The case for pension funds to consider buy and maintain

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Why should pension funds consider a buy and maintain strategy?

Lionel When we talk to pension funds, our conversation often focuses on how the credit market has changed following the global financial crisis. Late last year, Mark Carney, Governor of the Bank of England pointed out that "Fundamentally, liquidity has become more scarce in secondary fixed income markets … the time to liquidate a given position is now seven times as long as in 2008, reflecting much smaller trade sizes in fixed income markets". Not only do these conditions impact the time to trade, but also increase the cost of trading. Our own analysis suggests that an actively managed investment grade credit strategy with turnover of about 75% per annum will experience transaction costs of 0.40% while a passively managed strategy with about 20% annual turnover will incur transaction costs of 0.10%.

Faced with these statistics, pension funds are starting to look beyond the familiar active and passive investment grade credit strategies. Some are expanding into higher yielding areas of the credit market to be compensated for the extra cost, while others look to mitigate the impact of higher transaction costs by limiting turnover. A buy and maintain approach which experiences no turnover outside of reinvestment, can be expected to incur transaction costs of 0.05% in a year. We believe that in a low yield environment like the one in which we find ourselves in today, pension funds are attracted to this kind of approach.

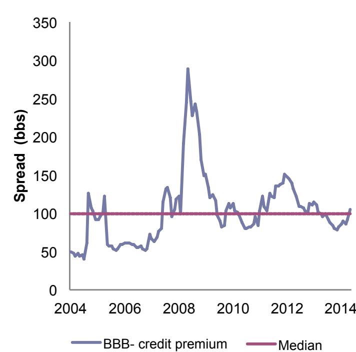
How are buy and maintain strategies being used by pension funds?

Tim In addition to Lionel's points about market conditions and transaction costs, there are also broader industry trends that make buy and maintain strategies well-suited for pension funds.

First, credit assets are often incorporated into a pension scheme's liability risk management strategy because their value is sensitive to movements in interest rates. We are seeing pension funds construct a buy and maintain credit strategy alongside their liability driven investment (LDI) strategy and then expanding the LDI hedge to remove or reduce any of the duration exposure of the credit assets. This approach gives the credit portfolio greater flexibility to improve diversification and generate higher risk-adjusted returns over the long term.

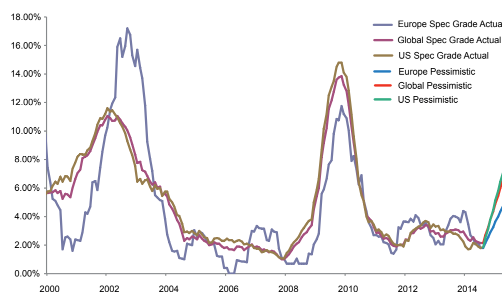
We also know that pressures on fee transparency are driving pension funds to evaluate the value that they are generating in exchange for the fees they are paying. Under this scrutiny, buy and maintain approaches are quite attractive, generating lower transaction costs and offering fees that are lower than active management. Furthermore, because the outcome of a buy and maintain approach is more predictable, value-for-money is easier to assess.

Figure 1: Investors are not rewarded for taking extra risk



Source: Bloomberg as at 31/12/14

Figure 2: Historical default rates



Source: Moody's as at 31/12/2014

Can the terms 'buy and maintain' and 'Smart Beta' credit be used interchangeably?

Tim The phrase 'buy and maintain' describes a particular way of managing a credit portfolio whereby on Day 1 an investor buys a diversified portfolio of bonds with a view to holding them to maturity unless the probability of default for a particular bond held rises to unacceptable levels (in which case it is sold and a replacement is purchased). The proviso is critical and explains why we suggest that 'buy and hold' is not enough. The portfolio needs to be maintained as new information is received about the financial state of the issuers of the bonds. We would regard some 'buy and maintain' strategies as falling into the Smart Beta category while others would not. There is no real definition as to what constitutes Smart Beta in the bond space but we would regard any strategy which looks to avoid some of the pitfalls of the traditional index tracking approach and instead constructs a diversified portfolio that aims to mitigate systemic and issuer-specific risks and protect against the downside as being a 'smart' way of harvesting beta.

Lionel Importantly, these concepts are not mutually exclusive. A buy and maintain Smart Beta credit approach recognises that the potential upside from holding an attractive corporate bond is limited, whereas the downside of holding a bond that defaults can be severe. Because of this 'asymmetric risk', it is important to seek out companies with solid longer-term credit fundamentals and to construct portfolios with a high level of diversification. This also underscores the importance of continuing to monitor the portfolio. This 'maintenance' element is not just about being prepared to sell holdings if their fundamentals deteriorate, but also managing the regular cash flows that are generated every year through bond interest payments and maturities. These cash flows provide natural liquidity to react to future opportunities and rebalance the portfolio to maintain the desired characteristics. When applied together, a Smart Beta buy and maintain strategy can be expected to deliver a more predictable, risk-managed outcome over the long-term.

How would you approach buy and maintain in today's environment?

Lionel First and foremost, we would approach it in a conservative way. In today's environment, investors are not rewarded for taking additional credit risks, meaning that there is minimal spread to be captured from moving down the credit spectrum into lower-rated sectors and names. The analogy that we like to use is that in today's credit market "it doesn't cost more to go organic" - meaning an investor's economic give-up for choosing top quality sectors/names is at historic lows (as illustrated in Figure 1). Furthermore, looking at a chart of historical default rates (included in Figure 2), we appear to be at the bottom of the default cycle – meaning defaults are likely to increase going forward, thus diversification is key. Together, these market conditions appear to suit a conservative, well-diversified buy and maintain approach.

Tim The point I would add is that a buy and maintain approach needs to be constructed to match the needs of the pension fund. Not only do pension funds want to ensure that the portfolio is suited to the current market environment, but it should also reflect the outcomes that they want to target and the journey that they are prepared to take to get there.

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