Enhancing returns in CDI portfolios

Azhar Hussain
Head of Global Credit

Since the so-called Mini Budget of 2022, which resulted in a sharp increase in government bond yields, many defined benefit (DB) schemes have found themselves with much improved funding levels.

Such improvement in funding levels has led many schemes to reduce allocations to growth assets within their portfolios and increase allocations to matching assets. These increased allocations are principally investment grade corporate bonds and government bonds/LDI – often as part of a cashflow driven investment (CDI) strategy.

Whilst funding levels may have improved, the requirement to pay member benefits continues, and with some scheme sponsors reducing contributions as a result of improved scheme funding levels, there is a greater requirement for the investment portfolio to deliver cashflows in a predictable manner to meet the cashflow liabilities as they fall due.

While the typical CDI portfolio will mostly allocate to high quality investment grade bonds, we feel that high yield can also play an important role, but is at present an overlooked asset class. Specifically, we believe that a strategic allocation to short duration global high yield can act to support income provision in a predictable way, whilst also helping to maximise returns in a risk controlled manner. In this article we explore this argument further.

Why short duration high yield specifically?

There are several advantages that an allocation to short duration high yield offers compared to a broad market allocation.

Seasoned bonds have lower default risk

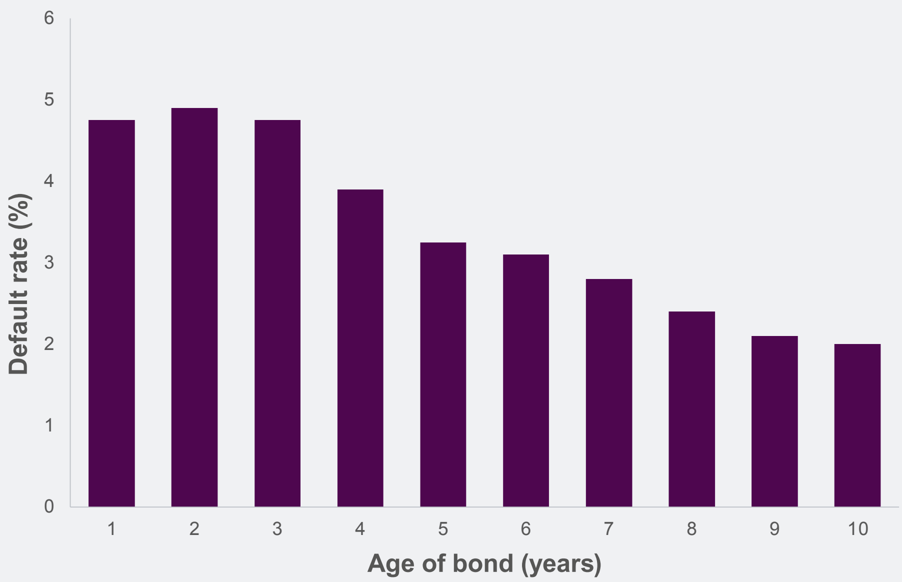
The first observation we make is that high yield bonds are less likely to default the longer that they have been in issuance. Using Moody's data that goes back to 1970, the evidence is clear that instances of default are nearly 50% higher in the first couple of years after a high yield bond has been issued than in the final two years before maturity, with default risk gradually reducing over a 10-year period. Knowing that defaults peak early in the life of a high yield bond (figure 1), an approach that focuses on buying seasoned bonds (bonds bought from the secondary market which have been in issue for several years), that only have a few years to maturity, can allow investors to structurally lower default risk within their portfolio.

Take advantage of flat yield curves

The second advantage that short duration high yield offers relative to the broad market is that investors are disproportionally compensated from a yield perspective, despite the lower instances of default as already observed.

Figure 1: Defaults peak early in the life of a bond

Distribution of defaults over 10 years



Source: Moody's Annual Default Study: Corporate Default and Recovery Rates, 1970-2015. As at July 2020. For illustrative purposes only.

