#3 / November 2017

PENSION FUNDS LETTER

Building together smart solutions to face a challenging environment

Confidence must be earned

Amundi ASSET MANAGEMENT

Thierry ANCONA
Global Head, Corporate Segment, Co-Head Treasury Business line

EXECUTIVE SUMMARY

Shifting approaches from yield spectrum to credit continuum

In their everlasting search for yield, pension funds have broadened and deepened their exposure to credit since the end of the financial crisis and shifted to a pro-active approach to balance funding risk with a strategic asset allocation. But in order to capture other types of returns beyond the traditional bond universe risk premia, it is necessary to push the limits or cross investment boundaries, be they theoretical, legal or accounting.

While the means of geographical diversification and lower ratings have compensated part of the yield reduction, pressure pushed investors to explore the credit continuum even further. Credit universe proves to be deep enough in terms of sub-asset classes and market segmentation to offer investor yield pick-up as well as diversification potential, but if earnings from credit continuum have a moderate risk profile, entering and going further in the credit continuum comes with slightly higher risk tolerance. While 2018 is approaching as a year of transition, it's probably time to reconfirm or not the benefits of such an approach.

Firstly, risky asset markets do deserve consideration in the current environment, which is characterized by 1) a more mature cycle, mild inflation and better growth macro fundamentals, 2) positive dynamics of corporates, including leverage stabilization, and 3) orderly standardization of monetary policies by Central Banks.

Secondly, risky asset strategies should offer resilience to long-term investors, whether considering country spread, issuer or debt structure. Priority should be given to quality of issuers, security selection with a focus on liquidity in order to capture alpha opportunities.

The European macro environment continued to improve with positive headlines supportive for credit benign technical factors, ECB accommodative policy, and an expected subdued primary market. The normalization process with rising rates is also expected to be smooth, the well communicated exit from stimulus programmes being anticipated to only generate short-term credit volatility.

Developed Markets corporate bonds fundamentals remain relatively stable both in the US and Europe. Emerging Market Debt (EMD) should increasingly be considered as a "carry trade" and a diversification story, the room for spread compression going forward being tight. EM countries' improved balance-sheet quality and financial stability conditions are positive. The asset class is still favored by investors' flows. This overall context is supportive of a Credit Continuum strategy as: "A credit continuum strategy aims to meet the end goal of investors looking for attractive yields by tapping opportunities across the credit spectrum with a focus on cash-flow generating".

Éric BRARD
Global Head of Fixed Income

Credit continuum: how to make the right allocation choices

A Credit Continuum strategy aims to meet the end goal of investors looking for attractive yields by tapping opportunities across the credit spectrum, with a focus on cash-flow generating assets and, to a lesser extent, on growth assets such as infrastructure or shipping.

The only common feature of this Continuum of asset classes, from Investment Grade to High Yield, secured assets to private debt, is Credit. In order to take full advantage of a Credit Continuum strategy and to make the right calls in terms of asset allocation, an asset manager will have to pay attention to each step of the process, from the client's risk/return profile definition to the portfolio construction and active investment.

In addition to traditional credit analysis, mixing fundamental and quantitative research to assess the strength of each credit instrument, we are convinced that the focus on market pricing is essential to deliver return in the portfolio. The constant analysis and follow-up of liquidity features is another prerequisite to bring real value to investors.

