For professional clients only

Aon's Investment Research and Insights

High Quality Short Credit

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Empower Results®

Contents

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Executive summary

- **High quality, low duration credit strategies provide an important role in investment portfolios as schemes de-risk and move closer towards their long-term funding targets.**
- **These strategies can offer a lower expected risk of default, lower volatility and desirable cashflow-matching characteristics.**
- **The high quality, low duration credit strategies that we recommend include asset-backed securities (ABS) and short-dated credit.**
- **In the current volatile market conditions resulting from coronavirus fears, these offer an excellent opportunity for institutional investors with actively managed bond strategies to gain from the market dislocation.**
- **For investors looking to reappraise their credit portfolio, these alternative credit strategies should be considered in combination as an attractive diversified credit proposition.**

Introduction

Traditionally, schemes de-risked by increasing the allocation to corporate and government bonds. However, as markets have become more sophisticated, there is now a wide range of alternative credit investments that can offer better risk-return, better liquidity, and provide additional diversification to portfolios.

Of course, pension schemes have more to consider than just reducing risk or even adding returns. Although these still play an important role in closing funding deficits or moving to self-sufficiency, investors also need to consider other factors such as cashflows, the impact of transfer exercises, or how best to prepare for a buy-in/buy-out (amongst others such as market opportunities).

We believe that high quality, low duration strategies offer an attractive solution for investors looking to de-risk, allocate excess cash, improve cashflow, or support their liability matching-strategy.

This note covers two specific ideas which are:

- **Asset-Backed Securities**
- **Short-Dated Credit**

For investors targeting higher returns, further opportunities in this space include multi asset credit (MAC) and absolute return bond fund (ARBS) strategies. These offer investors exposure across the broad fixed income universe, using manager skill to provide an attractive risk-adjusted returns. Although these typically target higher risk than the ideas discussed below, they may still be an attractive opportunity for investors building an alternative credit portfolio, particularly when used in combination.

The case for high quality, low duration credit

There are several notable factors that alternative credit strategies can offer relative to traditional credit strategies such as all maturity corporate bonds:

- **Lower volatility.**
- **Lower risk of default.**
- **Higher level of liquidity.**
- **More stable returns above cash.**

Although traditional credit strategies can provide the potential for greater return through higher yields and spread duration (the price sensitivity of credit to a change in credit spreads) they are less likely to provide an investor with the above characteristics.

Furthermore, in a credit market downturn (like we have seen in the markets in March 2020) price falls are likely to be amplified in traditional credit markets as they are typically longer-dated and the risk of default increases significantly in the lower rated credit markets.

The chance of default in higher quality credit is low, particularly at the upper end of the rating spectrum. For example, UK residential mortgage ABS with even a BBB rating would need to see UK house prices fall by 60% with 40% cumulative mortgage default rate before seeing just a 5% loss*. Given this, returns offered by high quality assets come with reduced risk and investors can be confident in their return expectations.

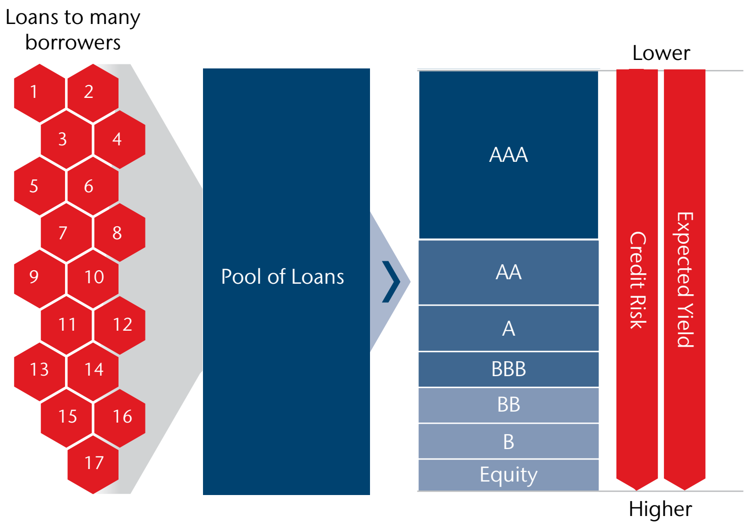
Shorter-dated credit may not offer the same return potential as longer-dated when credit spreads are wider, but it does provide lower volatility and more stable returns and cashflows.

These characteristics combine to be highly desirable for institutional investors looking to de-risk, enhance cash-like returns and improve cash flow.

** Source: Aegon Asset Management. Analysis based on BBB-rated UK RMBS*

Asset-Backed Securities

ABS are assets where returns, made up of interest and returned capital, are derived from an underlying pool of loan securities, the cashflows of which are pooled together and paid out to investors in priority based on the seniority of the debt held.



