AXA Investment Managers

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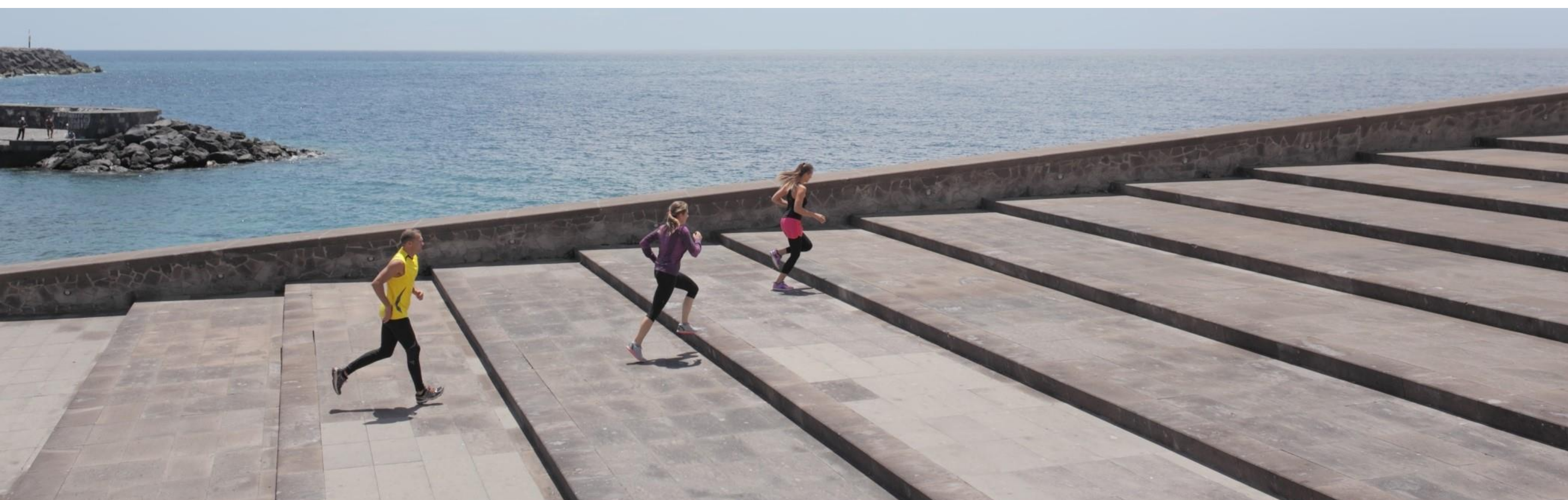
Defined Contribution Fixed Income

Member outcomes: three steps to improve your DC fixed income portfolio



Highlights:

- Fixed income remains a vital part of DC members' investments as they reach retirement age
- Passive UK corporate bonds often make up the bulk of this allocation, however we believe this approach is structurally inefficient and could be detracting from realised member outcomes
- The cumulative impact of turnover and forced selling can have a material, negative impact on passive strategy performance, well-designed Buy and Maintain credit strategies seek to overcome this issue
- Adopting a Buy and Maintain approach can also unlock the ability to implement climate-aware investments that help schemes better meet their regulatory and member outcome requirements
- Using a global credit universe to implement such a climate-aware strategy could have a cumulative positive impact by generating stable growth and providing a steady income

Introduction

Fixed income assets are a core part of every Defined Contribution (DC) member's journey as they get close to retirement. Even with the appetite for annuities dwindling, fixed income can still range between 30% to 60% of the strategic asset allocation for large master trusts and single trusts[i]. One of the reasons for this are the "pension freedoms" introduced in 2015 by which individuals can access their DC pensions savings at age 55. Providers must be positioned for a wide range of member behaviours at retirement. The bonds, often corporate, are required to fulfil the 'holy trinity' of investing – capital growth, preservation of value and paying an income. Yet we still see many passive UK corporate bond mandates within many default ranges - an approach we believe to be ineffective for meeting member needs. This stance is worth reconsidering as investments continue to move up the agenda and asset flows in late stage DC become significant.

