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Investment insight

Investing in sterling corporate bonds

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- Sterling corporate bonds typically form a significant part of the asset mix for UK pension funds
- A highly diversified passive portfolio can be attractive for its ability to offer a potential credit market yield premium, whereas active management is typically attractive only if it can consistently deliver an excess return that justifies higher fees
- We believe active management focused on selecting holdings that overcompensate for risk and avoiding credits that undercompensate has the potential to deliver attractive outcomes – and the sterling market regularly supplies mispricing opportunities

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance

Sterling corporate bonds form a significant part of the asset mix for most UK pension funds. They can be used to deliver a specific match to liability cashflow requirements, or may simply be valued for the return premium they typically offer over risk-free alternatives, often with lower volatility than for other asset classes.

There are many approaches to managing portfolios of corporate bonds and the appropriate one for any particular fund will depend on the objective being asked of the asset class. One of the principal initial decisions required is choosing between active and passive management. We aim to highlight some of the advantages and potential pitfalls of choosing between different approaches, such as these.

Passive management

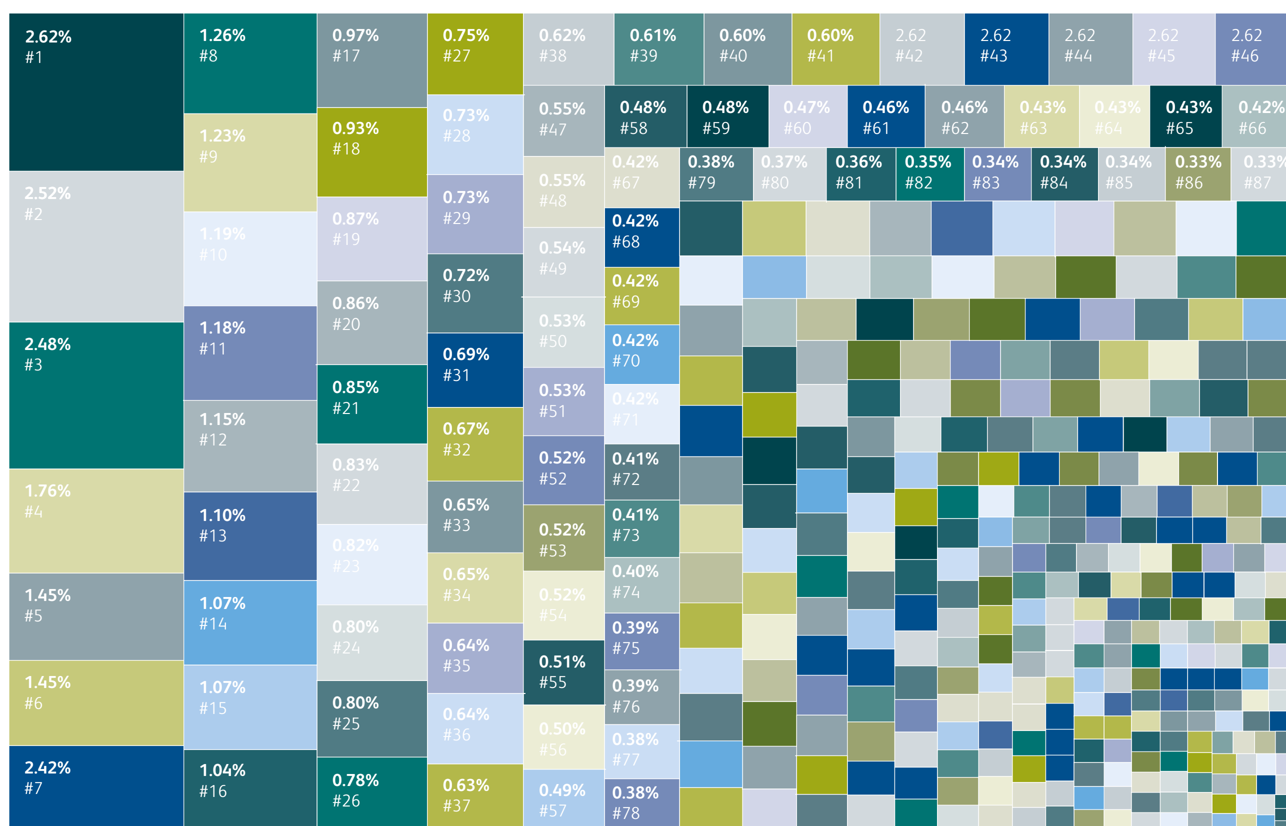
Active managers commonly highlight the shortcomings of passive management when they seek to defend the premium fees they charge. Those that propose 'Buy and Maintain' approaches cite similar reasons for charging fees at a premium to passive management. Their arguments typically highlight the risks inherent in passively matching a market benchmark – for example stressing problems of concentration, and a skew to larger holdings in corporates that have higher borrowings.

