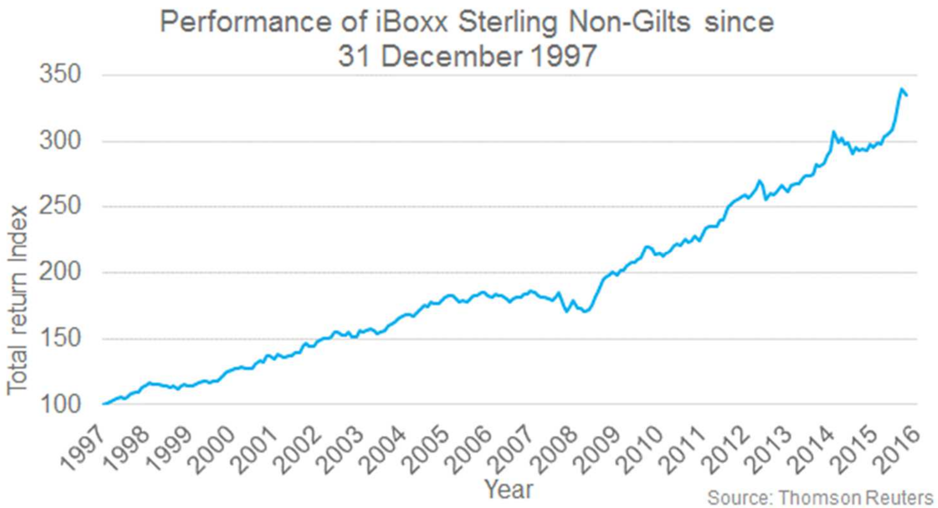
Quarterly investment briefing
Quarter 3 2016

First Actuarial LLP

Regulated in the UK by the Institute and Faculty of Actuaries in respect of a range of investment business activities.
First Actuarial LLP is a limited liability partnership registered in England & Wales. Number OC348086.
Registered address: First Actuarial LLP, Mayesbrook House, Lawnswood Business Park, Leeds, LS16 6QY.

Discussion topic - Corporate bonds

UK Corporate bonds are an important component of many schemes' investment portfolios. Performance of this asset class over recent years has been strong and recent extensions of Quantitative Easing to include the purchase of corporate bonds by the European Central Bank and the Bank of England have pushed prices up further. This has prompted many trustees to ask ***"should we sell our UK corporate bonds and invest the profits elsewhere?"***



This quarter, we look a little deeper at the UK corporate bond market to help answer this question.

In Brief

We have undertaken detailed analysis of the drivers of corporate bond performance over a number of years.

With yields now at all-time lows, there is a risk of suffering capital losses if yields were to start rising significantly. We consider that there is a strong case for investigating alternatives to a traditional UK corporate bond allocation and we believe that there are compelling alternatives available.

In summary, we looked at the UK corporate bond market by major sector and reached the following conclusions:

"Sovereign and sub-sovereign"
Overseas governments and government-backed organisations issue a surprisingly large proportion of the UK corporate bond market. This sector offers very little excess yield over gilts and we favour gilts and their leveraged equivalents (LDI funds).

"Collateralised"
There is a vast global market in collateralised lending and we question whether the UK is the best way of accessing this class.

"Corporate" corporates.
The remainder of the UK corporate bond market lacks diversification. This can be addressed by investing in the much larger global corporate bond market

This briefing presents the view of the First Actuarial investment team on the outlook for the UK corporate bond market. However it should not be relied upon as investment advice and specific advice should be sought before making any investment decision.

What is a corporate bond?

Put simply, a corporate bond is an ‘IOU’. An investor (the pension scheme) lends money to the bond issuer in return for a promise of getting a fixed amount back at a specified future date (the bond’s maturity date). In addition, the bond issuer will pay annual interest to the investor as coupons (see example opposite).

If a corporate bond is held until maturity, the return that the investor will receive (“redemption yield”) is known in advance. The risk is that the bond issuer becomes insolvent and does not honour the IOU. For this reason, credit rating (a third-party assessment of the credit worthiness of the borrower), is an important consideration.

