For professional investors

Investment grade credit-based solutions

Capturing the opportunity

April 2020

Empower Results®

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Summary

Notwithstanding the adverse economic impact of COVID-19, Aon believes now is an attractive point to incorporate global investment grade credit into your liability driven investment strategy to harvest the elevated illiquidity element available within current credit spreads, particularly in longer dated credits.

Selling some gilts from within the liability hedging portfolio, whilst retaining overall hedging levels, and selling growth asset diversifiers or absolute return bond funds that have retained their value over 2020, can finance the credit investment.

Perhaps 0.5% p.a. could be added to expected returns and investment risks, like trustees' cashflow risk and sponsors' future accounting position volatility, reduced. A credit allocation also helps reduce volatility relative to insurer pricing for trustees with a long term target of buy-out or phased buy-ins along the way.

Aon's existing client investment solutions enable trustees who wish to invest immediately to capture current spreads to do so.

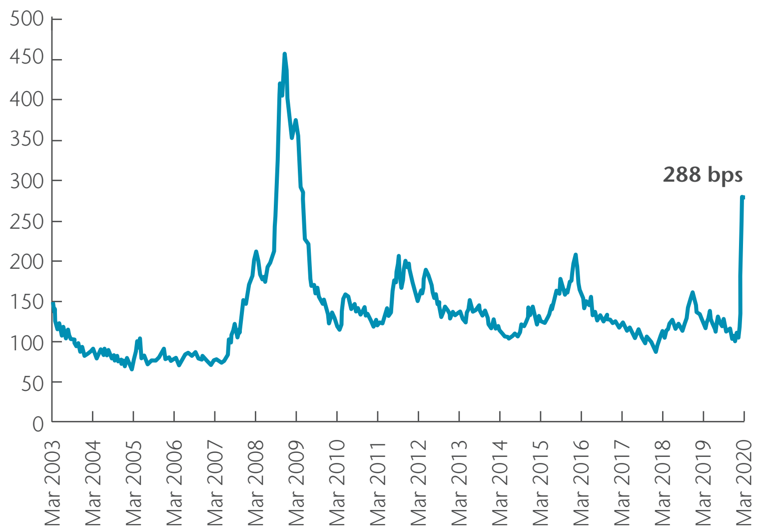
Credit market background

In Q1 2020, investment grade corporate bonds succumbed to the unprecedented economic and business pressures resulting from the COVID-19 virus and the dramatic slide in oil prices. UK and US investment grade corporate bond prices fell approximately 5% and 4% over the period, with prices of BBB-rated credits and longer-duration maturities falling by most.

The extra yield (the credit spread) offered by UK corporate bonds relative to government bonds (gilts) of similar-maturity has risen from 1% at end of 2019 to 2.59% at 2 April 2020. European credit spread increases have been similar, but greater in the US from 1.25% at end 2019 to 3.06% at 2 April 2020.

On a global basis, the average credit spread was 2.88% at 2 April 2020: the highest level, by some margin, since the 2008 global financial crisis.

Global investment grade credit spreads



Source : PIMCO, 2 April 2020

Credit spreads peaked in mid-March 2020 as corporate bond market liquidity dried up. Sellers of corporate bonds looking to raise cash greatly exceeding buyers. However, following Fed and European Central Bank stimulus packages, which include buying corporate bonds, credit spreads have reduced, but remain elevated.

Importantly, as we can see from the chart to the right for US bonds, the increase in credit spreads on corporate bonds has been significantly more, to now be around 2.20% more, than that on credit default swaps. These swaps are often considered the better measure of market's expectation of investment grade companies defaulting on their bonds.

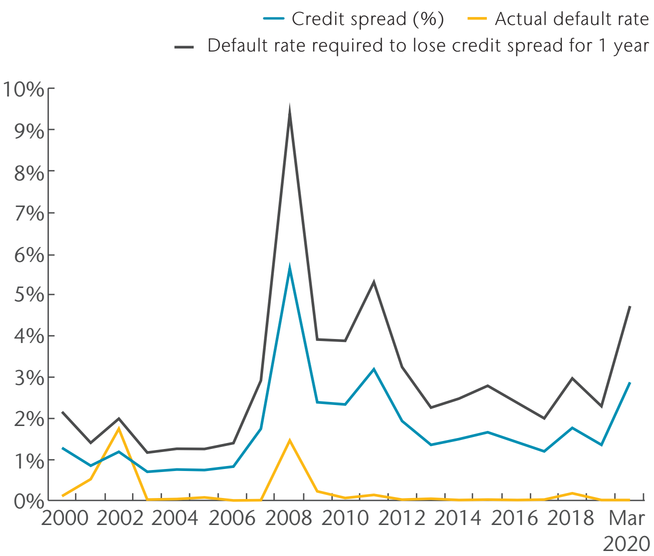
We can conclude that most of the credit spread increases on bonds is due to their higher illiquidity rather than company default risk.

