The case for manager diversity and global expertise:
Thinking differently about meeting pension liabilities

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Introduction

- Liability-driven investing (LDI) and Buy and Maintain Credit strategies are complementary but different
- Many investors adopt a "one manager fits all" philosophy without fully appreciating its potential drawbacks or the benefits that an alternative approach might bring
- We make the case for manager diversity and explain how global expertise can underpin a "best of both worlds" solution
- Such an approach enables clients to retain the interest-rate and inflation hedging possible within a leveraged LDI fund while at the same time benefiting from the higher yield that a globally diversified Buy and Maintain Credit fund can deliver
- Selecting each fund on its own merits can expand the investment opportunity set and lead to superior outcomes while still allowing efficient collateral management

Towards a new normal

As we explain in detail in another paper, An Introduction to CDI, meeting rising cashflow requirements is a growing challenge for Defined Benefit pension schemes. In short: assigning assets as "growth" or "liability matching" becomes less useful as schemes mature, and such a "barbell" approach can limit the pace of de-risking.

Growth and LDI strategies therefore need to evolve towards holistic cashflow delivery – a goal that cashflow-driven investing (CDI) aims to achieve. Within such an approach, Buy and Maintain Credit can be a key source of both duration and income.

Given their ability to complement each other, utilising LDI and Buy and Maintain Credit strategies in tandem may represent an attractive "new normal" for maturing schemes. It is essential to recognise, however, that the skills and resources involved in managing the two are different.

Key differences

To appreciate the benefits of the "best of both worlds" approach that we advocate, it is first necessary to understand what each manager aims to achieve. Below we briefly outline the key differences between LDI and Buy and Maintain Credit mandates.

LDI Manager	Buy and Maintain Credit Manager
Aims to invest in assets that will change in value in line with a scheme's liability value	Invests in assets that will generate income in line with a scheme's liability cashflows
Principal role is to manage the risks associated with changes in interest rates and inflation	Principal role is to manage credit risk
Focuses on gilts and other sterling-denominated, "risk-free" assets	Aims to capture credit risk by investing across geography, sectors and issuers while avoiding defaults and minimising turnover
Relatively limited in terms of the available investment universe	Able to access a much broader opportunity set to achieve their objectives

The importance of a global approach

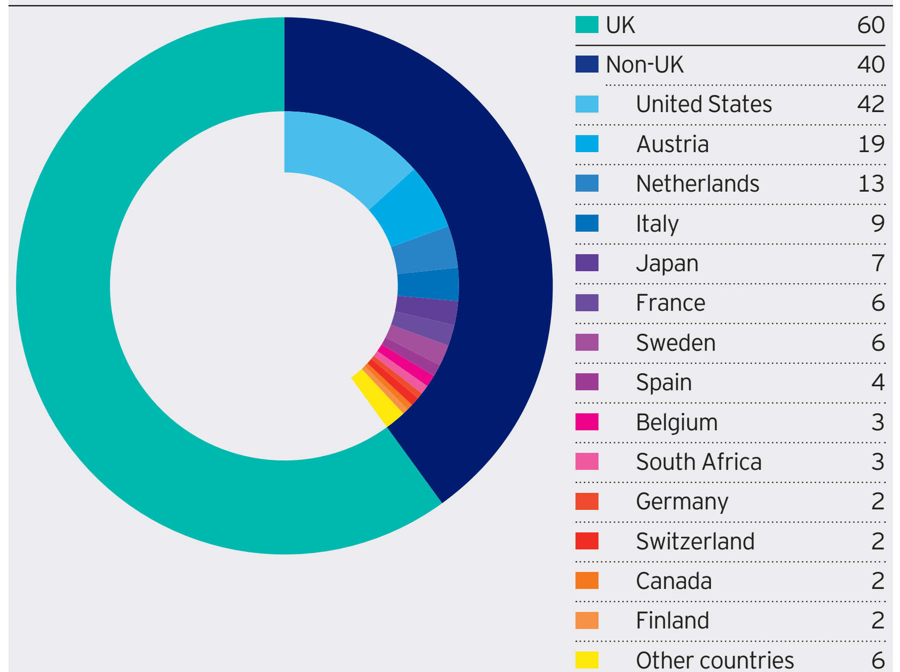
The last of the above points goes to the heart of our ideal of a global Buy and Maintain Credit manager. Simply put: there are many investment opportunities that might help a scheme meet its liabilities, but not every manager is equipped to identify and take advantage of them.

Consider figure 1, which illustrates how a substantial proportion of issuers of sterling-denominated debt are non-UK issuers by country of risk. Specific skills and resources are needed to assess the myriad opportunities that exist within this space.

At Invesco, for example, we have a worldwide team of almost 60 credit research analysts who consider the relative attractions of issuers across a range of regions and sectors – including US investment grade, European credit, emerging markets, Asia, high yield, global liquidity and municipal bonds. The skills and resources that such a team must have are likely to be very different from those used by an LDI manager – whose main focus, remember, is on gilts and other "risk-free" assets found within a comparatively limited investment universe.

This is why we believe that a global approach is critical to building diversified Buy and Maintain Credit portfolios that can provide maturing schemes with both duration and income. It significantly improves issuer and sector diversification, as well as improving yield (net of hedging costs) and offering increased liquidity.

Figure 1
Issuers of sterling-denominated debt by country of risk



Invesco, Bloomberg Barclays, as at 22 October 2019; based on constituents of Bloomberg Barclays Sterling Aggregate Corporate Index.

Exploding the myths around a "one manager fits all" approach

The convention of having the same manager oversee both the LDI portfolio and the Buy and Maintain Credit portfolio within a pension scheme has traditionally been rooted in three purported advantages. Below we briefly examine each in turn.