In recognition of the structural shortfalls, lack of flexibility and, in our opinion, inability to implement climate-awareness into passive UK corporate bonds, DB Pension Funds and Insurance companies have been moving away from these allocations in recent years. Further regulatory press for larger schemes will only accelerate this trend. We encourage UK DC schemes to take the same approach and consider how this important allocation can be improved. We set out three possible steps below which, when implemented together, could have a cumulative positive impact on members' pensions to help them grow and realise their retirement needs.

Step 1: Switch your UK credit to a global universe

There are clear financial benefits for DC schemes and members to switching from a passive UK to a global corporate bond allocation. The global universe can offer greater diversification, liquidity and more stable performance which can boost returns for members as well as reducing the dispersion of performance between members.

Table 1: Investment Grade Credit Market - Comparative Characteristics

	Global Investment Grade Corporate Index	Sterling Investment Grade Corporate Index
Size (in £bn)	9,900	442
Yield-to-maturity (%)	1.67	1.79
Credit spread (basis points)	96	110
Modified duration (years)	7.2	8.5
# of issuers	2,301	331
New issuance (£bn in 2020)	c.1,565	c.31
Average credit rating	A-	A-

Source: AXA IM, Bloomberg, BofAML 13/04/21

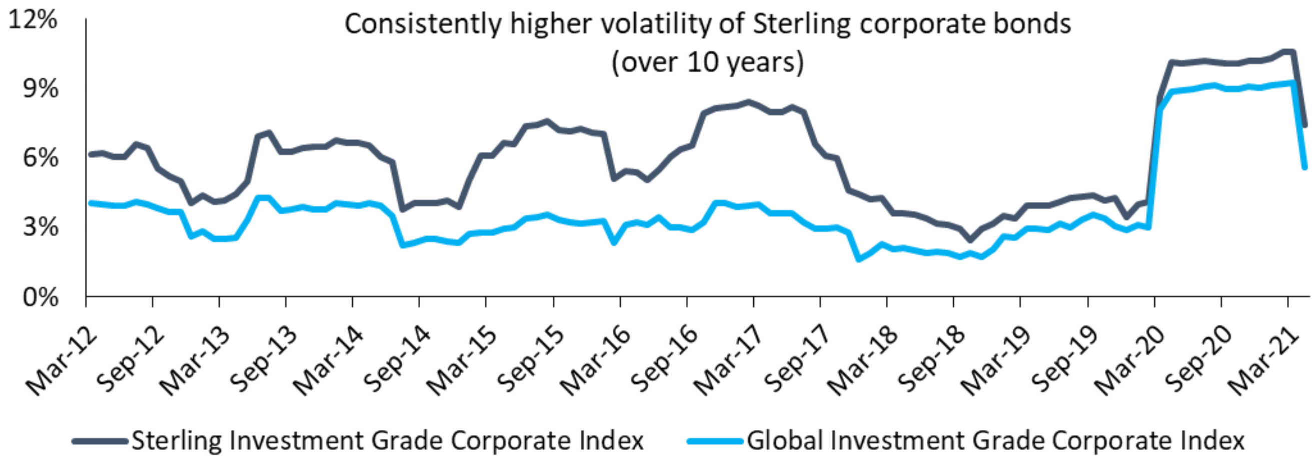
Table 1 shows that the yield, spread and average credit rating of the two indices are broadly the same, after accounting for the slightly longer duration of the Sterling index. However, **including the US and EUR markets increases the universe size by a factor of 20**. This has huge implications for both the liquidity of the bonds held and the diversification of risks. Higher liquidity means that it is less expensive to buy and sell bonds within the portfolio, benefiting investors. The cost of turnover or bond trading in the portfolio is a cost which investors bear through lower performance or explicit charges when entering or exiting the passive fund. The latter of these is a cost which may not show up directly in fund performance but could negatively impact a passive credit portfolio that is being used for regular drawdowns in retirement. Lower trading costs lead directly to higher performance.

