XPS Investment

XPS Liquid Credit:
Part 1 of 3

Looking beyond sterling investment grade credit

The case for **non-sterling corporate bonds**

July 2023

Contents

Overview

The landscape for UK Defined Benefit (DB) pension scheme investment has changed dramatically since the beginning of 2022, in light of improved funding levels for schemes and a renewed focus on risk and liquidity management.

This is expected to further increase the role credit assets play within UK DB pension scheme portfolios and the importance of having a well-built credit allocation. It will become increasingly important that trustees consider the full range of credit assets available to complement a core allocation to sterling denominated investment grade corporate bonds ('sterling bonds').

In this three-part series, we explore the investment case for the lesser-utilised liquid credit assets that we expect to play an increasing role going forwards.

In the first paper of this series, Steven Hickey, Head of Credit Research at XPS Investment, explores the use of non-sterling investment grade corporate bonds ('non-sterling bonds'), within a scheme's credit allocation.

In brief:

1	**More money invested in bonds –** It's widely anticipated that pension scheme allocations to liquid credit assets will increase at an accelerated pace from this point due to three important factors that have changed the landscape for UK DB schemes, namely, funding level improvements, regulatory pressure to de-risk and greater focus on liquidity.
2	**Greater risk from sterling bond market –** As bond assets account for more of a scheme's portfolio, it will become increasingly important to have a credit portfolio that utilises a broader range of liquid credit assets. Including non-sterling bonds directly alongside sterling bonds adds an increased opportunity set, improving diversification (particularly at longer maturities) and liquidity in stressed environments.
3	**Appropriate currency hedging is very important –** Non-sterling bonds introduce undesirable currency and overseas interest rate risk which can introduce material risks. Fortunately these risks can be be neutralised through appropriate hedging, so it is important that the fund selected incorporates suitable hedging.
4	**Overseas bonds are easily accessible –** Non-sterling bonds can be easily accessed by UK DB investors, large and small, via either pooled funds or segregated arrangements.

Non-sterling bonds have a key role as part of a scheme's corporate bond allocation. There are numerous benefits, particularly around diversification and access to a deeper opportunity set.

Steven Hickey
Head of Credit Research

Increased allocations to liquid credit

We've seen a persistent increase in the allocations made to liquid credit assets by UK DB pension schemes and we expect these allocations to increase at an accelerated pace from this point due to three key tailwinds.

3 key tailwinds leading to high bond allocations:

1	**Widespread funding increases** seen since the beginning of 2022 due to gilt yield rises are expected to further accelerate the trend of pension scheme de-risking with schemes moving from equity-like growth assets towards contractual credit assets.
2	**The direction of regulatory travel**, particularly the Pension Regulator's draft funding code, is expected to place stricter requirements on how much risk and return pension schemes can take and generally support de-risking.
3	**Increased need for liquidity** to support LDI mandates following the gilts crisis last year.

Sterling bonds have historically formed the basis of scheme credit portfolios due to their ability to match cashflows of sterling liabilities without currency hedging or other exposure to overseas interest rate risks.

However, adding a wider range of assets to portfolios will increase the opportunity set and resilience of a scheme's credit portfolio to help schemes meet their objectives. These could include include non-sterling investment grade corporate bonds, high yield bonds, securitised credit and emerging market debt. Their introduction also helps schemes avoid several shortcomings that are introduced by solely relying on sterling bonds.

This is particularly relevant as schemes get closer to their end-game targets, whether that be buy-out or running the scheme off. Mature schemes requiring a 'low-dependency' portfolio are expected to require 90% cashflow matching of liabilities under the latest draft of the new funding code.

Non-sterling corporate bonds can complement a core holding of sterling corporate bonds as UK DB pension schemes de-risk and move towards their end-game targets.

What are non-sterling investment grade corporate bonds?

These assets are debt-securities issued in non-GBP currencies by large corporations domiciled anywhere in the developed world, to raise money to finance their operations. For example, this could be a company headquartered in the US, which raises finance by issuing bonds in US dollars, or a company headquartered in Japan, which raises finance by issuing bonds in US dollars to help fund its US-based operations.