Market Pricing is a key driver of performance in a Credit Continuum strategy

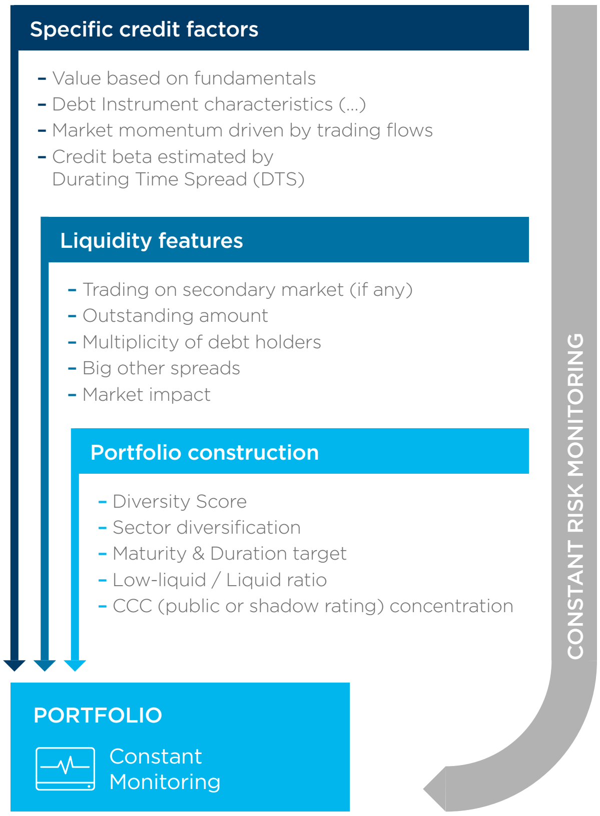
Our longstanding experience in credit markets taught us that performance comes from credit selection capabilities and momentum execution. Issuers' solvency and debt structure are of course key elements but are not sufficient. Market pricing drives the realized performance.

For instance, financing an LBO structure does not only depend on credit metrics and debt characteristics. The credit premium offered to investors, relative to market benchmarks, is the driving force of excess return for an active asset manager investing in the broadest range of debt types issued by a company. Pricing assessment must be carried out across a broadened universe: a senior secured loan can offer more value than a senior unsecured High Yield bond issued by the same corporate thanks to a well-structured loan with protective covenants. Conversely, using a dynamic perspective, a benchmark High Yield bond from a weaker issuer could be a better investment: the idea being to divest the bond as soon as the spread, benefiting from good market technicalities and supporting trading flows, has tightened enough.

The permanent monitoring of liquidity features highly contributes to the quality of asset allocation

This generic example shows that building performing credit portfolios mixing public and private debt over time, requires numerous axes to make sound investment decisions. A Credit Continuum portfolio is first and foremost a credit portfolio. Picking the optimal instrument and best allocating it across the wide-ranging available submarkets requires also permanent monitoring of the constantly evolving liquidity of each segment.

The various metrics that we consider in our analysis are as follows:



Source: Amundi

The specific credit factors regroup the traditional fundamental metrics we can infer from a credit research work and some quant indicators which estimate the sensitivity to market evolution and quantify the credit risk profile of an instrument.

Among the liquidity features, we must distinguish the elements which flag the existence of potential secondary liquidity and the way to value the cost of liquidity. Some illiquid products can become liquid if the investor accepts a significant haircut. The portfolio manager's ability to track this market information through his extensive network can be a key element of success. Investing in a diversified credit instruments portfolio does not only depend on a piece by piece analysis.

The portfolio construction must not be neglected. Mixing different duration profiles crossed with liquidity provided by the contemplated instruments will give a natural cash-flow generation for reinvestment or distribution to the portfolio during the investment period. This characteristic can multiply the entry points and mitigate the market timing effect. Tracking the most sensitive bucket to credit event within the portfolio must also be part of the rigorous process an asset manager should put in place in such an investment framework. It is in particular necessary to apply stress tests and operate a constant monitoring in order to decide whether to exit or not and at what price.

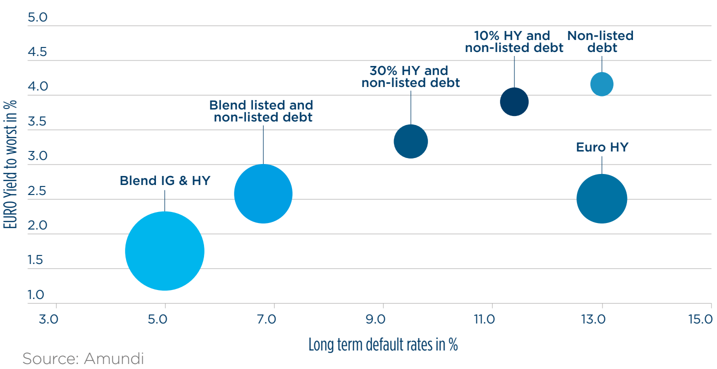
The ex-ante definition of investors' risk/return profiles is essential to build bespoke solutions, adapted to different investment horizons and liquidity constraints

To build the portfolio, the first step is to define the investor's risk/return profile, which in turn will define the investment universe of the portfolio. Establishing a cross-over profile will put aside the major part of the subordinated LBO debt; targeting a 4% to 6% return in Euro will make any purchase in the investment grade world very rare.