Exposure to a global universe can also diversify risks within a portfolio. Avoiding fallout from political risks, such as the new relationship between the UK and the EU, is just one example of how a global approach could dampen the impact of risk elevation within any one country. The UK market also has a greater than 50% weighting in just two sectors - utilities and financials - whereas the global market has a more even distribution. Finally, there could be an impact on the ability to implement an effective climate-aware strategy within a pure UK corporate bond universe as discussed later. A greater level of portfolio diversification across issuers and regions should reduce volatility and drawdowns, important for DC investors.

What does this mean for member experience?

The Sterling corporate bond market has had consistently higher level volatility compared to the Global Credit Index as the chart overleaf shows. Higher volatility can create a larger risk for individual members when they are drawing cash down in retirement. In addition, at a scheme level, it could lead to greater distribution of returns *between different members*, depending on when they decide to draw income.

Figure 1: Harnessing the global corporate bond universe can increase the stability of returns for members



Source: AXA IM, Bloomberg, BofAML, rolling 12-month index volatility UROO and GOBC (% p.a.) For illustrative purposes only.

Finally, global bonds can have a lower correlation to both UK and global equities, meaning they are a better complement to a total portfolio than their UK-only counterparts by again improving risk-adjusted returns.

Expanding your members' universe from UK to Global corporate bonds can increase the stability of returns for members by accessing a much broadly universe of issuers and a more balanced allocation of risks, even when looking at index allocations.

Step 2: Adopt a Buy and Maintain approach

Using a global universe has many advantages over focusing purely UK corporate bonds, but many of these benefits are untapped when using a passive approach. The flexibility of a Buy and Maintain approach can unlock these benefits, while keeping total costs at a minimum, to generate better member outcomes.

Buy and Maintain credit strategies sit neatly in the middle of active and passive management – using the same fundamental credit research and skills as active management but with the low-cost edge of passive management. A typical Buy and Maintain strategy has two fundamental objectives:

- Avoid the inefficiencies and risks inherent in tracking an issuance-based index
- Harvest the maximum amount of yield available in the credit universe as cheaply as possible

Structural concerns with a passive approach

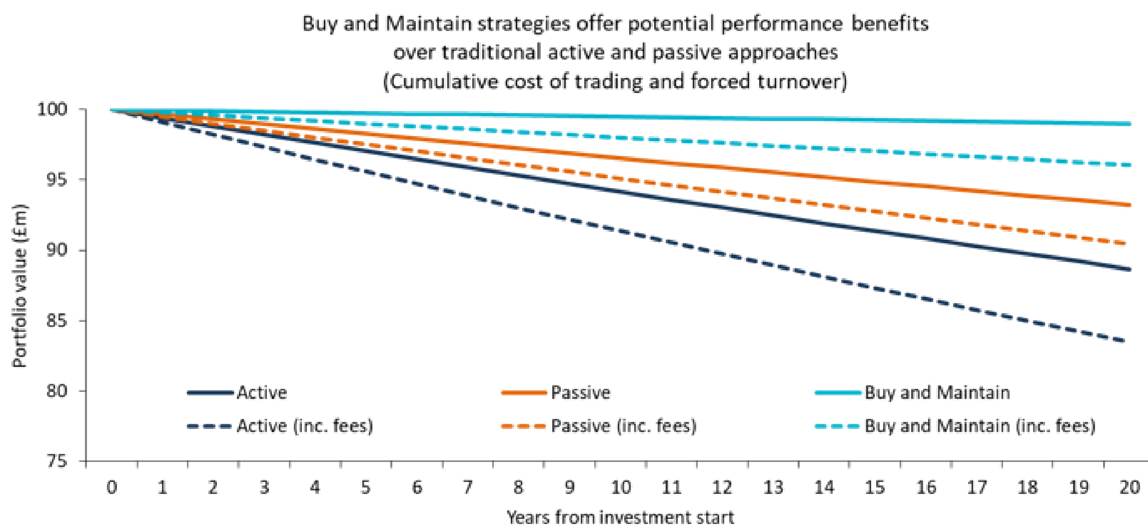
Passive strategies are structurally biased to be overweight the most indebted sectors and issuers and they aim to track their benchmark, irrespective of what is needed from the portfolio. This can increase risks for investors as a higher level of indebtedness is linked to a higher probability of default. Our recent article, *The problem with credit indices*, addresses these issues in greater detail. In contrast, Buy and Maintain strategies are benchmark agnostic and aim to mitigate downside risk through quality, focussed portfolio construction and low turnover. Our credit analysts place a high value on the long-term fundamental strength of an issuer to repay its debt, rather than a short-term relative value play which can result in higher risk exposures.