However, analysis suggests that a fully passive portfolio is often better diversified overall than the active or buy and maintain portfolios that might replace it. Some high concentrations do exist, particularly in the sterling market, and these can be addressed through active management. However, undertaking a comparison of many active portfolios with a benchmark index can weaken the diversification argument considerably. The bulk of many popular indices is generally quite well spread over a greater number of names than an active portfolio.

The assertion that passive investment will lead to larger holdings of highly indebted borrowers, widely considered to be a bad thing, is equally flawed. Analysis of the main sterling market index reveals that the largest constituents, with most outstanding debt that qualifies for the index, are not those with the highest debt levels relative to their size, but simply the largest corporates. Though they have most bond debt outstanding, they tend to have slightly lower leverage than their smaller peers.

Accordingly, we believe that a highly diversified passive portfolio can be attractive to institutional investors. It has the potential to provide investors with a credit market yield premium, which, for many years, has been more than sufficient to offset the negative impacts of impairments and defaults in the investment grade indices, and at a low cost. Therefore, an active manager should focus on demonstrating the advantages their investment approach brings to warrant higher fees, rather than simply highlighting inherent shortcomings of a passive approach.

Figure 1. ICE BofAML Sterling Corporates and Collateralised index has more than 370 issuers



Source: ICE BofAML Sterling Corporates and Collateralised index, as at 1 May 2019

Active management

The obvious and simple argument for active management over a passive approach is the provision of an excess return, for which higher fees may be justified. These excess returns are unlikely to be completely stable however, but even a closed pension scheme is likely to have a relatively long-term outlook to cope with variations in returns. It should become clear that, over an investment cycle, the aggregate return advantage is significantly greater than the additional costs involved, and it should avoid the sort of volatility that will cause valuation headaches for the scheme. It is, of course, also important that the manager has a transparent and consistently applied process, and is clear about the drivers of returns.

We believe that pension schemes should be wary of managers who claim that flaws within benchmarks make them easy to beat, and that any move from passive management will be positive. It is very tempting to believe that simple screening of the benchmark to "avoid the blow-ups" will lead to positive results when compared to passive management. In reality, identifying impending credit events requires significant research, analysis and understanding, and the credits that analysts want to avoid are often already priced to compensate for the risks involved.

However a manager of a concentrated portfolio of credits deemed to be strong, or good quality, by the credit analysts is still subject to potential negative credit surprises, and larger positions can increase the impact of any impairments. All too often such a portfolio simply seeks safety by sacrificing yield and return relative to the passive fund. In such circumstances a pension scheme may be better served by adopting a passive management approach. Therefore, we believe that a simple bias toward strong credits in a portfolio is not optimal. Rather you want a bias towards credits that overcompensate for the risks they bring.

Focusing on selecting holdings that overcompensate for risk, and indeed avoiding credits that undercompensate the holder, is itself a distinct approach to active management. It has been our experience that reacting to the extremes of valuation that emerge in both directions is an attractively consistent way of balancing the credit events that will affect every corporate portfolio, regardless of the credit analysis resources employed. It is also important that the manager should only depart from a well-diversified, or passive, portfolio when there is a genuine mispricing of risks. The manager should not feel pressure to create opportunities where there are none, nor take on those that are not compelling. Such action will only serve to increase the volatility of returns.

