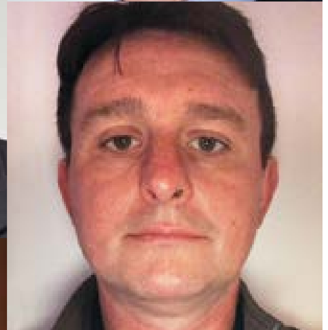
pi roundtable

FIXED INCOME



Janus Henderson INVESTORS

Jim Cielinski | Kilian Thevissen | Carl Hitchman
Alan Pickering | Ian MacRae | Peter Martin

MAY 2021 | PORTFOLIO INSTITUTIONAL

Janus Henderson
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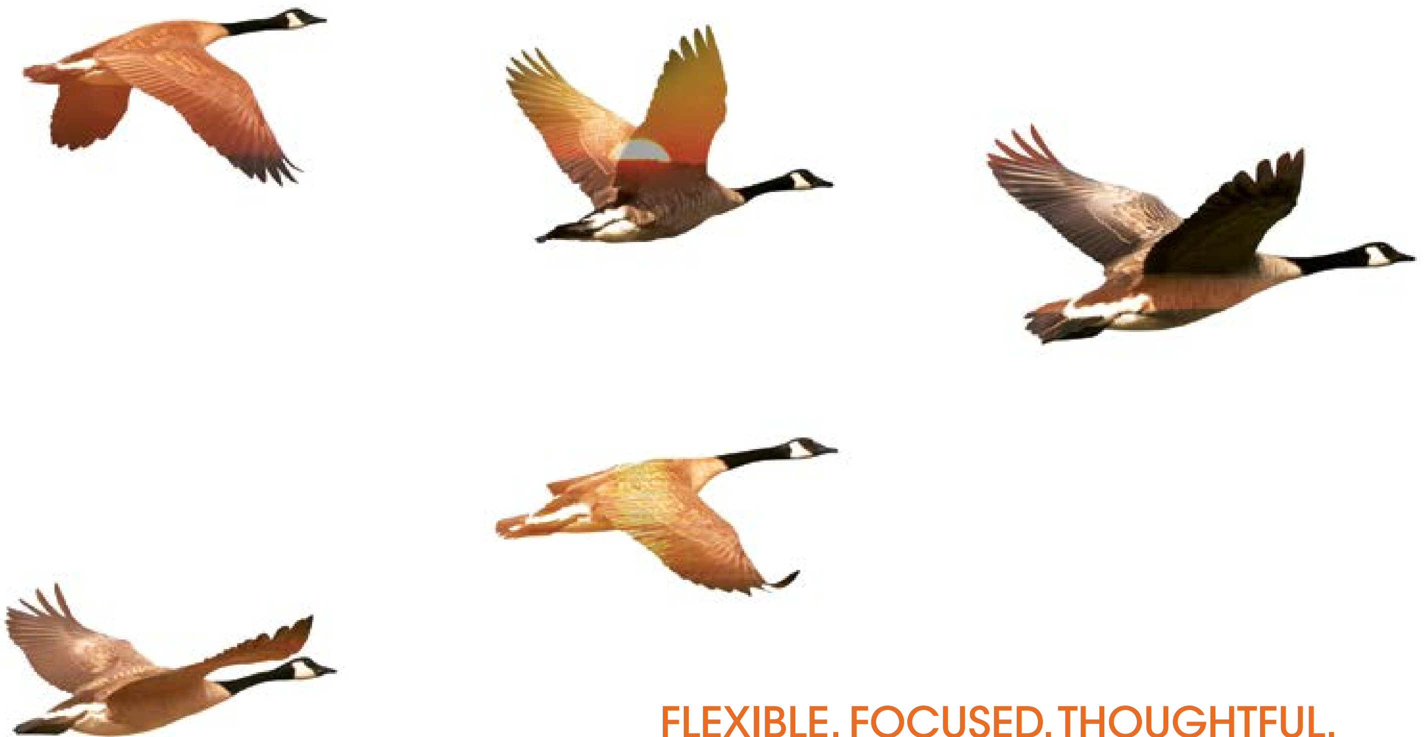

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FIXED INCOME

Bond investing has traditionally been viewed as the boring relation of equities. There is not much excitement. With bonds, losing money is about as eventful as it can get, while those trading shares could earn or miss out on a fortune. But bond management is changing.

Increasing cashflow negativity among defined benefit pensions schemes mixed with the Bank of England setting interest rates at 0.1% means fixed income managers are having to be more creative to generate the returns their clients' need.

Central banks have not helped. Their bond-buying programmes have caused uncertainty and inflated prices. So, investors are taking more risk at a time when spreads are tight.

Then there is inflation, of which we are told to expect more of in the coming months. This puts pressure on mature schemes which are approaching their endgame and are perhaps looking to entice an insurer to guarantee all future benefits.

The pandemic is another factor. The economic impact of Covid-19 has raised default fears, so the quality of an issuer is growing in importance.

Bond managers are also having to show how their portfolios are making positive environmental and social impacts. It's tough, as reporting here is described by some as "patchy", but they still have to please investors and regulators alike.

So, low rates, inflationary fears and pressure to build green portfolios means there is much for bond investors to navigate. It looks like fixed income will not be seen as the boring relative to equities for some time. Sounds like an ideal time to examine the market.

Mark Dunne
Editor
m.dunne@portfolio-institutional.co.uk

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Fixed income

These are interesting times for bond investors. Indeed, inflationary pressures, low interest rates and rising default fears mean there are many obstacles for investors to consider when building a fixed income portfolio.

To find out how institutional investors are approaching this market's many challenges, we brought asset owners together with a bond manager, a professional trustee and a consultant for an online discussion.

