Sweating it out in the search for yield

Schemes looking for higher yields face more risk – can they take it on the chin in today's feverish environment?

AT A GLANCE

It is impossible to increase yield without also increasing risk

Yet there are opportunities in fixed income as spreads have increased

Schemes can also earn an illiquidity premium by investing in assets such as private credit

TRUSTEES FACE extraordinary challenges as the deadly Covid-19 pandemic continues to disrupt people's daily lives and businesses. Global stock markets too have displayed extreme volatility on a daily basis and there is an uncertain outlook for at least the next six months as governments around the world pump trillions of fiscal stimulus into the economy to stave off financial collapse.

Dozens of firms have trimmed dividends and with even (unwarranted as yet) speculation over payouts from such blue-chip payers as Royal Shell, where the dividend has not been cut since the Second World War. Some pension schemes may be forced even to become distressed sellers of equities.

Research from MSCI, dated 30 March, based on a stress test and using the global financial crisis of 2008 as a comparator, indicates that investment-grade and high-yield bonds could sink a further 8% and 19% respectively. If equity and credit markets drop as much as they did in 2008 and early 2009, under such a scenario US equities could lose another 25% while the 10-year US Treasury yield could decrease by another 30 basis points according to the research.

Until the end of the epidemic is in sight, there will be no let-up in this volatility with risky assets often all moving in tandem and frequently downwards while the search for yield is more treacherous than ever. The only consensus solution is "diversify" but there are other answers than just "spray and pray?" in the elusive yield hunt?

ASKING THE IMPOSSIBLE

In this maelstrom, experts have a range of suggestions to sweat more yield out of a portfolio but achieving the Holy Grail of doing so without increasing risk is impossible.

PTL managing director Richard Butcher says: "The bottom line is trustees can't increase yield without also increasing risk. There really is no such thing as a free lunch. The trick, for trustees who need more yield, is to reassess their tolerance, as opposed to appetite, for risk to see if they can take more. It is possible to increase risk fairly moderately (for example with infrastructure) and gain a few extra basis points."

Diversification is the watch word but in even this is not enough. Indeed, Schroders solutions manager Jon Exley emphasises: "Unfortunately, there is no simple answer. When gilt yields are low, income from most secure income assets is also low as these assets tend to be priced using gilt yields plus a spread for credit risk and it is indeed challenging to increase yield without increasing credit risk."

He suggests other avenues: "What might cynically be called "one of the oldest tricks in investment", which is converting capital into income, but importantly, doing this through controlled and planned amortisation of principal."

"Private credit assets can be considered if illiquidity can be tolerated," he believes as: "these assets often offer a higher yield compared with public assets with the same underlying credit risk because they can earn an 'illiquidity premium' in addition to the spread earned for credit risk."

"Many private assets will come with covenant packages, if these are carefully monitored then the lenders can engage early with borrowers if credit conditions worsen, to seek extra protections, to get higher returns or to change behaviours," adds M&G Investments director of fixed income John Aktin. Private bonds will often also come with security over real assets, careful negotiation at the point of lending can help protect cashflows in times of economic turbulence."

MARKET OPPORTUNITIES

Amid a sea of gloom, Cardano head of LDI Paras Shah is relatively upbeat: "The current environment has opened up significant opportunities to enhance yields when compared to government bonds. Credit spreads on high grade corporate bonds have doubled (increased by well over 1%)

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Richard Butcher: maturity can be predicted well in advance so there is plenty of time for trustees to plan

in the current market turmoil. While there are certainly materially higher risks prevalent in the global economy at present there remain strong companies that are likely to work through the turmoil."

He adds: "Yields on government and investment grade bonds are extremely volatile at present, with risk free yields selling off materially at the time of writing to levels seen at the end of 2019. This coupled with the fact that credit spreads have increased materially means that for those investors willing to invest in income-based investments there may be significantly better yields available than any time in the last year."