The role of non-sterling corporate bonds

In this paper we are focusing on the investment grade part of the corporate bond market, which are bonds that have a credit rating of BBB or above, reflecting the fact they're judged to be the highest quality assets. We're also only considering bonds denominated in developed market currencies; most typically US dollars and/or Euros, but may also include a range of other currencies including Japanese Yen, Swiss Franc and Canadian Dollars.

Key features of non-sterling corporate bonds

Risk/return (over gilts)	0	**1**	2	3	4	5
Level of GBP interest rate sensitivity	**NONE**	LOW	MEDIUM	HIGH		
Liquidity	LOW	**MEDIUM**	HIGH	VERY HIGH		
Size of investment universe	SMALL	MEDIUM	LARGE	**VERY LARGE**		
Requirement to hedge currency and interest rates to GBP	**HEDGE CURRENCY RISK**	**HEDGE OVERSEAS INTEREST RATE RISK**				
Fund management fees	**LOW**	MEDIUM	HIGH	VERY HIGH		
Level of manager skill required	LOW	**MEDIUM**	HIGH	VERY HIGH		
Trading costs	LOW	**MEDIUM**	HIGH	VERY HIGH		
Scope to incorporate ESG considerations and invest sustainably	LOW	MEDIUM	HIGH	**VERY HIGH**		

7 benefits and considerations of adding these assets to your portfolio

Non-sterling bonds can have a key role in pension scheme portfolios due to their underlying characteristics.

1. **Yield and cashflow:** As with sterling corporate bonds, these bonds will typically pay out regular fixed interest payments over their life and return the principal payment on maturity. The predictable nature of these payments means the income can be used to help pay towards ongoing scheme cashflow requirements.

2. **Currency risk:** Non-sterling bonds provide unhelpful exposure to overseas currency risk and non-sterling interest rate risk (duration), given that their payments are not made in sterling. As such, hedging these risks is particularly important.

   Swaps can be used by a manager for this purpose to remove the overseas interest rate duration exposure, and forward derivatives for currency hedging. Another option is cross currency swaps, which hedges both.

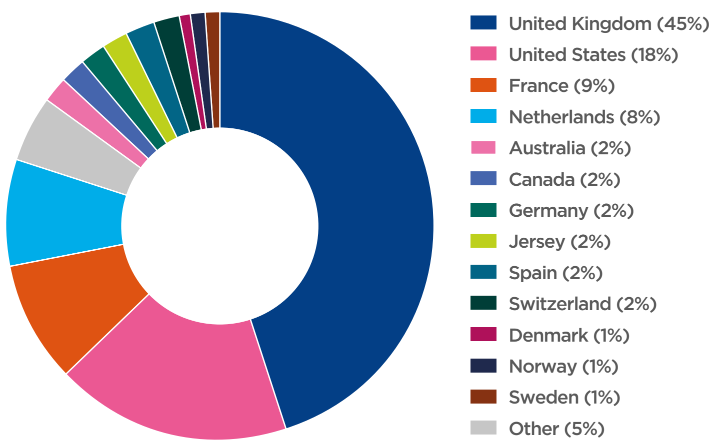
   Although this hedging can be completed in a cost-effective way, it does introduce some complexity and additional considerations for the manager because they will need to coordinate several trades at one time when making buying and selling decisions. Hedging also often introduces a slight return pickup or loss of return which is known as 'cross currency basis'. This needs to be factored into a manager's decision of whether to buy a bond.

3. **Contribution to liability hedging:** As a result of the need to hedge out the overseas interest rate risk, non-sterling bonds will not contribute directly to a scheme's LDI hedging. This is not an issue, however, as these contractual holdings can be combined with an LDI portfolio to get an accurate match at an overall portfolio level.

4. **Increased diversification and opportunity set:** This is the key benefit of using non-sterling assets alongside their sterling-denominated counterparts.

   Whilst the universe of sterling bonds is generally well-diversified by country of origin, this diversification becomes compromised for longer dated bond portfolios. The chart below displays a breakdown of the sterling investment grade bond universe by country of domicile.

