XPS Investment

XPS Liquid Credit:
Part 3 of 3

Looking beyond sterling investment grade credit

The case for **emerging market debt and high yield**

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Overview

UK Defined Benefit (DB) pension scheme allocations to liquid credit are expected to increase at an accelerated pace in light of significant funding level improvements and a more stringent focus on liquidity and risk management.

This will increase the role these 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 investment grade corporate bonds within a low dependency portfolio.

In the third and final paper of this three-part series looking at the investment case for the lesser-utilised liquid credit assets, Steven Hickey, Head of Credit Research at XPS, explores the role of emerging market debt (EMD) and high yield corporate bonds (HY) within a pension scheme's portfolio.

Part 1	**Our first paper discussed the use of non-sterling investment grade corporate bonds, to read this paper click here**	Part 2	**Our second paper discussed the use of asset backed securities, to read this paper click here**

In brief:

Emerging market debt

1	**Return pick-up** – Investing a portion of your developed market corporate bonds into investment grade EMD will lead to an increase in expected return while broadly keeping the credit quality of the overall allocation the same.
2	**The EMD universe is very diverse** – Different segments of the EMD market have very different characteristics and appropriate acknowledgment of these before implementation is important to ensure suitability.
3	**The choice of which currency to invest in is important** – Local currency EMD is unlikely to be suitable for a low-dependency portfolio due to currency hedging being prohibitively expensive. Focus instead should be on the hard currency parts of the market.

High yield corporate bonds

1	**Return pick-up** – An allocation to high yield will enhance the expected return of your liquid credit allocation.
2	**Global exposure is important** – The majority of the market is denominated in US dollars and therefore global investment is required to ensure appropriate diversification.
3	**High yield is more volatile** – High yield spreads are more volatile and the underlying assets tend to have a wider dispersion of return than their investment grade counterparts.

What is Emerging Market Debt (EMD)?

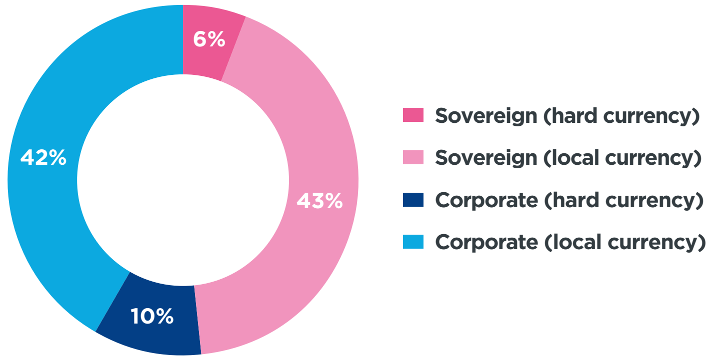
EMD is debt issued by an emerging market government or a corporate domiciled in an emerging market country. The debt is denominated in either a 'hard' currency, which refers to a developed market currency, often US dollars, or the 'local' currency of the issuer. Like their developed market counterparts, the bonds issued will be given a credit rating, with bonds rated AAA to BBB deemed investment grade, and bonds with a rating of BB or below considered high yield. The table below shows the widely used classification split for debt within the EMD universe:

Category	Estimated market size (total debt stock)	Description	Key characteristics
Sovereign (hard currency)	$1.5trn	Debt issued by an EM government/treasury. Mainly denominated in US dollars but can be denominated in any major currency.	Highly liquid and can be less volatile where currency exposure is hedged. Mainly driven by the macro top-down dynamics of the country issuer.
Sovereign (local currency)	$11.1trn	Debt issued by an EM government/treasury bonds, where bonds are denominated in the local currency of the issuer.	High volatility due to need to take currency and overseas interest rate exposure, due to currency hedging being prohibitively expensive. Typically used for return enhancement and to access FX and rate opportunities.
Corporate (hard currency)	$2.5trn	Debt issued by companies domiciled in an EM country. Debt is denominated in a major currency like the US Dollar.	Less liquid than sovereign but still relatively liquid. Undesirable risks can be managed appropriately. Typically used for diversification and return enhancement. Behaves in the same way as developed market corporates.
Corporate (local currency)	$10.7trn	Debt issued by companies domiciled in an EM country in their local currency.	Large market but not generally accessible to international investors. Due to its inaccessibility, this type of EMD is not covered further in this paper.
Total	**$25.7trn**		

Source: Ashmore, as at 31 December 2022. Includes all debt stock. Assets that are eligible for inclusion in the mainstream JP Morgan indices at the same date totalled $8trn. This lower figure primarily reflects ineligible assets in the local currency markets, in particular corporate local currency.

