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Buy and Maintain Credit

Buy and maintain credit

Helping pension funds to de-risk and improve their funding position

After more than a decade of ultra-low interest rates and bond yields, the transition to an environment of higher yields presents new problems for investors. However, the **challenge of maintaining meaningful returns**, whilst ensuring that long-term liabilities are met is ever-present for pension fund trustees and sponsors. Regulation has increased the focus for pension funds on **matching their current assets to their long-term liabilities** and trustees and sponsors are understandably concerned that any portfolio should be built with a pension fund's long-term cashflows in mind.

We believe **corporate bonds are a natural choice** for liability matching, as:

- Accounting rules focus on high quality credit bonds to determine the discount rates set for discounting pension fund liabilities
- Insurance companies tend to use credit based yields when determining the value of annuity books

At Royal London Asset Management we regard credit markets to be inefficient. Our buy and maintain strategy seeks to capture these inefficiencies, whilst providing the opportunity for attractive risk-adjusted returns.

Our approach

Our buy and maintain credit strategy invests in a diversified portfolio of investment grade corporate bonds. Portfolios are actively constructed to meet each client's specific requirements. The emphasis at the construction stage is on reducing the impact of default by focusing on covenants, security and structure. The aim is to deliver robust long-term cashflows, which go some way to matching pension fund liabilities. We feel that corporate bonds can provide a genuine opportunity for pension schemes to better match their liabilities but also to capture and 'lock-in' excess return for the long-term.

Key points

- Active and bespoke portfolio construction.
- Globally diversified portfolios, limiting credit specific risk and with a bias towards security and structure.
- Low portfolio turnover.
- High degree of confidence in coupon and capital payments.
- Socially useful investments (e.g. infrastructure, social housing).
- Straight-forward and flexible approach.
- ESG (Environmental, Social and Governance) considerations integrated into the investment process.
- Climate objectives embedded where appropriate (e.g. bespoke WACI (Weighted Average Carbon Intensity) targeting or global buy & maintain climate transition approach via pooled fund offering).

Our credit philosophy – what are the inefficiencies?

Benchmarks
- Rule-based index construction
- Weightings based on indebtedness

Ratings
- Not comprehensive: default, not recovery
- Increasing inflexibility

ESG
- Equity market origins
- Over-reliance on blunt 'analytical' tools

Security
- Market undervalues security
- Targeted analysis of structure and covenants to identify value

Liquidity
- Investors generally over-value liquidity
- Long-term investors can exploit heightened illiquidity premium

> **"Constraints imposed upon the market result in the mispricing of key attributes of assets."**

An explanation of market inefficiencies

The distorting effect of benchmarks

The increasing dominance of corporate bond benchmarks, as the credit market mirrors the historic evolution of equity investing, is distorting the efficient allocation of capital resource. Quite simply, a major problem with benchmark driven investing in credit is that a benchmark reflects the size of a company's outstanding debt and companies with the largest debt requirements will form a larger proportion of indices over time. This strikes us as a very odd starting point for efficient portfolio construction and often does not lead to the best risk adjusted returns for longer-term investors.

The recognition of the flaws inherent in credit bond benchmarks has given rise to sector constrained (pseudo-passive/smart beta) approaches. These strategies aim to reduce some of the pitfalls of benchmark investing by limiting exposures to sectors and stocks. We believe that this is still a flawed approach and leads to further anomalies that are avoided by a more strategically focused buy and maintain philosophy. In our view there are two main problems with a pseudo-passive approach. First, it leads to indiscriminate capital flows towards smaller sized credit sectors. As an example, we fear that inappropriate allocations will be made to unsecured consumer and industrial issues (more cyclical areas) whilst exposure to financial bonds is likely to remain high. Second, it does not address the key problem that credit ratings are an unsatisfactory guide to risk.

A successful buy and maintain investor has the luxury of investing in the most robust credit bonds without being a slave to arbitrary benchmarks.

The inflexibility of ratings

In addition to a bond's size, which we do not believe has any direct bearing on fundamental credit risk, inclusion in a credit benchmark is also a function of a bond's rating. Whilst the rating provides insight into an agency's opinion on a bond's probability of default, typically it does not detail an investor's likely loss on default. Specifically, this means that genuinely protective features embedded in certain bonds such as seniority, security and strong covenants are often not reflected within the credit rating.

