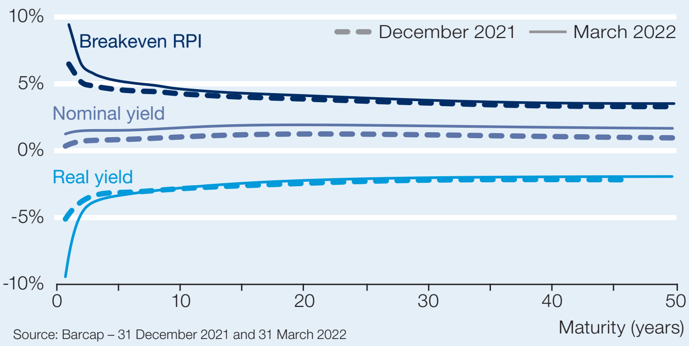
Market Monitor: Q1 2022

Alpha Real Capital

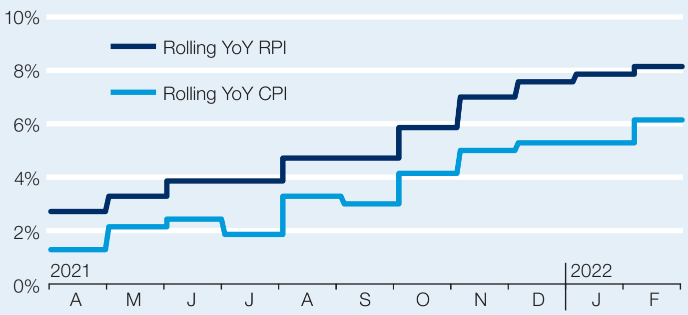
Rates, inflation and credit spreads

Gilt yield curves



Source: Barcap – 31 December 2021 and 31 March 2022

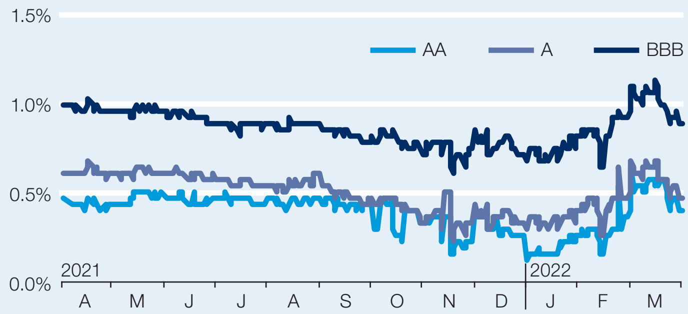
12 month rolling inflation



Source: ONS - 31 March 2022

- Real Gilt yields increased c. 30bps on average over the quarter at medium and long maturities. Nominal Gilts showed an even greater increase of c. 70 bps at shorter terms and above 60 bps at longer maturities. The short-term increase is primarily driven by rising Bank Rate and inflation expectations: RPI (CPI) rose c. 9% (c. 7%) in the last 12 months.
- Actual inflation continued its upward trend over the quarter. Shortages in goods and the labour force; supply-chain bottlenecks; higher commodity prices and the government unwinding pandemic support measures were key drivers of the recent uptick as was the ongoing war in Ukraine. In March 2022, the Bank Rate was raised from 0.5% to 0.75% to combat inflation. The Bank of England expects the rate of inflation to reach c. 8% this spring.
- Investment Grade bonds have continued to benefit from a “flight to quality”; credit spreads for UK Investment Grade bonds remain tighter than pre-Covid levels. The uncertainty provoked by the war in Ukraine increased the spread volatility, explaining the upward trend recorded more recently.

Credit spreads



Source: S&P Capital IQ 10 year non-financial GBP bonds – 31 March 2022

Secure income market update

Spreads remain compelling for secured long income assets

- As the Covid-19 period lasts, resilience continues to be demonstrated across Long Lease real estate markets, most notably for high quality Income Strips, Social Real Estate and Commercial Ground Rents.
- Spreads over Gilts for Long Lease, Income Strips, Social Real Estate and Commercial Ground Rents have tightened by 30 bps from the previous quarter.
- Spreads for Renewables are shown over both real and nominal gilts.

Asset class definitions

Renewables Infrastructure: 15+ year inflation-linked cashflows from unlevered wind and solar infrastructure assets subject to Feed-in Tariff (FIT) or Renewable Obligation Certificate (ROC) regimes.

Long Leases: 15+ year inflation-linked leases on commercial real estate. Traditional sale & leasebacks fall within this market.

Social Real Estate: 15-20+ year inflation-linked leases on operational real estate across the housing, healthcare and education sectors.

Income Strips: 30+ year inflation-linked leases on commercial real estate where the lessee has an option to purchase the real estate back at the end of the lease for a nominal amount (e.g. £1).

Commercial Ground Rents: 100+ year inflation-linked leases on commercial real estate, with a higher degree of rental and value cover than a traditional sale & leaseback.

Sources: Alpha Real Capital (for illustrative purposes only and for typical transactions available to pension schemes in these asset classes). Data as at 31 March 2022. The future returns and opinions expressed are based on Alpha Real Capital internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Alpha Real Capital nor as advice of any nature. Source of corporate bond spreads: S&P Capital IQ 10 year non-financial bonds – 31 March 2022.

