Bonds: A big role to play

Summary
- Fixed income has long been a major part of the traditional pension portfolio.
- Fixed-income assets, such as gilts and bonds, have historically been used as diversifying tools, balancing out equities.
- DB and DC schemes tend to look for different outcomes from their fixed-income allocations.
- Following the mini-Budget in 2022, the bond market turbulence showed fallibility in the sector and shook pension funds up considerably.
- Today, yields are higher and contribute to improved funding levels.
- Allocations remain stable and pensions are still heavily invested in fixed income.
- There is a heightened awareness, since 2022, of the need to consider alternative means of diversification too.

Sandra Haurant explores the important role fixed income has to play within DB and DC portfolios, despite the market volatility experienced in recent years

In September 2024, the Pensions Policy Institute (PPI) published the results of independent research into just what is being done with the £3 trillion worth of assets held in UK pension funds. The report, *Pensions scheme assets – how they are invested and how and why they have changed over time,* outlines the proportions of different assets – equities, bonds, alternatives and cash – showed that bonds still dominated portfolios. Traditionally diversifying assets, bonds still play a big, and sometimes very big, part in pensions.

Combining data from both defined contribution (DC) and defined benefit (DB) pensions in the public and private sectors, the report found that 38 per cent of pension fund assets were held in bonds, compared with listed equities at 33 per cent (19 per cent was held in cash and 10 per cent in alternatives).

Defining differences

There are, of course, marked differences between the requirements of DC and DB schemes, and even within DB, between the private and public sectors. In public sector DB schemes, 51 per cent of assets were invested in equities, and 18 per cent in bonds.

But in private sector DB schemes, almost the reverse was true: Some 55 per cent of portfolios was invested in bonds, 20 per cent in 'cash and other', 14 per cent in alternatives and 11 per cent in equities. (Of that 55 per cent in bonds, 43 per cent was in index-linked gilts; 23 per cent was in conventional gilts; 21 per cent was in corporate bonds; and 13 per cent was in other government bonds or short-term debt instruments.)

DC schemes were different again, here, 56 per cent was held in equities, and a quarter (24 per cent) in bonds.

Troubled times

It's impossible to address fixed income without mentioning recent challenges, and the PPI's report offers a potted history. Going back to the global financial crisis in 2007/08, interest rates fell to low levels and bond yields went down with them, the PPI report says. At that time: "Yields on government bonds fell to their lowest for many years, making them considerably less attractive for all types of pension scheme than some other asset classes."

An uptick in rates in the early part of 2022 led to an improvement in yields, and a fall in the market value of bonds. Then came the collapse in bond values following the now infamous 'mini-budget' in September 2022, which, the PPI report says: "Triggered a forced sell-off of bonds, as DB schemes sought to meet margin calls on LDI contracts, thus prompting a downward spiral in bond values necessitating the Bank of England to intervene in the market."

The result was a reported £425 billion fall in asset values for DB pension schemes in 2022 and so, the PPI report says, while "bonds still play a central role in investment strategies, particularly in DB pensions," there has nonetheless been "a marked shift away from government towards corporate bonds".

Moving on

A shift in emphasis, then – but not a departure. Is fixed income still a crucial part of pensions investment today? Cardano head of credit, Justin Hatch, says: "Yes. Fixed income remains a valuable component of a pension scheme's investment toolkit. For DB schemes, a well-structured investment solution should incorporate liability hedging. This is prudent risk-management. Fixed income instruments are vital for this application and should form the bedrock of a liability-driven investment (LDI) portfolio."

Russell Investments global head of fixed income and foreign exchange, Van Luu, agrees, and adds: "After the chastening experience of 2022 when bonds failed to be a counterweight to falling equities, we think the return of inflation to normal levels will largely

restore the diversification function of fixed income."

What's more, recent higher yields have been leading to falling liabilities and improved funding rations for pensions. As XPS Group CIO, Simeon Willis, says: "Higher yields have in the main had a very positive impact upon DB pension schemes." And Willis adds: "For credit assets, the credit spread has contracted, leading to an increase in price relative to an equivalent gilt, resulting in outperformance."

Different strokes

As the report shows, DB and DC need different things from fixed income. "Given the focus on increased liability matching within DB, long-dated credit kills two birds with one stone – modest additional return plus liability matching, whereas shorter dated credit provides useful cashflow," Willis says. "In DC, fixed income is something that features more prominently when members get closer to retirement. At this point, long-dated fixed income can either help or hinder a strategy, depending on each individual's retirement objectives," he adds. "For example, the certainty of long-term fixed income comes at the cost of short-term volatility in price, which is counterproductive for a member focused on capital preservation. Here short-dated fixed income can be very helpful to balance the level of risk without introducing price volatility."

"Traditionally diversifying assets, bonds still play a big, and sometimes very big, part in pensions"

Traditionally, Willis explains, DC has shifted into gilts, index-linked gilts and cash in line with lifestyle objectives. "But all of these suffer from a common shortcoming, which is that none of them offers a return premium over the risk-free rate. Credit assets are better suited here generally."

However, WTW's senior associate, investments, Sophie Pierce, says: "For our DC client base, solutions that allow members exposure to illiquid assets are emerging, which broaden their investment toolkit beyond traditional asset classes." That does not reduce demand for credit overall, and, Pierce says: "We expect private debt and other types of alternative credit to play a greater role in DC portfolios in the future. As members approach retirement, high quality government and corporate bonds, as well as cash, remain a popular asset mix for a large proportion of our client base."

Changing landscapes

Things have calmed down since 2022, and allocations to fixed income have been "relatively stable" over the past 12 months, says Willis, rising 1 per cent over the 12 months to 30 June. And, says Pierce, there has been an increased shift into "cashflow-aware sterling-focused investment grade corporate credit ('buy and maintain') that provides cashflows and contributes to schemes' hedging objectives."

Buy and maintain strategies, as the name suggests, aim to produce sustainable returns with a low turnover of underlying assets, and Luu, too, sees it playing a more important role. Luu says: "In DB pension schemes, investment grade corporate credit has attracted more assets. High quality corporate bonds are often acceptable to insurance companies as part of a buyout, and are therefore attractive to pension schemes close to risk transfer." And Luu adds: "Buy and maintain credit strategies have been in demand as a way of generating predictable cashflows, especially important for schemes that are cashflow negative."

What future for fixed income?

Pensions have long relied on fixed income as a diversification tool, a means of ensuring sustainable income, and as a source of growth, and these asset classes will continue to form part of the bedrock of pension schemes' portfolios. Nonetheless, Luu says, there is still room for alternative approaches such as trend-following and long volatility strategies. After all, pensions need to learn from past mistakes. "Despite the significantly improved return-risk profile of fixed income, the 2022 experience illustrates that pension funds should consider alternative sources of diversification for periods of high and rising inflation," says Luu.

Written by Sandra Haurant, a freelance journalist