Market Musings 3/25

For Professional Investors only

The Corporate Bond Conundrum

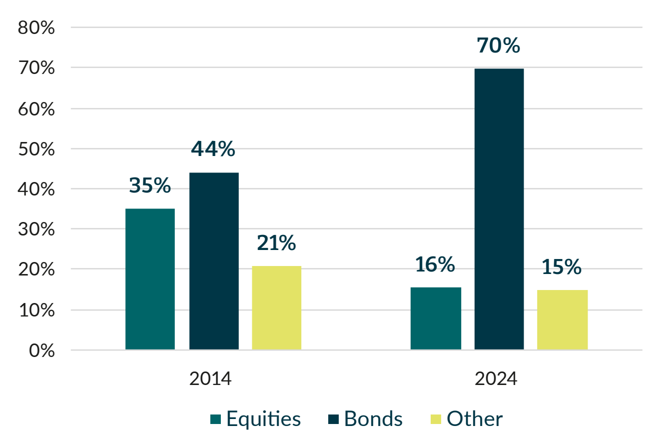
Should pension schemes look elsewhere for now?

Investment-grade corporate bonds are a cornerstone holding for well-funded UK DB pension schemes in order to match cashflows and better align with insurer pricing. However, with current valuations appearing stretched compared with historical norms and insurers shying away, is it time for pension funds to rethink this strategy?

Background

The rise in gilt yields since 2021 has significantly improved the funding levels of UK defined benefit (DB) pension schemes. On an estimated full buy-out basis (the cost to transfer the liabilities to an insurer), the average funding level for these schemes now stand at around 94%, roughly a 20% increase over the last 3 years.

Figure 1 – Evolution of pension scheme asset allocation



Source: The PPF Purple Book

This financial improvement has meant that schemes have de-risked their investment strategies, targeting lower investment returns. Over the last 10 years, corporate DB pension schemes' equity allocations have more than halved, whilst allocations to bonds have nearly doubled.

Within this bigger bond holding, allocations to investment grade UK (and partly US and European) corporate bonds have increased markedly, and now account for 22% of overall allocations based on the latest data from the Pension Protection Fund. And whilst the aggregate position is already material, if we focus only on schemes which are well-funded on a low-dependency basis, they will likely have even higher allocations.

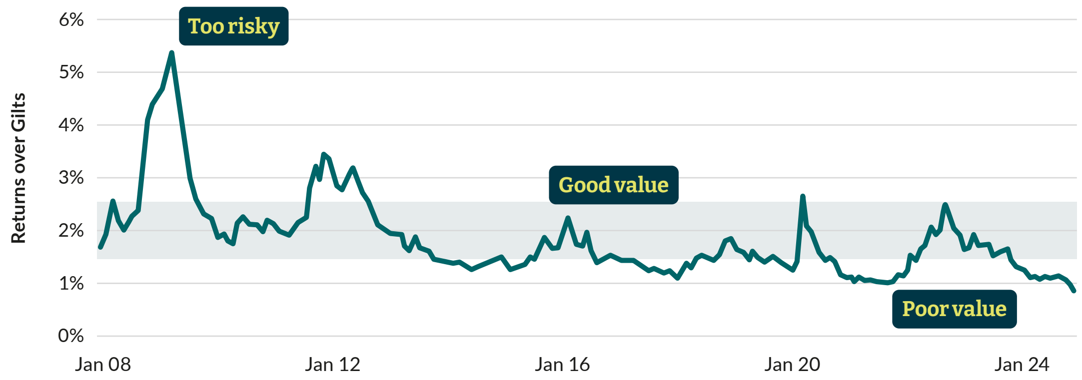
The shift over the last decade is partially due to corporate bonds being viewed as a high-quality asset delivering cashflows that matched the benefit payments which pension schemes needed to make, and did so at a better yield than gilts. Hence they formed the foundation of buy-and-maintain credit portfolios.

What's changed?

To fully understand the recent changes in credit markets, it's essential to understand the factors influencing corporate bond returns. The yield on an investment-grade corporate bond is composed of the yield from a comparable government bond and the so called 'credit spread', which represents the risk premium that an investor requires to compensate for the risk that the bond might default (or have its credit rating – a measure of its creditworthiness – downgraded).

As government bond yields have risen to relatively high levels compared to the last nearly two decades of being driven by quantitative easing, credit spreads have significantly tightened of late. Our analysis show that since 2005, sterling investment grade credit spreads have traded tighter than currently, just 13% of the time. Or, to put it another way, the extra yield investors receive on UK corporate bonds relative to gilts has been more attractive 87% of the time since the start of 2005. It is important to note this is not just a UK specific matter, with a similar story being told in both the US and Europe – in fact even more pronounced in the US.