FIXED INCOME IN FIGURES

$119trn

The size of the global bond market

Source: Securities Industry & Financial Markets Association

$17.4trn

The size of China's bond market

Source: S&P Global

$1trn

The estimated size of the sustainable bond market in 2021

Source: SEB

0.77%

The average gilt yield in 2019-2020

Source: UK Debt Management Office

2.92%

The US' Aaa corporate bond yield at the end of April 2021, which is below the 6.64% long-term average

Source: Moody's

0.7%

UK CPI inflation in March, up from 0.4% a month earlier

Source: Office for National Statistics

Six

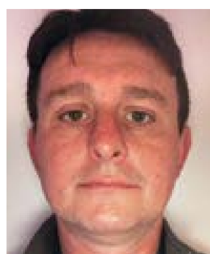
The number of sovereign debt defaulters in 2020 [Argentina, Belize, Ecuador, Lebanon, Zambia and Suriname]

Source: S&P Global

PARTICIPANTS

Jim Cielinski
Global head of fixed income
Janus Henderson

Jim Cielinski oversees all of Janus Henderson's global fixed income products and teams as well as leasing corporate credit. He joined from Columbia Threadneedle in 2017, where he was global head of fixed income for seven years. Before that he spent 12 years at Goldman Sachs Asset Management as managing director and head of credit. He has also been the head of fixed income for Utah Retirement Systems, assistant manager of taxable fixed income for Brown Brothers Harriman & Co and an equity portfolio manager for First Security Investment Management.

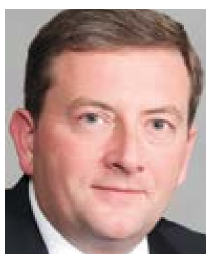


Ian MacRae
Pensions investment manager
JaguarLandRover

Ian MacRae manages JaguarLandRover's defined benefit (DB) scheme's asset and liability risks together with its funding arrangements. He also chairs the management committee of the car-maker's defined contribution (DC) pension scheme.
For nine years MacRae has worked within the treasury function to improve the stability and predictability of the DB scheme's funding. Before joining JaguarLandRover he was an investment consultant at Mercer in Edinburgh.

Kilian Thevissen
Investment manager
National Grid UK Pension Scheme

Since 2016, Kilian Thevissen has been responsible for National Grid's UK pension scheme's portfolio construction and manager selection. He also monitors its asset allocation sleeves, which include LDI, fixed income, equities, alternatives and private market investments.
Before joining the scheme, he spent seven years at Philips' pension scheme in the Netherlands, holding various roles within its investment team focusing on analytics and risk management as well as manager selection and monitoring.



Peter Martin
Investment officer
Medical Defence Union

Prior to becoming the investment officer of the UK's largest medical defence unions, Peter Martin was head of manager research at pension consultancy JLT Employee Benefits. Martin sits on the Society of Pension Professionals' investment committee and represents the organisation in the Debt Management Office's quarterly consultation.

Alan Pickering
President
BESTrustees

Not only is Alan Pickering president of BESTrustees but he is also a trustee of the retirement plan for plumbers and mechanical engineers as well as for workplace scheme The People's Pension.
His industry experience is vast having served as a non-executive director of The Pensions Regulator and a member of the Occupational Pensions Board. Pickering is also a former chair of the body that is now known as the Pensions and Lifetime Savings Association (PLSA) and held the same position at the European Federation for Retirement Provision. In 2002, he wrote the government-sponsored report *A Simpler Way to Better Pensions*.

Carl Hitchman
Chief investment officer
UK investment consulting
Buck

Carl Hitchman is responsible for Buck's investment philosophy and approach to advising on managers and markets. This has included strategic asset allocation, asset/liability modelling, liability-driven investment, cashflow-driven investment, derivatives and asset transfers. His experience extends to asset administration, fiduciary manager oversight and investment governance.
He has spent more than 35 years in the retirement industry. He started his career as a pensions actuary before becoming an investment consultant in 1993.

portfolio institutional: How are institutional investors using bonds these days?

Kilian Thevissen: National Grid's pension scheme is relatively mature, so our fixed income allocations are primarily investment grade.

While there are some pockets where we aim to generate alpha over appropriate benchmarks, the bulk of our investment-grade fixed income exposure is in long-term buy-and-maintain portfolios or private investments, where we look to harvest an illiquidity premium over public market equivalent bonds.

Ian MacRae: We have a strategy to create a secure and reliable income stream to match the benefit outgo for our pensioners. Our schemes are relatively immature, so that makes up around 40% of our assets. The balance is spilt between our liability-driven investing (LDI) and growth portfolios.

Within LDI we look to hedge interest rate and inflation risks for non-pensioner liabilities, while the growth portfolio uses bonds to diversify and access different risk premiums.

Alan Pickering: LDI is at the heart of most of my defined benefit (DB) schemes. We are on a journey plan, which for three of my four schemes will come to an end during this decade.

In the run up to buy-in/buyout we are using bonds to provide diversification, risk management and, to some extent, create a buy-in/buyout-ready portfolio. For instance, we might use short duration bonds which could be easily liquidated when the time comes for buy-in/buyout.

As we move towards low dependency on the sponsoring employers, we are trying to tap into different aspects of the fixed income market. A, to provide a return slightly north of bonds, and b, to prepare for buy-in/buyout.

PI: How does it differ in your defined contribution (DC) schemes?

Pickering: The jury is out as to whether it should be growth all the way during the accumulation phase, or if there should be a bond element within the default funds. There is a lot of thought being given to diversification and multi-asset at all points in the accumulation phase. If it is used, I favour dynamic management of fixed income portfolios than a passive approach.

As we come to the consolidation and decumulation phases, there will be a role for fixed income. In the self-select element within a DC scheme, again I would support a dynamic rather than passive option.

PI: What do your clients want from fixed income these days, Jim?

Jim Cielinski: I view it as a bit of a dichotomy. A lot of our clients are seeking income, but there is a dearth of income even with the rate and yield increases we have seen. They want income, but income with risk control, income with a defined drawdown.

Equally, there is a focus from our clients, particularly away from DB, on shorter duration products, on limiting interest rate risk – with rates last year moving to extraordinarily low levels. So, there is a desire to have many types of credit risk and the ability to rotate across sectors.

We have seen a shift. It is more conservative on the rate risk side. We still have clients who want longer duration to hedge liabilities, but more often than not they want that agnostic approach.

Carl Hitchman: Many of our clients are focused on cashflow. In cashflow-driven investing (CDI) the starting point is: do you have enough money to solely invest in different types of credit and gilts. If not, how much do you need to hold in growth assets to fill the

There is a desire to have many types of credit risk and the ability to rotate across sectors.