We implement a maturity-based approach to risk by capping the maturity of issuers with a high level of financial- and climate-related risks to well under 10 years. This structure is designed to materially improve the resilience of portfolios and gives our Buy and Maintain strategies the same average rating and yield as the universe but with a lower level of risk and turnover.

Cost-efficient access to credit markets

Liquidity and transaction costs in the corporate bond market have increased dramatically since the Global Financial Crisis. This long-term structural change has made it more expensive for passive managers to track their index and to sell any bonds that are downgraded to the high yield universe. Buy and Maintain portfolios tend to target zero active turnover and should have a total annual turnover, which includes the natural re-investment of coupons and principle, of less than 10% on average. The costs of turnover and forced selling are even more important in the current environment as they drag on the already low available yield and thus member returns.

Figure 2: The cost efficiencies of a Buy and Maintain approach



Investment style	Transaction costs incurred (bps)	Forced selling of high yield (bps)	Total cost analysis (bps)
Active	40-80	N/A	c.60
Passive	10	25	c.35
Buy and Maintain	5	N/A	c.5

Source: AXA IM, based on internal assumptions and calculations. Buy and Maintain credit based on a representative global Buy and Maintain portfolio. For illustrative purposes only.

The average turnover in our Global Buy and Maintain credit strategy was 10% in 2020 and has been just under 10% p.a. since inception in 2013[1].

Taking advantage of the flexibility

Moving away from a passive approach provides portfolio managers with relative value opportunities to lock in higher yields. For example, immediately following the March 2020 COVID-19 induced sell-off, the spread available on USD bonds was highly attractive relative to GBP bonds, allowing our Portfolio Managers to re-invest natural cashflows and new portfolio flows into those higher yielding opportunities before the spread differential narrowed.

Table 1 highlighted that in 2020, there was £1.6tn of new issuance in the Global Credit market and just £31bn in the Sterling Credit market. New issuance allows portfolio managers to cost effectively rebalance their portfolio and buy bonds, often at a discount to market pricing, called the 'New Issue Premium'. Passive approaches have limited ability to take advantage of the most attractive new issue opportunities.

[1] *Source: AXA IM, Global Buy and Maintain credit strategy representative portfolio 15/1/13 to 31/3/21. Past performance is not a guide to future performance.*

Buy and Maintain strategies also help enable portfolio managers to fully factor in Responsible Investment considerations in their security selection and portfolio construction. There is a litany of ways in which passive approaches fail to be able to integrate Responsible Investment considerations into the portfolio and this is especially true for climate-related risks. We discuss this further as part of Step 3.

The flexibility, cost efficiency and structural advantages of Buy and Maintain credit strategies can lead to stronger capital growth and, importantly, more stable outcomes for DC members.

Step 3: Help protect your members from the emerging risks of climate change

Climate-related risks can emerge over both the near-term and longer-term horizons. For DC members, climate change will impact their portfolios irrespective of whether they are in a UK or Global, passive or Buy and Maintain credit strategy.

How can climate change affect member portfolios?

Extreme weather events and the abrupt introduction of regulation are just two of the ways in which climate change could increase the volatility of returns and the risk of credit defaults. Perhaps more pressing for DC investors is the enormous investor, political and regulatory momentum in climate-aware investing. This momentum alone, irrespective of how the physical risks will impact asset prices, justifies a consideration of climate risks due to the material financial impact it could have on their bond portfolios.