Figure 2 – UK investment grade corporate bond spreads



Source: Bloomberg, Refinitiv, Van Lanschot Kempen

Whilst valuations appear stretched, corporate fundamentals do remain strong. Interest coverage ratios (a measure of a company's ability to pay interest on its debt) are relatively high. Secondly, credit downgrades (albeit a lagging indicator of health) are below longer-term averages. Over Q3 2024, there were only nine corporate downgrades (which was an all-time quarterly low) and quarterly downgrade ratios (proportion of corporates which have been downgraded relative to upgraded) was also at its lowest level since Q4 2021.

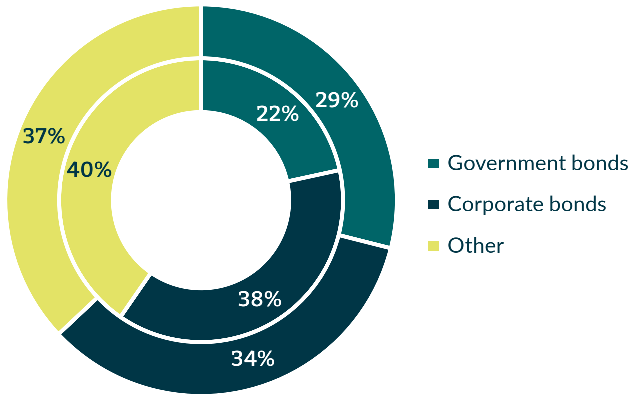
Finally, from a technical perspective, strong demand for corporate bonds coupled with a slowdown in issuance (supply) provided further support for a tightening of spreads. And that is good news for UK plc. But it begs the question of whether there is enough return left on the table in the credit spread for an investor today compared to just buying a government bond.

The impact of insurers

Historically corporate bonds have traditionally been the largest single component of insurers portfolios. In light of regulatory changes[1] and credit market conditions, insurers have reevaluated their investment strategies and decreased their allocations to corporate bonds.

Whilst there is no one size fits all approach for insurers, they have generally been strategically increasing their UK government bond (gilts) allocations, in anticipation of rising credit spreads in the future. Gilts are currently attractive to insurers due to their yield spread over swaps (their main basis for measuring their own liabilities).

Figure 3 – Change in annuity providers asset allocation



Source: PIC, Just Group, Rothesay Life, VLK estimates

Investing in gilts also offers insurers lower initial capital requirements and flexibility to switch to more attractive investments if spreads widen – and the tightness of spreads means that there is little cost to waiting. Some UK annuity insurers are also now using innovative strategies to leverage gilt holdings and achieve higher returns, contributing to even higher gilt exposure.

Pension funds seeking to hedge potential buy-out pricing would do well to take note – and may wish to follow suit.

Is now a good opportunity to take profits?

One way to analyse the current relative attractiveness is to examine how credit spreads have moved in the subsequent 12 months after reaching a given spread level.

When analysing data going back to 1996, for months where spreads have been less than or equal to current levels, the historical dataset shows there is greater than 75% chance of spreads widening in the subsequent year. When this has happened, credit spreads have widened by an average of 39bps, which equates to a roughly 4% fall in total value of the bond, all else held equal. Whilst past performance is certainly no indicator for future performance, it can provide useful context.

> With spreads already narrow, there's limited potential for further tightening, but significant room for widening creating a negative asymmetry for investors holding corporate bonds.

[1] Basel III regulations have adversely impacted corporate bond holdings by mandating that banks maintain higher capital and liquidity reserves, thereby increasing funding costs and, in turn, raising borrowing expenses for corporations issuing bonds.

Other considerations – defaults, credit quality and sector concentration?

1. Defaults

Interest rate risk is the primary concern for investment-grade corporate bonds, but default risk is also a key concern. Historically, default rates have been low, often under 1% annually. Even when defaults occur, recovery rates have averaged around 40% over time. Although default rates are low, they lag behind market conditions, so any increase would likely be indicated by widening credit spreads first.

2. Credit quality

Over the past 30 years there has been a deterioration in the average underlying credit quality of UK investment grade corporate bonds. In the 1990's, UK corporate bonds' credit quality was predominately AAA and AA rated. Fast-forward to present day, and the average credit quality typically ranges between AA to BBB rated. This is an important point, highlighting the potential for greater credit stress should wider economic conditions worsen.

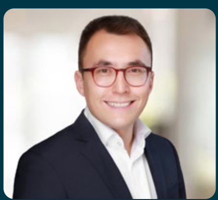
3. Sector concentration

Finally, let's examine the concentration in the UK corporate bond market. The market is heavily concentrated in a few sectors—financials, utilities, and consumer goods and services—which make up over half of the universe. This concentration poses risks, as demonstrated by the exposure to the UK water utility sector, particularly Thames Water.

What does this mean for pension funds?

At Van Lanschot Kempen, we are dynamically managing clients' portfolios to reflect our cautious view on UK credit. In most instances we have reduced overall allocations. Where we have reduced our overall exposure to UK IG credit, we have reallocated proceeds between a combination of UK gilts, alternative credits (e.g. the securitised credit markets) and even equities using a broader collection of opportunities than typically available to insurers.

Market Musings author



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