So a Credit Continuum solution must be defined precisely on an ex-ante basis with the final investors. First, the tolerance for illiquidity is a key characteristic: we can sum it up by a target proportion of the portfolio in private debt, which can be marginal near 10%, or which can be the main goal of the product by reaching up to 100% at the end of the investment period.

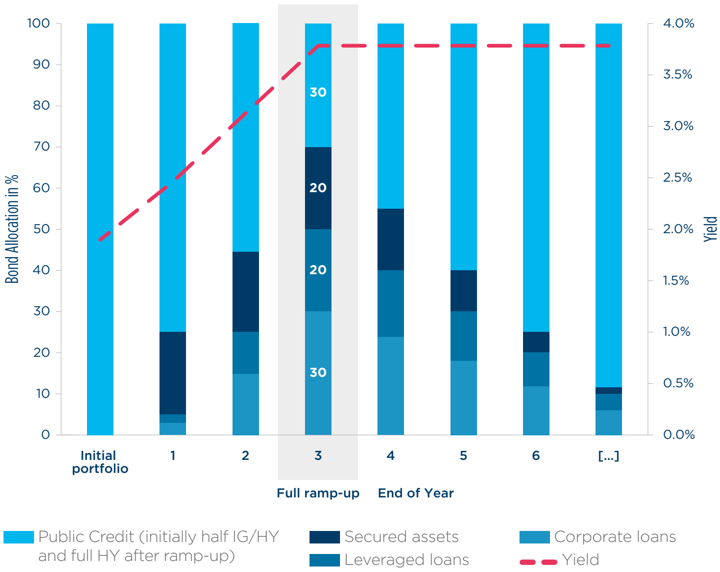
The length of the investment period is also important before entering an amortizing period. The longer it is the more active the portfolio can be. The investment manager can be focused on very rare and opportunistic transactions if he gets years to substitute private loans to conventional listed bonds. If he has a short time period, he will be more concentrated on classic deals such as large cap LBOs with potential secondary offers.

The following graph shows the different portfolios we can propose depending on the risk/return profile and tolerance for illiquidity:



Source: Amundi

Illustrative portfolio:



Source: Amundi

A 3-year ramp-up period is enough to build the final mixed portfolio as we plan to keep a relatively significant liquid part in the product (70% based on public bonds, secured assets (SME CLOs and Leveraged loans). This well-balanced portfolio enables to benefit from the different credit market segments without suffering from a too static structure. The weighted average life is less than 5 years which represents a good trade-off between market opportunities to catch and the required holding period.

In a Credit Continuum strategy, asset managers are able to deliver extra return by their ability to make the right decisions in terms of asset allocation at the right time. In particular, we need to rely on market segment experts acting on a day-to-day basis to source transactions, meet debt issuers and perform relative value strategies.

In the current market environment (low yields, central bank tapering risk), European High Yields bonds and private debt (private placements, leveraged loans and even uni-tranches) are cornerstone performance drivers in a Credit Continuum approach. In addition, these two components of the credit spectrum show real interconnections as a contemplated issuer may finance his business either through a secured private loan or a listed High Yield bond. Beyond these commonalities, dedicated investment approaches are required to better tackle from specific market information and legal set-up.

Market segment focus #1

European High Yield bonds: taking advantage of their diversification and yield pick-up potential

Should European High Yield Bonds continue to add value in a Credit Continuum strategy after such a strong performance? The answer is clearly positive.

The purpose of the Credit Continuum strategy is to make the most of credit opportunities. European High Yield, which consists of corporate bonds at the lower end of the rating spectrum, is among the most attractive asset classes within the Credit universe.