The relatively flat yield curve is a clear market inefficiency, offering what we see as a sweet spot in terms of attractive yield with limited interest rate duration and reduced default risk, which is particularly pronounced in the case of bonds with one to two years to maturity (figure 2). By selecting high quality seasoned assets, which are defensively positioned at the front end of the yield curve, we believe that investors can enhance returns in a risk-controlled way.

Figure 2: Mismatch between return and risk

Source: RLAM analysis. For illustrative purposes only.

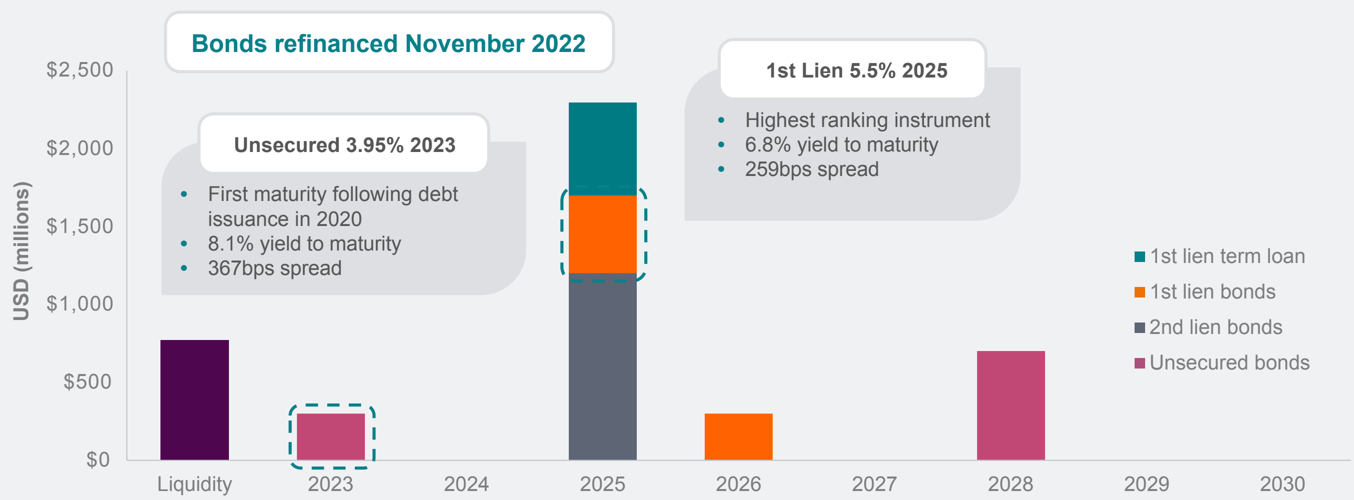
Narrow focus of credit rating agencies

Credit rating agencies assign the same rating on a company's bonds, regardless of their tenor. We however believe that this overlooks the phenomenon that we've termed 'temporal seniority' – the instance where a subordinated bond is due to mature before a senior bond.

The capital structure of Spirit Aerosystems illustrates this well (figure 3). The 2023 bond was subordinated to the 2025 1st lien bond but was due to mature before it.

With $1bn liquidity and a free cash flow positive business, the credit rating did not accurately reflect the risk in our opinion, with the 2023 bonds being the first to mature. Such inefficiencies can be exploited and help enhance returns in CDI portfolios, locking in attractive yields whilst minimising risk.