Source: Aon.

ABS will include loans that are widely familiar to investors such as:

- Mortgage backed securities (e.g. residential or commercial property).
- Consumer loans (e.g. auto loans, student loans, credit cards).

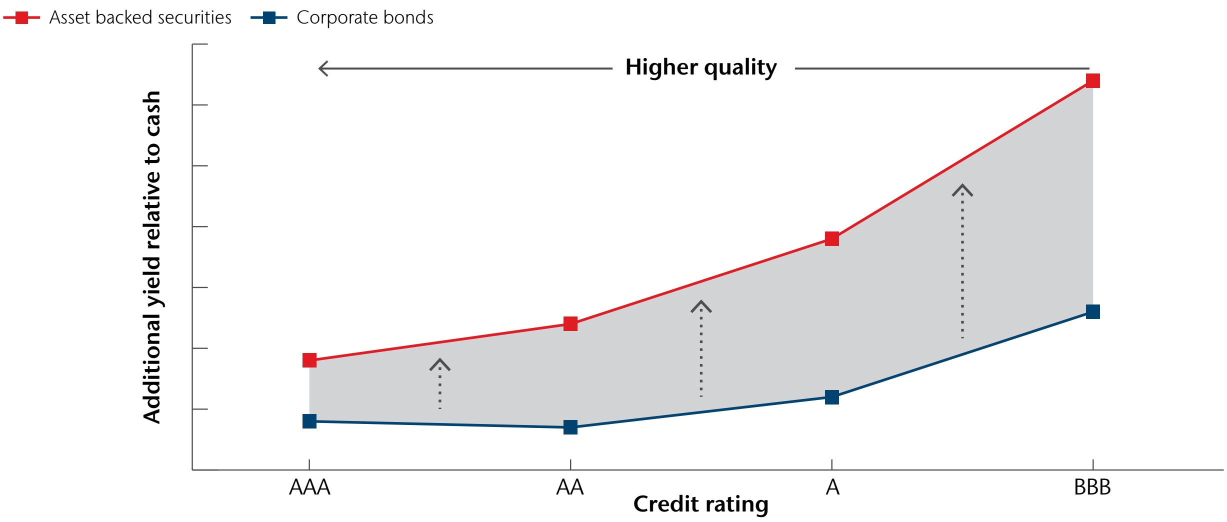
An attractive feature of ABS is that for the same credit quality and term, it can offer a higher yield compared with traditional credit. Much of the ABS market has a floating rate, meaning that the cashflows generated by the underlying pool of assets would increase in a rising interest rate environment. Not only does this mitigate interest rate risk, it also means there is minimal interference with any liability-hedging strategies in place.

ABS returns also have a low correlation to traditional fixed income or equity markets and when compared with traditional corporate bonds we see additional advantage in this asset class primarily due to:

- Fewer distortions caused by quantitative easing than in traditional credit markets
- Less market crowding due to lack of inclusion in traditional passive benchmarks.
- Competitive barriers to entry for managers.

As ABS consists of an underlying pool of loan securities, they still face the risk of these loans defaulting. Likewise, they may see a fall in their market value in times of market stress. However, the prevalent factors outlined above result in an asset class that can offer higher returns for securities that have similar risk.

ABS vs corporate bonds illustrative spread difference across rating spectrum



Source: Aon, stylised representation of the extra spread from investing in asset-backed securities compared to equivalent rated corporate bonds. Illustrative purposes only

Short-dated credit

A short-dated credit strategy focuses on purchasing securities with maturities of up to five or six years. Although these securities are selected from the same universe as traditional investment grade credit, the short nature of their maturities allows certain favourable characteristics:

