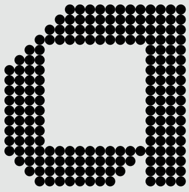

Rethinking fixed income for DB schemes

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UK defined benefit (DB) pension schemes have seen a huge shift to fixed income assets over the last 15 years, with many schemes de-risking amid improving funding levels and changes to regulations.

This trend towards fixed income is likely to continue as schemes mature, cashflow requirements rise, and regulations tighten.

But does an overweight to fixed income mean sacrificing yield, returns, and the opportunity for members to invest in line with their values?

We believe it's time to look beyond the traditional and rethink fixed income for DB schemes.

In this article we'll review some sophisticated sources of fixed income return, and ways to make a positive impact on the world by investing in the asset class.

We'll also explain the benefits of moving towards a more holistic approach aimed at meeting scheme objectives.

Corporate credit – a DB cornerstone

Investment grade corporate credit usually has a role to play in terms of volatility and cash flow management for DB schemes.

However, value and yield have not been easy to find in recent years. Today, despite concerns about inflation, the path of interest rates, unwinding policy support, and a potential wave of transformational M&A, valuations still look high by historical standards globally, making returns hard to find.

One sector to watch out for within quoted credit is Oil and Gas, where we've seen underperformance on the part of some companies due to question marks over long term business models, concerns over weakening balance sheets, and new regulations. Conversely, we have seen high demand for bonds issued by perceived climate leaders.

This leads us to an important question: how do you run a fixed income climate investment strategy while seeking to maintain returns?

Climate Change – the megatrend

Climate change is the single most important megatrend within investment right now. Investors, businesses and consumers – DB scheme members included – are only too aware that urgent action is needed to tackle global warming and adapt to its consequences.

> **"Today's ideal is to deliver a dual climate and return outcome."**

It follows that for DB schemes, today's ideal is to deliver a dual climate and return outcome. But how do we overcome the limitations of existing fixed income climate approaches? Low carbon strategies are often backward-looking, while green bond funds offer limited diversification and are typically lower yielding with longer duration.

Should schemes go carbon-free?

It's tempting for fixed income investors with climate goals to stay away from assets with high carbon emissions and stick to lower-emitting alternatives. However, this does not help to reduce real-world emissions, and it also risks cutting off investment into the areas that need it most.

We believe in investing in companies and countries that are mitigating the causes of climate change and adapting to the consequences of it, whilst also targeting attractive returns and income.

Our active research process, which relies on in-depth analysis, the use of our carbon reporting and climate scenario tools, and engagement with companies ensures that we're satisfied that climate-related targets are ambitious and credible enough.

In this way schemes can support emissions reducers, facilitate climate change adaptation, and contribute towards helping the global economy to decarbonise. Clients can also benefit from effective TCFD[1] compliance and reporting – an important consideration for many larger DB pension funds.

Pooled fund approaches to climate transition bond investing are available to schemes of all sizes. This enables schemes to capitalise on a global opportunity set and take advantage of a selection of best ideas, with the aim of achieving compelling return and income as well as positive real-world improvements in line with today's member values.

Private Credit – a varied and growing landscape

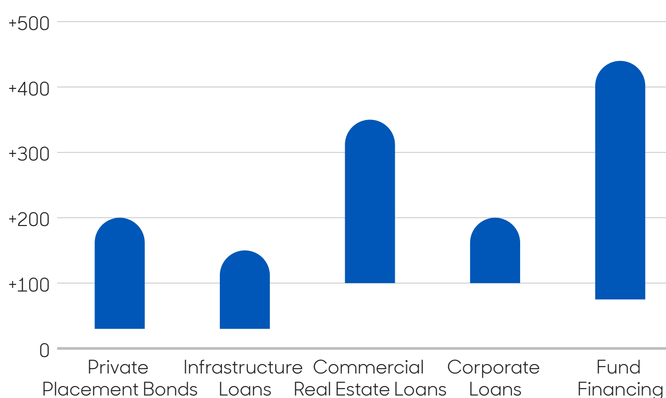
Another potential source of compelling return and income is private (as opposed to quoted) credit.

Private credit can be used to finance corporates, real estate projects, infrastructure projects and other investments. Until relatively recently creditors would have approached banks for finance, but the opportunity for private lenders to invest has grown over the past decade.

The asset class can offer investors the potential for higher yield compared to similarly rated public corporate bonds, thanks in part to an illiquidity premium (the reward investors get for investing in harder-to-trade assets).

Figure 1: Private credit can offer the potential for higher yield than public corporate bonds

Additional yield vs public bonds (bps)



Source: abrdn. Yield pick-up vs. similarly rated public corporate bonds. Yield pick-ups are indicative only. Gross of fees.