High Yield in general has an atypical profile compared to other Fixed Income products due to its relatively high spread component, compensating investors for a higher credit risk. Over a long term period, High Yield exhibits a negative correlation to interest rates as well as a positive correlation to Equities. Therefore, investing into High Yield brings significant diversification to a Fixed Income portfolio.

European High Yield specifically offers a compelling risk / return profile. Over the past 10 years, except for 2008 and 2011, its total return / excess return performance has always been positive, at least driven by carry. At the same time, its volatility has been much lower than Equities for comparable or higher returns.

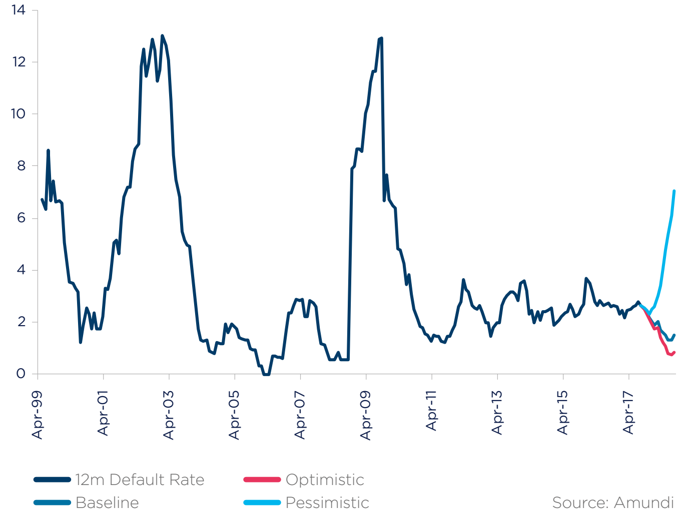
Both diversification qualities and an attractive risk/return profile have made credit investors' allocation into European HY more structural over the past years. The significant growth of the asset class, from less than €50bn in 2008 to around €350bn now, and the increasing proportion of BB grades (i.e. 2/3 of the market, including Fallen Angels), have given investors more comfort, improved market diversification and above all, liquidity.

With an annualized average return of +7.6% over the past 5 years, the European High Yield market has also undoubtedly benefitted from cyclical factors, including the Eurozone macroeconomic recovery and a low rate environment driven by Central Banks actions. Though not eligible to the ECB's CSPP[1], European High Yield has indirectly benefited from it with Investment Grade investors going down the rating spectrum.

Should European High Yield Bonds continue to add value to a Credit Continuum strategy after such a strong performance? The answer is clearly positive as this market segment will continue to be supported by a moderate but improving growth, strong High Yield companies' fundamentals (lower leverage, higher interest coverage, low refinancing needs, below average default rate expectations) and positive technicals as search for yield should continue in a low rate environment.

Accommodative monetary policies have reached their limits, at least within the current economic cycle. The consequences of the expected more restrictive Central Banks' policies will be a rerating of financial assets, part of which was due to very low interest rates. For the Euro zone, this does not translate into much higher spreads but this will surely put a brake on a further tightening of them. Carry more than capital gains will therefore be the drivers of performance for premium assets, notably European High Yield.

Europe 12m Issuer-Weighted Spec-Grade Default Rate Forecoasts (As of 08/31/2017)



Source: Amundi

1. CSPP: Corporate Sector Purchase Programme

Market segment focus #2

Private Debt: providing access to senior debt holdings and capturing extra-return from additional risk premia

Private debt offers investors an excellent way to diversify their fixed-income exposure, allowing them to mitigate both duration and credit risk, which is particularly relevant in the current financial market environment.

Private debt is a singular asset class, with a dual DNA. While it owns similar characteristics to standard credit bonds, such as the search for regular income and capital preservation, it also shares common features with private transactions markets, in particular a high level of decorrelation, as well as an access to asset classes with high barriers to entry and attractive risk premia to capture. In a Credit Continuum strategy, we progressively increase the share of private debt holdings until reaching the full ramp-up stage of the portfolio, as we believe private debt is a key driver of diversification and excess return for investors.