Credit default swap spread less bond spread

Source : PIMCO, 2 April 2020

"We can conclude that most of the credit spread increases on bonds is due to their higher illiquidity rather than company default risk."

Comparing credit spreads with defaults



Source : LGIM, Barclays, Moddy's 26 March 2020

"Investment grade credit yields are currently attractive, particularly the illiquidity element which longer term investors, such as pension scheme trustees, can harvest by buying and aiming to hold corporate bonds to maturity"

Considering default risk further, as the chart to the left shows, investment grade corporate defaults have historically been very low (gold line).

They reached only 1.5% in the 2008–09 global financial crisis. The level of 'breakeven defaults' (grey line) would need to be over 3× that previous high, at 5% over the next year assuming 60% losses (the historical average) for one year's current credit spread of around 3% to be lost.

Historically, the widening in credit spreads has always more than compensated for the increase in defaults.

Whilst, there may be some corporate casualties from the economic downturn, Aon's view is that investment grade credit yields are currently attractive, particularly the illiquidity element which longer term investors, such as pension scheme trustees can harvest by buying and aiming to hold corporate bonds to maturity.

Increased investment in investment grade credit typically also has the support of the corporate sponsor due to the greater alignment with the corporate accounting position. Despite the significant recent falls in growth asset prices the widening in credit spreads could mean the current IAS19 (or comparable) accounting balance sheet position has not deteriorated much, or even improved. Increasing the investment grade credit allocation will help capture part of that accounting position.

Incorporating the credit opportunity in your investment strategy

What to sell?

Purchases of investment grade credit can be financed by selling:

- **Gilts** currently owned within the Liability Driven Investment (LDI) strategy (often 80% to 100% of Technical Provisions (TPs) for many schemes), whilst maintaining overall interest rate hedging.
- **Diversifying growth assets** or **absolute return bond strategy assets** that have held their value

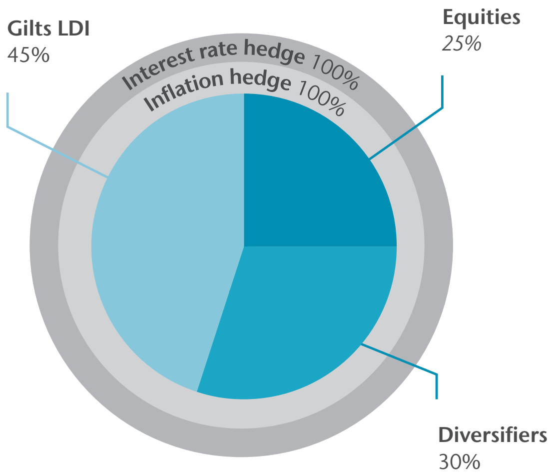
Transaction costs to buy investment grade credit were around 3× higher at around 0.9% compared to 0.3% in normal markets, but these costs have been reducing and would also quickly be recouped from the higher credit spreads.

Trustees can consider the extent to which the investment grade credit is allowed for in your LDI hedging, and also your policy for meeting LDI collateral calls, with advice from your investment consultant.

An example

Let us consider the following scheme as at 31 March 2020:

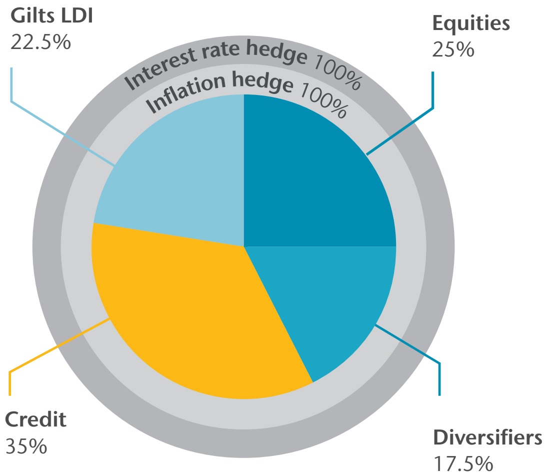
- £220m of TPs on Gilts + 1.25% p.a. basis
- Strategic asset allocation is 60% Growth : 40% Gilts / LDI
- £200m of assets, currently underweight Growth, invested as to the right
- £90m Gilts / LDI are now 2.2× leveraged (lower end of operational range as yields have fallen)
- By value, £80m of the TPs are projected to be paid in the next 12 years, £140m for years 13+
- £70m invested in a global investment grade portfolio currently yielding Gilts + 2.5% p.a. is modelled to meet next 12 years' cashflows



Proposed strategy changes:

- Sell £45m from the Gilts / LDI (45% to 22.5%)
- Sell £25m of diversifiers that have retained their value over 2020
- Invest £70m (35%) in corporate bonds yielding Gilts + 2.5% p.a. to aligned to match the first 12 years' cashflows
- Increase leverage from 2.2× to 3.1× on the remaining £45m Gilts / LDI to hedge the £140m of year 13+ cashflows

