Aon Investment Research and Insights

Re-thinking Income

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Empower Results®

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About Aon Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions support trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

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Executive summary

We are in a low yielding, low return environment and this is posing a challenge to pension schemes trying to balance the need for return and income from their portfolios.

Attractive opportunities are available which can help address these challenging times but this will involve pension schemes continuing to diversify portfolios away from the more traditional asset classes which have historically been the main source of return and income.

In this paper we have highlighted the following opportunities that Trustees may wish to consider as a way to enhance portfolio income and/or return.

- Private credit
- Global corporate bonds
- High yield and emerging market debt

Introduction

The fall in yields has had a significant impact on pension schemes. Pension scheme deficits have mostly stayed the same, despite strong asset returns and continued contributions over the past few years.

In addition pension schemes are becoming more mature as most are now closed to new members and also future accrual. As schemes mature their near term liability cash flows are increasing and they are becoming cash flow negative, i.e. contributions and/or investment income do not cover annual benefit commitments.

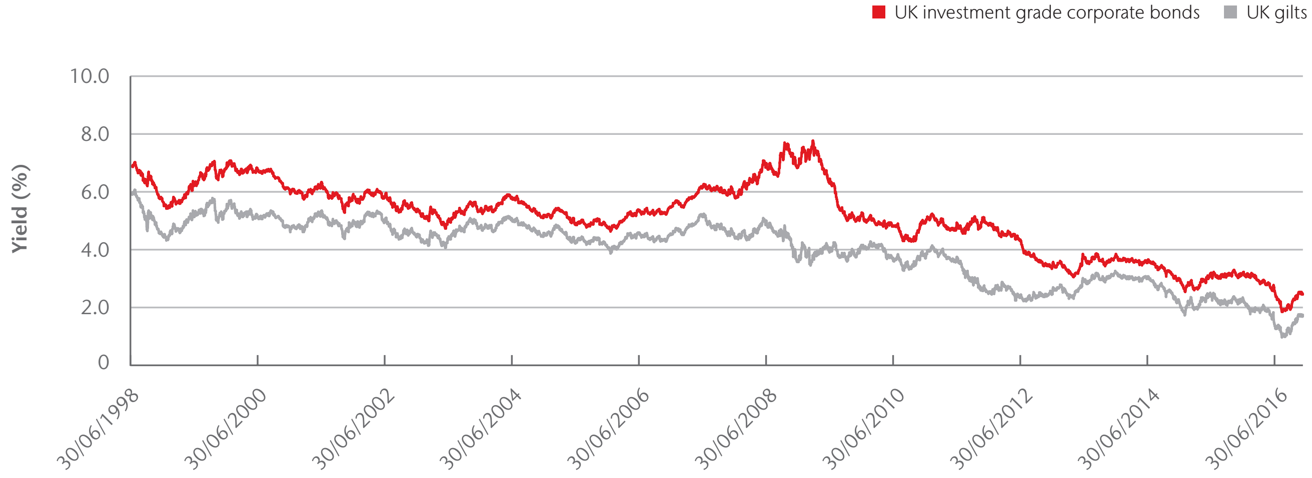
With increased pressure on pension scheme deficits one of the (many) difficulties facing trustees is balancing the portfolio so that it can deliver the performance needed to close the deficit but also provide income without forcing sales of assets during down markets to meet cash obligations. The opportunities identified in this paper can potentially improve the income and/or return profile of a pension scheme portfolio.

Low yield

Pension schemes have typically relied on gilts, UK investment grade credit and property to provide income, with UK investment grade credit and property also providing a return in excess of gilts.

However, the collapse in yields is having a major impact on the ability to meet the desired level of income whilst maintaining the necessary level of return. Yields on traditional assets are at or near historical lows.

Fall in yields



Source: iBoxx, Aon

To illustrate the impact that the fall in yields has had on income the chart below shows the investment required in a 20 year gilt in order to generate £100,000 in income per annum.

We can see in the chart below there has been a steady increase in the investment amount required to generate an income of £100,000 per annum.

At the start of 2009 an investment of £2m in a 20 year gilt would have generated £100,000 per annum in income whereas now an investment of £5m would be required to generate the same level of income and this was as high as £8m in 2016.