Establishing the size of the EM debt universe is challenging and estimates can differ significantly depending on the data provider used. One of the key challenges is defining the size of the local currency corporate bond market, given many areas of it are highly illiquid and inaccessible to foreign investors. This is also the main reason why the size of the market as measured by total debt issued is significantly larger than the debt reflected when considering popular EM debt indices. These indices set certain eligibility criteria that a bond must meet for inclusion to ensure it is tradeable and accessible, thereby giving a better indication of the tradeable EM debt universe, which is estimated to sit around $8trn in size.

Chart 1: Breakdown of EMD universe by sector



Source: JP Morgan CIB (total debt issued). Data as at 31 December 2022.

The role of EMD

Our focus in this paper is on the hard currency investment grade sovereign and corporate parts of the EMD universe. The underlying characteristics of these assets mean that they can complement a core allocation to developed market corporate bonds to help a DB pension scheme achieve its objectives, both in terms of return enhancement and risk diversification.

Local currency EMD can play a role in a UK pension scheme strategy, however the scope to make a meaningful allocation is heavily compromised by the associated currency risk. Within a low dependency portfolio, seeking certainty of cashflow, any currency risk can materially undermine the security of the portfolio. Unlike developed market currencies which can be hedged with relative ease, most emerging market currencies are extremely expensive to hedge. By removing the currency risk the residual return earned by the investor is often eroded to a point of being uneconomical. Therefore, in this paper we focus on the applications of hard currency EMD within a low dependency strategy.

Key features of EMD

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 responsibly	LOW	**MEDIUM**	HIGH	VERY HIGH		

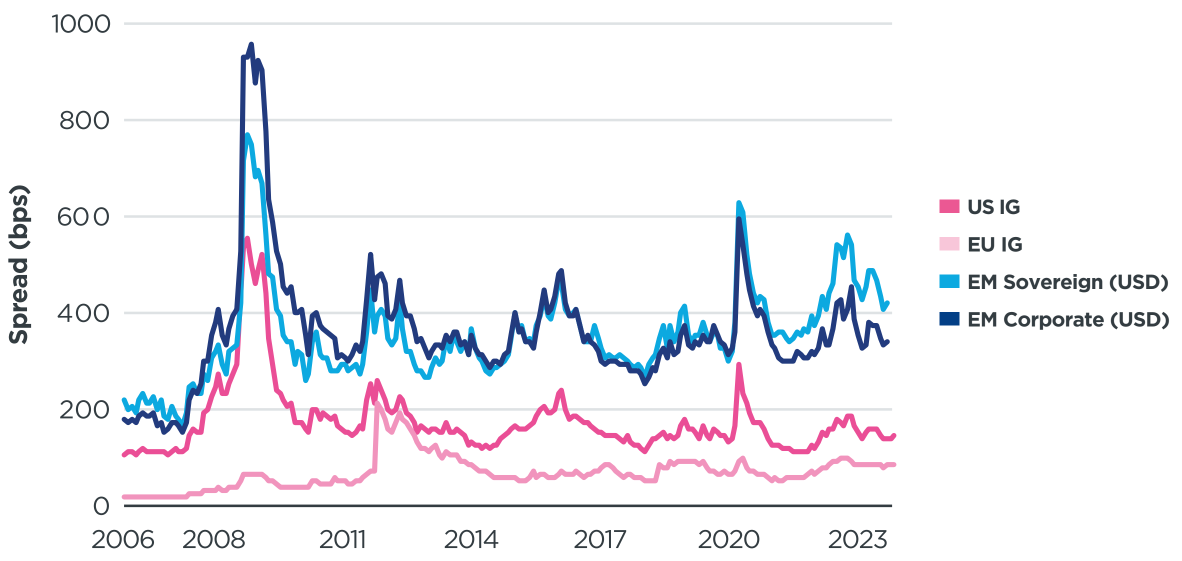
Local currency EMD can play a role in a UK pension scheme's strategy, however the scope to make a meaningful allocation is heavily compromised by the associated currency risk. We therefore focus in this paper on hard currency EMD.

EMD — 8 benefits and considerations of adding EMD to your portfolio

1 **Regular cashflow:** As with their developed market counterparts, these bonds pay out fixed interest coupons at regular intervals over their life and return the principal payment on maturity. This income can be used to help fund ongoing scheme cashflow requirements.