Uncovering ESG insights

Our approach to ESG in credit has always been built on the belief that credit markets do not accurately price idiosyncratic risk. We use ESG analysis in the same way as any other form of credit research – to uncover information that credit rating agencies and other market participants might be missing, helping us to make better investment decisions for our clients and potentially deliver excess returns.

ESG integration, and the impact of decarbonisation within credit markets, is less well-established than within equity markets. As a result, perceived best practice is continually evolving. But in our view, there is no asset class to which sustainability of cashflow is more important than credit. As carbon reduction objectives become the norm in future, proprietary data around carbon intensity is a significant contributing factor in helping to minimise the risk of stranded assets, as well as reducing the emission levels of the funds in an effective manner.

Accessing an in-house Responsible Investment team that understands the idiosyncrasies of credit as an asset class, and is capable of conducting rigorous and meaningful bottom-up credit and ESG analysis, is a core part of our investment process. Having better data on issues such as carbon intensity means we can see where poor performance is and helps us make more informed investment decisions.

The liquidity premium

Credit bond yields incorporate three main factors:

- A risk free interest rate
- A return to compensate for potential loss
- A return that compensates for the lower liquidity of credit bonds relative to government bonds/swaps

Given the well-documented funding issues faced by banks, liquidity within corporate bond markets is materially below historic levels and the so-called 'liquidity premium' appears elevated. As pension funds generally have a low requirement for liquidity (given their longer-term cashflow requirements), it is a return that such funds are well positioned to access. Naturally, this is particularly pertinent for buy and maintain credit strategies.

