Broadening the universe: The strategic case for alternative credit

The falls over the past two years in high yield and emerging market debt ('alternative credit') credit spreads,[1] along with indications of late-cycle behaviour in the US, has led some investors to be nervous about allocating to these areas. But should pension schemes reconsider?

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While we sympathise with investor caution over alternative credit at this point in economic cycle, we believe that many pension schemes are significantly underweight the asset class in their strategic asset allocations. In this article – one of a series on broad asset classes – we detail the strategic benefits of allocating to alternative credit and why we believe investing in the asset class could be beneficial for many schemes.

DIVERSIFICATION: THE ONLY FREE LUNCH IN FINANCE

For many institutional investors, the majority of their growth assets continue to be allocated to global equities. This leads their risk profiles to be dominated by equity risk.

Alternative credit, along with other asset classes such as property and private market assets[2], offer investors the opportunity to diversify their risk exposure and improve their risk-adjusted return profile. For example, in Figure 1 (overleaf) we've modelled two portfolios with similar expected returns. Portfolio A's risk profile is highly concentrated in equities with the 60% allocation accounting for over 80% of the portfolio's total risk. In portfolio B we have improved the diversification by allocating to US dollar-denominated emerging market debt (EMD) and high yield. This has led to a lower concentration in equity risk (below 60%) and nearly a 10% reduction in the investor's total risk.

1. Credit spreads are defined as the difference between the yield available on the credit asset and the yield on a government bond of the same duration
2. We plan to release an article on setting strategic allocations to private market assets later this year

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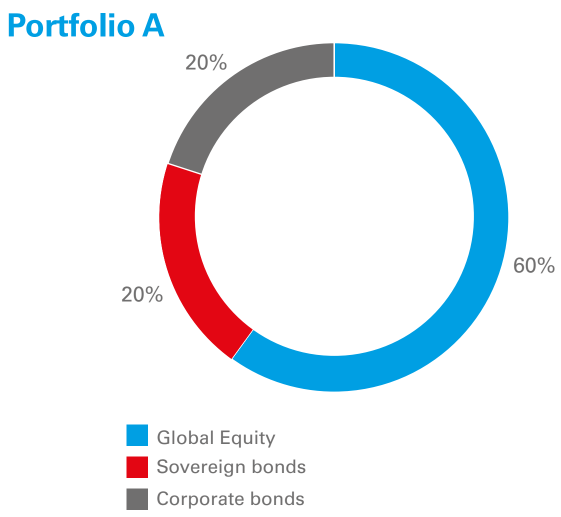
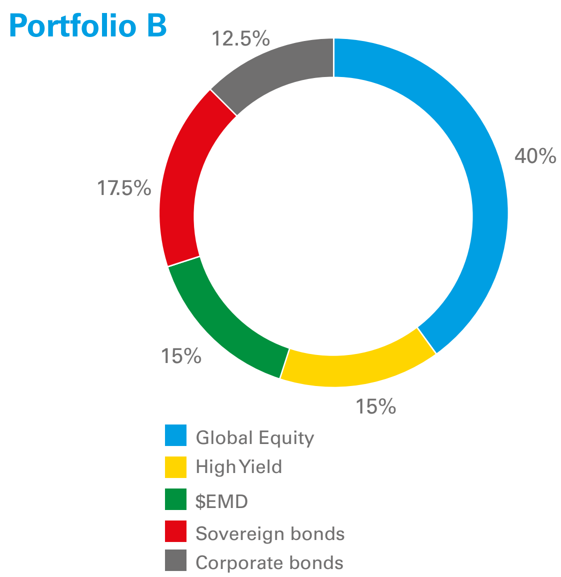
Figure 1. Portfolio B has a similar expected return to A, with lower risk





	Portfolio A	Portfolio B
Expected rate of return over gilts[3]	2.65%	2.65%
1 year 95th percentile FLaR[4]	9.3%	8.6%