Chart 1: Country Split of Sterling Corporate Bond Universe



Source: Refinitiv, iBoxx £ Overall

As shown below, whilst the number of sterling-denominated bonds issued at short-to-medium maturities (typically defined as 1-10 years) are plentiful, supply thins out at longer maturities and is very concentrated across a few sectors, particularly housing associations and utilities. Table 1 below displays the number of bonds denominated in sterling, euro and US dollar at each maturity, respectively.

Table 1: Number of investment grade corporate bonds at different maturities for different currencies

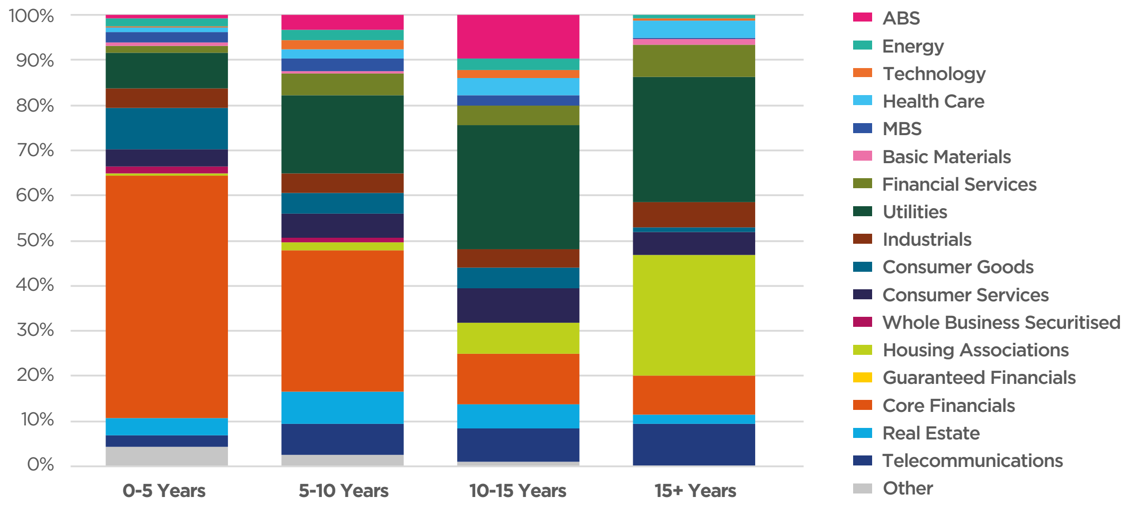
	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040	2041	2042
GBP	54	87	106	64	56	61	30	42	28	36	17	22	23	12	14	14	11	10	16
EUR	261	359	384	355	281	213	182	143	140	91	55	28	18	12	13	18	16	10	11
USD	396	511	441	366	256	146	169	133	132	72	14	27	28	30	28	22	28	39	44

	2043	2044	2045	2046	2047	2048	2049	2050	2051	2052	2053	2054	2055	2056	2057	2058	2059	2060	2060+
GBP	14	4	4	2	6	9	7	10	4	5	3	3	4	2	3	2	2	2	7
EUR	10	3	5	3	8	4	12	8	5	4	2	0	1	4	3	1	1	1	6
USD	24	24	36	28	23	36	30	36	29	37	15	2	4	5	1	2	2	7	21

	Total number of bonds
GBP	796
EUR	2,671
USD	3,244

Source: Insight Investment

Chart 2: Sector Split of GBP Bond Universe at Different Maturities



Source: Refinitiv, iBoxx £ Overall

We also observe that the overall size of the sterling corporate bond market is approximately 1/6th of the size of the euro bond market, and 1/22th of the size of the US dollar market.

Bond denomination	Market size as at 28 June 2023
GBP	£358bn
EUR	£2,317bn
USD	£7,813bn

Source: JP Morgan

The inclusion of non-sterling bonds within a portfolio significantly increases the opportunity set and number of bonds available for investment at different bond maturities, in terms of access to different companies, sectors and economies.

The importance of investing overseas increases as the size of the allocation grows and the portfolio focuses towards longer maturity assets.