Secure Income and what this means for LDI

Secure income assets can be a great match for a pension scheme's liability cashflows and provide attractive returns. Their increasing use by pension schemes, which is part of the broader move towards cashflow driven investing (CDI), throws up some interesting questions as to how pension scheme investment portfolios are traditionally put together and managed. In this note, we provide some thoughts on what a material allocation to secure income assets means for a scheme's strategy, including implications for its LDI portfolio.

So what is happening and why?

Schemes are de-risking and increasingly investing in assets that provide contractual income. The attractions for doing so are clear.

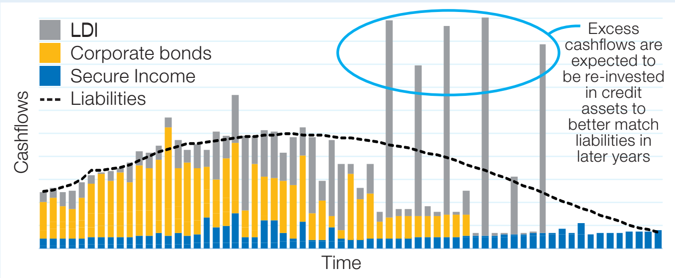
- Private market assets provide an illiquidity premium – as we report in this market monitor regularly spreads can be as high as 4% to 6% p.a. above index-linked government bonds.
- The contractual cashflows are long-dated and inflation linked. These provide a good match to the payments that need to be made to scheme members. Such matching assets provide relatively inexpensive inflation protection, in a world where assets paying inflation-linked cashflows are scarce.

As schemes mature and funding levels improve, trustees are focusing on making sure cashflows - member benefit payments - are met as they fall due. So now, alongside **hedging** interest rate and inflation risk and meeting **return** objectives, schemes have a third objective to **meet cashflows**. The latter has always been there of course, but as a scheme becomes cashflow negative relying more on the asset portfolio for cashflow as opposed to contribution income – meeting this objective becomes a bigger driver of investment decisions.

Meeting cashflows as an important objective and a primary driver of asset allocation decisions is at the heart of so called Cashflow Driven Investment (CDI) strategies. This change in emphasis requires investors to evolve their approach to investing to meet pension scheme objectives. To bring the discussion into relief, we describe the characteristics of a stylized CDI portfolio as a means of outlining areas where thinking and approaches are evolving.

What could a CDI portfolio look like?

We answer this conceptually by illustrating a portfolio that could meet the primary objective of meeting cashflows, as well as a scheme's return and hedging objectives. It is worth bearing in mind that many pension scheme will transition towards this type of portfolio as they approach their long-term funding targets. The chart below illustrates how a CDI strategy that has an income generating portfolio designed to match liability cashflows and meet return expectations could work alongside a LDI portfolio that 'fills in the gaps' to meet the scheme's liability hedging objectives.



What does this mean for how pension scheme assets are managed?

While there may be far-reaching consequences for the traditional pension scheme investment frameworks, here we limit ourselves to three key observations:

- Given the emphasis on meeting cashflows, assets that provide contractual income are likely to play a larger role within pension scheme portfolios. This may include public assets such as investment grade corporate bonds, and UK government bonds (held primarily to support the LDI portfolio rather than for their cashflow generation characteristics) and a variety of private market (and illiquid) assets. ***We expect continued demand for assets with long-dated inflation linked cashflows***.
- A consequence of the preceding point is that in a duration-matched portfolio, credit risk would become the dominant driver of portfolio returns. Hence, the skills required to manage a portfolio of credits across public and private markets (in a variety of contractual formats) so that the portfolio achieves the best risk-adjusted return will be critical to success. In relation to this, ***measuring performance and risks of such portfolios will need to evolve (e.g. shifting focus to default risk rather than mark to market risk). This has implications for both asset only and versus liabilities perspectives***.
- The Role of the LDI in a scheme's portfolio would also change. Traditionally LDI used leverage to provide two key benefits, simultaneously hedging liabilities while remaining invested in growth assets. As schemes get closer to the end game and invest in assets that match liability cashflows both of these benefits need to be re-evaluated. Taking each in turn:

  a) Hedging is not the same as cashflow matching. LDI portfolios are designed to change in value in line with how a scheme's liability value changes in response to changes in interest rates and inflation expectations. It is important to appreciate that an LDI portfolio does not have to actually generate any cashflows to achieve this hedging objective, and indeed a traditional LDI portfolio would not meet a scheme's cashflows. As schemes increase assets that actually generate matching cashflows, the need for those matched liability cashflows to be hedged as part of the LDI mandate is arguably diminished. At the least, the LDI manager's benchmark needs to reflect the existence of the cashflow generating asset. When the latter assets are not marked-to-market, it adds another layer to the discussions. Adjusting the LDI benchmark to allow for illiquid cashflow generating assets is an area where best practice is emerging.

  b) As schemes' funding levels improve fund and portfolio return targets are lowered, they are unlikely to use leverage to the same extent. Leverage comes at a cost which may not need to be incurred. However, the ability to use leverage (and derivatives) will still be valuable for schemes, for example as a source of inflation exposure if this is not provided by the physical assets the scheme invests in. Also gilts can be used in the repo markets to generate cashflows, helping to meet liabilities when the assets are not generating them naturally.

In conclusion then, the evolution of pension scheme investing continues. As schemes naturally mature and focus migrates to meeting cashflows, secure income real assets are likely to play a growing role in pension scheme portfolios. This has implications for the skills and approach needed to manage assets versus liabilities. In particular the role of LDI in a scheme's portfolio may evolve to complement the cashflow matching assets, and managing liquidity to better meet cashflows.

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