Janus Henderson INVESTORS

Building Better Buy and Maintain Credit Portfolios

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In this paper, Portfolio Manager James Briggs and Head of UK Institutional Anil Shenoy explore how trustees can collaborate with their credit manager to ensure their scheme's allocation to Buy and Maintain corporate bonds is optimised to meet the specified objectives both now and in the future.

Key takeaways:

- Defined benefit (DB) pension scheme allocations to corporate bonds managed on a Buy and Maintain basis will continue to increase, as schemes reach maturity and approach their long-term objective (LTO).
- The strategy fulfils several different objectives including generating cash to pay pensions, helping to achieve a scheme's ESG goals, capturing spread and enhancing overall portfolio diversification.
- Optimising a portfolio with respect to these different objectives means partnering closely with a Buy and Maintain manager, so that these goals can be fully integrated when constructing the initial portfolio. In addition, the portfolio can evolve as the relative importance of these objectives to a particular scheme change over time.

Whatever the endgame, corporate credit is key to de-risking

As UK DB schemes approach maturity, trustees are defining their ultimate goals and the asset allocation that can help them along their de-risking journey. This has been given extra impetus by The Pensions Regulator's new DB funding code – which remains under consultation – that highlights the need for schemes to have a LTO and an established journey plan to achieve it.

By the time such schemes are, in regulatory parlance, "significantly mature", they are also expected to have a low level of dependency on the employer and assets invested with a high resilience to risk. Irrespective of what a scheme's endgame looks like – whether self-sufficiency, a full insurance buyout or another avenue – we believe corporate bonds managed on a Buy and Maintain basis will be a key strategy and allocations will continue to increase.

While funding ratios have recently improved, it is important that de-risking is managed carefully. Buy and Maintain managed with a proactive approach involves gently refreshing the portfolio to capture better value – while minimising turnover – and aligning portfolios to evolving objectives over time.

Achieving LTOs with Buy and Maintain credit

While the primary focus of such portfolios remains spread capture and downgrade/default avoidance, the strategy has evolved in tandem with schemes' needs and can fulfil several objectives. The main ones are:

i. **Generating cash flow –** as schemes approach maturity, they are more likely to become cash flow negative where pension outgoings exceed the investment income and contributions received. In this situation, schemes should aim to avoid being forced sellers of assets to meet payments. A Buy and Maintain portfolio can help mitigate this risk as the coupon payments and redemption proceeds can be structured to pay a block of pension liabilities as they fall due.

ii. **Capturing spread –** for schemes in deficit, the portfolio's spread potential can be maximised through the inclusion of riskier credits and/or by broadening the investment opportunity set. Even for schemes that have reached maturity and achieved self-sufficiency, the typical low dependency funding target of gilts plus 25-50bps means that some spread capture is still needed.
iii. **Helping achieve ESG objectives –** the long-term investment horizons typical for a Buy and Maintain portfolio means more exposure to the potential risks arising from climate change. However, there is also the opportunity to participate in an improvement of ESG performance via the engagement that is possible through a longer investment horizon and an active investment approach.

Building better Buy and Maintain portfolios

In partnership with the manager, trustees can define how each objective can be expressed into simple measurable metrics so that the manager can fully integrate the objectives into the portfolio construction. Using the above objectives these might include:

i. **Generating cash flow** – total cash generated by the portfolio in the first 10 years expressed as a percentage of the initial portfolio.
ii. **Capturing spread** – locked-in spread expected over the lifetime of the portfolio net of expected defaults.
iii. **Helping achieve ESG objectives** – achieving an expected temperature increase of no greater than ***X*** centigrade by 2050 (based on bond issuers' policies and carbon metrics).

At Janus Henderson, credit selection reflects a combination of bottom-up fundamental analysis and a degree of top-down macroeconomic analysis to identify secular risks and opportunities. Such an assessment also considers whether a credit can fit within a portfolio that aligns to the scheme's objective(s). While a low turnover requirement and a focus on preserving capital necessitates prudence, it also means taking a long-term lens to opportunities. This does not mitigate the need to evolve the portfolio to changing client needs and to take advantage of better opportunities as they arise to optimise its risk-adjusted return potential.

Approaching an endgame: evolving a portfolio over a scheme's life

As a scheme approaches maturity, requirements tend to change. While portfolios may have similar headline characteristics – such as interest rate duration, average rating and yield – portfolio construction can differ to solve for a client's needs as they evolve. As an example, the higher risk Portfolio A profiles a scheme that is some way off maturity, which is gradually transformed into the lower risk Portfolio B with a focus on climate change mitigation as the scheme matures and achieves self-sufficiency.