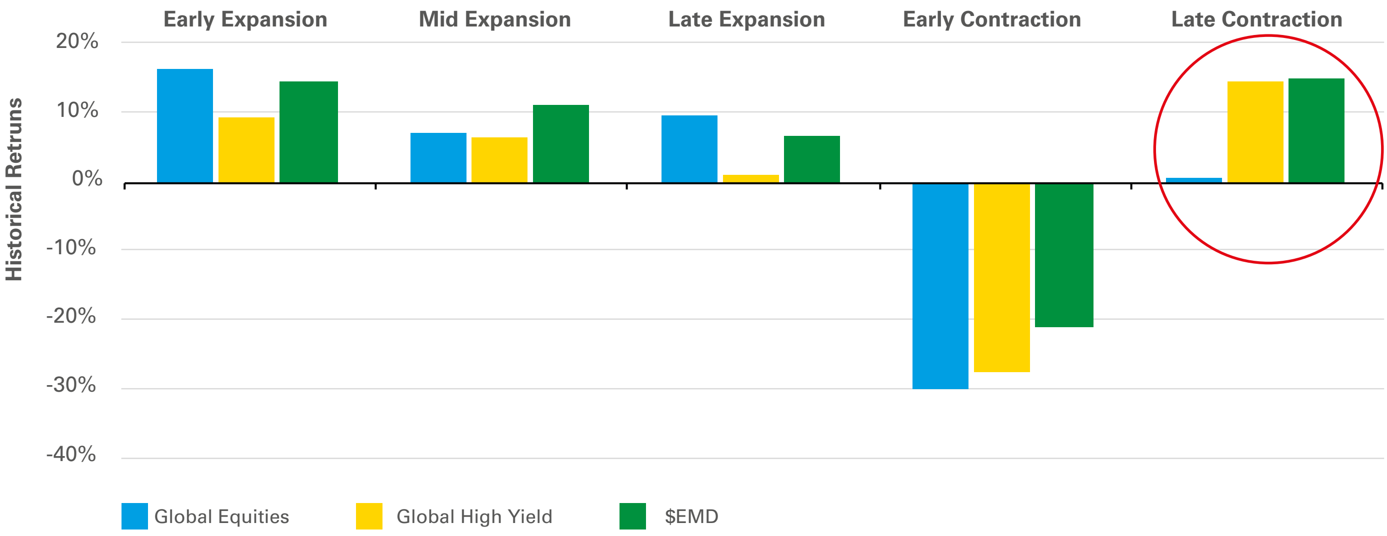
Source: LGIM as at 31 December 2017. For illustrative purposes only.

Memories from 2008, where almost all growth assets experienced significant falls in value simultaneously, have led people to question the benefits of diversification. In times of global economic turbulence, growth assets are likely to perform poorly across the investment universe. However, in these episodes there often still are relative winners and losers and having a diversified portfolio can moderate the impact of a downturn. During the dotcom crisis in the early 2000s, global equities fell 44% peak to trough. Over the same time period, high yield only fell 3.9%, with $EMD returning +6.7%. Over this period Portfolio B would have outperformed Portfolio A by over 7%.

Additionally, alternative credit assets tend to recover more quickly than equities following a downturn. Figure 2 plots the average historical performance of global equities, high yield and US dollar-denominated EMD over different parts of the economic cycle. It can be seen that in the early contraction phase, each of the asset classes have historically performed poorly, as investors become risk averse. This comes however with the caveat that the lack of a long history of returns for alternative credit can lead to an overemphasis on the interaction of assets during the credit crisis, which was an extreme end-of-cycle episode. Irrespective of the relative short history of data, high yield and US dollar-denominated EMD have shown evidence of posting strong returns in the late contraction part of the cycle, quickly recovering from their falls. Equities meanwhile do not tend to really recover until the early expansion phase of the cycle. In summary, while alternative credit is not completely uncorrelated with the economic cycle, the diversification it offers can be very beneficial for pension schemes, particularly if the end of the cycle coincides with large cash requirements, or a covenant event.

3. Based upon 10-year projections
4. The one-year 95th Percentile Funding level at Risk (FLaR) measures the amount an institutional investors funding level could fall over a one- year time horizon in a 1 in 20 downside scenario

Figure 2: Alternative credit has historically recovered quicker following a market downturn



Source: LGIM, Bloomberg, NBER as at 28 February 2018. Excess returns are annualised averages over the period April 1973 until February 2018, splitting the period up in expansion and contraction using NBER's definition of the US economic cycle, and splitting up expansion and contraction in three and two equal periods respectively.

A STABLE SOURCE OF CASH

Maturing pension schemes and an uptick in transfers out have put meeting benefit payments high on the agenda for many pension schemes (as we covered in our recent article **'Raising cashflow awareness'**).

While we believe the endgame portfolio for most pension schemes should have cashflow-matched buy and maintain investment grade (IG) credit as a cornerstone, the expected return from IG credit may be insufficient to meet some schemes' return requirements. Additionally, the dearth of long-dated corporate bonds can create practical issues for matching long-dated liabilities, leading to a requirement to hold lower yielding long-dated government bonds, which further reduces the expected return. For these schemes, we believe a cashflow aware approach rather than pure cashflow matching can be appropriate.