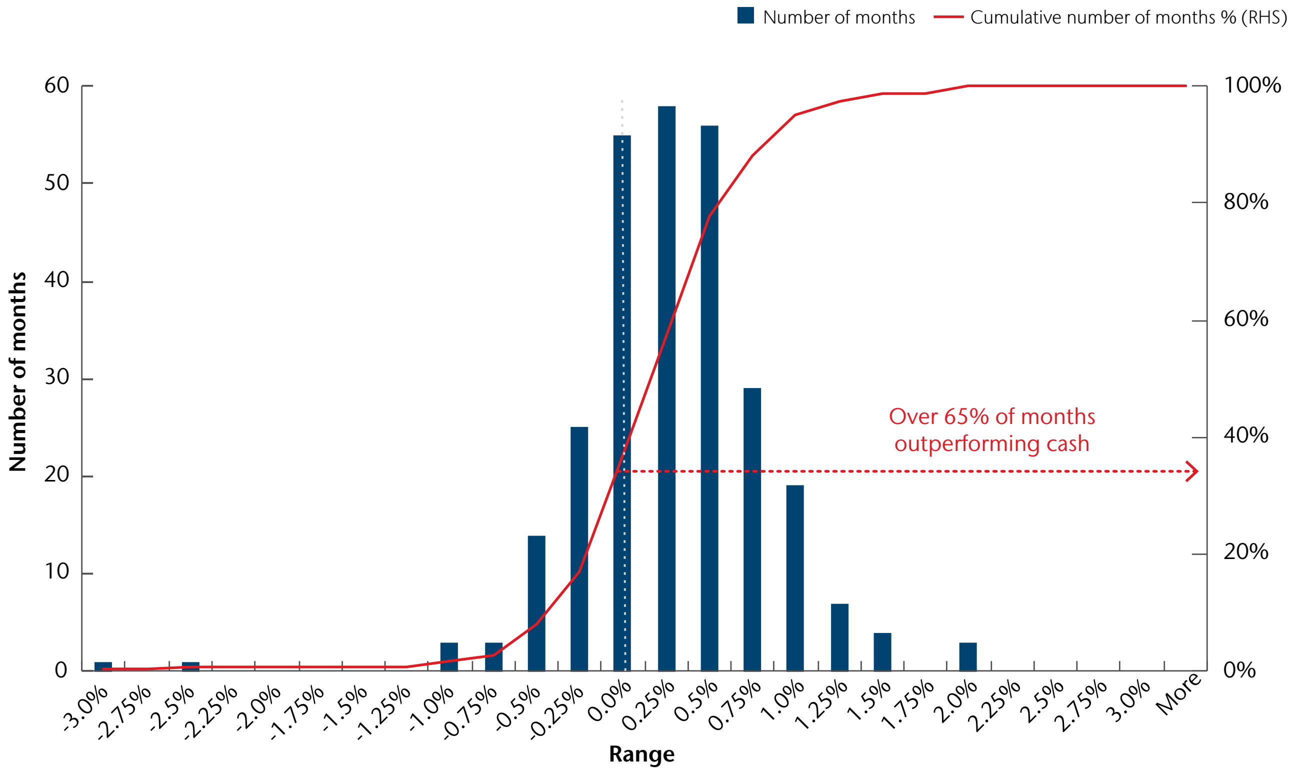
- **Lower volatility**
- **Strong capital preservation**
- **Relatively attractive yield**

Compared with longer-dated credit, short-dated credits' reaction to changes in bond prices is subdued. Because of this, prices of short-dated credit remain relatively stable in times of macro market turbulence and will typically have a more cushioned price drop and a faster rebound in extreme market tail events than longer-dated credit.

As this asset class is short-dated it is, by nature, close to maturity. Because of this, issuers that have both the ability and willingness to pay are strongly expected to provide any final coupon payments and repayment of the principal. This confidence in cashflow typically provides a higher level of liquidity than other credit assets.

Like corporate credit of any maturity, short-dated credit still holds the risk of defaults and falls in market value through market stress, issuer quality downgrades, liquidity shocks, or other market events. However, when the characteristics above are combined, it leads to short-dated credit being an attractive return-enhanced alternative to cash which can be seen by the distribution of relative returns below.

Short-dated credit relative performance — distribution of monthly performance vs cash since 1997



Source: Aon, Bloomberg (ICE BoA 1-5Year Global Corporate Index). Monthly performance data up to and including February 2020.
NB: Past performance is not an indicator of future performance.

Incorporation into strategies

There are several reasons why these alternative bond strategies may be useful in a portfolio.

Schemes maturing and/or de-risking

- The Pensions Regulator expects allocations to high average credit quality, liquid investments to increase as schemes mature* and these bond strategies meet those criteria as an attractive place to help schemes to de-risk.

- Maturing schemes increasingly need cash that can be sourced from these bond strategies, to pay benefits as they fall due, whilst avoiding a drag on investment returns.

Complementing cash and LDI strategies

- A LDI manager may re-leverage or de-leverage its portfolio as interest rates and inflation expectations change, causing cashflow movements in and out of the funds. It is natural to complement a LDI strategy with a liquid source of collateral such as high quality credit to maintain portfolio efficiency and increase expected returns. However, recent volatility has reminded us of the importance of having access to liquidity that is also separate to the LDI manager, in the case where demand for cash can spike across its book of clients. Multi-client demand for collateral from the LDI manager's own products can cause a significant strain or an equivalent 'run' on its fund and an adverse price impact..

As a medium term holding position

- These bond strategies can work neatly to preserve capital ahead of future transactions. This could be an asset transaction such as funding illiquid drawdowns, or liability transactions such as a bulk transfer exercise, buy-in or buy-out.