	Portfolio A	**Portfolio B**
Primary objective	Steady cash flows over the next 10 years	Climate risk management focused on greenhouse gas emissions reduction and climate change mitigation alignment
Performance objective	Achieve a yield at inception in line or in excess of the Markit iBoxx £ Non-Gilts Index while minimising exposure to default and downgrade risk	Achieve steady income with a view to minimising default and downgrade risk
Portfolio duration	Interest rate and credit spread duration – 8 years	Interest rate and credit spread duration – 8 years
Limits and exclusions	Maximum exposure to high yield of 10% No property exposure	No exposure to high yield at inception
Asset classes	Mainly sterling investment grade with 30% allocation to non-sterling opportunities.	All sterling investment grade (no need for hedging)
Average credit rating	BBB1	A3
Asset swap spread (bps)	150	136

Source: Janus Henderson Investors, at 31 March 2022. Asset swap spreads represent the difference between swap rates and treasury bond yields.

Portfolio A

To achieve significant yield, portfolios can allocate to high quality high yield names – at Janus Henderson these are the strongest ideas assessed by credit analysts who cover the whole rating spectrum. Given the need for steady income while preserving capital, this exposure is focused on 'rising stars' (names that have the potential to be upgraded to investment grade), which offer attractive risk-adjusted opportunities.

The client is also looking for the portfolio to provide diversification benefits. Given their significant exposure to property through private markets, this sector was excluded from the portfolio. The spread impact of this exclusion can be mitigated through higher allocations to other sectors.

Coupled with the variation in the shape of yield curves across currencies, this resulted in a meaningful allocation to non-sterling securities, taking advantage of the steeper credit curves in USD relative to GBP. This allocation benefits the client by increasing the opportunity set and best exploits Janus Henderson's global credit expertise.

Portfolio B

As the scheme matures and achieves self-sufficiency, it has a lower risk tolerance and is well hedged against liabilities, but now requires evolution to become climate aware. Objectives around greenhouse gas emissions reduction and climate change mitigation alignment were decided on, as these best aligned to the client's goals and beliefs. The portfolio was structured to reflect optimal tenor points, resulting in exposure being clustered in the belly (middle) of the yield curve.

To measure the enhancement of climate performance, the following metrics were chosen:
Backward-looking measures:

- Weighted average carbon intensity or WACI (tCO2e/Revenue)
- Absolute Scope 1 & 2 and Scope 3 emissions (tCO2e)

Forward-looking metrics:

- Year of exceeding Sustainable Development Scenario (SDS) budget
- Implied temperature increase by 2050

As shown below, when the output of the portfolios is run through data provider ISS and compared to a global investment grade index, Portfolio B is materially better across all metrics. Of note, Scope 1, 2 and 3 absolute emissions and WACI are significantly better, in line with the goals of the portfolio. Overall, the portfolios' meaningful divergence in sector, rating currency and client exposure, together with a ~10bp spread pick up, demonstrates that there is a significant amount that can be solved for by evolving portfolios over time to meet different requirements.

ISS Analytic	Portfolio A*	Portfolio B*	Comparison index
Scope 1&2 emissions	8,770	3,080	10,420
Incl. Scope 3	77,664	24,889	60,712
WACI	169.04	84.02	333.55
Exceeds SDS budget	2033	2037	2022
Temp increase 2050	2.2	1.9	2.9

Source: Janus Henderson Investors, Bloomberg, at 31 March 2022. *On a £100m portfolio, Comparison index is G0BC = ICE BofA ML Global Corporate Index.

Maintain is equal in priority to Buy

As a scheme approaches maturity or experiences a material change to either its funding position or to the strength of the employer covenant, the objectives of a Buy and Maintain portfolio are likely to change. For instance, a scheme that is some way off maturity with a strong covenant can take on more investment risk and so focus on spread capture, whereas a scheme that is more mature and cash flow negative might be more focused on closely matching a specific schedule of cash flow payments. Such objectives will need to be reflected in the portfolio initially and updated later as the circumstances of the scheme changes.

Such a shift in the scheme's situation may also on occasion be accompanied by a change in the LTO, which can then be reflected in portfolio construction. For example, if the scheme switches to an insurance buyout as opposed to self-sufficiency, the manager can incorporate this by gradually investing in bonds that are more capital efficient from an insurance capital perspective (e.g. avoiding those bonds that are less favourably treated under Solvency II's Matching Adjustment). This may facilitate the eventual transfer of the assets to an insurer. Portfolio construction, as well as credit selection, is important for Buy and Maintain portfolios.

It is therefore key that trustees revisit their Buy and Maintain portfolio periodically, perhaps following a triennial valuation, so that the objectives remain relevant and maintain a regular dialogue with their manager. This ensures that the portfolio continues to meet the needs of the scheme both now and in the future.

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