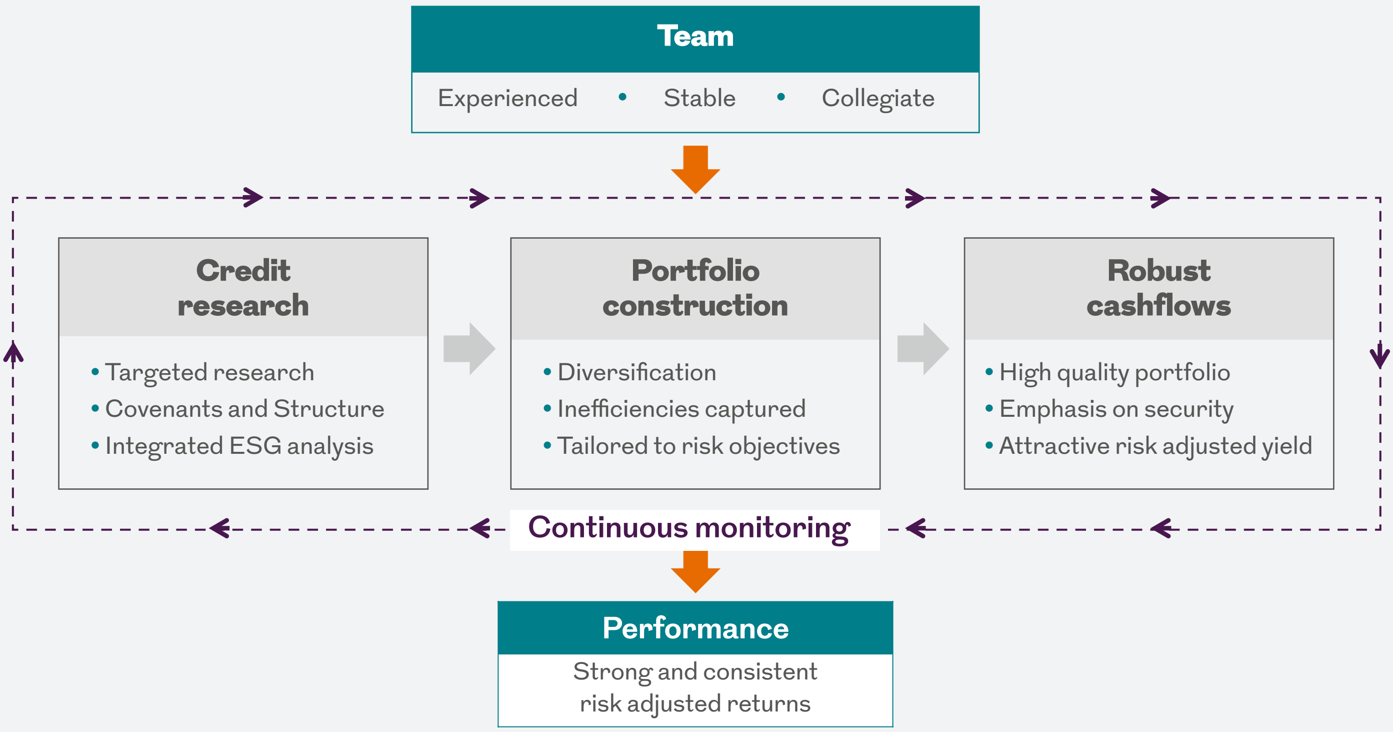
The under-valuing of security

We have long believed that genuine and protective credit enhancements are undervalued by investors and that, conversely, liquidity and credit ratings are over-emphasised. We believe secured and asset backed debt remains undervalued due to the anomalies discussed above (i.e. liquidity focus and rating agency focus). Our sector and stock selection is based upon an assessment of fundamental risk and return, with a particular focus on covenants, security and structure. We believe that the permanence of these features offers our buy and maintain clients a long-term performance and risk advantage.

Holding diversified portfolios

Royal London Asset Management are strong advocates of security diversification within credit portfolios. Due to the asymmetric characteristics of investment grade bonds it is important that sufficient security diversification is achieved (by issuer and underlying business profile). This is well demonstrated in all the active and buy and maintain investment grade portfolios that we run.

Summary of investment process



Why Royal London Asset Management?

Our fixed income team has developed a reputation as one of the UK's leading managers of corporate bonds. We manage over £35.7 billion* in credit strategies. Our approach to fixed income investing is highly differentiated, established and repeatable, which gives us a significant advantage in buy and maintain portfolio management. Our success is based on truly understanding the investment objectives of our clients and using our in-depth market knowledge to exploit investment inefficiencies that help us meet these aims. It is the experience, skill and stability of our 33 strong team that sets us apart, giving us an edge in a highly competitive market. We believe that by using our experience and exploring parts of the market that others overlook, we are able to add value for our clients.

We believe buy and maintain fits perfectly with our long-term value orientated credit philosophy and that we are well-placed to construct portfolios that meet the long-term needs of our clients. It is a strategy in which we have experienced considerable growth over the last five years. In recognition of our expertise and experience in constructing robust portfolios that exhibit characteristics best suited to long-term investors, some of the UK's largest pension schemes have entrusted us to manage buy and maintain mandates on their behalf. Our buy and maintain capability is a natural extension of our active credit offering that has been evolving over the last 25 years. We manage over £3.5 billion* in buy and maintain strategies across segregated accounts and pooled funds.

*as at 31 March 2023.

Our offering in summary

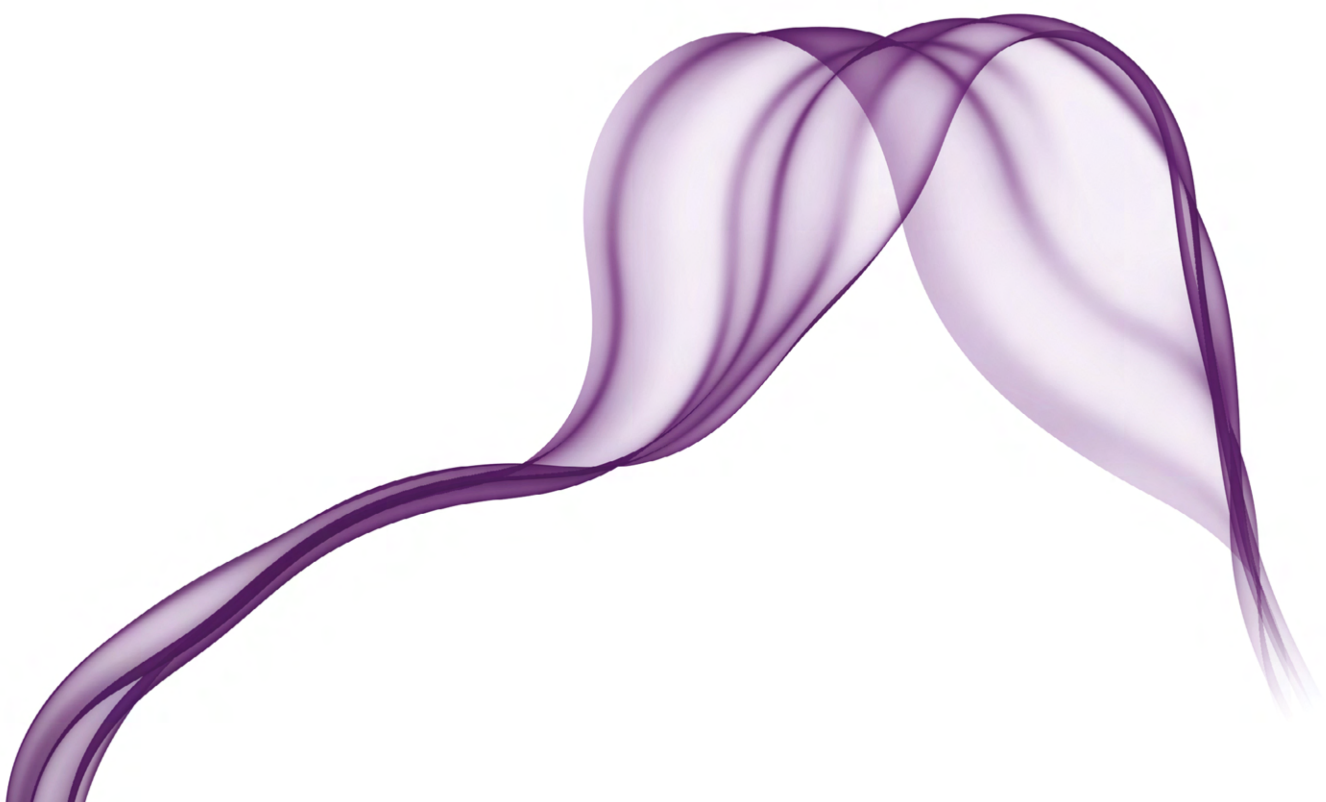
- Globally diversified portfolios with a bias towards highly covenanted and secured bonds.
- An established approach that captures illiquidity premia and market inefficiencies.
- A high level of confidence in coupon and capital payments.
- A stable, collegiate and experienced fixed interest team with diverse skills.
- A long-term partnership between our clients and our investment team.