Jim Cielinski, Janus Henderson

gap? In holding growth assets, the portfolio is typically structured on the assumption that they will be held long term. So, you are allocating them against your cashflows 15 to 20 years down the line. Essentially, you are letting those growth assets grow. You are not going to become a forced seller but what you can do is exploit the upside volatility if those assets deliver stronger returns than anticipated.

Key to all of this is that as pension funds mature, fixed income is going to be a much bigger portfolio component. This in an area we are focusing on.

Peter Martin: With bonds it is a question of being open minded in looking for opportunities without taking excessive risks. It is not necessarily about maximising return but trying to get an appropriate return from the combination of assets available.

Going forward, we must be cognisant of the environment we are in – where rates are low and credit spreads are tight. Quality is safe and stable and that is appropriate for some, but it is a mediocre return for the foreseeable future. If that is deemed not sufficient, you have to move up the risk profile, so there is no free lunch. We are in a different environment from 10 or 20 years ago in that the 'easy money' has gone.

PI: What impact has the pandemic had on fixed income portfolios?

Cielinski: Aside from rates plummeting to record lows and bonds becoming overvalued on most metrics, what has changed is the regime in which we live. This crisis passed the baton from monetary to fiscal policy, which created fears of a notion that you can borrow unlimited amounts and it stays affordable. So, there has been a shift in how the policy reaction will work.

When we look back, this will be the moment when our framework had to adjust to the outlook for inflation, the outlook for deficit spending and the outlook for politics, in that we could see people elected on the promise of more spending.

Pickering: Quantitative easing (QE) and modern monetary theory have promoted us to rip-up everything we learnt from textbooks in our youth. It has created uncertainty and an air of challenge.

This is a good thing in that you cannot take anything for granted. Who would have guessed that we would end up having big government in the UK and US?

At a more micro level, the pandemic has forced us to focus on quality. We need to concentrate on the covenant of those on the other side of the fixed income products to a greater extent than we did before. So, we have uncertainty at a macro level and uncertainty at a micro level, which selfishly makes my job so enjoyable.

PI: Ian, has the pandemic forced you to focus on quality?

MacRae: Our investment strategy is based on moving assets from growth/LDI to our CDI portfolio as our liabilities mature. That gives us opportunities over time to take advantage of relative pricing differences between cash from the LDI portfolio or growth assets compared with bonds and other assets purchased for our CDI portfolio.

The turbulence we saw in 2020 helped us transition more of our liabilities into our CDI portfolio at attractive prices relative to the assets we sold.

The quality of the covenant of the bonds we buy is critical, especially as, ideally, we would hold them in our CDI portfolio to maturity. We buy bonds that we are confident will retain their quality and income. That security comes in many forms, whether it is the covenant of the issuer or the collateralisation.

Thevissen: In February and March 2020 we saw a significant spread widening, which was an interesting time to consider an increase of exposures to long term investment-grade credit.

It was an opportune time, but as usual we took a careful approach, always considering potential downside risks. Before you invest with a buy-and-hold to maturity objective it is essential to have a profound long-term view of a company, for example a clear idea of

Fundamentally, if you want to see the importance of ESG look around the world to see what is happening.

Carl Hitchman, Buck

how the company is aligning its strategy with the ongoing energy transition. If you are investing for 10 years plus you have to get it right in the first place, otherwise you may be forced to amend your exposure later on – likely at a wider spread and incurring transaction costs – which is not ideal for a buy-and-maintain portfolio.

PI: Inflationary fears have been rising. Do you expect that to continue, Jim?

Cielinski: I do not see it dissipating, but markets have priced in a lot of inflation. In most developed markets we are looking at 2.5%, although the US' longer term inflation expectations are slightly higher.

It is difficult, if you look at the last 30 or 40 years, to get meaningfully above that. The inflation expectations have been behind the rate increases we have seen this year, although I am having a hard time expecting that to continue from those levels.

That said, inflation will be higher in the next few months. Quoted inflation is done on a year-on-year basis, so we are moving into a period where we have pandemic-related deflation. Combine that with commodity prices and we are likely to see inflation numbers that look a lot worse than they have been. That does not lead to another round of inflation fears. I am more worried about the level of real rates and if global growth is strong enough to drive them higher.

Martin: It is always right to consider how exposed you are to unexpected inflation, either positive or negative, and have a scenario plan to see if your portfolio could withstand it or not.

There is a pent-up demand for inflation protection from pension funds in the UK and that is not going away. The price of UK inflation will remain expensive given the demand and with clarification of the CPI changes, which will drive more trading because the uncertainty has gone.

It is, on a relative value basis, whether you are prepared to pay for inflation-linked gilts or areas that provide inflation within the assets, such as corporate linkers or housing associations.

With my trustee hat on it is about de-risking. If you can take the risk off the table it is a price worth playing, but you can still play that journey sensibly.

Hitchman: The risk of inflation has increased. The extent of the fiscal stimulus pushes us into a different space in terms of: is a policy response going to help us through the crisis or stoke inflation? No one knows, is the frank answer.

Over the past 20 to 30 years there have been all sorts of reasons why inflation has been coming down and has been sticky. For example, there has been lots of discussion about the impact of demographic changes and whether the underlying dynamics are starting to change.

The market in the first quarter gave a taste of what could happen.

Rates were rising and trigger points were being hit in some leveraged LDI portfolios with cash calls made to fund these.

Over the past 10 years as rates have been coming down, leveraged LDI has not only generated strong returns, but thrown off a lot of cash that has paid pensions and rebalanced portfolios.

The challenge is that if it starts going the other way and there are cash calls, you have to fund that from somewhere, assuming that you want to keep your hedging. Does that then eat into the growth assets you rely on to fund your deficits?

It is crucial when setting strategies in this environment to factor in the increasing risk of rising rates and have liquidity and collateral ladders in place that will allow you to meet these cash calls without jeopardising the long-term funding of the scheme. From that perspective, considerations of inflation are key given where we are and the fiscal response that has come our way.