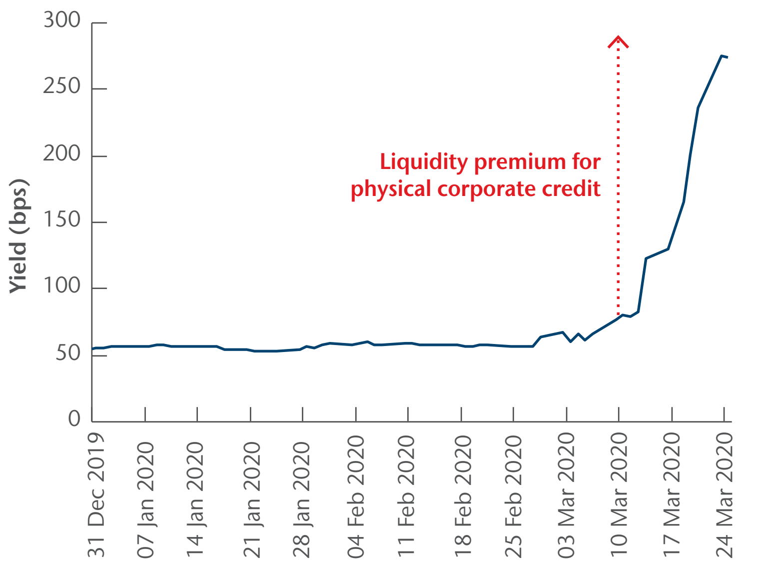
As outlined above, each of these strategies offer favourable characteristics for today's bond investors.

** Source: the Pensions Regulator, DB funding code of practice consultation, 3 March 2020*

Current market opportunities

During the month of March 2020, we witnessed the fierce struggle by investors to raise liquidity by selling their most liquid bond holdings. Both US and European ABS and short-dated credit were sold indiscriminately, given their high liquidity, leading to an excellent opportunity for institutional investors with actively managed bond strategies to gain from the market dislocation. The "liquidity premium" available to pension schemes, determined broadly as the difference between the credit premium offered by physical bonds and more liquid bond derivatives, has become particularly attractive compared to historic levels.

Difference in yield between US credit index (OAS) and US IG CDS



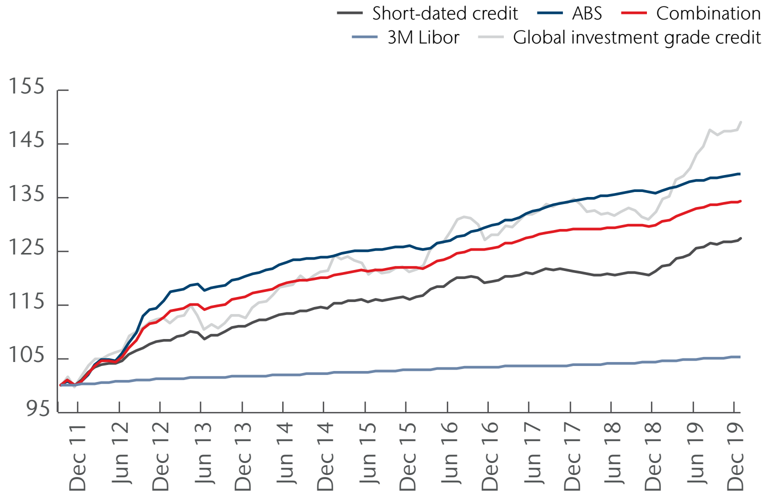
Source: Factset. Indicative based on comparison of the ICE BofA US Corporate and Markit CDX.NA.IG Continuous indices. Although comparable, there are index differences.

Combining assets

We have high conviction in each of the alternative bond strategies mentioned in this note as they complement each other when facing different market conditions. Allocating dynamically between strategies will further add value.

A combined portfolio of ABS and short-dated credit therefore offers a liquid, high quality solution in a diversified mix of contractual income assets that is superior to traditional investment-grade credit in today's market environment.

Cumulative performance — ABS and short-dated credit have provided stable, positive returns over time and volatility is visibly subdued



Source: Aon, Evestment (representative global ABS manager performance, 3m LIBOR) Factset (ICE BofA Global Corporate Index, ICE BoA 1-5Year Global Corporate Index). Combination is 60% ABS, 40% short duration portfolio, a representation of Aon's best ideas fund. Performance to 31 December 2019. NB: Past performance is not an indicator of future performance.

Conclusion

There are many ways investors can enhance their portfolios to suit their ever-changing requirements. Credit has long been used as the asset class for investors looking to de-risk away from equity and lock in funding levels as schemes move closer to maturity. As markets get increasingly sophisticated, alternative ways of accessing credit have become available. Utilising the best credit ideas such as ABS and short-dated credit will allow investors to create efficient portfolios that much better match the needs of investment strategies in today's environment.

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