Apart from corporate bonds, he says: " there are several other asset classes that trustees should also seek out, for example infrastructure debt, asset backed securities, ground rent, social housing debt and other forms of high-quality secured investments where Trustees can enhance yield by harnessing illiquidity premiums without compromising on credit quality."

"Another way of gaining additional yield can be found in broadening the currency spectrum when it comes to corporate bond portfolios," says State Street Global Advisors EMEA head of LDI Jeremy Rideau. "For example, buy and maintain and CDI portfolios can gain exposure to USD corporate bonds with interest rate and inflation rate risks hedged back to GBP providing additional yield but also diversification to their portfolios. Again, such portfolios also bear some collateral risk."

Shah advises investing in assets that provide contractual cashflows and are appropriately diversified by asset class, issuer type, sector, etc. but cautions " to ensure predictability of income we would encourage trustees not too compromise on credit quality to seek out additional yield unless appropriate due diligence has been done on the underlying investments."

"Derivative overlay strategies have an important role to play in stabilising the pattern of asset cashflows, and provide inflation exposure to meet benefit payments with more certainty," he says but stresses "keep a portion of assets invested in cash or government bonds".

JOURNEY TO THE END GAME

"Recent market movement is a good illustration of the potential volatility that trustees may need to tackle in their journey to the end-game," says Insight Investment head of client strategy Ren Lin. Trustees who have adopted a cashflow focused strategy have been able to remain comfortable that they will be able to meet their near-term liability and hedging obligations without necessarily having to sell assets," he adds.

Schemes can manage being cashflow negative by proper planning and modelling. Butcher says it "is not a disaster for a scheme. It merely shows its level of maturity and as, in the vast majority of cases, that maturity can be predicted well in advance so there is plenty of time for trustees to plan – and no excuse not to have done so."

He adds: "A plan's objective should have the cashflow as needed (which can be modelled with a high degree of accuracy), and to avoid distressed selling of assets. For example, there shouldn't be a reliance on frequent equity large scale disinvestment and to maintain risk, return, liquidity and costs at an acceptable level given the wider objectives of the scheme." He explains: "A simple model would see a gradual systematic run down of high-risk assets in favour of lower-risk assets."

In reality, Butcher concludes: "It's almost impossible to ensure you are not a forced seller. The best you can do is plan (perhaps with a margin) to avoid being a forced seller within your acceptable risk tolerance (i.e. there is a cost which trustees will have to judge as acceptable)."

Contingency plans are also helpful. "A holistic liquidity management framework can help mitigate forced-selling risk. Integrating your liquidity pool with an existing collateral pool can provide a readily accessible, flexible source of liquidity that can help meet all of a scheme's cash requirements without the need to sell assets," says Insight Investment's Lin: "Our experience suggests typical collateral pools represent 10-20 years of pension payments, and are therefore sufficiently large to temporarily absorb a degree of cashflow mismatch without impeding their primary role of meeting collateral calls."

He adds a caveat: "where trustees are seeking to achieve low dependency/buy-out over a shorter period (say 5-15 years), illiquid longer dated assets may introduce other unintended risks. E.g. mark-to-market risk at the point of wanting to enter into the buyout, or increased concentration risk over time."

Secor Asset Management investment strategist Devan Nathwani adds: "Sensible asset allocation, downside protection, constrained leverage, and the ability to use derivatives for rebalancing can significantly cut the risk of being a forced seller. In contrast, over emphasis of cashflow matching virtually assures that the portfolio will need to be rebalanced at exactly the wrong time."

Spence & Partners director Hugh Nolan notes: "Trustees may decide to keep higher floats in their bank accounts as a buffer, particularly given the low interest rates available elsewhere. Schemes may also be prepared to delay unexpected payments like significant transfer values to give them extra time to realise the funds needed."

Nothing is certain. Indeed, what works could be partly down to luck rather than skill, judgment and market timing. The only certainty is that the pandemic is a stress 'test' beyond the wildest modelling of any investment strategy, even those of a Nobel prize winner.

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