The changing landscape of sterling credit

The characteristics of sterling credit markets and rating agency methodologies have seen radical changes over the years. Royal London Asset Management (RLAM) has responded to these developments, while being consistent in the application of our investment philosophy – seeking to optimise the balance between risk and return, and offer investors an attractive income and total return in a period of ultra-low interest rates.

The decline of AAA, the growth of BBB

To demonstrate the changes in the wider sterling credit landscape, we consider one of our sterling funds, the RL Ethical Bond Fund, over the last decade. The table below compares the credit rating profile of the fund with the sterling credit market. As can be seen, there have been fundamental changes at both the portfolio and the index level over the last 10 years.

Composition of the RL Ethical Bond Fund and the Markit iBoxx Sterling Non Gilts Index by credit rating in 2009 and 2019

Credit Rating	Fund (August 2009)	Index (August 2009)	Fund (August 2019)	Index (August 2019)
AAA	21.6%	33.6%	3.7%	19.6%
AA	11.1%	14.2%	4.5%	14.3%
A	27.9%	33.7%	26.8%	27.6%
BBB	21.4%	17.9%	39.9%	36.8%
BB and below	4.5%	0.6%	11.3%	1.5%
Unrated	13.5%	0.0%	13.8%	0.1%

Source: RLAM, September 2019.

Based on the RL Ethical Bond Fund. Index used is Markit iBoxx Sterling Non Gilts Index. Figures shown include the impact of cash.

Sterling credit indices now have much lower weightings in AAA rated bonds. This is the result of a ratings decline in 'monoline insured' PFI infrastructure issues, encompassing hospital building and refurbishment, road upgrades and government office modernisation. Such deals were more prevalent before the 'credit crunch', when they were rated AAA according to credit rating agency methodologies at that time. The fund has reduced its exposure to AAA bonds due to their low yield advantage over government bonds, as well as the lower index weighting.

The weighting of BBB rated bonds has increased significantly, for both the fund and the index, reflecting tougher credit rating methodologies, downgrades during the financial crisis and more issuance by companies that have decided to adopt balance sheet/leverage positions consistent with BBB ratings. PFI infrastructure issues are now generally rated based upon an assessment of the characteristics of underlying operations, and so are often rated BBB, despite the progression from project phase to operation.

The fund's increase in bonds rated BB and lower is primarily the result of holding bonds that have been downgraded to sub-investment grade as a result of tougher rating methodologies. Our willingness to retain them reflects our preference for assets with risk characteristics aligned to our investment grade orientation and which take advantage of what we consider to be credit rating anomalies – as opposed to higher risk assets which flatter the fund's yield.

The fund's allocation to unrated bonds, typically with investment grade characteristics and backed by claims on assets or cashflows, has fluctuated over the years. This has arisen from the interplay of several factors. First, patience has been required to rebuild exposure gradually as the fund size grows. Second, the number of investment trust bonds outstanding has fallen as older issues have been repaid – replaced in many instances by private placement debt. Third, the growth of the social housing sector has been accompanied by a decline in the unrated proportion of that sector.

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Fallout from the credit crunch

The table below, using the same fund and index as before, shows the sectoral changes over the past decade. The global financial crisis resulted in swathes of regulations that have had deep impacts upon a few, once dominant, sectors. It is noteworthy that many of the significant changes in the fund's sector weightings simply reflect such changes in the market landscape.

Composition of the RL Ethical Bond Fund and the Markit iBoxx Sterling Non Gilts Index by sector in 2009 and 2019

Sector	Fund (August 2009)	Index (August 2009)	Fund (August 2019)	Index (August 2019)
Banks & Financial Services	31.1%	25.1%	20.1%	16.3%
Consumer Goods	1.0%	4.8%	0.7%	7.2%
Consumer Services	2.0%	4.4%	6.5%	6.4%
Covered	N/A	N/A	2.5%	3.4%
Foreign Sovereigns	N/A	N/A	0.0%	0.8%
General Industrials	2.0%	4.5%	0.9%	5.1%
Insurance	5.3%	4.7%	11.4%	5.6%
Investment Trusts	6.2%	0.1%	2.0%	0.0%
Real Estate	4.7%	1.5%	5.1%	2.7%
Social Housing	4.2%	0.7%	13.4%	4.3%
Structured	26.3%	9.1%	24.1%	9.7%
Supranationals	7.5%	31.5%	0.3%	20.7%
Telecommunications	4.3%	5.0%	1.8%	5.4%
Utility	7.3%	8.9%	10.9%	12.5%

Source: RLAM, September 2019.

Based on the RL Ethical Bond Fund. Index used is Markit iBoxx Sterling Non Gilts Index. Figures shown include the impact of cash.

The weighting of bank debt has fallen as a result of deleveraging undertaken to reduce risk profiles. Prior to the credit crunch, banks tended to be more highly rated than corporates, despite their capital gearing generally having progressively increased. Regulation since then has required increasingly robust capital backing and risk management processes, though credit ratings remain subdued.

The marked reduction in the weighting of supranational bonds is tied up with the decline of AAA rated bonds, reflecting the developments in credit rating agency methodologies. Throughout its existence the fund has had little exposure to supranational issuers such as EIB and KFW, which constitute a substantial part of AAA benchmark weighting, due to their low yield advantage over government bonds.

The weighting of social housing has grown as capital markets offered maturities that banks were reluctant to match. Having previously been a small part of the sterling credit market, with typically unrated issues, the sector has become significant – with issues now usually rated and benchmark constituents. Our preference for the social housing sector is reflected in the trebling of the fund's allocation.

Looking forward

In spite of the manifold challenges that sterling credit markets have presented investors over the past decade, RLAM's sterling credit funds have maintained their consistent track record of outperformance. The principles underlying the team's investment process, centred on exploiting enduring inefficiencies in credit markets, are demonstrably durable and adaptive to the vicissitudes of markets. With an experienced team, a clear philosophy and high-quality credit research, we have managed to navigate various challenges and believe that we are well placed to face new and different ones.

Contact us

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

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