Thevissen: Inflation is a risk that we hedge similar to how we hedge rate risk.

When it comes to liquidity/collateral management, we did not get into a difficult situation in the past few months, but it is a space that we watch.

MacRae: We consider inflation and rates from the view of do we want that risk? We are heavily hedged against those risks and that has been positive while rates have been dropping. We need to look at where rates could go and the risk of higher rates.

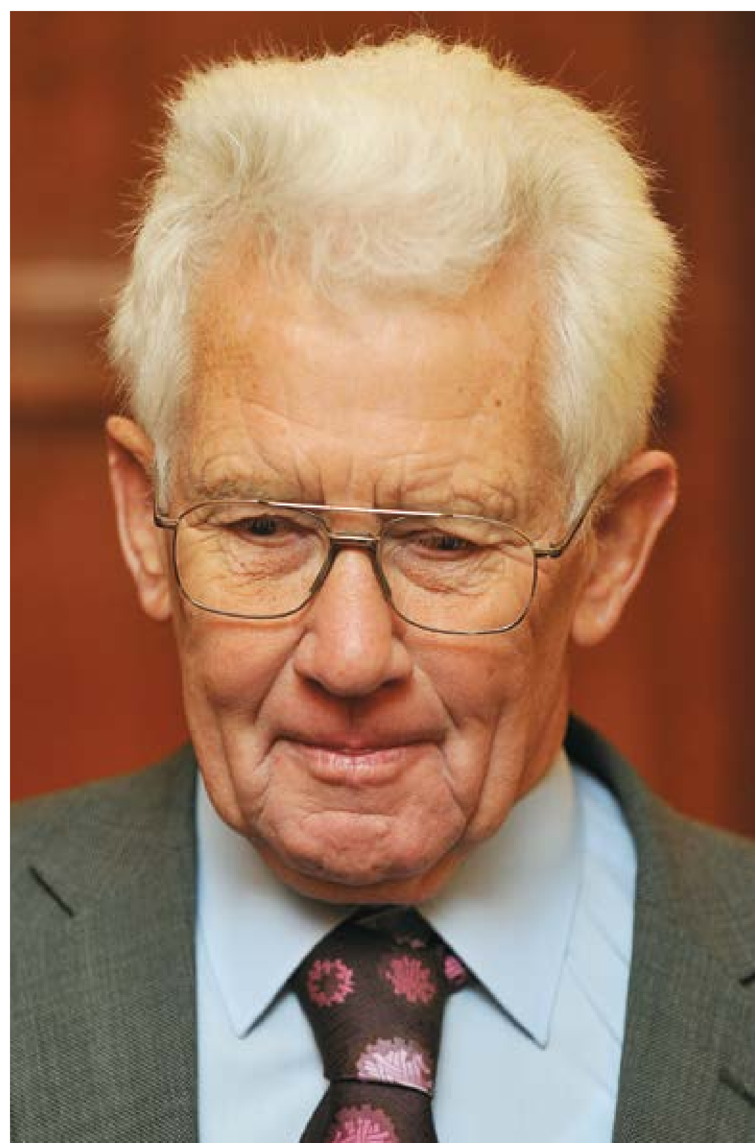
On the inflation side, the cost of hedging in the UK is high, especially post 2030. We use real assets to access inflation protection in our CDI portfolio, which we overlay with direct inflation hedging. We consider the cost of hedging that risk against the reduction in volatility we could achieve, so there is a regular re-evaluation of the costs of hedging versus its benefits.

In summary, if you cannot absorb the risk, you need to hedge it. If you can take some risk, and it is expected to generate returns, then you can move away from a naturally hedged position to some extent.

Pickering: There has been an unholy alliance between the sophisticates and the not-so-sophisticates who say there is a limit to what price you want to pay for protection against inflation. Today, the argument that the approach should be scheme specific holds good, and if the employer and trustee want to batten down all risks, they may be willing to pay a higher price for battening down the inflation risk.

In DC land, members might be sensible in battening down inflation risk if their pension is the only income they have in retirement. If they have other sources, they maybe more relaxed about battening down every risk. As far as volatility is concerned, it will increase as large amounts of money exploit opportunities or react to uncertainty.

As a long-term investor, volatility can be your friend, but if you have a short-term horizon, as many defined benefit schemes have, then it could be your enemy.



Quantitative easing and modern monetary theory have promoted us to rip-up everything we learnt from textbooks in our youth.

Alan Pickering, **BESTrustees**

PI: How will fiscal and monetary policy effect the price of bonds and risk assets going forward?

Cielinski: Monetary policy's affect is now limited to the forward path of short-term rates because central banks can stay on hold forever, so it is up to the fiscal side to drive bond markets.

At some point you start to price in rate hikes, but that is a long way off. For bond market drivers in the near term, I am looking at fiscal policy and if central banks keep testing the limits of how much they can borrow and spend before it pushes bond markets too high. When you do that it can be self-correcting as at some point bond yields will go too high and impact other risk assets.

Keep in mind that it is not just about spending today but the fiscal cliff that gets created a year from now. One-off big expenditures become detractors. Everything feels great right now, but in a year it could be a different story. This spells more uncertainty and volatility on inflation, rates and policy.

PI: How do schemes select a bond fund manager?

Pickering: As a trustee, I rely on the intermediary. I need a consultant in whom I have confidence that they understand the market and what I require from that market. One of the advantages of being a professional trustee is that I do not necessarily need a household name, provided that the consultant can convince me that the fixed income manager is not only good but is appropriate.

Hitchman: Credit selection skills are fundamental to everything. In credit, active management is the way to go because there is a lot of value that could be added from a proper credit assessment to mitigate the default risk. Credit spreads have tightened, and asset prices generally have been pushed up because of QE, so the margins have become thinner. That is an environment where a good credit manager can make a huge difference in delivering returns.

Above and beyond that, a lot depends to some degree on the nature of the credit. In the private credit market, you need people with experience of structuring – and sometimes restructuring – as well as the contacts to originate deals. These assets are illiquid, so what access do they have to the market and how quickly can they execute?