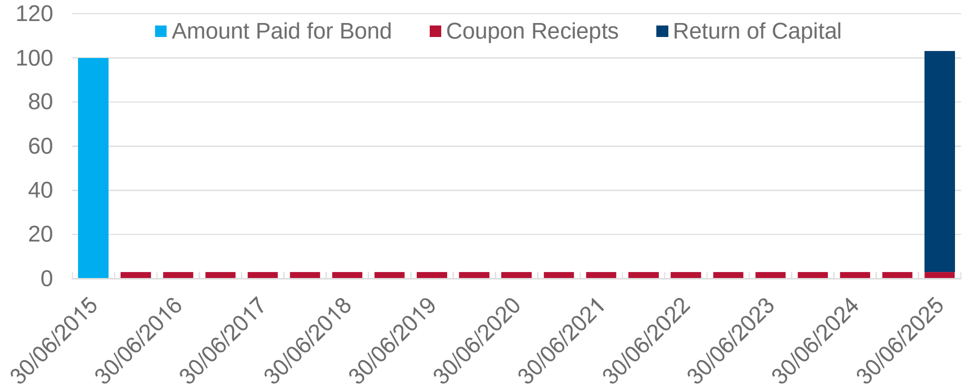
Better-rated bond issuers are seen as being more certain to repay their debts, so the interest paid on their bonds is lower. In contrast, ‘high yield’ bonds are issued by less credit worthy organisations. Here the investor will receive a higher return on the investment – but accepts an increased risk of default on the IOU.

Corporate Bonds vs Gilts (UK government bonds)

Gilts are similar to corporate bonds with the only difference being that the ‘IOU’ is issued by the UK government rather than a corporate entity.

Because the risk of the UK government failing to honour its IOUs is seen as virtually nil, the redemption yield on gilts is nearly always below that of a corporate bond. The difference in redemption yield between a corporate bond and a gilt of similar maturity reflects the compensation an investor receives for being exposed to credit risk.

10 year corporate bond, 6% pa coupon (payable semi-annually)



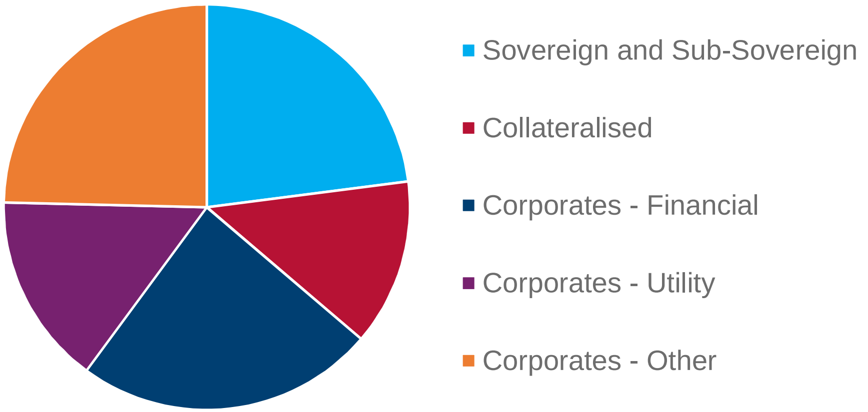
For that reason this difference in yield is referred to as the “credit spread”

It’s also worth noting that gilt funds and their leveraged equivalents, (known as LDI funds), offer advantages over corporate bonds for the pension scheme investor. Both are available in inflation-linked form, and allocations to both can be tailored to match the liability profile of a particular scheme. In the case of LDI funds, increased capital efficiency is also an advantage.

The credit spread on corporate bonds needs to be sufficient to compensate for credit risk and to overcome the advantages of gilts and LDI funds.

What does the UK corporate bond market look like?

We breakdown the UK corporate bond market and provide a description of each of the major sectors below:



Sovereign and sub-sovereign

These are bonds issued by overseas governments or government-backed organisations. The European Investment Bank is the largest borrower in this sector (and the whole market) issuing 7% of the UK corporate bond market. Other major issuers include KfW (a German Government owned development bank established after World War II), Network Rail and the Italian Government.

Sovereign and sub-sovereign bonds are seen as very low risk and offer yields only marginally above gilts (the credit spread on these instruments is currently only 0.3%). Since gilt funds and their leveraged equivalents offer superior matching characteristics for pension scheme liabilities, we question the value of investing in the sovereign/sub-sovereign sector.

Collateralised

Whereas the IOU associated with most bonds is backed by the general ability of the borrower to repay, collateralised bonds are secured by a dedicated pool of assets.

Amongst the most frequently used forms of collateral are commercial property and the residential mortgage books of banks. More esoteric collateral such as trains, army barracks and pools of equity release loans can also be accessed in this sector.

