Investment strategy – Alternative credit

Addressee

This paper is addressed to the Pensions Sub-Committee ("the Committee") of the London Borough of Hackney Pension Fund ("the Fund"). It recaps on the strategy changes previously agreed buy the Committee and proposes next steps in relation to identifying a suitable alternative credit allocation for the Fund.

Introduction

Following an in-depth review of investment strategy during the triennial valuation, the Sub-Committee agreed to reduce the strategic allocation to equity by 10% to fund an allocation to multi-asset/alternative credit. Now that the transition of equity assets from legacy mandates to LCIV arrangements is complete, in this paper we recap on the rationale for an allocation to alternative credit and consider next steps in relation to implementation.

To recap, the rationale for the strategy changes are as follows:

- Equity returns are unpredictable in the medium term and we consider there to be greater potential for downside than upside surprises;
- Equities are currently the main source of expected return and risk in the overall allocation; and
- The overall expected return from the investment strategy remains broadly unchanged but moves a proportion of the allocation from assets that are dependent upon positive growth outcomes, to assets with more predictable returns and less dependent on continuing economic growth.

We recommend that the Committee allocates 10% of Fund assets to illiquid mandates, specifically private debt. We look forward to discussing this paper with you at the forthcoming Sub-Committee meeting.

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For and on behalf of Hymans Robertson LLP
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Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Why alternative credit?

The Fund currently has exposure to fixed income assets primarily via the BMO mandate, which invests predominantly in investment grade sterling corporate bonds along with government issued gilts and index linked gilts. The Fund's two diversified growth managers also have flexibility to hold investments across the credit spectrum.

So-called 'investment-grade' bonds carry a low (though non-zero) risk of default and offer a higher yield than gilts to cover the risk of default and, more importantly, to reflect other risks, such as their lower liquidity and higher price volatility. The level of the extra yield offered can vary considerably over time. The yield on broad sterling investment-grade indices is currently about 1% p.a. higher than gilts, a premium that is broadly in line with the long-term average.

The range of credit markets and, in particular, the potential risks and returns they offer is very wide. The broad characteristics that affect the level of risk and return are discussed later, but credit markets offer opportunities that offer yields barely higher than gilts, through the investment-grade bonds mentioned above to high-risk lending that can offer yields of 5-6% p.a. or more above cash interest rates. Most of these opportunities will be in investments denominated in foreign currencies. However, any currency exposure will tend to be hedged by a manager to remove currency risk, although this depends on the specification of the mandate.

Market background

The level of debt in the world's developed economies grew steadily for more than a decade before the financial crisis in 2008. Although this leverage was prevalent across all sectors of the economy, it was the financial sector that was most exposed. Following the sub-prime mortgage market blow-up in the US in 2007, the systemic crisis that ensued led banks suddenly to reverse their earlier expansion. This process ('deleveraging') can be done in three ways.

A bank can:

- raise new equity, which can be costly;
- sell assets, which could mean realising significant losses on impaired debt; or
- reduce its overall lending activity.

The third of these approaches has been the most economical and therefore the favoured approach taken by the banks to date. Coupled with the reduction in the overall number of banks, as levels of bankruptcy and mergers increased post the financial crisis, this has resulted in a lending demand and supply imbalance. Today, banks continue to face deleveraging pressures, with new regulation being the key driver.

Opportunities for institutional investors

In Europe, close to two thirds of corporate lending is done by the banks. By comparison, in the US only around 25% of the economy is bank financed.

The supply of debt financing has a strong bearing on the wider economy. Investment managers, both traditional and alternative, are now able to take the place of banks in some areas of lending, and other more specialised areas of finance. This in turn allows pension schemes to invest in a broad range of asset classes and strategies that were previously the domain of the banks.

There are a number of debt markets that offer institutional investors the potential to exploit the global financial deleveraging. These provide a much wider range of higher yielding opportunities beyond the traditional fixed interest investment grade bonds in which the Fund has invested for many years. These markets provide diversification by issuer and by bond type and, although correlated to the investment-grade market, they do not necessarily move in parallel with it.

There are various key characteristics of the different opportunities:

Liquidity

We have categorised the various opportunities as liquid or illiquid. ('Private' is also sometimes used as an alternative description in the latter case.) These descriptions are relative – none of the opportunities offers the liquidity available from gilts or investment-grade bonds. In normal market circumstances, trading will be possible in the liquid opportunities. Investment in the illiquid opportunities will typically involve a period where capital commitments are drawn down as opportunities arise and a lock-up period before capital is returned.