Investment required in 20 year gilt to generate £100,000 in annual income

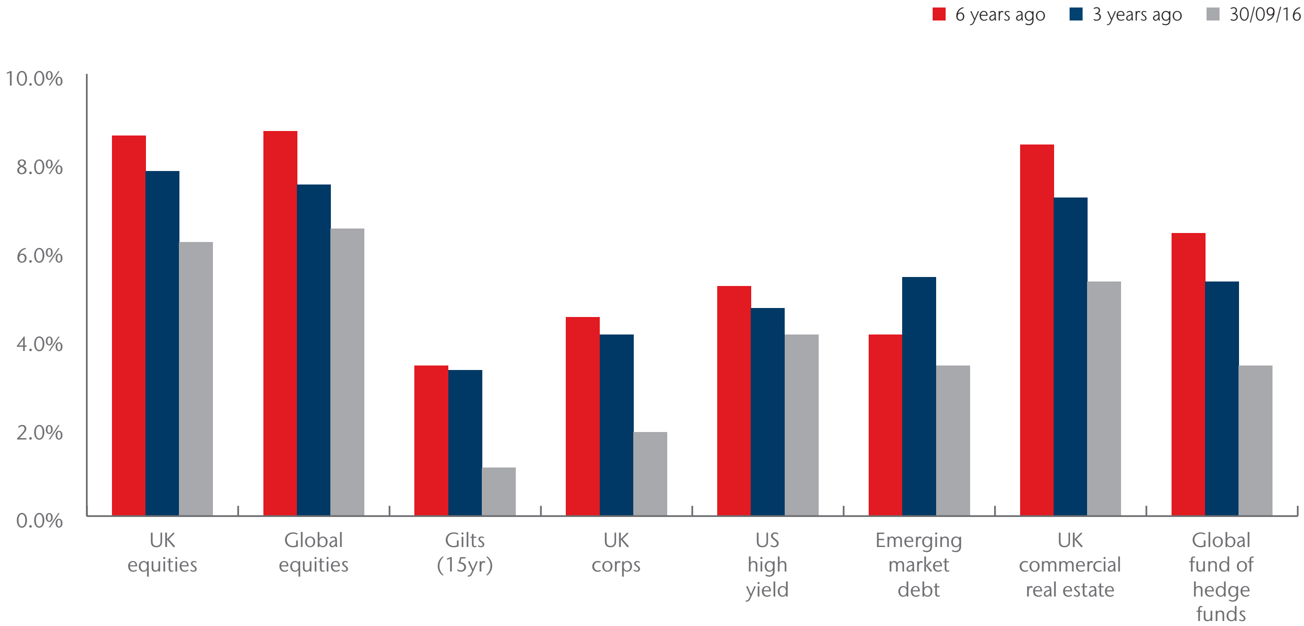
Source: Bank of England, Aon

Lower returns

The yield on investments is an important component of asset returns. The continued fall in yields (increasing asset values) has been a key contributor to the strong asset performance experienced over the past few years.

The combination of a lower starting level on yields and strong historical asset returns has led to lower expected returns going forward (see chart below).

How our return assumptions fell away (10 year capital market assumptions)



Source: Aon Capital Market Assumptions

The lower expected return on traditional assets is making it challenging for pension schemes to close their deficits while the low yield on assets is making it more difficult to generate the income that schemes require. In addition the need for income from the portfolio is increasing as schemes mature. How do we square that circle?

However, all is not lost! Despite this being a challenging time, it is also creating opportunities which pension schemes are ideally positioned to benefit from.

We see opportunities for pension schemes to improve returns, increase income, reduce risk or the combination of all three through adding more alternative strategies and continuing to diversify portfolios away from the traditional asset classes which have historically been the main source of return and income.

We discuss a few of these opportunities next.

Private credit

Private credit is a growing area and one that offers a very unique and compelling investment opportunity to pension schemes due to its attractive risk-return characteristics and income it provides.

New bank regulations implemented in response to the global financial crisis have led to a reduction in bank lending activity which has long-term implications for the way businesses and consumers borrow (see our previous note Bankers lose interest – April 2015).

Many companies used to rely on banks to raise capital for refinancing, growth, acquisitions and restructuring. As banks reduced lending, institutional investors like pension schemes have the opportunity to step into the role traditionally played by banks and capture the enhanced returns for providing finance in private markets.

Two opportunities that we see currently in private credit are property debt and direct lending strategies. Property debt strategies focus on the real estate market and direct lending strategies focus on small to mid-sized companies.

The table below summarises the characteristics of these strategies.

	Property debt	**Direct lending**
Expected return	3.5% - 10% depending on strategy	6% - 14% depending on strategy and leverage
Cash yield	4% - 6% per annum	4% - 8% per annum
Distributions	Typically quarterly	Typically quarterly
Return type focus	Income	Income
Term life	7 - 10+ years	6 - 8 years
Risk	Low to moderate	Moderate to high
Liquidity	Low	Low
Typical minimum investment	£10m	£10m
Fees	0.4% - 1.25%, usually with performance fee	0.75% - 1.5%, usually with performance fee

Source: Aon

We see value in these private credit strategies relative to other traditional assets due to the following:

- Higher potential returns which should help close deficits.
- Income generation, which can help meet cash flows.
- Increasing diversification of sources of risk. These strategies are comparable with Diversified Growth Funds (DGFs) in terms of risk level.

