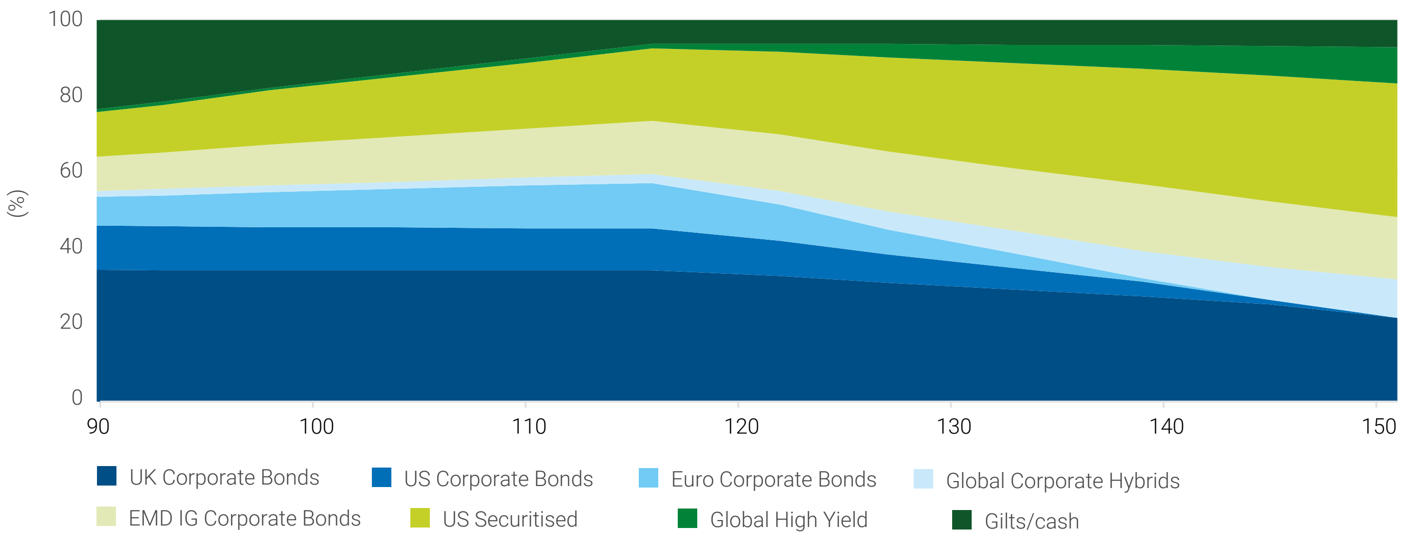
Subordinated bond holders receive their payments after more senior bond holders. However, they can still sit relatively high in the capital structure and always sit above equity.

LGIM B&M portfolios look for corporate hybrids that are exclusively issued by investment grade companies and favoured by our analysts. Structural features of these securities such as deferrable coupons and call features, in addition to their subordinated nature (and therefore lower recovery rates in the event of default), mean that these securities typically see higher mark-to-market volatility but can trade at a significantly higher spread than senior bonds of the same issuer. We believe that B&M investors who can weather the higher volatility could be well placed to harvest the spread pick-ups available over longer investment horizons.

How to construct your B&M portfolio? Optimisation tools with qualitative overlays

LGIM has developed a proprietary optimisation tool which factors in 20 years of historical data, producing a continuum of model portfolio asset allocations to achieve different expected return levels and also takes into account expected credit losses. Chart 3 shows the different weights in each sub-asset class.

Chart 3 – Indicative optimised portfolios[5]



5. Source: LGIM, as at December 2023

Key risk: The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

This broad framework can be useful in helping clients to consider their allocations to different fixed income sub-asset classes at a given point in time, depending upon their specific risk and return objectives. For example, clients with a lower risk appetite and return objective may favour an asset mix further to the left side of the graph. Those seeking a higher return may wish to give us more guideline flexibility to allow us to target an asset mix further to the right of the chart.

In practice, quantitative modelling can only get you so far. Our full portfolio construction framework overlays such analyses with our qualitative considerations such as current market sentiment, technical factors including supply and demand, liquidity management and ESG risk (discussed in more detail below), to name a few. This helps to ensure a portfolio is adapted to the current market environment.

Portfolios built for yield, diversification, liquidity and cashflow generation

By allocating to the full opportunity set, we believe our B&M portfolios can seek to deliver benefits in the following areas:

✓ **Improved yield** – including these higher yielding sub-asset classes introduces the possibility for yield enhancement

✓ **Improved diversification** – increasing diversification could help your investment portfolio remain healthy and resilient[6]. It can seek to be achieved by combining different fixed income asset classes that are imperfectly correlated. As illustrated by the correlation matrix below, several of the sub-asset classes in the broader opportunity set show relatively weak correlation to that seen within the universe of senior investment grade UK, Euro and US bonds

Chart 4 – Sub-asset class spread correlation[7]

	UK Corporate Bonds	US Corporate Bonds	Euro Corporate Bonds	Global Corporate Hybrids	EMD IG Corporate Bonds	US Securitised	Global High Yield
UK Corporate Bonds	100%	89%	96%	96%	85%	86%	89%
US Corporate Bonds	89%	100%	92%	82%	93%	91%	97%
Euro Corporate Bonds	96%	92%	100%	91%	90%	88%	91%
Global Corporate Hybrids	96%	82%	91%	100%	80%	84%	84%
EMD IG Corporate Bonds	85%	93%	90%	80%	100%	88%	94%
US Securitised	86%	91%	88%	84%	88%	100%	93%
Global High Yield	89%	97%	91%	84%	94%	93%	100%

6. It should be noted that diversification is no guarantee against loss in a declining market.
7. Source: LGIM, Bloomberg and JP Morgan for the period of 2000-2023.