Borrower

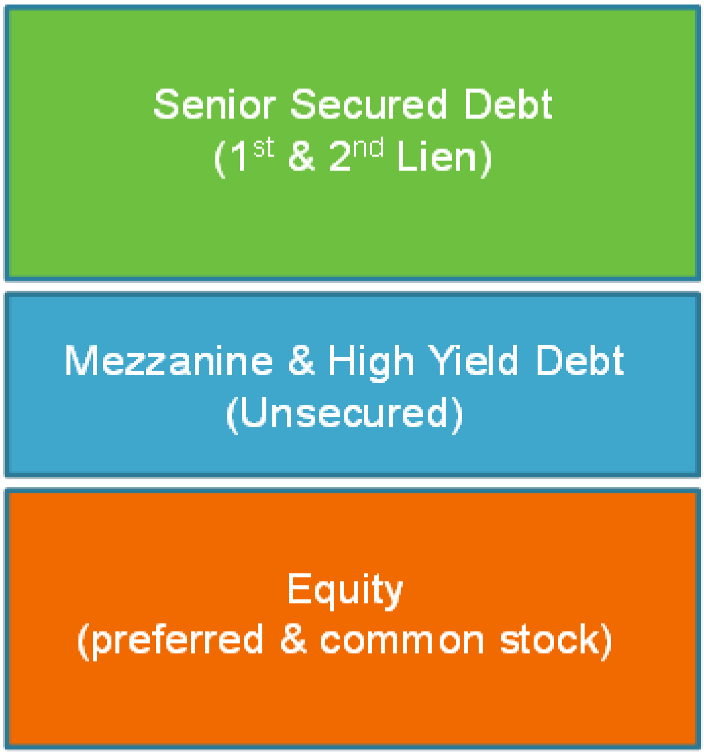
The borrowers can be corporate – commercial or industrial companies (often with higher levels of borrowing than investment-grade companies, giving these corporates a sub-investment grade rating). They can also be property companies or infrastructure-backed projects.

Income type

Most of the opportunities pay floating rate income, where each payment is calculated with reference to prevailing short-term interest rates, in contrast to the fixed income payments from gilts and investment-grade bonds.

Capital structure and security

Lending can be senior and secured on the assets of the borrower or subordinate to the senior debt and unsecured, i.e. there is no prior claim on the assets of the borrower. Where debt sits in the capital structure and its level of security are important in the event of default, as senior secured debt will be repaid in full before subordinate debt receives any payment.



We provide an example of a typical capital structure on the right (highest ranking capital at the top). This type of structure applies to all types of borrower. Details can vary; not all capital structures will include all types of debt and some high yield debt can have security over assets. Broadly speaking, the lower the rank of the debt, the higher the correlation with equities and the lower the correlation with gilts.

Yield

Variations in the characteristics noted above are reflected in a wide range of yield premiums available. We provide a brief introduction to the major debt opportunities below.

Liquid credit market opportunities

Syndicated senior secured loans

Senior secured lending involves lending to US and/or European sub-investment grade companies. The lending is through banks originating and syndicating debt out to the primary market. The syndicated loans market has a functioning (to varying degrees) secondary market.

The purpose of the borrowing will typically be to finance company growth, acquisitions, mergers and private equity sponsored leveraged buy outs (LBOs). As the name suggests, senior secured loans sit senior (1^{st} lien) within an issuer's capital structure and are secured against specific company assets. In the event of bankruptcy, senior debt will be repaid before other subordinated lenders. Historically, banks have been the dominant lender in this space. However, regulation has forced banks to scale back their lending activities creating a demand for privately negotiated non-bank lenders.

High yield bonds

These are corporate bonds rated below BBB, also referred to as 'sub-investment grade' bonds. The universe includes bonds rated below investment grade at issue and bonds issued at investment grade but subsequently downgraded by the public rating agencies. Often the debt is unsecured, i.e. with no backing assets and sits below any senior secured debt. Typically the debt is issued with a fixed rate with terms of 5 years plus. The high yield bond market has a higher average loss from defaults than the investment grade credit market and, as such, pays higher coupons to compensate investors for this increased risk and the greater volatility in pricing.

Asset backed securities (ABS)

ABS are collateralised by a pool of underlying loans which generate the cash flows from which income and capital payments on the bond are made. ABS are typically classified according to the source of the underlying loans, e.g. residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS), collateralised loan obligations (CLO) backed by syndicated senior secured loans and securities backed by credit card receivables.

The loans are pooled in a special purpose vehicle (SPV), a company specifically set up to hold the loans and coordinate payments and which does nothing else. The SPV will usually issue a range of securities backed by the same pool of loans but carrying different levels of exposure to the risk of default in the underlying loans (and, as a consequence, different coupons). Typically bonds will be issued with maturities of between 2 and 10 years and will be a floating rate over LIBOR.

The ABS universe offers a wide range of risk/return strategies, ranging from prime RMBS (given the highest AAA rating by the public rating agencies), with current spreads over cash of less than 1%, through to sub-investment grade paper offering high single digit spreads.