5 **Reduced issuance of long dated sterling bonds:** Over the last decade the sterling bond market has seen issuance reduce at longer maturities above 15 years. If this persists it will compound matters with a shortage of desirable assets to meet demand from UK DB schemes, as they de-risk and utilise bond-based low dependency strategies, and insurers.

These dynamics, if they continue, could push prices up and put downward pressure on the credit spreads available on sterling bonds leading to a mispricing. It's important to avoid paying over the odds, and the introduction of a deeper opportunity set will enable pension schemes to manage this as market conditions change.

6 **Liquidity and suitability as collateral to support LDI:** The addition of non-sterling bonds can improve the overall liquidity profile as they offer access to an additional large market of buyers in the event a scheme needs to sell their bonds.

A good example of where this helped in practice was during the gilts crisis last year. This was a UK specific stress event, and the effects were largely felt within UK focussed markets, including elevated trading costs. Schemes that had access to wider global markets were generally able to liquidate global holdings more quickly and at a lower cost.

Non-sterling bonds represent a viable source of collateral if needed, and therefore create more flexibility for different market environments. That said, we wouldn't typically suggest they are in the first tier of a scheme's collateral waterfall given the potential complexity with currency hedging.

7 **Role in the run up to buyout:** For schemes looking to target buy-out, non-sterling bonds can play a medium to longer term role on the basis of the desirable features set out above. That said, non-sterling bonds are unlikely to feature in a price-lock offered by an insurer in the run up to a transaction and will in all likelihood need to be sold prior to the transaction completing. Therefore this does not represent a sensible short term investment for schemes within 1-2 years of transacting.

How to access these assets

Our preference is for schemes that access these assets to do so through a pooled fund or segregated mandate dedicated specifically to investing in developed market investment grade corporate bonds.

Buy and Maintain works particularly well given they are not typically managed to a sterling bond index. This allows them to invest in a wider, ‘off-benchmark’, opportunity set, including in non-sterling bonds. Buy and Maintain funds also typically hedge currency risk and overseas interest rate exposure of the bonds back to sterling.

There aren’t currently global benchmarks available where non-sterling interest rate exposure is hedged back to sterling. As a result, passive or active funds that invest with reference to a specific benchmark index typically avoid utilising non-sterling bonds. Those that do, such as aggregate fixed income mandates which invest in global bonds, will typically have substantial exposure to overseas interest rates, which isn’t desirable.

Non-sterling corporate bonds can also be accessed by multi sector credit funds. These funds will typically be higher risk than a typical investment grade corporate bond fund, given they will invest in other liquid credit assets in an unconstrained manner.

Fund management fees

The management fee of the fund will depend on the approach taken. A buy and maintain investment grade corporate bond fund can be accessed relatively cheaply with costs of between 0.05% and 0.20% depending on mandate size. Multi sector credit funds will be more expensive at between 0.15%-0.60%, as will active corporate bond funds (0.15%-0.40%) but a range of competitive options are available to suit different requirements.

Conclusion

We believe non-sterling bonds should be considered for a key role as part of a scheme’s overall investment grade corporate bond allocation. There are numerous benefits to doing so, particularly around diversification and access to a deeper opportunity set.

The longer the maturity of a scheme’s corporate bond allocation and the greater the allocation as a proportion of your overall assets, the more important it is to consider diversifying into non-sterling corporate bonds.

Low dependency portfolios meet both these criteria, and even small schemes can access non-sterling bonds, so the case for utilising them is strong.

Key actions for defined benefit trustees

1	**Understand the extent to which non-sterling bonds are used within any investment grade corporate bond allocation your scheme has.**
2	**Assess the size of your current corporate bond allocation and the extent to which you may be negatively affected by concentrations of risk within those assets.**
3	**Consider the scope for using non-sterling bonds and how they can complement your current credit allocation and strategy as a whole.**

XPS Liquid Credit Series

Part 2 Our second paper in this three part series will look at the benefits of considering **asset-backed securities** within a low dependency portfolio.

Part 3 Our third paper in the series will look at **emerging market debt and high yield**.

How can we help?

If you'd like to find out more about non-sterling corporate bonds and the role they might play within your scheme's investment strategy, please get in touch with Steven Hickey or your usual XPS contact.

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