

# How corporate are your bonds?

The recent market crises have impacted on all asset classes. Whereas the impact on equity markets has been well documented, the impact on bond markets has not received as much coverage.

This note considers some of those issues relevant to pension scheme trustees investing in sterling bonds. With the recent and continued changes to bond markets trustees may wish to review their bond investment policy to ensure it remains appropriate.

## Bond investment – a reminder

The UK Government borrows money by issuing bonds (gilts). Lenders to the Government buy these bonds and in return receive regular interest payments and a lump sum at the end of the term.

Similarly other organisations borrow money through the capital markets by issuing bonds. Such bonds issued by companies are known as 'corporate bonds'.

Bonds may be bought and held to maturity in which case the investment return will be defined by the yield at outset. Alternatively, they may be bought and sold over the term in which case the return actually achieved will depend on market conditions on the date of purchase and sale.

The 'yield' or investment return from investing in a corporate bond is higher than from a comparable gilt for a number of reasons, the main one being the greater chance that the corporate bond issuer will not be able to repay its borrowing.

Investors require this extra yield as compensation for taking on the extra risk. This 'spread' or 'credit spread' over the yield on gilts can widen or narrow and these changes can result in significant outperformance or underperformance of corporate bonds relative to gilts. These changes are driven by the market's view of likely future default experience.



## Pension schemes as bond investors

Pension funds invest in corporate bonds primarily to benefit from the spread, as well as increasing the overall level of portfolio diversification. They usually restrict investment to bonds issued by borrowers with higher credit ratings – 'investment grade corporate bonds.'

Analysis has shown that historically the spread has more than compensated for actual losses due to defaults and investors have generally been better off in the long run from investing in corporate bonds than from holding gilts, albeit with greater volatility of returns.

## Economic background

Since the onset of the 'credit crunch' the spread between yields on investment grade corporate bonds and UK gilts has increased from an average level of about 0.5% per annum to 3% per annum due primarily to worries that actual defaults will increase. This has been driven by investors worries that:

- the number of defaults will increase; and
- if a default does occur, the amount recovered in the insolvency (through the sale of assets, for example) to be shared between the bond holders will be low.

We have already seen a significant increase in the incidence of corporate insolvency, the most familiar being Woolworths and Zavvi (formerly Virgin Megastore).

In addition, a significant fall in corporate bond trading volumes has increased the additional return required to compensate investors for bonds being less readily tradable than gilts.

This resulting lower level of liquidity also has another significant impact in the corporate bond market. Recently it has been virtually impossible for new corporate debt issuance to take place without the issuer offering a very high spread over gilt yields, thereby making interest payments more expensive (although this has eased somewhat). The total value of corporate debt in issuance is therefore expected to fall sharply as bonds mature but less new debt is issued as a result of this affordability issue.

## Changing nature of the market

The main exception to the above affordability issue relates to those bonds effectively underwritten by the Government – in particular the majority state-owned UK banking sector. These bonds are perceived as less risky than those without a Government guarantee and hence the spread offered does not need to be so high.