With collateral offering protection in the event of default, collateralised bonds have some appeal. However the UK corporate bond market represents only a tiny fraction of the global market in collateralised lending. We therefore question whether the UK corporate bond market provides a sensible means of accessing this market.

“Corporate” corporate bonds

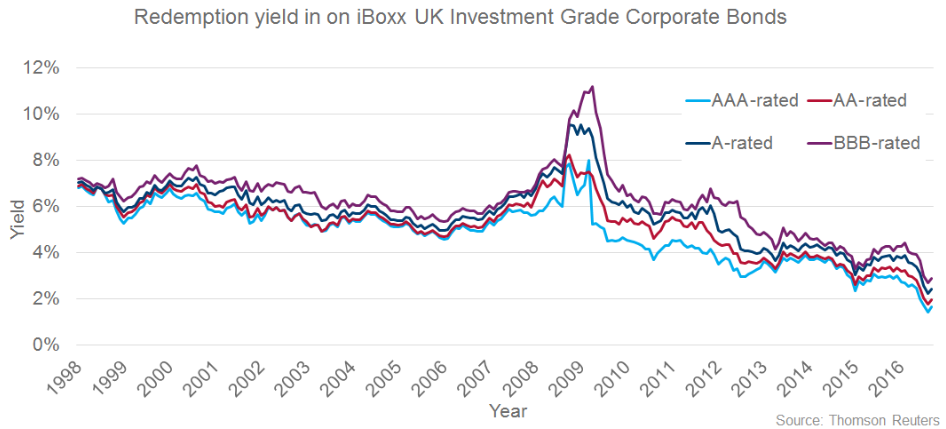
The remainder of the UK Corporate bond market is made up of borrowing by organisations that most people would consider to be “corporate” entities.

Without definitive government backing or collateral in place to back the bonds, diversification is the key mitigation against default risk within this sector. However, diversification is distinctly lacking from the UK corporate bond market. For example, bonds issued by the utility company EDF account for around 3.5% of the UK “corporate” corporate bond market. Financial and utility companies combined represent 60% of the market.

Diversification can be enhanced significantly by investing in a global corporate bond portfolio.

What returns are likely?

The redemption yields are charted below. Those with the strongest credit rating (AAA) offer the lowest risk of default and the lowest yields, whilst those with the weakest credit ratings (BBB and lower) offer a higher risk of default but higher yields.



Yields across the credit ratings are at all-time lows. Credit spreads (i.e. yields in excess of gilts) across the credit ratings are also close to all-time lows, with AAA-rated bonds credit spreads being less than 0.5% pa at the time of writing. However you look at it, by historic standards, corporate bonds look expensive.

An increase in yields will, as it did in 2008, result in a significant fall in the value of the corporate bond market. The longer dated a bond, the more its value will fall in a rising yield environment, all other things being equal.

The average duration of the UK bond market is around 8 years, meaning that a 1% rise in yield would be expected to result in an 8% fall in the value of UK corporate bonds. Lending that has a shorter period is less exposed to fluctuations in price.

The UK Corporate bond market offers record low yields, and, by virtue of its relatively long duration, is exposed to the potential to suffer from a significant fall in price. These observations support the argument for profit-taking on corporate bond holdings.

But where should we invest the proceeds?

Over recent years, corporate bonds have fulfilled two useful roles for pension schemes. They have provided a measure of protection against rising liabilities and they have delivered returns that exceed the performance of an equivalent gilt portfolio. However, in current market conditions, we consider that, for many schemes, there are other asset classes that would better meet the investment objectives.

We remain keen on the idea of being paid to lend money but we do not necessarily think the UK corporate bond market is the best way of achieving this. As an alternative, there are many pooled funds available which offer diverse exposure to global bond markets and other forms of lending such as collateralised debt.

If your scheme holds corporate bonds, the investment has probably served you well over recent years. However, it might be worth considering whether the time is right to review this part of your portfolio.

Small print

First Actuarial disclaimer

The information contained in this briefing is, to the best of our knowledge and belief, correct at the time of writing. However, First Actuarial cannot be held liable for any errors contained herein and the recipient accepts that the information stated is provided on an "as is" basis. This briefing is for general information only. It does not and is not intended to constitute advice. Specific advice should always be sought from the appropriate professional on all individual cases.