01

Claim — **A single manager can take advantage of a shared collateral pool**

Reality — **There is no need for a shared collateral pool**

A global approach to Buy and Maintain Credit brings diversification and potentially superior yields, but it also introduces currency and interest-rate mismatches. These risks should be hedged, which means that collateral must be available to meet mark-to-market changes.

A Buy and Maintain Credit manager needs recourse to a "collateral waterfall" to settle losses on such hedges. This provides a clear order of priority with regard to the assets that can be drawn upon.

But a manager does not need recourse to an LDI portfolio for this collateral if it has access to the same tools itself. If corporate bond repo is used, for instance, there should be no shortage of collateral in a Buy and Maintain Credit portfolio. This point is well evidenced by the fact that pooled Buy and Maintain Credit funds have always managed their own collateral.

02

Claim — **LDI managers are unique in their ability to use repo**

Reality — **Buy and Maintain Credit managers can also use repo**

A Buy and Maintain Credit portfolio that is run alongside an LDI portfolio may have recourse to cash from the latter to settle cross-currency hedge movements. Yet repo is not exclusive to LDI: it is one of the tools that a Buy and Maintain Credit manager can use to manage collateral within a portfolio.

As stated above, corporate bonds can be repo'd directly. Repo funding using high-quality corporate bonds is similar in cost to using gilts, and the absolute cost is low because of the much lower extent of repo required (as Buy and Maintain Credit portfolios are not leveraged). The impact on any price difference is therefore modest. In addition, capital can be allocated efficiently without risk management being compromised.

Similarly, a Buy and Maintain Credit manager with the right toolkit can make use of liquid credit ETFs. These can be sold if needed, reducing the amount of cash that has to be held.

03

Claim — **A single manager reduces the governance burden**

Reality — **Manager diversity can result in less complexity**

The need for an LDI portfolio to account for the interest-rate protection provided by a Buy and Maintain Credit portfolio is sometimes cited as a reason to manage the two together. The standard argument is that this avoids complexity of calculation, rebalancing or cash movements.

However, institutional asset managers are accustomed to handling data from multiple sources. They are well equipped to receive external information, including from other managers – for example, via a feed from a client's custodian.

It is therefore possible to retain a holistic view of a scheme's exposure while allowing each manager to benefit from the other's data. Importantly, each is also able to focus on its own area of expertise, which should lead to superior investment decisions and outcomes.

We can see, then, that the claims routinely made in support of a "one manager fits all" approach do not withstand scrutiny. Though widely accepted, they are misguided and in some cases misleading. Exploding these myths reinforces our case for manager diversity.

Anatomy of a specialist global Buy and Maintain Credit manager

The myths examined in the previous section suggest that a "one manager fits all" philosophy often boils down to convenience. Yet choosing a manager should be a question of quality.

It makes little sense to allow an LDI expert to manage a Buy and Maintain Credit strategy if another manager is better qualified for the task. The objective should be to make full use of the capabilities that each can offer and thus enjoy "the best of both worlds".

So what are the qualities that mark out a specialist Buy and Maintain Credit manager – one that can work in tandem with a specialist LDI manager to deliver maximum benefit? There are a number of factors, but the three below perhaps best summarise the skills and resources required.

- A specialist Buy and Maintain Credit manager should have a **global credit research** capability. This is necessary to evaluate issuers from the broadest geographical and sectoral perspectives and to achieve greater diversification and higher yields
- A specialist Buy and Maintain Credit manager should have both **fundamental and ESG expertise**. Both are crucial to avoiding downgrades and defaults and to achieving superior risk-adjusted returns
- A specialist Buy and Maintain Credit manager should be capable of delivering **bespoke solutions**. This means employing proprietary analytics, expert portfolio construction and sophisticated tools – including within-portfolio collateralisation – to meet specific needs

Ultimately, the expertise and risks involved in an LDI strategy are not the same as those involved in a Buy and Maintain Credit strategy. This is why a scheme should select a manager that has the skills and resources needed to identify the large number of globally diversified issuers that will best deliver yield and preserve capital over the long term.

In summary

The potential dangers of putting all your eggs in one basket are well known in the world of investment. This is why freedom of choice is regarded as a cornerstone of successful investing. The idea is particularly important as Defined Benefit pension schemes enter the de-accumulation phase.

Recognition of respective specialisms should translate into more investment opportunities and higher expected returns – vital considerations as a scheme de-risks and a higher proportion of liabilities must be met from the returns generated by a Buy and Maintain Credit portfolio. A truly global outlook is central to this "best of both worlds" philosophy.

Defined Benefit investment approaches have always developed as the schemes themselves have changed. We believe that it is time for them to move on again and for the question of Buy and Maintain Credit manager selection to at last be given the attention it deserves.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Buy & Maintain strategies will invest in derivatives (complex instruments) which will result in leverage and may result in large fluctuations in value.

Debt instruments are exposed to credit risk which is the ability of the borrower to repay the interest and capital on the redemption date.

Investments in debt instruments which are of lower credit quality may result in large fluctuations in value.

Changes in interest rates will result in fluctuations in value.

Contact us

Our team would be delighted to discuss further the idea of manager diversity, particularly with regard to issues such as collateral management, the benefits of a genuinely global approach and the scope for effective collaboration between LDI and Buy and Maintain Credit managers. Please get in touch if you require additional information.

Chris Evans
Head of UK Pensions
& EMEA Consultant Relations
chris.evans@invesco.com

Mark Humphreys
Head of EMEA Client Solutions
mark.humphreys@invesco.com

Derek Steeden
Portfolio Manager
derek.steeden@invesco.com

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Issued in the UK by Invesco Asset Management Limited
Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK
Authorised and regulated by the Financial Conduct Authority.

EMEA6461/020920