2 **Spread premium and default risk:** Both corporate and sovereign investment grade EMD have historically provided a spread premium over investment grade developed market corporate bonds, reflecting the additional incentive that investors require to go to the additional effort of investing outside of the mainstream developed markets.

Chart 2: EM spreads versus investment grade

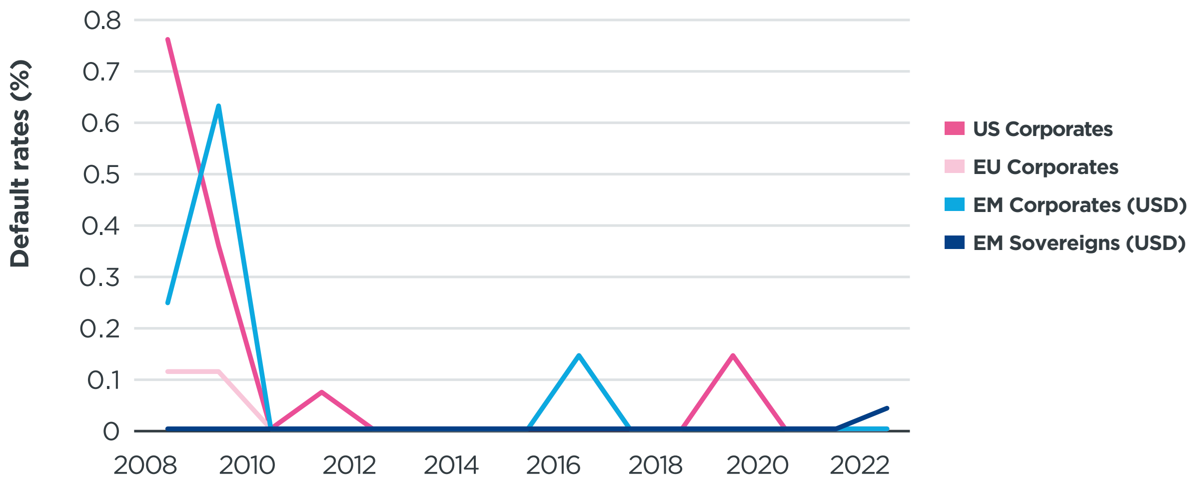


Source: JP Morgan Asset Management as at 31 October 2023

This spread premium is generally not considered compensation for greater credit risk as the risk is reflected in the credit rating. This is supported by the observation that there has not been a material difference in downgrade and default risk between EM and developed market bonds historically, as shown in the figure on the next page.

Recovery rates, which is the amount recovered in the event of a default, have been slightly lower for EMD historically and have also differed materially between EM regions. Protections for creditors in most EM countries lag those in developed market countries, but this is accounted for as part of the credit rating given to the issuer.

Chart 3: Investment Grade default rates

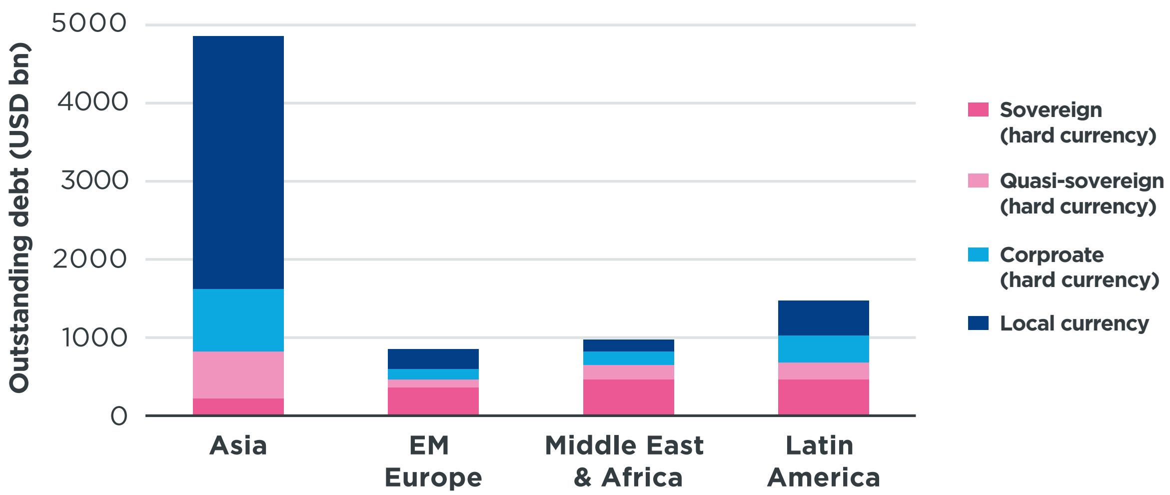


Source: JP Morgan Asset Management, 31 December 2022

3 **Price volatility:** Sovereign and corporate EMD have tended to display similar price volatility as developed market corporate bonds (allowing for duration) in normal market environments. The exception to this is when markets sell off; in these environments EMD asset prices tends to be more reactive.