Typical portfolio characteristics

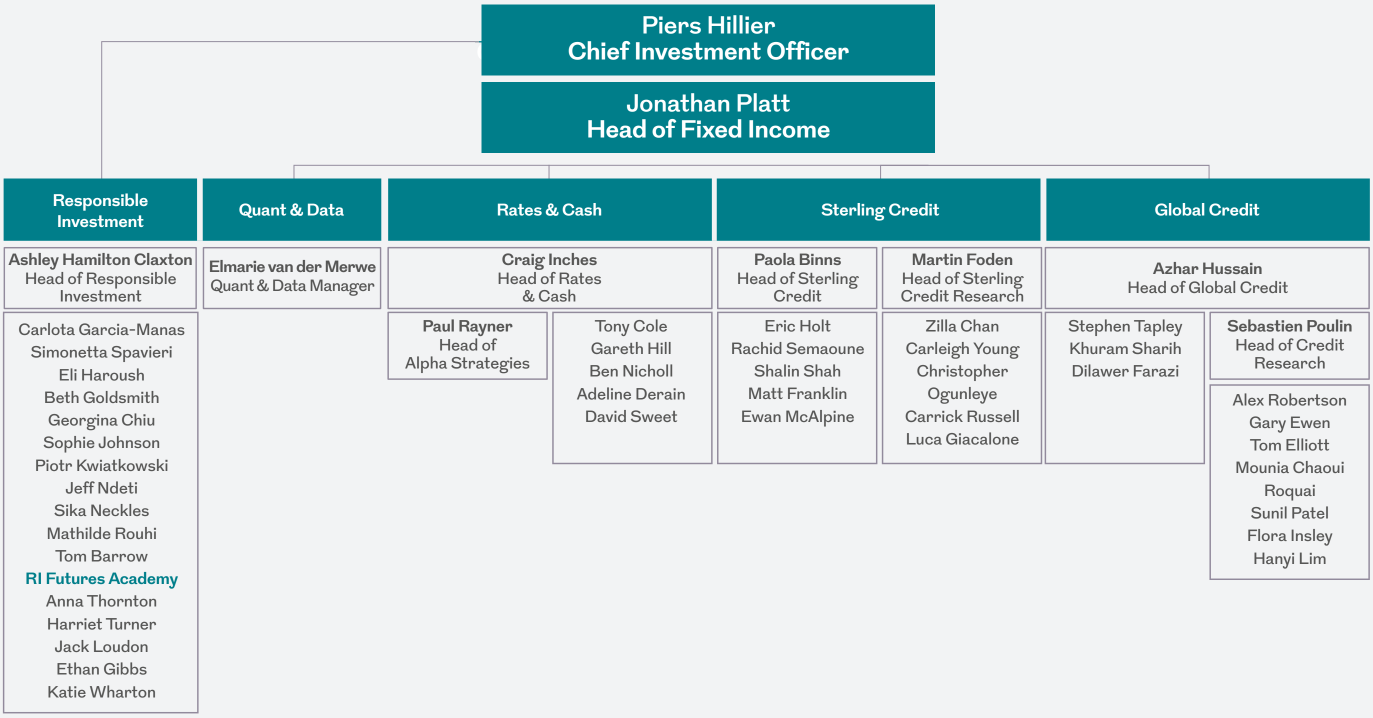
Typical duration	5-9 years
Benchmark*	None, but reference index levels can be provided
Performance objective	To achieve a yield of +1-1.5%† in excess of gilts
Number of holdings	>150 issuers
Average credit rating at inception	"A" rating band
Turnover	Minimal
Structure	Evergreen or amortising
Vehicle	Pooled or segregated
Secured debt weighting	Typically over 50%