Trustees want to have confidence in a manager, but they also want to monitor that manager. If that manager does not have the disclosure policy or the communication skills to articulate what are complex assets, it becomes difficult to build confidence in terms of monitoring the manager. So, the ability to communicate around the asset class, such as performance, is a key component.

Martin: You need people who can deal in this asset class because bonds are a specialism.

A lot of the fundamentals have not changed, but there are different additional questions that I would ask now. One is around how they handled the pandemic.

It is also important to consider what a bond manager is doing on responsible investing. Given the current environment, delve beyond ESG integration which was perhaps sufficient three or four years ago. The story has moved on.

I am not interested in the apple pie-type statements, but what can they measure? What impact can they show? How are they doing things differently with TCFD reporting coming our way? How are they aligned with the Paris Accord? The transition pathway? It is an important topic and you need to find a partner that can help you on this journey.

Reporting on high level ESG metrics is relevant, but is only the tip of the iceberg in terms of what you want to see from your managers.

Kilian Thevissen, National Grid UK Pension Scheme

In looking for a new bond manager it is about how they manage that process, what lessons they have learnt and how it makes them stronger going forward.

MacRae: In our CDI portfolio, we need to think about a bond manager's analytical skills as we look to hold credits ideally until they mature.

It is a huge universe and we are not only looking at investment grade, so market access is critical. We need managers who understand the environment in which they are investing. We use a fiduciary to select managers to meet our goals, which means we need to be careful about the philosophy we expect our managers to follow and that this is clearly communicated.

Thevissen: Do not just provide 10 slides on ESG, show me evidence of how it has made an impact on the portfolio. That is the key challenge we ask our candidates to solve these days.

The world has moved on, we have all progressed and are more ambitious than ever to integrate relevant ESG factors into the investment processes that drive our portfolios. A lot of managers are struggling with this, and those who have, are still facing challenges to evidence it in a structured and consistent way. Reporting on high level ESG metrics is relevant, but is only the tip of the iceberg in terms of what you want to see from your managers.

PI: So, how do you want ESG integrated into your portfolios?

Thevissen: Climate change is a key systematic risk that needs to be addressed. We have a strategy which will see us divest from coal-related assets by 2022. Beyond this, we are engaging with our managers across the various asset classes to integrate relevant ESG factors into their ongoing investment processes.

While with regards to coal we chose divestment, we generally prefer an engagement route that results in firms changing their long-term strategy to address climate change risks and opportunities. However, that ambition will not succeed with every investment we hold, so divestments might happen over time.

MacRae: Reporting is currently patchy and, in my view, easy to misinterpret. It is also backward looking, so the concept of making decisions based on this reporting does not make sense.

The idea of whether to divest or engage based on reporting is important. As the reporting does not reflect how companies are developing their future strategy, we generally prefer engagement. We want to get to a position where our managers make sensible decisions based on the fundamental comparison of the price and the resilience of our bonds incorporating the ESG considerations.

PI: Alan, most of your DB schemes are on the path to their endgame. Is ESG important if you are going to exit in this decade?

Pickering: ESG is important whether I am in DB land or DC land. When it was called ethical investment or socially responsible investment, I was a sceptic. I am, however, a fan of ESG, provided we give equal weight to each of those initials.

I see a world soon where there will not be ESG investors and non-ESG investors. ESG should be embodied in everything we do. What worries me as a trustee is that I am on the receiving end of a bureaucratic paper chase. From all quarters, I am being asked to comply with this target and that target by a particular date. It is so overwhelming that if we are not careful, ESG will become a box ticking affair rather than a brain box consideration.

PI: Jim, are you seeing rising demand from asset owners to factor ESG into their fixed income portfolios?

Cielinski: We do not have a conversation with a client without ESG coming up. There are different styles and some clients want a different approach. Like active management, this is a sector where there are different ways to do it.

That said, they want to see an impact on portfolios. The greenwashing element has come to the fore and people want to know that you are practising something that will make a difference. Engagement is usually the way to make that happen.

Reporting is currently patchy and, in my view, easy to misinterpret.

Ian MacRae, JaguarLandRover

We can do exclusion lists, positive impact, best-in-class screening, but one of our principles is to choose companies that might be poor at ESG, but if we engage with them and make them better, that is a success. But reporting is backward looking, so it might penalise the client who is trying to do that.

We are at the point where we have integrated ESG into our analysis, but as an industry we need to do a better job of defining what it means, how it can be used and evidence the impact we are having on portfolios.

It is evolving quickly. We are trying to be partners and good strategic thinkers alongside our clients to make this work across their portfolios.

PI: How easy is it to engage with companies as a bondholder?

Cielinski: Surprisingly easy. We are not voting stakeholders in the way that equity holders are, but these companies are frequently accessing debt markets. If they can sell their bond at a quarter of a percentage point lower if they did not have these ESG risks, they start to listen. Aside from that, they know that with the trends that are unfolding they have an obligation to deliver on more than one front.

As a stakeholder on the bonds side, we say we will lend to you at a lower rate if you can do this. They are receptive to hearing that.

PI: How would you describe the quality of ESG reporting?

Hitchman: It is a changing landscape. It is not just about looking backwards. It is a journey in terms of the reporting trustees receive from their advisers and managers to evidence the actions they are taking and the value they are adding.

Fundamentally, if you want to see the importance of ESG look around the world to see what is happening. These are important issues that pose real world risks to all investments, so it is imperative that these are looked at. ESG is one of many risks and it is important to judge this as part of the assessment of a company's credit risk.

Martin: Everyone is on a journey. The infrastructure needs to be put in place to provide the reporting needed. There are issues between loans, private equity sponsors, liquidity and what is available, but just because it is hard does not stop you from doing what you can and then engage to improve it over time. This is a journey. I do not expect perfection today, but we have to start somewhere. It might be the easier bits that we start with, but we have to take that forward.

It is not a question of a 'nice to have'. The world has changed and there are a series of increasing demands on trustees to report on these matters.

Fixed income investors can play an important role in discussions with companies. In respect of equities, you are generally buying 'second hand', you are not providing capital, IPOs aside. For a new issuance or companies which regularly tap the debt market, you

can say as a bond investor that "for me to lend you money you must provide the following criteria or improve your reporting on them". If they cannot produce that reporting, we may not lend them the money or perhaps charge more for it.