4 **Diversification:** The EMD universe has grown and matured significantly, more than doubling in size since 2012. This has coincided with emerging and developing economies taking an increasing share of global GDP, now accounting for close to 60% today, on a purchasing power parity basis, compared to under 40% in 1980. As such, accessing EMD significantly increases the investable universe for investors, given the size of the universe. This enables exposure to different countries, sectors and issuers and the unique set of risks and political and economic dynamics they are facing.

Chart 4: Emerging markets — Outstanding debt by region



Source: JP Morgan Asset Management, 31 December 2022
The data within the chart reflects the split and classifications as per the 'Broad' JP Morgan EM indices.

5 **Currency and interest rate risk:** Sovereign and corporate EMD is denominated in a hard currency, typically US dollars, which is undesirable for a low dependency portfolio but can be hedged back to sterling. This can be easily completed in a cost-effective manner by the manager of the strategy using currency forwards.

An EMD allocation will also be sensitive to interest rate movements of the currency they are denominated in. The duration of the corporate segments of the market is 4.2 years and sovereign segments longer at 6.9 years. This interest rate risk will typically lead to US dollar interest rate exposure.

This exposure can be hedged using interest rate swaps or cross currency swaps (which hedge both interest rates and currency risk at the same time).

6 **Contribution to liability hedging:** Pooled EMD funds won't typically hedge this US interest rate exposure back to sterling. This doesn't necessarily cause an issue for a scheme's LDI hedge given EMD duration is relatively low and an EMD allocation is unlikely to be material as a proportion of a scheme's total portfolio, meaning any duration impact will be small. Interest rate risk is less of an issue than currency risk but does introduce some mismatch which needs to be borne in mind.

7 **Liquidity and suitability as LDI liquidity buffer:** Investment grade EMD is generally a liquid asset class with broadly comparable liquidity to that of developed market corporate bonds in normal market conditions. Transaction costs have also improved as the market's matured.

The asset class has large diversity of investor type and location, and is exposed to different liquidity dynamics, which can protect investors in an event which prompts mass liquidation by a certain type of investor, helping diversify a scheme's overall liquidity profile.

Its liquidity means EMD can form part of a scheme's collateral waterfall. However, it shouldn't necessarily be the first port of call given its liquidity can be stretched in stressed market conditions and the complication with currency and interest rate hedging. EMD asset values are also likely to be volatile at such a time, so not being a forced seller is beneficial.

8 **ESG:** The fast-paced growth of EM countries and their reliance on cheap sources of energy means they often emit high levels of carbon dioxide. Social and governance, and other environmental issues, can pose material financial risks, such as employee welfare and working practices. This increases the importance of having a robust ESG integration when investing into the asset class.

It also offers investors a valuable opportunity to make an impact and help finance ESG development and the transition to a low-carbon global economy. By investing in the market there is a scope to engage directly with companies; investors tend to get the same level of transparency and access to management as they would in a developed market company.

Accessing EMD significantly increases the investable universe for investors. It enables exposure to different countries, sectors, issuers and the unique set of risks and political and economic dynamics they are facing.

What are high yield corporate bonds?

These bonds, otherwise known as junk or speculative grade corporate bonds, have a credit rating of BB or lower. They are available in developed and emerging markets however in this paper we are focusing on developed market high yield bonds.

The lower credit rating reflects that the bonds are at greater risk of defaulting on their repayments. Credit ratings aren't static, however, and bonds may be upgraded or downgraded over time, including to an investment grade rating should the fundamentals of the underlying company improve to meet requirements.

High yield bonds can play a role in providing additional return over and above investment grade bond asset, with a more predictable return than equity investment. Their role in a low dependency portfolio can be either helping deliver the final push to achieve the long-term target, or as a moderate longer-term allocation to enhance the general return of the strategy.