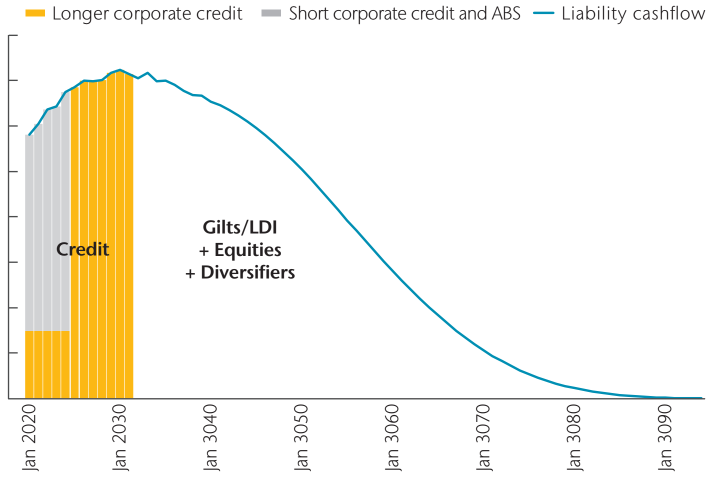
The new asset allocation is as follows :



The revised strategy is modelled to:

- Increase expected investment returns by c.0.5% p.a.
- Increase the investment efficiency (return per unit of risk)
- Provide a robust strategy to meet the next 12 years' cashflows from annual coupons and redemptions from investment grade corporate credit and asset backed securities:

Nominal cashflow (£)



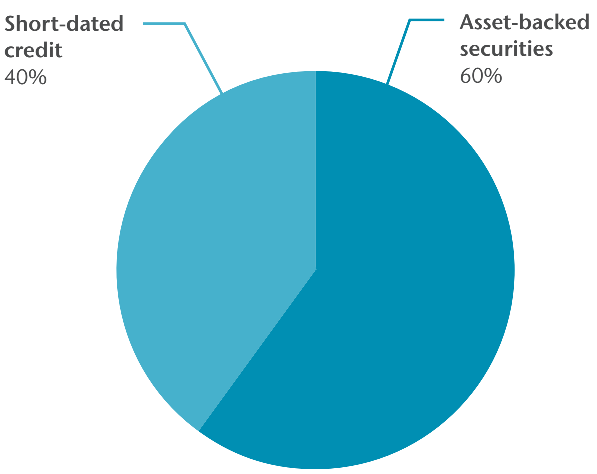
Source : Aon, for illustration only

Implementing the solution

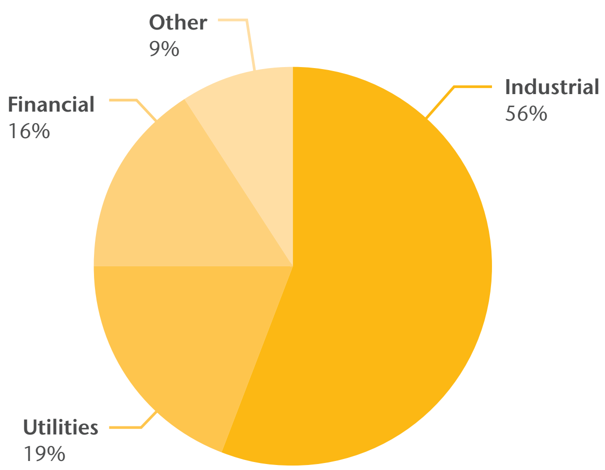
To meet the cashflows in the first five years, we would recommend investing in **a mix of short dated corporate credit and asset backed securities (ABS).**

ABS offer higher yields, improve diversification by issuer and sector and in normal market conditions can be sold quickly at low spreads to meet any unexpected cash or collateral requirements.

Aon's short dated credit and ABS investment fund solution enables immediate exposure for clients who wish to invest before spreads narrow.



For years 6 to 15, we recommend a **diversified long dated global investment grade corporate credit portfolio**, such as this illustrative portfolio :



Number of issuers	83
Average credit rating	A
Yield to maturity	3.0% ~ Gilts + 2.5%
Maturity profile	Up to 2031

We recommend these portfolios should be managed actively with higher turnover to target additional return in excess of the benchmark or with low turnover on a buy and maintain basis to target avoiding defaults, and if this is achieved the yield on the portfolio at inception, such as the 3% in the illustrative portfolio, will be achieved over the portfolio's term.

With the recent cuts in global interest rates, currency hedging costs are at historical lows, so we recommend non-sterling exposures are hedged.

Aon has an established buy list of pooled funds and segregated solutions to enable trustees of schemes of all sizes to implement this strategic change.

Aon's integrated Growth and LDI investment solution uses higher leverage, perhaps up to 3.5×, due to daily management of collateral by the portfolio manager. Trustees who may wish to delegate more of the management of their growth assets in this way can therefore release additional capital for reinvestment in investment grade credit.

Next steps

For trustee or corporate clients who would like to consider incorporating additional investment grade credit in their strategies, your usual Aon contact will be pleased to construct a proposed solution for your circumstances.

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About Aon

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