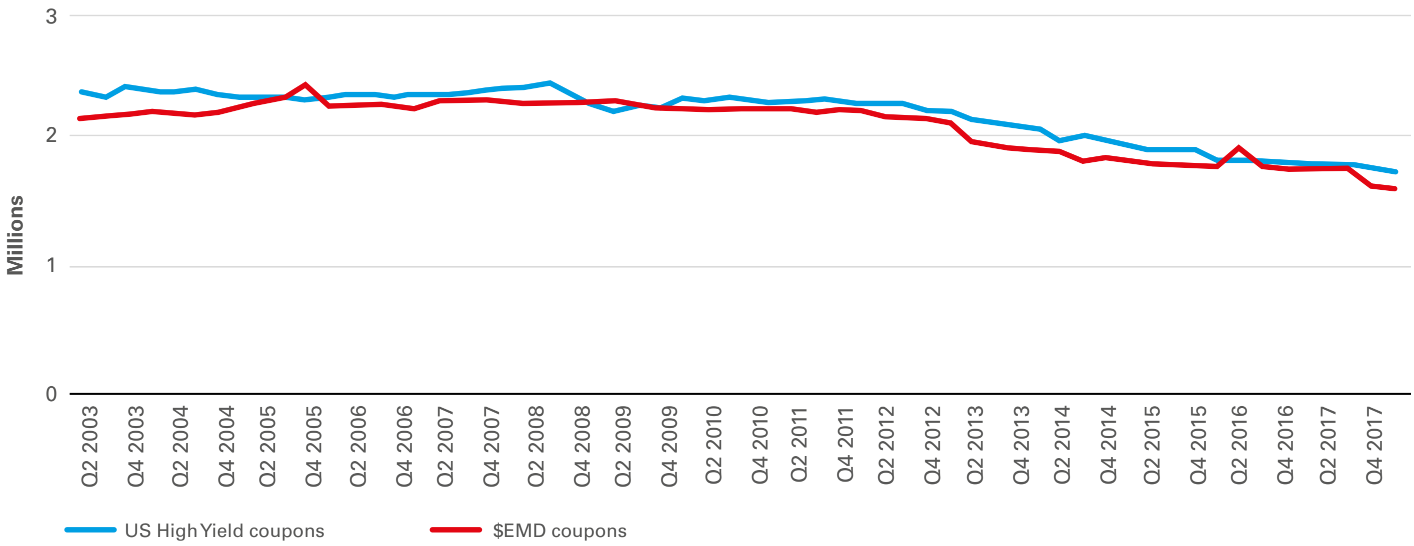
In a cashflow aware approach, a pension scheme can obtain cashflows from a range of sources by "turning on the taps". This may include equity dividends, property rents and distributions from 'secure income' assets; e.g. long lease property, infrastructure debt etc. We believe alternative credit is a useful component of a diversified cashflow aware strategy and offers a number of attractive qualities relative to other income-distributing assets.

WHY IS ALTERNATIVE CREDIT 'CASHFLOW AWARE' AND NOT 'CASHFLOW MATCHING'

The principal criterion of a cashflow-matched strategy is the asset cashflows must be known with a high degree of certainty. Many people will argue where the line should be drawn in terms of when an asset's cashflow can be known with a high enough degree of certainty to be called cashflow matching. The most common definition we see draws the line at investment grade (i.e. BBB and above) and indeed the capital considerations for insurers tends to coincide with that view, where the expected cashflows from sub-investment grade bonds are significantly reduced due to the possibility of the issuers being downgraded or defaulting.

We believe high yield and US dollar-denominated EMD cashflows do not offer the required certainty to be managed in a cashflow-matched buy and maintain fashion. Issuers in this space are operating with higher business, default, financial and political risk than their investment grade peers, with bonds issued typically containing features which are unattractive for cashflow matching (e.g. callability). As such, we believe an active approach for alternative credit is more appropriate, with bond coupons used to supplement income from other assets in a cashflow aware strategy.