In some respects, bond investors can arguably have more influence than equity owners on these aspects.

For pension schemes, which have a lot of their money held in contractual fixed income assets, engagement will become more important. However, transparency will have to improve greatly.

PI: What do you expect to see in the fixed income markets in the coming year?

Cielinski: Rates could rise further, but from these levels they will be contained. That said, I would focus on growth assets, credit risk, mortgage risk, increasingly look at things secured by real assets which should benefit from the recovery. You are still not paid enough for taking a lot of interest rate risk. So, I would favour shorter maturity bonds. Much of the rate rise we expected is probably behind us now. Bond yields are now at fair value, if not a little bit above. They have priced in higher inflation, so a lot of the pain we have seen in the past few months will not persist.

Pickering: Fixed income will be an interesting place for young investment managers to work. In the past it was regarded as a boring, poor relation of the equity market. Now there are so many ways we want to tap the fixed income markets that there is opportunity for creativity to make it a win-win for borrower and lender.

Hitchman: There are some interesting opportunities, but with the fiscal medicines that have been provided in the past 12 months, when things start reverting to the new normal, whatever that looks like, default risk will potentially rise. Whilst there are attractive opportunities, having a good credit manager to mitigate those risks will be key to generating returns from current pricing, which we believe has been inflated by QE. There is a real risk of inflation increasing and the impact that could have over the medium term.

MacRae: Whilst taking opportunities to capture attractive pricing will improve overall returns, ultimately the overall strategy trumps most things. Systematically securing the income we need over time, and measuring liabilities based on this income yield, transforms funding discussions with the sponsor.

Taking advantage of pricing opportunities that arise to capture the quality of income we need, either relative to cash or growth assets values, improves the funding position. But ultimately, you need to have a clear funding and investment strategy to drive funding outcomes. Bond pricing is not a secondary issue by any means, but it may not be the first consideration for the pension scheme investor.

We are in a different environment from 10 or 20 years ago in that the 'easy money' has gone.

Peter Martin, Medical Defence Union

Jim Cielinski
Janus Henderson's global head of fixed income, assesses the rise in bond yields and whether markets are justified in their inflation concerns.

ARE INFLATION JITTERS JUSTIFIED?

The yield on the US 10-year treasury leapt in February and March, accelerating a climb since summer that has seen it rise to 1.7% from 0.6%. US Federal Reserve (Fed) chair Jerome Powell described the move towards higher yields as a statement of confidence in the economy, yet central banks will be keen to avoid a disorderly re-pricing of rates.

Regime change for inflation?

We will likely get an inflation upswing in coming quarters – the question is whether this is temporary or persistent? The year-on-year base effect from 2020 lows should push it sharply higher, then rapidly fade (see Figure 1). Consumption should act similarly, initially surging on pent-up demand. But inflation is a rate of change index and this pent-up demand is arguably a one-off. It is harder to argue this is a precursor to a new regime of structurally higher inflation. Despite fiscal and monetary stimulus, unemployment remains high and the output gap wide; it will take time to reduce both to the point where they threaten inflation.

Moreover, regional Fed underlying inflation measures are trending weaker. This could change, but it reinforces the idea that the Fed has no reason to respond and that inflation would need to move above 2% and stay there to meet their criteria to begin hiking rates under their new average inflation targeting regime.

Are markets too optimistic?

Economists have over-predicted inflation for more than a decade, but this time fiscal and monetary policy are working in tandem. The risk of an inflation 'surprise' is probably greater in the US due to larger fiscal spend, huge treasury supply and a higher potential growth rate compared to other developed economies.

Countering this, the fiscal multiplier may be low because excess savings have mostly been accumulated by the top 20% of income earners, who have a lower marginal propensity to consume. The world's developed economies will also exit this recession with substantially higher debt levels than 12 months ago. In already highly indebted economies, the low marginal productivity of this debt has acted as a gravitational pull downwards on government bond yields. Additionally, Chinese credit growth is rolling over, which may suggest a slowdown into 2022, just as fiscal stimulus elsewhere is being reduced.

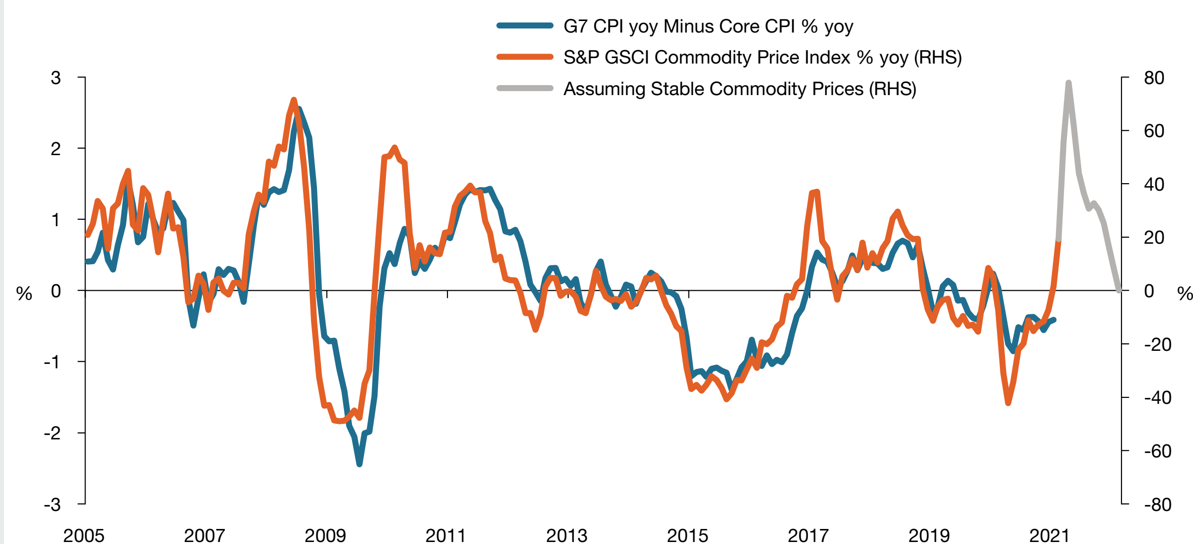
What could spark disorder?