Illiquid credit opportunities

Direct senior secured loans

Direct senior secured lending is analogous to the syndicated lending described earlier, but involves a different issue mechanism. Deals are negotiated directly with the borrower by a single lender or by a ‘club’ of a few lenders, often including a bank that originates the transaction. As with the syndicated market, non-bank lenders have become more prominent in recent years as banks have scaled back their activity.

These private deals will have a very limited secondary market, if any, and offer an illiquidity premium over equivalent syndicated deals. Currently, lenders could expect this premium to be around 1% p.a.

Generally these will be midsized companies, unable to raise finance through the public high yield bond markets or syndicated loans. The purpose of the borrowing will typically be to finance company growth, acquisitions, mergers and private equity sponsored leveraged buy outs (LBOs).

Mezzanine debt

Mezzanine debt is unsecured, subordinated, private lending to companies typically with an equity component. The debt sits subordinate to senior debt within a company’s capital structure and will often have no specific asset backing. Exposure to mezzanine debt can be through specialist funds or multi-direct lending funds which will combine exposures to mezzanine debt alongside senior secured lending.

Senior property debt

Senior property debt involves lending to UK and/or European commercial property investors, either on a fixed or floating rate basis. Prior to the financial crisis, banks were the main source of funding in this market. However, as with other direct lending, opportunities now exist for non-bank lenders. Borrowers in this market include sovereign wealth funds, listed property companies and insurance companies. The term of lending is negotiable and can vary from 4-10 years. The market is private in nature, with no established secondary market (at this point). As such, clients need to accept illiquidity during the loan term.

A key measure of quality is the loan-to-value ratio (LTV), the proportion of the value of the assets on which the loan is secured equivalent to the amount of the relevant lending plus any prior claims.

Infrastructure debt

The case for investing in infrastructure debt is very similar to that for property debt – scarcity of capital should result in higher income returns than has been available in the past. Initially banks continued to lend on core infrastructure assets since the cash flows are viewed as predictable and stable.

However, regulatory changes such as Basel III are reducing lending, in particular long term lending with short-term liabilities through increased capital charges. As a result, we have started to see a wave of infrastructure debt products launch which invest at both the senior and more junior levels. This market is in its infancy, although a relatively small number of fund managers have operated in the infrastructure debt arena for over 10 years (mainly in Australia).

There is little standardisation of products. One of the attractions highlighted by infrastructure debt proponents is the inflation-linkage characteristics of infrastructure assets. However, in reality, the debt funds are not distributing inflation-linked coupons, nor does the principal invested grow with inflation.

Next steps

We continue to recommend a target allocation to alternative credit of 10% of Fund assets and that the allocation is introduced gradually once a suitable manager is identified. We would expect this strategy/strategies (2 mandates may be suitable to achieve a 10% allocation) to target a return in the region of cash + 3-5% p.a..

Given the long term nature of the Fund's liabilities and the potential premium on offer for investors who can tolerate investment in less liquid asset classes, **we recommend that the Committee initially focuses on illiquid mandates, specifically private debt. Whilst an allocation to liquid credit may have a role in future strategy, the recent contraction in market yields makes the investment case less appealing at present.**

Appendix 1 - Risks associated with investing in alternative credit markets

The risks associated with these strategies will vary by debt type, but also within each debt type there will be potential for variation in the terms of each bond. Key risks are as follows:

- **Issuer or portfolio credit risk** – risk of a downgrade and/or default;
- **Prepayment risk** – early repayment leading to a loss of the yield enhancement;
- **Liquidity risk** – some debt instruments are illiquid in nature (e.g. the direct lending markets, including corporate loans and real estate debt). Other elements of the market can become more illiquid under stress;
- **Reinvestment risk** – in the case of pooled funds, it may be that the yield benefit or discount to par price of existing investments becomes diluted if a pooled fund automatically reinvests proceeds into new bonds/loans. Where the yield on these is lower than on existing investments it may no longer be sufficiently attractive.
- **Interest rate risk/duration** – this is the sensitivity of a bond or portfolio of bonds to movements in interest rates. A typical core investment grade portfolio will have a duration of c. 7 years, which means if interest rates increase by 1% over what the market is pricing, the value of the portfolio will fall by 7%. However, interest rate risk is often significantly lower in alternative multi-credit portfolios given much of the investment universe, including structured credit and leveraged loans are floating rate (over LIBOR) and high yield debt has an average duration of around 3 years. Typically we would expect the duration of an alternative multi-credit fund to be less than 5 years. In addition, the market is pricing in a very gradual increase in interest rates and spreads, in particular, in the US high yield debt market where ex-energy and commodity names are more than compensating for any increase in interest rates currently.
- **Mark to market volatility –** much of the alternative credit market is rated sub-investment grade by the public rating agencies or assigned an equivalent sub-investment grade rating by the investment managers. This rating reflects the increased risk of default which exists within these markets and, as such, these markets will often show significant mark to market volatility. General Transition Risk Warning