* Due to the unique nature of buy and maintain credit portfolios, there is no natural benchmark. We believe it is important for us to work closely with clients and their advisers in setting up parameters that help make the construction of the portfolio robust and practical for on-going monitoring.

†Subject to market conditions.



Fixed income team



Source: Royal London Asset Management as at 31 January 2023.

Shalin Shah – Senior Fund Manager

Royal London Asset Management's's buy and maintain strategy is managed by Shalin Shah, who joined the Fixed Income team in 2008. Shalin is an experienced senior fund manager responsible for managing corporate bond portfolios, including RL Corporate Bond Fund, Sustainable Managed Income, Sustainable Managed Growth and Diversified Asset-Backed Securities funds. Since joining he has been involved in the development and management of our buy & maintain proposition, and remains responsible for managing a range of buy & maintain and active portfolios. Shalin won a Fund Manager of the Year award in 2021. Prior to joining Royal London Asset Management, Shalin worked at PricewaterhouseCoopers LLP where he was involved in advising clients on a variety of investment solutions, including LDI and strategic asset allocation. Shalin holds a BSc in MORSE (Mathematics, Operational Research, Statistics and Economics) from the University of Warwick and is a qualified actuary.

Matt Franklin – Fund Manager

Matt is responsible for the management of a variety of sterling corporate bond portfolios, as co-manager of Royal London Sustainable Managed Income, Sustainable Managed Growth, Corporate Bond Monthly Income and Corporate Bond, as well as several segregated portfolios. He joined Royal London Asset Management's Sterling Credit team in 2014 as a credit analyst, building a deep understanding of both unsecured corporate bonds and asset backed securities across a variety of sectors, as well as playing a key role in the development of the team's approach to ESG integration. Matt has a degree in Economics from Durham University, is a CFA Charterholder, and a Certified Financial Risk Manager (FRM).

Martin Foden – Head of Credit Research

Martin Foden joined Royal London Asset Management at the start of 1998. He initially joined our UK Equity Team, with responsibility for analysing the transport, business services and construction sectors. This experience greatly enhanced our credit research capabilities when he joined the fixed interest team at the beginning of 2003.

Since moving to the fixed interest team, he has been instrumental in developing Royal London Asset Management's analytical process through the advancement of the team's cash flow forecasting and evaluation of issuer structures.

Martin has a degree in Industrial Economics from Nottingham University.

Investment risks:

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

Fixed interest security 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. Unlike the income from a single fixed interest security, the level of income (yield) from a fund is not fixed and may go up and down. Bond yields (and as a consequence bond prices) are determined by market perception as to the appropriate level of yields given the economic background. Key determinants include economic growth prospects, inflation, the government's fiscal position, short-term interest rates and international market comparisons. The returns from bonds are fixed as at the time of purchase. Therefore the fixed coupon payable and the final redemption proceeds are known at the outset. This means that if a bond is held until its redemption date, the total return that could be expected is unaltered from its purchase date, subject to counterparty default (see 'Credit risk' below). However, over the life of a bond, the yield priced by the market (as opposed to actual fixed coupons payable) at any given time will depend on the market environment at that time. Therefore, a bond sold before its redemption date is likely to have a different price to its purchase price and a profit or loss may be incurred.

Credit risk: The value of a fixed interest security will fall in the event of the default or reduced credit rating of the issuer. Generally, the higher the rate of interest, the higher the perceived credit risk of the issuer. This fund may invest a percentage of it's assets in sub-investment grade bonds. Such bonds have characteristics which may result in higher probability of default than investment grade bonds and therefore higher risk.