Central banks have tolerated the rise in long-term bond yields as a sign of improving economic sentiment. But when does a rise go

from good news to bad? We believe this has to do with the pace and the cause. Central banks would be concerned if they saw more disorderly markets (like March 2020). While real yields remain negative, the Fed is likely to remain sanguine, but it will not want to see a repeat of the taper tantrum of 2013 when real yields rose sharply.

Higher real rates not only increase costs of debt finance but also affect credit spreads and equity market valuations, which tighten financial conditions. Ultimately, a rise in real yields may end up being self-limiting if it feeds through to a significant correction in risk assets.

Figure 1: Inflation and commodity prices



Source: Bloomberg, Janus Henderson Investors, 1 January 2005 to 1 January 2022, as of 15 March 2021

Janus Henderson
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FIXED INCOME: IT'S NOT ABOUT THE MONEY

Warren Buffett says that fixed income has become bad news, but, as *Andrew Holt* discovers, for institutional investors there is more to bonds than income.

Fixed income is being labelled as the bleak midwinter option for institutional investors. The key culprit in the demonisation of the asset class is legendary US investor Warren Buffett. At the end of February, the chair and chief executive of Berkshire Hathaway warned in his annual letter to shareholders that fixed-income investors worldwide face a bleak future.

The Sage of Omaha noted that the income available from a 10-year US treasury bond at the end of 2020 was 0.93%, 94% lower than the 15.8% yield available back in the heady days of September 1981. "Fixed-income investors worldwide – whether pension funds, insurance companies or retirees – face a bleak future," Buffett said.

Yet asset owners with considerable liabilities, such as pension funds and insurers, value fixed income as an asset class because of the defined returns such assets offer. "This statement [by Buffett] implies an environment of steadily rising rates which will erode the value of existing holdings of bonds," says Mark Hedges, Nationwide Pension Fund's chief investment officer. "So yes, in such an environment values of exiting fixed income holdings decline."

However, Buffet has overlooked the key crux in his analysis, Hedges believes. "Pension fund liabilities also fall as rates rise as they suffer larger discounts," he says. "Fundamentally, for a pension fund, much of the holdings of gilts and linkers are not bought for their investment returns, they are primarily about managing liability risks."

However, Ben Shaw, director at financing platform HNW Lending, believes that other elements of Buffet's assessment are worth exploring. "The Sage of Omaha indeed has a point in that there are real prospects for inflation in the economy and so those investing in long-term fixed debt may well see not only very modest interest income but also a decline in the real value of their capital," he says.

There is no doubt that the spectre of inflation is causing unease and eats into real bond returns. "Inflation would erode fixed income, though holdings of index-linked gilts will remain attractive," Hedges says.

It is in this inflationary impact that Shaw has a warning for fixed income's outlook. "I see more people beginning to realise the implications of the enormous government borrowings and stimulus packages on inflation and therefore in their asset portfolio and taking action.

"Fixed income, therefore, in my opinion, has further adjustment coming over the next year," Shaw adds. Such a scenario presents a potentially complicated and challenging picture for institutional investors.

In March, the Bank of England kept interest rates at a record low of 0.1% and decided not to increase the pace at which it buys government bonds, while showing little concern for inflation. At the same time, the European Central Bank increased its bond-buying program from €500bn (£430bn) to a whopping €1.85trn (£1.59trn), which could see some active managers increase their bond exposure.

Although at some points on the yield curve there is a fundamental problem, with yields below -0.7% out to seven years, according Legal & General Investment Management (LGIM). "That means eurozone investors who hold the bonds to maturity can expect a materially lower return than if they just held cash at current deposit rate levels," says John Roe, LGIM's head of multi-asset funds.

Different landscape

"There is certainly no free lunch anymore," is how Anand Kwatra, life and investment actuary at insurer Phoenix, assesses the situation. "The future investment landscape will be very different from

the past. Investors will need to learn to navigate an era of low returns and elevated volatility."

Chetan Ghosh, chief investment officer of the Centrica Pension Schemes, says that in the current environment bond investing should be seen as a long-term strategy. "Low prevailing bond yields mathematically cap the prospective short to medium-term returns available from fixed income and invariably returns from this asset class will likely be low in that time frame.

"The position for UK pension schemes that are well hedged is a bit more nuanced," Ghosh adds. "The hedging changes the purpose of fixed income assets in the portfolio. Rather than using fixed income to deliver high total return, the investment problem becomes more focused on successful credit spread capture over time. Investors can still seemingly harvest reasonable excess returns from credit spreads at current prices."

On another measure, in a rising interest rate environment fixed-rate bonds become cheaper, and, therefore, may be more attractive assets to hold. "In addition, variable rate bonds in the form of structured credit products are going to benefit from rising rates as their coupons rise," Hedges says.

Hedging risks

Analysing the picture further, as gilt yields/bond prices impact pension schemes on the asset and liability side, what should pension funds keep central to their thinking?

Hedges offers a succinct outline. "Pension funds face four risks that they don't get rewarded for, three of them impact the liabilities: interest rates, inflation and longevity; the fourth is sponsor risk," he says. "So, hedge the risks and then focus on investments to make returns to drive funding towards the long-term objective."

Ghosh adds that investors should understand why they are buying bonds. "It is really important to get clarity of purpose for why fixed income assets are being held," he says. "For example, highly hedged schemes may be happy to harvest spreads from potentially low return fixed income assets under a cashflow driven investment framework and not be unduly worried about rising government bond yields."

Shaw notes there are niche classes within fixed income that still offer value – particularly short-term loans offering high yields. "By short term I mean six months to maybe 18 months and by high yield I mean several times what most traditional fixed income debt is paying.

"There are non-mainstream asset classes out there which can provide good yields and while traditionally these non-mainstream assets – such as P2P loans and private debt – have formed a very small proportion of assets, maybe the time has come to change that balance," he adds.