We believe that successful active management relies on a sufficient number of mispricing opportunities arising. Recent reductions in the liquidity provided by banks, and more tellingly, a trend among institutional sterling corporate bond investors towards a more passive style of investing, have led to larger and more frequent mispricing of risks associated with individual issuers. In particular, many more defensive-style mandates appear to now be effectively forced to hold the same bonds, thus creating an increasingly concentrated sterling market. This trend creates an obvious source of mis-valuation. Our experience is that this herding of buyers into a small number of perceived "good" credits means that significant opportunities can more readily arise elsewhere. It may also have the effect of creating some danger for those investors in the herd as the assets they buy become expensive more easily.

In any evaluation of fee levels, the excess returns objectives should be compared with the costs of achieving them. This is a subject that the investment management industry often avoids. It is often assumed, wrongly, that decision between passive or active management is a choice between a virtually-zero-fee index tracker or a high octane/high fee active product. In the world of corporate bonds, passive fund fees tend to be around five basis points (bps) per annum (pa). Competition has gradually driven active fees for many larger funds down into the mid-teens in basis point terms. This means that the fee premium for active management is likely to be roughly ten bps. If an institutional investor can find an active manager capable of achieving an average and fairly consistent outperformance of say, 75 to 80bps pa, then we believe that reflects delivering corporate bond returns at an attractive cost relative to a passive mandate. It also seems intuitively fair that the lion's share of the excess return should accrue to the party whose capital is at risk.

There are also some additional factors that are neglected in the simple comparison above. The sterling corporate bond market is well-correlated with the interest rate risks of most UK pension funds, but it does have some limitations. It has become a less important borrowing market than it has been in the past so that lower bond issuance has seen it become increasingly concentrated. As we have highlighted, the cross-market passive benchmark often provides greater diversification than many active funds, but at the margin there are a few very heavy weightings, and relatively fewer opportunities for selectivity than some other markets afford. An active manager can avoid some of the largest concentrations in the index, particularly by widening the opportunity set. One way of doing that may be by allowing the use of bonds in other currencies or investments in other areas, such as the asset-backed-securities (ABS) market. The tactical allocation into lower risk government and quasi-government sectors can also help the manager reduce investments in sterling corporate bonds that may sometimes get squeezed to unjustifiably expensive levels through a lack of market supply.

Active management can be augmented beyond traditional economic factors and allows for some tailoring to a pension fund's specific requirements. This is becoming more important, especially around environmental, social and governance (ESG) risks, where the fund may have a responsibility to ensure that their managers are doing more than simply investing passively, heedless of certain risks.

Alternatives to passive and active management

The approach to corporate bond management that a pension fund chooses will be significantly influenced by what it requires from those assets. Most defined benefit schemes of UK corporates are now closed, and many are moving towards buy-outs. In cases where the cashflows of future liabilities are known with some certainty, and where the fund wishes to de-risk, corporate bonds can be used to match specific outflows, making a decision between active and passive argument less relevant. Challenges remain in terms of finding the right assets at reasonable levels, given that many other funds have similar objectives, and that the sterling market currently has limited opportunities in specific maturity areas. However, these issues may be addressed to some extent by the use of overseas and private markets.

There is also a whole continuum of "buy and hold" and "buy and maintain" funds on the spectrum from passive to active. In these areas it is important that any pension scheme should judge that they are gaining sufficient value for incremental fees paid over passive management. As we have highlighted, it is important not to overpay a "buy and maintain" manager because of some perceived flaw in the passive approach. Any claims that a buy and maintain approach will offer superior results should still be judged on the manager's ability to select credits that will perform better than a well-diversified passive portfolio, even if these assets are held for the long term.

Many funds also have an increasing need to use the cashflows from their corporate bonds to meet current pension payments. In this case, it is worth noting that a passive market portfolio may currently be expected to generate an income stream of nearly 4% as a result of the higher level of historical coupons in the market.

We believe that active management can offer an advantage over passive, but only if it can consistently deliver superior returns of a scale that justify any higher fees. However, for sterling corporate bonds, that fee premium may be relatively small compared to other markets.

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