Overseas markets risk: Funds investing in overseas securities are exposed to, and can hold, currencies other than Sterling. As a result, overseas investments may be affected by the rise and fall in exchange rates.

Derivatives risk for Efficient Portfolio Management: Derivatives may be used by this Fund for the purpose of efficient portfolio management. This restricts the use of derivatives to the reduction of risk and the reduction of cost. Such transactions must be economically appropriate and the exposure fully covered.

Derivatives risk for investment purposes: This fund may undertake transactions in derivatives and forward transactions (both on exchange and over the counter (OTC)). These may include interest rate swaps and interest rate futures for the purposes of meeting the investment objective, protecting the risk to capital, duration and credit management, as well as for hedging. While the discerning use of derivatives can be beneficial, derivatives also involve specific risks. These risks relate specifically to market risk, management risk, credit risk, liquidity risk, the risk of mispricing or improper valuation of derivatives and the risk that derivatives may not correlate perfectly with underlying assets, interest rates and indices. The use of derivative instruments may from time to time alter the economic exposure of the fund causing it to deviate significantly from the performance of the market as a whole. The use of these derivatives will be within the parameters allowed for linked funds by the Financial Conduct Authority and Prudential Regulation Authority.

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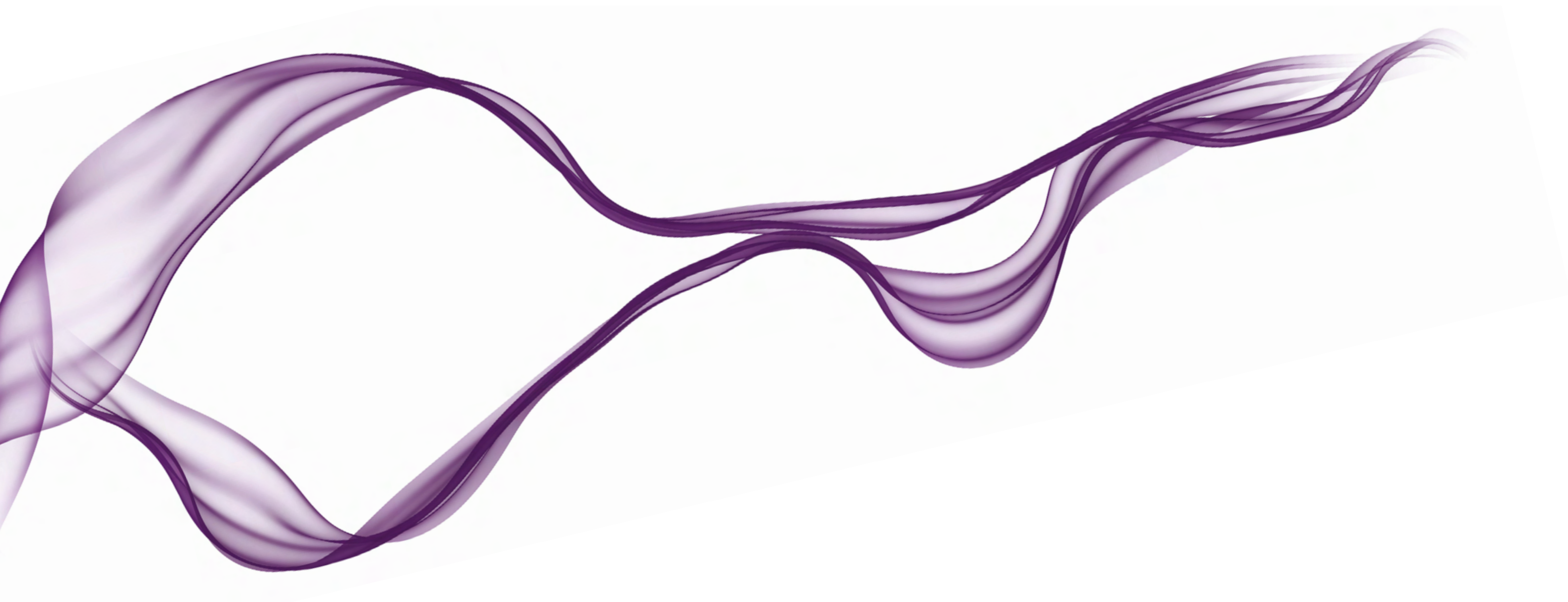

Contact us

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

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