Figure 3: Spirit Aerosystems refinancing



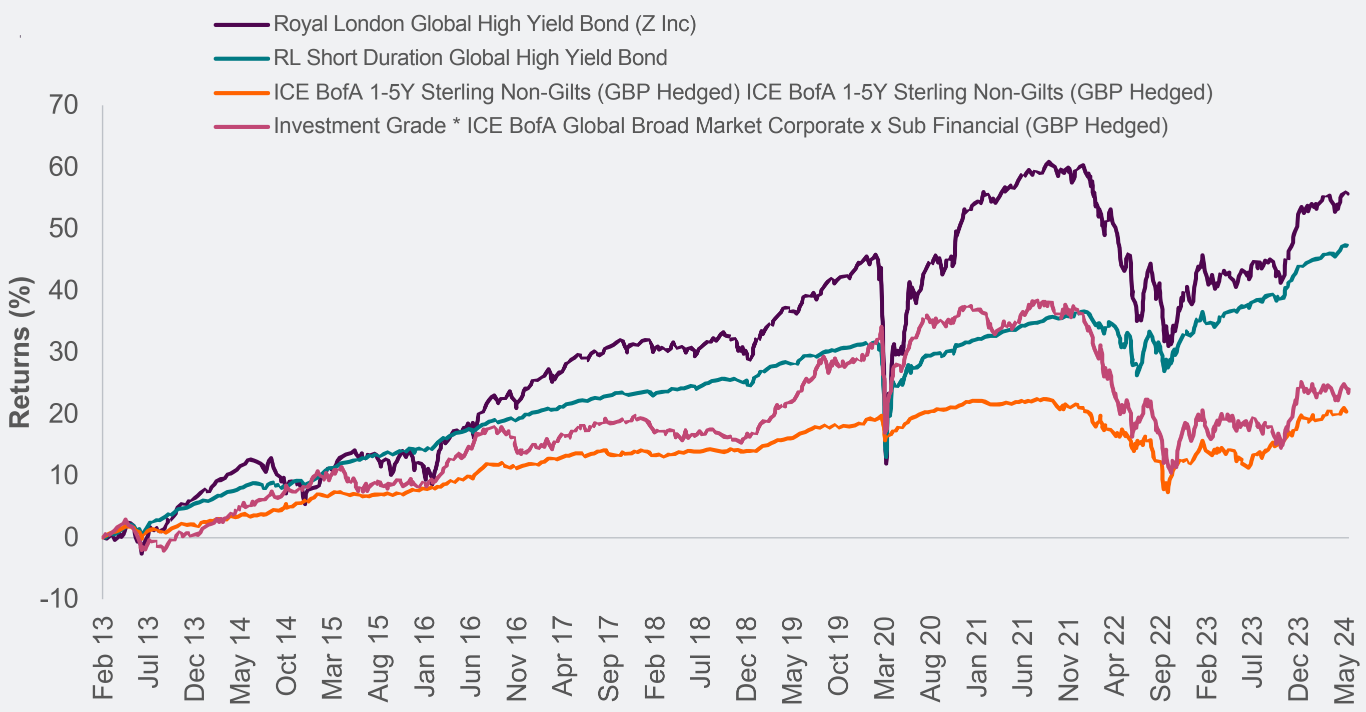
Source: RLAM for illustrative purposes only. Capital structure and bond characteristics as at 31 January 2023.

Our approach

Definitions matter

We define short duration as bonds being redeemed within two years, either through maturity or call. This more precise definition means that left alone, the portfolio would self-liquidate over a very short period of time, helping to provide natural cashflows – which can be used to pay member benefits. The added advantage of this focus is that many bonds benefit from the 'pull to par' effect, which helps smooth the overall return profile of the portfolio. This is not a theoretical benefit – for instance while it might be expected that Royal London's Short Duration Global High Yield strategy exhibits lower volatility than the broader high yield market, since inception it is also compares favourably with both global investment grade and short-dated investment grade markets (figure 4).

Figure 4: Short-dated high yield can offer a lower volatility journey



Source: RLAM and ICE Bank of America as at 31 May 2024, all figures based on close of business returns for both the fund and index, gross of fees and gross of tax, in GBP for the Z share class. Inception date of the Fund is 15 February 2013.

Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.