There may be a 'first-mover advantage' in the climate transition with faster-moving investors being able to execute their climate-aware strategies fully and cost-efficiently, while slower movers are left behind as the availability of assets dries up.

What can DC investors and decision makers do about climate change?

DC schemes have the opportunity to be at the forefront of this shift, and benefit from any structural shift in asset prices, if they integrate a climate framework across their entire default and self-selected fund ranges. A July 2020 survey[ii] showed that 80% of DC members wish to invest in impactful strategies, particularly those that consider climate change, as part of their pension.

Climate-aware investing aims to:

- Mitigate the risks to portfolios from a range of temperature scenarios
- Help limit the global temperature rise to 1.5-2.0°C above pre-industrial levels by 2100

Both aims can improve member outcomes either through the financial benefits of risk mitigation or from the positive impact of the investment to the wider world.

How can schemes integrated climate-awareness into their member options?

There is no passive approach to climate investing in credit. Every decision on which fund to adopt is a statement on the importance of the world climate.

Buy and Maintain strategies can aim to lower both the implied global temperature rise and the risks faced by portfolios from the climate transition. This is through considering climate risks and impact as part of the security selection and portfolio construction process, something over which passive strategies have no control. For example, when selecting in which bonds to invest, assuming all other characteristics are equal, our investment team will choose those with the lowest carbon intensity or the steepest pathway towards decarbonisation. A passive approach will own both bonds, irrespective of their climate impact.

Passive bond strategies should at least undertake engagement activities. However, we believe Buy and Maintain strategies will have greater influence over target companies due to the willingness and ability to divest should a company fail to meet the required objectives. A passive strategy will not have the same ability to divest as they are required to hold the bond due to strict index tracking guidelines.

> **"We believe passive strategies are subject to higher climate-related risks and have a lower impact on the climate transition."**

Climate risks are just starting to be realised, and as the divide between climate leaders and laggards widens, we expect greater divergence in the performance of passive and Buy and Maintain portfolios. Historical performance analysis may not show this demarcation, but future performance may well do.

Having access to a global universe gives portfolio managers the full toolkit to implement a climate-aware strategy. This could be in the form of a sterling-focussed strategy which has the flexibility to use the global breadth or a fully global strategy. For example, the EUR-based market currently has a much higher volume of green bonds and a larger proportion of new green bond issuance, a critical component in any climate-focussed strategy. While the USD-based universe has been slower off-the-mark with regards to green bonds, it also houses some of the heaviest carbon emitters and most heavily decarbonising issuers. By investing in, and engaging with, these issuers we can transition the world towards a low carbon economy.

Complementing existing member objectives

We believe climate investing should complement existing member objectives. Climate-aware investing should mitigate against the risks of a range of temperature scenarios while protecting the world in which your members will retire.

Members using fixed income as part of an income drawdown proposition will want to alleviate potential shocks from physical and transition risks. This should help to maintain or improve their pension pots to generate a higher level of income for a longer period. The long-term nature of these portfolios will have a natural alignment with the timeframe over which climate-related risks, particularly the physical risks, may emerge.

For members targeting an annuity, either at retirement or some time thereafter, well-designed, climate-aware strategies should be more resilient to unexpected shocks, increasing the stability of capital to achieve the highest possible annuity rate. We know from our parent company, AXA Group, that many insurance companies are rapidly integrating climate awareness into their portfolios. Schemes that implement climate-aware strategies may be expected to hold assets that are more likely to mirror those held by insurance companies, which has the benefit of more closely matching annuity pricing.

> **“We have already seen several large pension schemes and other asset owners start to implement climate strategies.”**

A climate-aware strategy can fulfil members’ financial and impact-driven objectives. The structural and low-cost benefits of a Buy and Maintain strategy, implemented with the flexibility of a global universe, provides the potential to do this.

Investments involve risks including loss of capital.

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[i] Growing pains.pdf (dcif.co.uk)
[ii] The key to unlocking member engagement.pdf (dcif.co.uk)