BlueBay
Asset Management

In a post-Covid world, pension funds need to cast a wider net

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As we face the prospects of a stop-start economic recovery, could flexible mandates with a 'go-anywhere' remit be the optimal approach?

The early 'tenties' was a golden era for multi-asset credit (MAC), with multiple investment funds launching to meet growing demand. The format was particularly popular among UK defined benefit (DB) pension schemes, with the investment strategy complementing their 'de-risking journey'.

But economic conditions have changed considerably since then. Central banks and governments have released tremendous amounts of market support in response to Covid-19 and this in turn has impacted asset prices. While in the long run assets always find their 'right price', over the medium term opportunities will likely shift more sharply between different parts of the credit market. As such, these DB schemes would do well to re-assess how they approach their MAC strategies.

In our view, casting a wide net is one way of responding to what may be a multi-year, stop-start economic recovery.

No amount of government support can fully compensate for the global economic impact of Covid-19 and its aftereffects. Even if a vaccine is found in the short term, behaviours and perceptions have changed with significant consequences – remote working is now a viable option for many (and often preferred), a lot of businesses can operate surprisingly well virtually, buying online is beating bricks and mortar, business travel is much curtailed, international holidays may be fewer and so on. In time, it may even mean rethinking transport systems and the role of cities if the short-term trends gather momentum.

For pension funds, two consequences come to mind:

1. There will be rising defaults in parts of the market negatively exposed to these societal changes.

2. Flexibility may be the key ingredient for future success.

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Flexible mandates

The 2008 global financial crisis was the catalyst for greater flexibility in credit mandates where, as is the case today, government and central bank supported impacted asset prices and the role of navigating a safe path was delegated to investment managers, with MAC strategies growing in popularity as a result.

Today's Covid-19 crisis presents a similar set of circumstances for investors – asset prices are impacted (mostly inflated) by central banks and risk-free rates are near zero or negative. The added complexity this time around is the changing of behaviours, some irrevocably.
In our view, this will result in the industries that facilitate remote working benefiting while close-proximity activities suffer.

Static allocations to credit markets can serve pension funds well when the world is broadly stationary – they serve them less well during transitionary phases. The same can be said for index-tracking credit strategies, particularly as default rates rise.

The reality is nobody knows what the next few years hold, but a flexible approach at least allows pension funds and their asset managers the ability to fully react to change.

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Working harder to get returns

In many countries, 10-year government bond yields are lower than inflation expectations, so investors expect to lose capital in real terms. While this may have less of an impact for DB pension funds, avoiding loss remains a key objective nevertheless.

Earning, say, cash +3-6% in today's credit markets requires investors to buy largely sub-investment grade bonds...and that comes with attendant credit (default) risk. In many ways, it makes sense for investors to provide greater flexibility where there is greater credit risk. It allows the manager to rotate into and out of opportunities.

MAC – what asset classes to include?

There is a wide spectrum of MAC products out there, ranging from 'narrow MAC', which includes just a few asset classes, to 'go anywhere MAC' that does just that.

At the current juncture, we believe a wide net conveys some advantages. These are both structural and asset-class specific and include:

- **Zero weight** – having access to more asset classes provides a greater ability to hold zero exposures. With plenty of asset classes to choose from, a manager can more easily opt to have zero exposure to parts of the market. This is harder when fewer assets are included in the universe.

- **Diversification** – a more diversified MAC exposure is less susceptible to unexpected central bank/government interventions, which can have asymmetric impacts on specific asset classes.

- **Convertible bond universe is 'Covid friendly'** – pharmaceutical companies and tech businesses tend to issue convertible bonds. Including these in a MAC strategy gives the manager the ability to access some of the possible beneficiaries arising from the crisis. There has been tremendous issuance in recent months with many companies that have never issued a convertible bond before attracted to the asset class.

- **Cocos (financial capital bonds)** – this asset class is unique in that it is made up of hybrid instruments and in certain circumstances investors may not receive a coupon or may suffer a principal loss if a bank's capital level falls below a predetermined rate. In effect, an investor is selling an option to the bank/regulator, and, in our view, being paid handsomely to do so. Given the amount of government support for banking institutions, they are largely the conduit of any recovery. We believe this asset class presents some very interesting opportunities and is one expression of the theme of staying close to parts of the market that directly benefit from central-bank support.

- **Developed market investment grade** – within our own flagship MAC strategy, we had not purchased any developed market investment grade bonds for the past seven years, due to the low yields on offer. That changed in late March and April 2020 when investors could potentially achieve 3-4x the average spread and, although clearly a very sporadic tactical opportunity, the ability to capitalise on unexpected opportunities favours a wide net.

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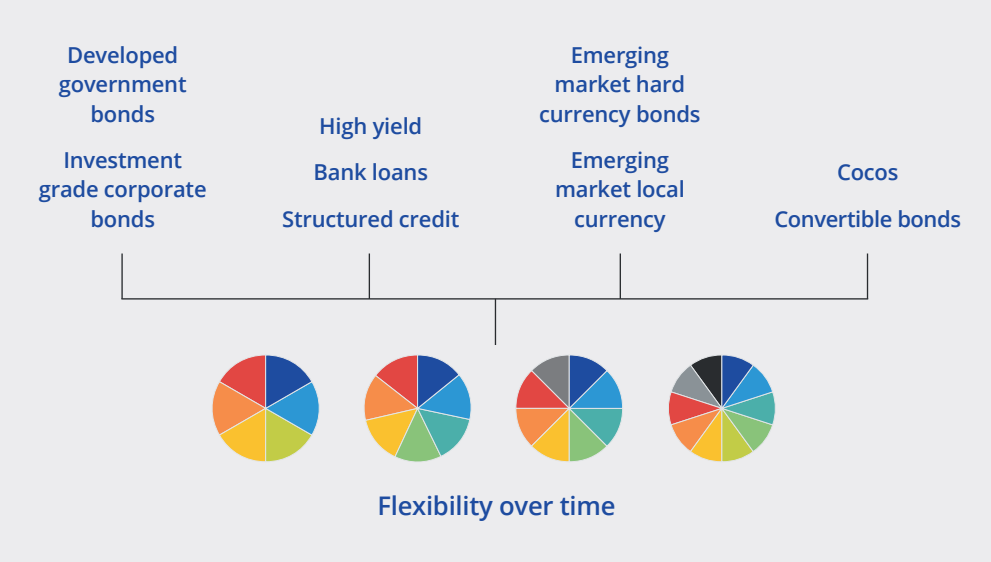
Liquid credit asset classes



Source: BlueBay Asset Management, August 2020

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In summary

With risk-free rates low for the foreseeable future, we believe return-hungry pension funds will have little choice but to seek out returns from lower credit-quality bonds. This comes at a time when unprecedented support has been pumped into markets and Covid-19 restrictions have left some industries beleaguered, perhaps for the long term.

While a wide net is a useful tool – and perhaps an essential one – that is not the whole story. The other component is avoiding defaults. Credit managers haven't been meaningfully tested in this regard since the last financial crisis and this time around investors will also have to factor in government support to a much larger degree. Whatever awaits us, in the words of Charles Darwin, *"it's not the strongest or most intelligent who survive, it's those who adapt."*

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