Figure 3: Alternative credit coupons can offer a stable source of cashflow



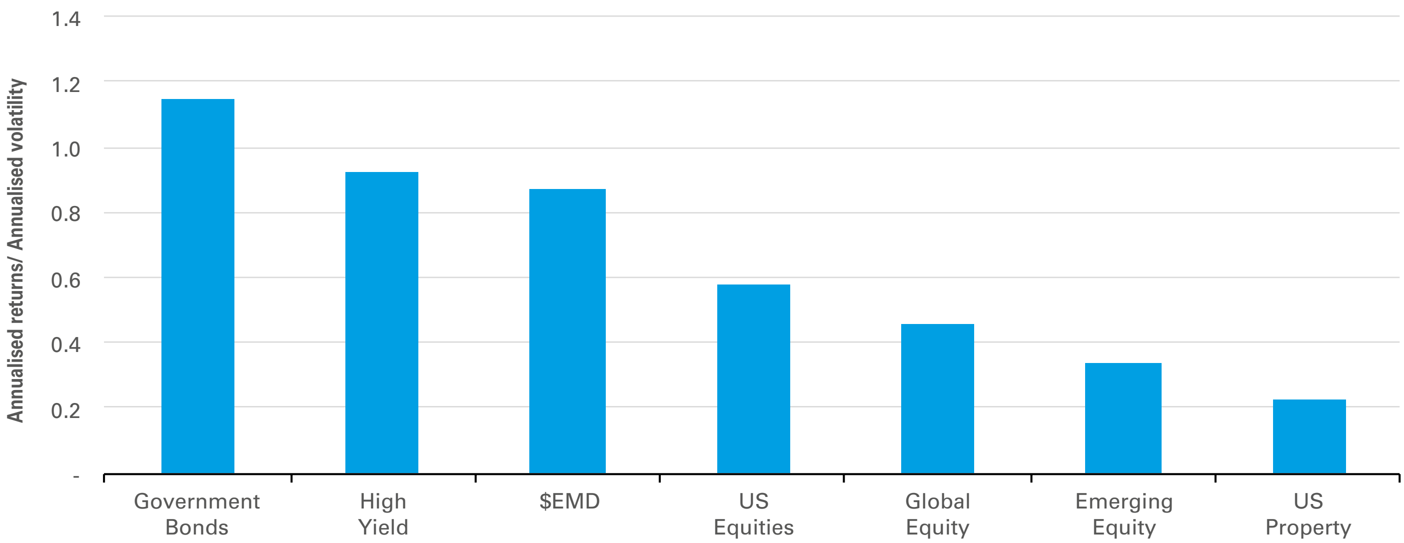
Source: Barclays Live and LGIM as at 31 May 2018

Figure 3 plots the cashflows an investor would have received from a £100 million investment made in 2003 in either high yield or US dollar-denominated EMD. It can be seen that while alternative credit spreads widened significantly during the financial crisis, the actual income received from coupons in high yield and US dollar-denominated EMD were broadly unaffected over that period. By contrast, dividend income on the S&P 500 fell 30% peak-to-trough over that time. The higher certainty of income, even over times of severe economic stress, makes alternative credit very attractive for pension schemes as it reduces the risk that a scheme has to sell assets at depressed prices to meet benefit payments. It is also important to note that while the distributions received from high yield and US dollar-denominated EMD have decreased in recent years, with companies issuing lower coupon bonds due to lower yields, at 6.3% and 5.3% they are currently far in excess of the dividend yield of most stock indices.

ATTRACTIVE RISK-ADJUSTED RETURN POTENTIAL

The key driver in asset allocation for the majority of investors is what return one can expect relative to the amount of risk. Figure 4 plots the ratio of returns over volatility[5] for a range of asset classes from 1993. It can be seen that alternative credit assets have been among the top performing asset classes on a risk-adjusted basis.

Figure 4: Alternative credit is one the strongest performers on a risk-adjusted basis