Key features of high yield

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				
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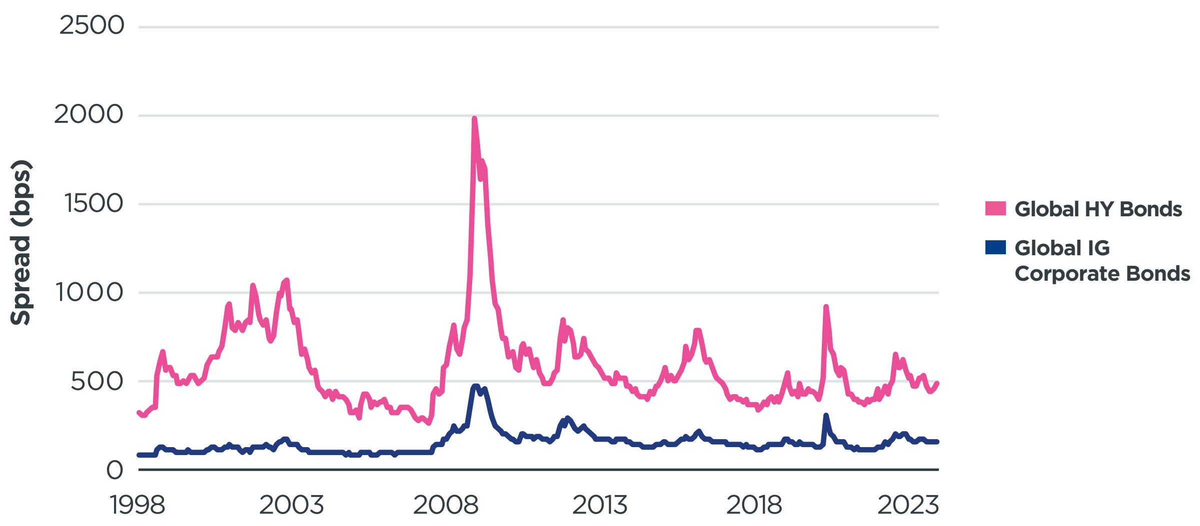
Level of manager skill required	LOW	MEDIUM	**HIGH**	VERY HIGH		
Trading costs	LOW	**MEDIUM**	HIGH	VERY HIGH		
Scope to incorporate ESG considerations and invest responsibly	LOW	**MEDIUM**	HIGH	VERY HIGH		

High yield — 5 benefits and considerations of adding high yield to your portfolio

1 **Yield and spread:** High yield investors expect to earn higher overall compensation relative to investment grade bonds through increased coupon payments and buying at a discount to reflect the increased risk of default. Payments are typically fixed and can help towards a scheme's cashflow requirements. Some bonds will be callable meaning they can be redeemed by the issuer prior to the bond's maturity date, which can meaningfully bring forward the payment ahead of schedule.

Chart 5: High yield versus investment grade credit spreads



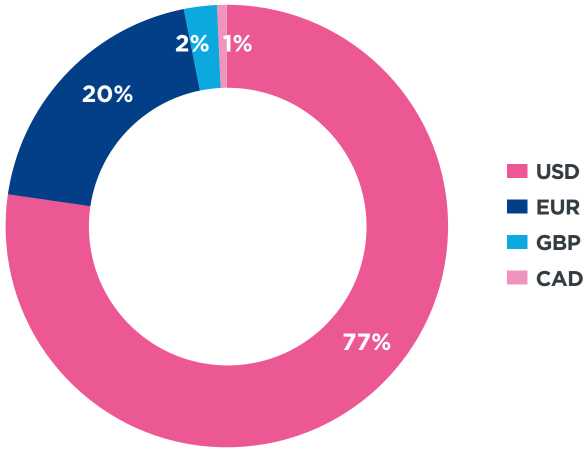
Source: Barings, ICE BofA Global High Yield Index (HW00) and ICE BofA Global Corporate Index (G0BC), effective 31 October 2023

2 **Diversification:** The high yield market is sizeable in its own right, although it has shrunk recently, now sitting around $2.2 trillion, and is composed of bonds of different denominations, issued by companies based across geographies and industries. The market is exposed to certain industries that are relatively less represented in the investment grade part of the market, such as energy.

That said, spread movements for high yield tend to be highly correlated to investment grade, although high yield spreads are more volatile and the underlying assets tend to have a wider dispersion of return.

3 **Currency and interest rate risk:** The majority of the market is denominated in US dollars and therefore global investment is desirable to ensure appropriate diversification. This means investors will obtain exposure to non-sterling currency risk and this should be hedged appropriately.