Another advantage is the opportunity for diversification, given that private credit assets are often uncorrelated with each other and the economic cycle. Most importantly for DB schemes, private credit offers predictable cash flows across a range of maturities, which is ideal for cash flow planning.

As with public markets, an active research process and highly selective approach are vital. Specialist underwriting and debt structuring capabilities are also an advantage, as well as access to the networks required to source below-the-radar opportunities.

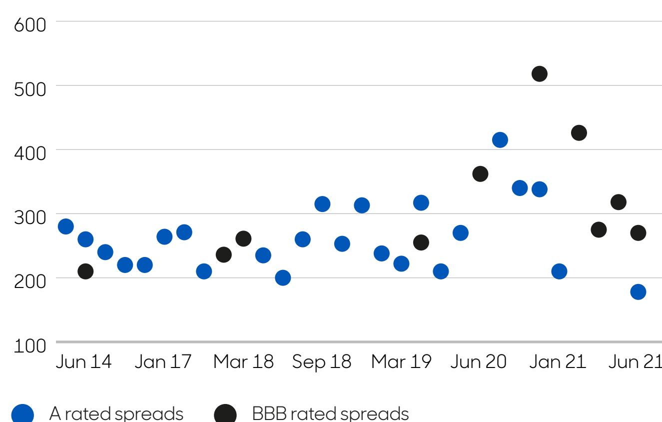
Commercial Real Estate Debt – a clear opportunity

One area of private credit where we see a clear potential for returns and income as well as real-world positive impact is commercial real estate debt (CRED).

The withdrawal of banks from this market has led to an expected shortfall in financing of GBP30bn in the UK[2]. This in turn has led to large illiquidity premiums. The chart below shows the "spreads" of highly rated CRED deals over risk-free interest rates. The spreads demonstrate the extra interest investors earn from CRED deals over and above those risk-free rates.

Figure 2: In 2020/2021, CRED spreads reached 10 year highs

abrdn CRED deal spreads 2014-2021 (bps)

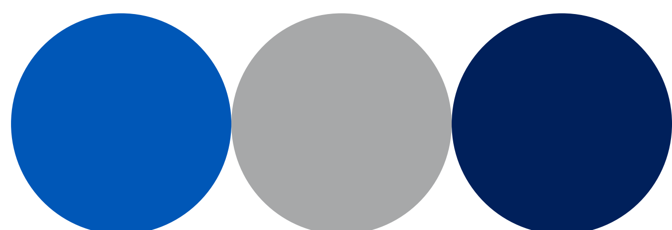


Source: abrdn as at June 2021.

Relative to quoted credit, these transactions offer high value, but robust analysis and careful stock selection backed by diverse global investment capabilities are crucial.

It's also possible for investors to engage with creditors to achieve clear, positive environmental and social outcomes. Drawing on the experience and expertise within our real estate business, we work with borrowers to implement a sustainability framework for each transaction. We then set challenging, meaningful targets for each property in line with ESG best practice.

Lenders, borrowers and tenants alike are all rewarded with a more sustainable property. This can also result in reduced refinance risk and an improved credit profile.



[1] TCFD = Task Force on Climate-related Financial Disclosures.

[2] Cass Commercial Real Estate Lending Report June 2020.

Towards a more holistic approach

So we can see that there are innovative climate solutions which aim to avoid fixed income investors having to give up returns to meet sustainability goals. We can also see that there is still value to be found in today's fixed income markets, for investors with a flexible mandate.

But what does all this mean for pension schemes? Typically a scheme's fixed income allocation is made up of three areas: liability driven investment, public credit and perhaps a private credit allocation.

We believe it's important to look holistically at those allocations in a combined solution to meet the objectives of the pension scheme, taking into consideration three crucial areas: return above gilts, risk management, and cash flows.

We've certainly noticed a sharpening focus on the latter in recent years. As UK DB schemes mature, and an increasing proportion of members become pensioners, schemes need more cash flow to meet benefit payments.

Cash flow driven investing, or CDI, can help. This involves asset managers working with scheme actuaries to understand future cash flow requirements, then building a tailored investment solution that provides contractual income from the assets to meet those cash flows – without the scheme having to disinvest significantly from the assets.

In recent years asset managers, consultants and pensions schemes have been able to work together to enable schemes of all sizes to achieve these integrated fixed income solutions.

As 72% of UK schemes have assets of less than GBP100m[3], we have developed innovative new ways to allow schemes of all sizes to build holistic solutions. These solutions use pooled fund building blocks across liability-driven, CDI buy-and-maintain credit, and private credit strategies.

Final thoughts

For investors with a flexible mindset, there is still value to be found in today's fixed income markets. There are also innovative ESG solutions that aim for real-world impact as well as attractive returns and income. Asset managers with an integrated approach and all these strategies at their disposal can help DB schemes of any size build fixed income allocations tailored to their cash flow and climate requirements.

[3] Source: Purple Book 2021.

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