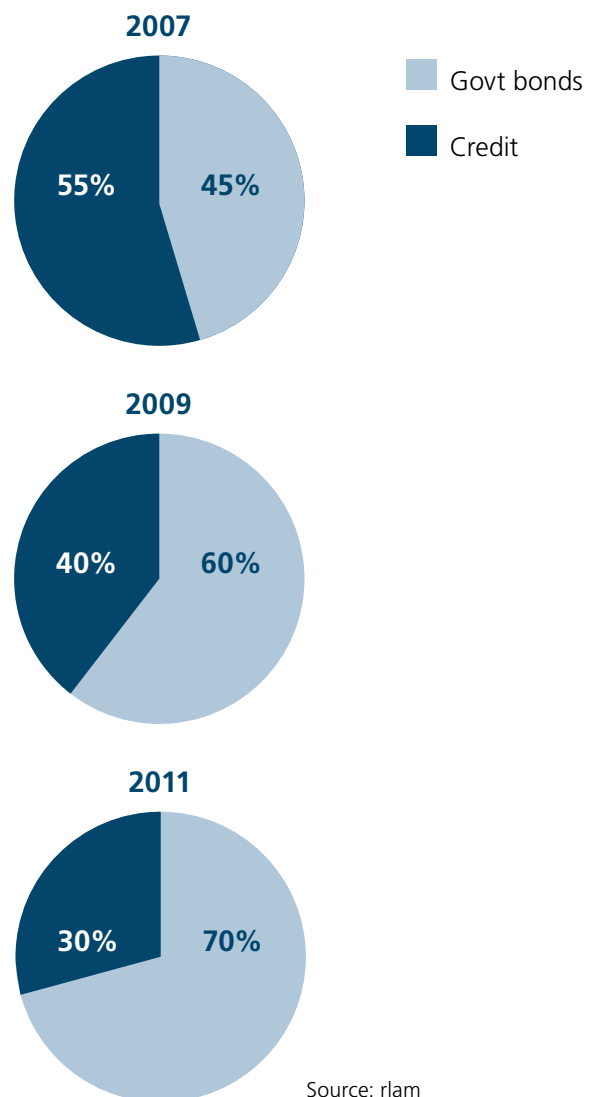
Similarly, supranational organisations and foreign governments are still able to raise finance via debt markets relatively cheaply. As a result the proportion of bonds available in the market that are not Government or quasi-Government backed will fall if market illiquidity remains.

Coupled with this, the UK government is planning to issue unprecedented amounts of new gilts. The planned £350bn issuance will increase the total value of gilts in the market by 50%.

These factors will change the fundamental structure of the sterling bond market significantly:

- The balance between gilts and other bonds will swing strongly to the former;
- The dwindling non-gilt market will become more weighted towards issues backed by a Government guarantee, whether explicit or implicit, and supranational organisations.

Split between sterling government and other bonds, historic and projected



Further research from rlam suggests that by 2011 approximately 80% of total sterling bonds in issuance will be AAA rated. Taking all of this together the average credit rating of a typical aggregate bond index will be expected to increase, as will that of a typical investment grade non-gilt index.

## Performance measurement benchmarks

Most corporate bond mandates are benchmarked against Sterling Non-gilt indices. If the above scenario pans out in practice these non-gilt indices will become increasingly unrepresentative of 'true' corporate bonds due to the increased weighting of bonds issued by supranational organisations and debt backed by governments.

Pension fund trustees will need to consider the specific implications of any benchmarks they monitor, whether 'non-gilt' or 'corporate'.

- Those with 'non-gilt' indices will find that their portfolios become more heavily skewed towards bonds that could be considered not actually 'corporate' in nature;
- Those with corporate bond benchmarks will find that their managers are holding less secure (and hence less liquid) stocks.

## Investment approaches

As the nature of bond markets changes, so must the approaches followed by investors. We have already considered above the increasing importance of distinguishing between 'non-gilt' and 'corporate' bonds. The implications for these two families of portfolios are somewhat different.

- Non-gilt portfolios, with their increased weighting towards more secure issuers, will see average credit ratings improve and hence the spread offered over gilt yields will be lower. This may be accompanied by an increase in liquidity as the proportion of portfolios comprising illiquid stocks is reduced;
- Corporate bond portfolios on the other hand will experience the opposite effect. As issuance becomes scarcer, trading volumes and liquidity will decrease, as they did immediately following the onset of the credit crunch. This in turn will lead to a rise in trading costs. Managers will tend to pursue buy-and-hold strategies, holding bonds for a significant period or to maturity for fear of damaging their performance by increased trading costs.



## Implications for pension schemes

- Corporate bond spreads over gilt yields recently reached historic highs and hence may appear increasingly attractive to investors. It is important to understand the reasons behind these increased spreads and to select bonds based on their specific characteristics, rather than automatically assuming that bonds are generally good value;
- Schemes with existing corporate bond investments should review their choice of benchmarks in the light of the nature of the specific stocks held and ensure they remain appropriate;
- Schemes with regular switching or rebalancing programmes between asset classes should ensure that these remain appropriate given potential changes in transaction costs;
- Trustees should consider whether any corporate bond managers without a buy and hold mandate may need to change their strategies.

If you would like to discuss these issues further please contact your usual Barnett Waddingham consultant.

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