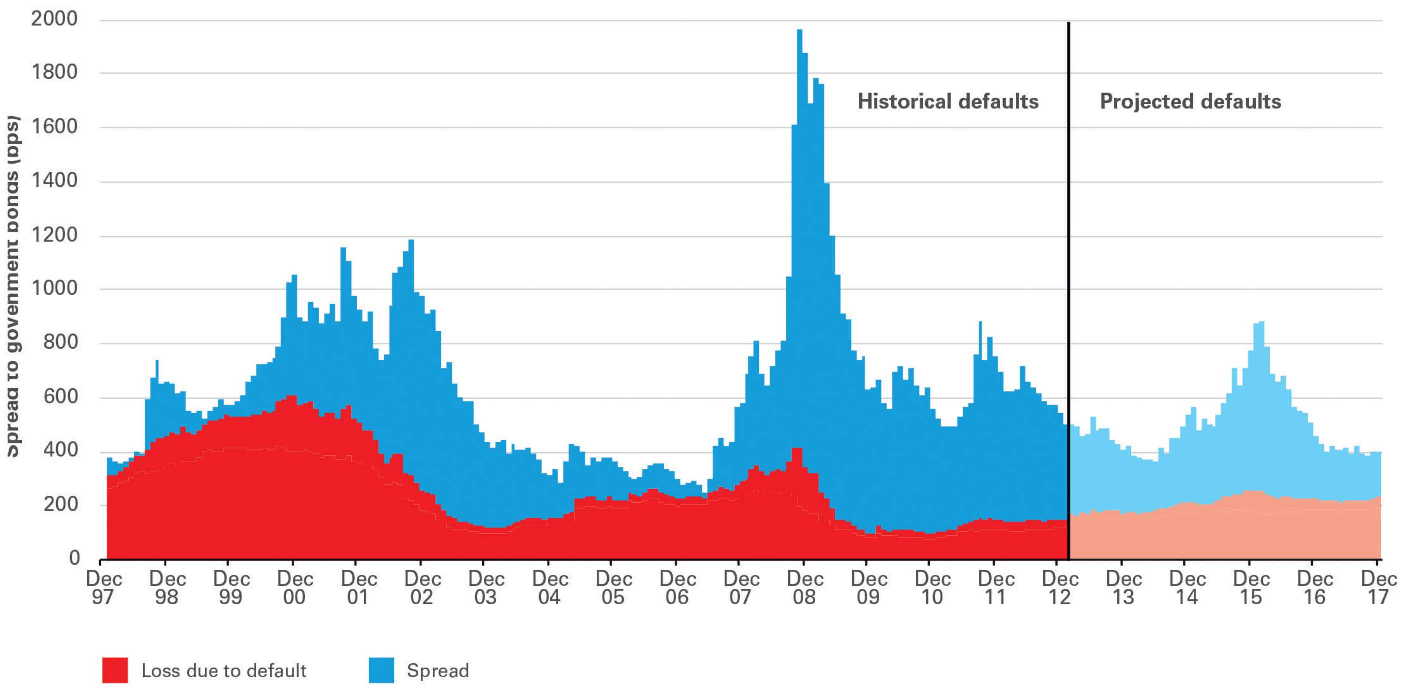
Source: Barclays Live, Bloomberg. Based on monthly returns in USD from January 1993 to May 2018 for all assets except US property which is from June 2005 to May 2018).

5. Derived as the annualised average month returns of each asset class over that period, divided by the annualised volatility of those returns

Assessing the attractiveness of asset classes based on historical returns is dangerous as it can lead to investors driving their asset allocation by 'looking in the rear view mirror'. Indeed, at the start of the observation period, high yield was a niche asset with a large 'complexity' premium and the constituents of the EMD universe were largely sub-investment grade. The erosion of the complexity premium as these assets have become more mainstream, together with the rating upgrades in EMD means that this performance is unlikely to be repeated in our view.

The question that remains therefore is do current spreads compensate for the risk an investor experiences? In Figure 5, the blue bars show the history of US high yield credit spreads. The red bar shows the default loss an investor would have experienced (left side of the dotted line) or projected to experience (right side of the dotted line) if they purchased the assets underlying the high yield index. It can be seen spreads have compressed in alternative credit and are at the lower end of their historical range. However the blue bar remains significantly higher than the red, indicating high yield still overcompensates for the expected default experience and rewards investors for the additional risk they take by investing in sub investment grade. This is similarly true of US dollar-denominated EMD, where the current credit spread 3.54% is only eroded by 1% when allowing for projected defaults[6]. While the high default rate experienced by high yield bonds issued in the late nineties eroded most of the spread value, it should be remembered that the high yield index was relatively embryonic at this stage, with fewer issuers leading to a more concentrated index.

Figure 5: Despite recent compression, high yield spreads still more than compensates for expected defaults



Source: LGIM, BoAML indices (HUC1, HUC2, HUC3), Moodys default rates

A POTENTIALLY IMPORTANT COMPONENT OF YOUR STRATEGIC ASSET ALLOCATION

Alternative credit has a number of attractive qualities including diversification benefits, a stable source of cashflow and returns in excess of expected defaults. While the current low level of credit spreads and the evidence of late cycle dynamics support being cautious, we do not feel this supports having a very low or zero allocation[6]. For example, LGIM's Diversified Fund, which targets achieving the most efficient way of accessing long-term investment returns, has a c.15% allocation to alternative credit. The 'optimal allocation' to alternative credit varies by investor but we believe alternative credit is an important constituent of the asset class universe and should form a meaningful part of most pension schemes' strategic asset allocation.

6. Based upon Barclays Emerging Market Sovereign index and Moody's default rates as at 29 June 2018

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