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Expanding the opportunity set to include more of the fixed income universe can help to ensure issuer, sector, regional, currency and rating diversity.

- ✓ **Better liquidity** – linked to diversification, in periods of stress the ability to dispose of assets in affected markets diminishes. Taking the 2022 UK government bond market crisis as an example, while the UK investment grade credit market was strained, the US investment grade market didn't suffer from the same issues and so was a way for schemes to access liquidity in a cost-efficient way. In a similar way, other areas of the market have different investor bases. For example, the US securitised investor base is typically dominated by US banks and insurance companies

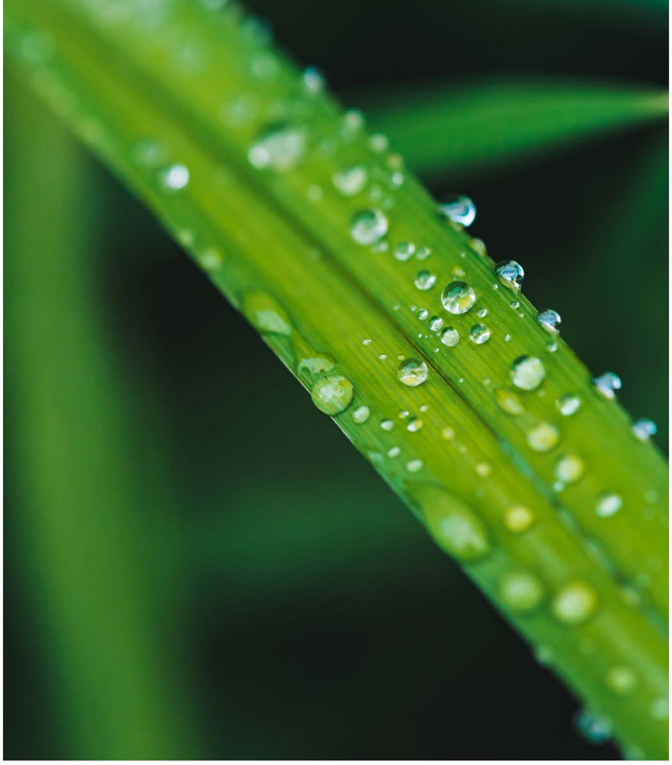
- ✓ **Cashflow generation** – as members of the fixed income universe, the highlighted sub-asset classes provide regular contracted cashflows. This means that investors can be relatively certain of the cashflows they can expect to receive. For those LGPS funds that are cashflow negative, the approach of cashflow matching can help to ensure they have sufficient cash coming in to meet upcoming benefit payments without becoming a forced seller of assets at an inopportune time

Bespoke built-in Environmental, Social and Governance (ESG)

ESG considerations now feature prominently in LGPS funds' investment objectives. Regardless of schemes motivations for integration, ESG risk is a key factor to be managed for long-term investors as investment performance can be hurt by poor ESG integration.

As LGPS diversify into fixed income, ESG considerations are therefore key. For any of our B&M portfolios which combines several fixed income sub-asset classes, it is essential that ESG factors are considered at the security, sub-asset class and overall portfolio level. This can help to balance the need for exploiting specialist sub-asset class expertise with an awareness of aggregate ESG exposures.

At LGIM we use temperature alignment to assess issuers on a standalone basis and relative to one another, the extent to which they are behaving in a way that is consistent with the decarbonisation goals of the Paris Agreement and therefore how well they are managing their transition risk. It enables us to identify issuers with business models and assets that can



adapt to a world of rising temperatures and avoid those companies which have unsustainable business models and potentially stranded assets.

We also believe analysing alignment with the *UN Sustainable Development Goals (SDGs)* is an increasingly important aspect of credit research in terms of mitigating risks, driving impact, and identifying the winners and losers of the future. Whether companies are aligned to the SDGs can be determined by assessing if company revenues are from products that contribute to or detract from the goals, or if business practices contribute to or detract from the goals.

B&M credit can help LGPS to capture the opportunity presented by their current funding levels

In conclusion, as LGPS funds find themselves better funded than ever before, we believe considering an allocation to a buy and maintain credit portfolio that takes into account the full credit universe could offer potentially attractive opportunities. As well as targeting enhanced returns and positive cashflow, this type of portfolio could also offer the potential for increased yields, diversification and liquidity benefits, and opportunities to strengthen the scheme's approach to ESG risk management.

At LGIM, we design and implement B&M portfolios that have access to the full credit opportunity set. We would love to talk more about how to design a portfolio which best meets your needs.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

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Key Risks
The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

Fund risks

Global Buy and Maintain Fund, Maturing Buy and Maintain Credit Funds
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Future World Buy and Maintain Credit Funds
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