Control transaction costs

We adopt a buy and maintain approach when managing our short duration global high yield portfolios, helping to keep transaction costs under control. Such an approach is only really possible because of the relatively short investment horizon over which we are looking to analyse and forecast the fortunes of the companies that we are lending to in the portfolio. Active management is however integral to the approach, and we will always monitor credits to ensure that they remain appropriate, and adjust position sizing accordingly.

We generally expect bonds to either be called by the issuer, or to mature. This means that cash is returned to the portfolio with no transaction costs versus alternative approaches that rely on selling bonds back into the secondary market to raise cash. Where the portfolio has generated cash in excess of scheme cashflow requirements, this can be immediately redeployed into markets to generate further income. In aggregate, we would expect the portfolio to fully self-liquidate over a 24-month period, offering investors a high degree of flexibility should their requirements change.

Dynamic approach to lending across the rating spectrum

With the expectation that our portfolio will self-liquidate over a 24-month period comes the flexibility to reinvest in a dynamic manner. With cash constantly being returned to the portfolio, this offers the manager the ability to take advantage of prevailing yields, and to opportunistically increase the credit quality of the portfolio at times of wider spreads. If prevailing yields have widened, the strategy could tactically allocate a greater degree of capital towards investment grade bonds, whilst remaining confident that it can achieve its SONIA +2% p.a. target. Such decisions typically coincide with times of market distress, allowing us to de-risk the portfolio when market sentiment worsens.

Summary

We believe that a short duration global high yield portfolio can play an important role as part of a CDI strategy. The attractive yield and volatility characteristics of the asset class can help pension schemes to boost income provision to help meet member benefits without taking undue risk. As we can demonstrate, the volatility of our strategy is more similar to that of short duration investment grade credit, whilst having delivered approximately double the return since inception. We think that pension schemes do not have to choose between investment grade and high yield; our belief is that a blended allocation to investment grade and sub-investment grade has the potential to deliver a better risk-adjusted outcome.

Royal London Asset Management has a highly skilled, experienced Global Credit team that has formed an enviable reputation. We have steered our portfolios through changing economic conditions and business cycles. We believe that the most effective way of implementing our investment philosophy is by experienced managers undertaking the right type of analysis, operating with the right team structure that supports a collegiate approach. We have developed the Short Duration Global High Yield proposition to meet client demand for a truly global credit product, that aims to deliver an attractive level of income with limited volatility, in an increasingly uncertain environment.

Investment risks

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Efficient Portfolio Management (EPM) Techniques: The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Exchange Rate Risk: Investing in assets denominated in a currency other than the base currency of the Fund means the value of the investment can be affected by changes in exchange rates.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity Risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging Markets Risk: Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Contact us

For more information about our range of products and services, please contact us.

Royal London Asset Management
80 Fenchurch Street, London, EC3M 4BY

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

We are happy to provide this document in Braille, large print and audio.

www.rlam.com

For Professional Clients only, not suitable for Retail Clients.

This is a financial promotion and is not investment advice. The views expressed are those of the author at the date of publication unless otherwise indicated, which are subject to change.

Telephone calls may be recorded. For further information please see the Privacy policy at www.rlam.com

The funds are sub-funds of Royal London Asset Management Funds plc, an open-ended investment company with variable capital (ICVC), with segregated liability between sub-funds. Incorporated with limited liability under the laws of Ireland and authorised by the Central Bank of Ireland as a UCITS Fund. It is a recognised scheme of the Financial Services and Markets Act 2000. The Investment Manager is Royal London Asset Management Limited.

For more information concerning the risks of investing, please refer to the Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on www.rlam.com. Most of the protections provided by the UK regulatory system, and the compensation under the Financial Services Compensation Scheme, will not be available.

Issued in July 2024 by Royal London Asset Management Limited, 80 Fenchurch Street, London, EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Ref: AL RLAM PD 0184

Asset management excellence with a longer-term perspective

ROYAL LONDON
ASSET MANAGEMENT

129187 07/2024