Income stream

It is therefore an environment in which many subtle factors are at play, so Hedges believes that pension funds should stick to what they know. "Pension funds' primary obligation is the payment of pensions to their beneficiaries. Fixed income will generate an income stream and notwithstanding a change in the bond's value, the cashflow in terms of coupon payments remains unchanged, so changes in the interest environment don't necessary change the cash that a fund is going to receive."

Although Christopher Teschmacher, fund manager at LGIM, says that the traditional view of bonds is being challenged. "The efficacy of bonds as a safe-haven asset class in risk-off periods is now heavily compromised," he says. "Indeed, recent months have shown an increasingly worrying pattern of bond yields rising on days when equities are falling, rather than the other way round. Holding duration in your portfolio hasn't helped when you need it most."

Shaw offers an alternative to fixed income for those concerned about yields. "It's time to look at alternative assets," he says. "But do spread your net widely and don't invest too much in each alternative investment – try to get a basket of investments, and in that basked don't stick to one provider but invest in a variety to reduce your risk profile."

Ghosh urgers caution here. "Alternatives to fixed income come with likely higher risk implications," he says. "Pension funds need to evaluate if the purpose of fixed income is for driving high total returns or spread capture.

"If the ambition is high total return, then other options that allow

For a pension fund, much of the holdings of gilts and linkers aren't bought for their investment returns, they are primarily about managing the liability risks.

Mark Hedges, Nationwide Pension Fund

greater upside opportunity, for example, equity or convertibles, may need to be entertained.

"We hear a lot of talk about credit spreads compressing further and there may need to be a conversation in 12 to 18 months as to whether enough credit spread is now available to be harvested," he adds. "This will be a challenging scenario as there are likely to be few options for decent returns at that point. One option could be to become temporarily defensive, for example, raising a little cash, and wait for the next buying opportunity."

End of an orthodoxy?

The current debate around fixed income leads back to questioning the 60/40 orthodoxy – which, for many funds has held sway for some time. Is 60/40 therefore still relevant?

Shaw knows what should replace the 40% share of portfolios if fixed income is discarded. "Fixed income should potentially be replaced with floating rate or index-linked securities, plus a little more higher yield debt. Plus, probably some swaps to counteract the impact of moving interest rates on the calculation of the liabilities," he says.

Teschmacher is focusing on inflation. "Intriguingly, we now believe that exposure to inflation-linked assets should be reduced or hedged. "In fact, short exposure to inflation may benefit portfolios as a global economic shock would most likely see both equities and inflation falling, so this position could act to offset losses."

Kwatra turns the situation on its head. "Perhaps there will be no such thing as 'orthodox' in this low-return higher risk world," he says. "Every asset owner will re-appraise objectives in this climate and align portfolios towards their individual goals and risk appetites. For example, some may replace some of the fixed income with more equities or alternatives, others will increase the perceived illiquidity of fixed income portfolios."

Although the 60/40 methodology is not a blanket approach to be used in all circumstances, as the founder of modern portfolio theory Harry Markowitz and his successors would no doubt highlight. "The 60/40 orthodoxy is a case-by-case consideration," Ghosh says. "However, the question is more about what level of returns are needed and whether fixed income is being relied upon for high returns."

And adjusting a portfolio is not a clear-cut business. "Any increased allocations to equity or convertibles would likely need to be offset by lower risk elsewhere in the portfolio if risk budgets are to be maintained. This is not straightforward," Ghosh says. "One could also consider greater use of illiquid assets, such as private debt or infrastructure, to reduce reliance on traditional liquid fixed income."

Considering a wider range of assets gets Teschmacher's vote. "Our go-to response to any portfolio challenge is to increase diversification, looking for more and varied return streams from the available investment universe to help smooth portfolio returns," he says. "Where we do continue to hold government bonds, we want to seek higher yields from steeper yield curves, as we believe these yield curves have some propensity to compress if the world faces a new economic downturn. Examples could include Australian and Chinese bond markets."

For Hedges, it all comes down to the specifics of the fund. "It will vary from fund to fund," he says. "As rates rise fixed income may become more attractive; many fund managers may have been short duration so they can capture this relatively painlessly. In addition, we have seen pension funds embrace private credit and debt funds as an alternative means of generating cashflow and higher returns.

"Open pension funds are also likely to look to other forms of cashflow investments and invest in core infrastructure and operational renewable energy activity as a way of enhancing and diversifying their cashflow generation."

Risk appetite

The central point, and one that is difficult to escape, is that fixed income assets perform an important function for institutional investors, underpinning many portfolios. "Pension funds still need investments which deliver predictable cashflows to meet liabilities," Kwatra says. "To avoid chasing excessive risk in this low return world there needs to be a clear risk appetite framework to decide how much investment risk can be tolerated and where is it most efficient to take this," he adds. "A range of strategies across public and private investments is required."

And pension fund allocation is very much a mix of liability matching assets and return seeking assets. "Fixed income straddles both portfolios," Hedges says, "but the rationale for holding them in the matching assets portfolio is risk management not investment return."

The needs of pension funds differ, depending whether they are closed, open, how well funded they are and where they are in their lifecycle. "So, the need for fixed income will be different for each scheme," Hedges says. "But there will always be a need for cashflow – and fixed income will play a role in this."

As pension funds are long-term investors, liabilities are long dated and they are only going to materialise slowly. "So, pension funds don't panic, they are not hedge funds or day traders they invest for the long term," Hedges says.

"Strategic asset allocations are long term, and while funds may take advantage of tactical market opportunities ultimately taking such activity is incremental to overall return which is predicated on a long-term investment view," Hedges adds.

Therefore, on the future fixed income outlook within pensions portfolios, Hedges indicates it is a simple case of not being taken in by the current Buffett driven headlines. "There will still be a role for fixed income: pension funds need to hedge their risks and need to generate cashflow to meet pension liabilities."

Editor: Mark Dunne
Acting deputy editor: Andrew Holt

Publisher: John Waterson
Head of sales: Clarissa Huber
Head of roundtables: Mary Brocklebank
Marketing manager: Tabitha Tebbatt
Sales and marketing executive: Silvia Silvestri

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Clarissa Huber
+44 (0) 7557 911 233
c.huber@portfolio-institutional.co.uk

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