These strategies are not risk free and the two main risks for them are default risk and liquidity, however we believe both of these risks are mitigated for the following reasons:

- **Default risk:** These loans are typically secured, backed by say an underlying property, or rank high in the company's capital structure and therefore benefit from better recovery rates than traditional bond investments.
- **Liquidity risk:** Most pension schemes have adequate liquidity in their portfolio and can benefit from capturing the illiquidity premium from these strategies. In addition the term of these strategies, <10 years, fits within the recovery period for most pension schemes.

How to fund these investments?

Pension schemes have benefitted from diversifying their portfolios over the past few years. One particular area has been into DGFs which typically target LIBOR + 4%-5%. In an environment of increased volatility, lower expected asset returns and yield, these strategies may not deliver the absolute returns that they were expected to deliver when originally implemented.

Given the potential return, income and the complexity / liquidity premium that private credit strategies offer, pension schemes may want to consider reducing their allocations to DGFs in favour of these private debt strategies.

Going global with corporate bonds

Most pension schemes allocation to corporate bonds is in the form of sterling denominated investment grade credit. Although schemes have been diversifying their portfolios globally the allocation to corporate bonds has remained UK focussed.

The chart below compares the yield pickup above the risk free rate (the spread) for global corporate bonds and sterling non-gilt bonds.

Corporate bond spread vs government bond

Source: Barclays

Global corporate bonds offer a marginal improvement on yield compared to UK non-gilts. Although in isolation this improvement may not make an overwhelming case to switch to global bonds, when factoring in the following we think the case becomes much stronger and more compelling for pension schemes from a strategic perspective to switch to a global corporate bond mandate.

- Greater diversification: The global corporate bond market is 12x as large as the sterling corporate bond market and has over 9,000 more issuers which allows for greater diversification within the portfolio.
- Improved liquidity: Global corporate bonds are better positioned to withstand a liquidity squeeze due to size.
- Improved return potential: More opportunities for managers to add value.
- Lower interest rate sensitivity: The lower duration on global corporates compare to UK corporates will be a benefit if yields increase.

	Global corporate index	Non-gilt index
Number of issues	10,076	945
Market value (£bn)	6,738	527
Yield	2.7%	2.4%
Credit spread	1.3%	1.2%
Duration (yrs)	6.6	8.2
Rating	A3	A1

Source: Barclay, 31 December 2016

Consideration would need to be given to transaction costs, hedging currency exposure, a slightly lower overall credit rating etc prior to switching to a global mandate (see our previous note Corporate Bond Liquidity – September 2016).

However, we believe pension schemes should start to explore switching their UK corporate bond mandates to a global corporate bond (100% sterling hedged) mandate and in the longer term would benefit from this move for the reasons highlighted above.

High yield and emerging market debt

Higher yielding fixed income assets such as high yield credit and emerging market debt (EMD) can increase the overall income within a pension scheme portfolio and these strategies should be considered as part of an overall well diversified portfolio.

High yield credit is a higher coupon paying bond with a lower credit rating than investment-grade bonds.

EMD is issued by governments, municipalities or corporations within developing economies. EMD can be further classified into Hard (issued in a developed market currency, typically USD) or Local (issued in the domestic currency).

Similar to debt issued by developed economies or investment grade rated corporates the principal risk for EMD and high yield investors is whether an issuer will default on their debt obligations.

Because of the higher risk of default, these bonds are priced at a higher yield. High yield debt is currently yielding 6% and EMD is yielding 5.4% to 6.8% depending on the specific strategy.

How to fund these investments?

From a risk perspective, as measured by volatility, EMD and high yield are comparable to most growth assets already in portfolios, for example equities, property, hedge funds or DGFs.

EMD and high yield could be funded from further diversifying the portfolio and reducing the allocation to core growth assets, without necessarily increasing the overall risk of the portfolio while improving the income generation.

Alternatively these strategies could be funded from current investment grade fixed income assets as a way to improve the income and expected return of the overall portfolio.

	EMBI global diversified (Hard EMD)	**GBI-EM global diversified (Local EMD)**	**CEMBI broad diversified (Hard EMD)**	**Global corporate high yield**
Issuer type	Sovereigns and Government agencies	Sovereigns	Corporates	Corporates
Sources of return	US treasury yield + spread	Local government yield +/- currency movements	US treasury yield + spread	Government yield + spread
Market cap ($bn)	445	707	406	1,844
Yield	5.8%	6.8%	5.4%	6.0%
Average credit rating	Ba1	Baa2	Baa3	Ba3
% of issuers rated investment grade	52%	75%	61%	0%
No. of countries	65	15	51	53
Duration (years)	6.5	4.9	4.8	3.9

Source: JPMorgan, Barclays, Data as of 31 December 2016

Summary

Many opportunities are available, and we have only highlighted a few here, which we believe can improve the income and/or return profile of a pension scheme portfolio however it will mean schemes continuing to diversify away from the traditional strategies they have relied on.

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With thanks to our author

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