Chart 6: Split of high yield market by currency



Source: Barings Asset Management, 31 October 2023

High yield investors tend not to hedge the overseas interest rate risk from the bonds. Duration is typically less than 5 years (at 31 October 2023 it was around 4 years) and being callable potentially shortens the duration further. With high yield being at the higher end of the risk spectrum, less certainty around cashflow means these assets won't typically be accounted for as part of a scheme's LDI hedge.

4 **Liquidity and use as LDI collateral:** Given the size of the market, high yield is generally not as liquid as the investment grade corporate bond universe. That said, daily liquidity is typically available in normal market conditions and trading costs are reasonable. These assets can therefore sit within a scheme's collateral waterfall structure and be used to raise liquidity if required. However, they shouldn't be relied upon as a first port of call given liquidity can dry up and trading costs can blow out in times of market stress. In normal market conditions the bid/offer spread would be 0.5-1pt, but in stressed market conditions this can widen to 1-3pts in European/US markets.

5 **ESG:** Barriers around a lack of data availability have improved significantly over the last few years and managers now have good information coverage of the universe of assets, particularly across public credit markets.

With asset classes such as high yield it is particularly important that managers focus not only on ESG screening and exclusion but also on engagement with underlying issuers. Compared to investment grade credit, high yield markets have a higher weighting towards sectors such as energy, which could be automatically screened out due to their ESG practices, but which can still form an important part of a diversified portfolio and are crucial for the global transition to a low carbon economy. Selecting a manager with well-integrated ESG practices, which also include strong stewardship, is important for high yield.

How to access these assets

Both EMD and high yield bonds can be successfully accessed on a standalone basis or through a multi sector credit fund using either a pooled fund or segregated arrangement.

The choice of which implementation route will often depend on the size of the allocation and the governance requirements and constraints of a scheme.

Funds are typically offered on an active basis with some employing a passive index tracking approach. A key consideration when choosing which is most applicable will be how the allocation to each different element is managed and the extent to which undesirable risks are appropriately hedged.

Actively managed multi sector credit funds are a popular approach given the breadth of exposure that is obtained through investment in a single fund; they obtain exposure to both asset types (alongside other liquid credit assets). An alternative, lower governance, approach can involve a single-manager CDI approach set up with an LDI managers that also run EMD and high yield bond funds alongside other liquid credit investments.

We also observe that some buy and maintain investment grade corporate bonds funds, which have a core exposure to developed market investment grade bonds, may also have a small satellite exposure to EMD. Most buy and maintain funds will have an allowance to hold high yield bonds (typically maximum 10%) but this is commonly to ensure they aren't forced sellers when a bond is downgraded from investment grade to high yield, rather than to purchase high yield at the outset.

Fund management fees

Fees on these funds can vary, particularly depending on a range of factors, but we typically see a range of between 0.35-0.50% for standalone active funds. Multi sector credit funds can be typically accessed at reasonable cost between 0.15%-0.60%.

Conclusion

Both high yield bonds and emerging market debt are often underutilised assets which can complement a scheme's core allocation to investment grade corporate bonds.

Investment grade hard currency EMD has a role alongside a core holding of investment grade corporate bonds to deliver a return pick-up along with diversification benefits away from the concentration of the sterling market.

High yield bonds can be used where overall return requirements exceed what can be delivered by investment grade assets alone. They can either be used as a medium-term return boost, to propel a scheme towards its long term target, or can be used as a long-term holding to deliver a persistent enhancement to longer term target returns.

Neither of these asset types are likely to feature in a price-lock offered by an insurer in the run up to a transaction and will need to be sold prior to a transaction completing, meaning their role for schemes approaching buy-out is relatively modest.

Key actions for defined benefit trustees

1. **Understand the extent to which EMD and HY feature within the liquid credit funds currently used within your strategy.**
2. **Consider the scope for using EMD and high yield and the role they could play in helping to meet your scheme specific requirements and long term objectives.**
3. **Understand the governance-related considerations related to any decision to invest.**

XPS Liquid Credit Series wrap-up

As UK DB schemes de-risk and move towards their end-game targets, the role of liquid credit, particularly sterling bonds, will become more central as part of a scheme's investment strategy. We've highlighted throughout this series that certain concentration risks and other limitations can present themselves, particularly if solely using sterling bonds.

As a result, ensuring that your liquid credit allocation is fit for purpose requires a proper understanding of these risks and when they present themselves. It also requires an examination of whether other liquid credit assets, particularly non-sterling bonds, ABS, EMD and high yield, could be used to improve the make-up of the allocation to ultimately improve the certainty of achieving your end-game targets.

How can we help?

If you'd like to find out more about any of the assets explored within this series 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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