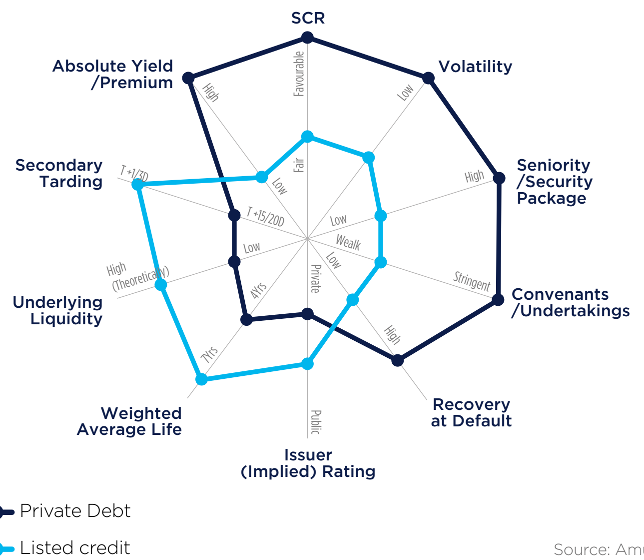
Private debt offers investors an excellent way to diversify their fixed-income exposure, allowing them to mitigate both duration and credit risks, which is particularly relevant in the current financial market environment. In a context of low to negative returns, modified durations of traditional fixed-income instruments are getting higher and higher. Private debt, through the use of floating-rate loans, provides a hedge against this increasing duration risk. In addition, by using private debt instruments, investors gain access to highly senior debt, with a better recovery rate in case of default. The credit risk is also mitigated by the existence of several protection mechanisms, like collateral packages and negotiated covenants.

Senior Secured Loans (SSLs) illustrate very well how private debt instruments may be used as a way to mitigate both interest rate and credit risks. SSLs are characterized by an ultra-short duration via the use of floating-rate notes, with average interest rate reset periods of 45 to 60 days[2]. They also benefit from a comprehensive set of credit risk mitigation measures, from legal documentation to post-investment monitoring, enabling SSL's holders to be ranked first in the repayment list, should any default occurs.

Not only does private debt enable investors to reduce their exposure to major market risks thanks to its diversification properties, but it also represents an attractive asset class in terms of performance, by capturing extra return that lies in a number of additional risk premia, coming for example from a relative illiquidity and complexity of transactions. We estimate this gross extra return, which might be partly mitigated by costs inherent to stringent legal package and guarantees, to average between 75 bps and 100 bps[3], compared to traditional fixed-income returns.

In order to fully leverage on the potential of the asset class in a credit continuum strategy, we have identified five key success factors to combine: large sourcing capability, in-depth credit analysis, thorough transaction structuring, qualitative asset allocation, and active portfolio management. In the private debt sector, nothing can start without having an excellent sourcing network, in order to maintain a discriminant hit ratio (1/20) and capture the best deals. During the due diligence phase, we believe it is essential to have an unparalleled access to information and management for the credit analysis. In order to properly identify the transaction embedded risks, the ability to structure the legal documentation is also key, as it will determine our future ability to steer the relationship with the counterparty in case of credit deterioration. When allocating between the different private markets, the main performance driver will lie in our capacity to detect the relative value among them and to identify the best risk premia to capture. Last but not least, a private debt strategy cannot bring value in the long term without a permanent quality assessment and an active monitoring of the constructed portfolio.

Combination of the best opportunities offered by listed credit and private debt:



Source: Amundi

2. Source: Credit Suisse. Data as at 31 December 2016.
3. Estimation based on Amundi

Conclusion

KEY MESSAGES

What are the key success factors to implement a credit continuum strategy?

1 Large coverage of expertise: fixed-income platform going from IG bonds to private debt

2 Governance allowing the cross-fertilization of ideas between the investment teams and an efficient decision-taking process (Global CIO)

3 Strong research and analysis capability

4 Global investment tools shared by all credit investment teams

What are the key benefits of a credit continuum strategy for clients?

1 Bespoke solution

2 “All-weather” solution due to wide investment spectrum, flexible allocation, predefined time horizon allowing to stick to market cycle

3 One stop shop solution to onboard yield and diversification opportunities where they stand

4 Flexible stance to phase illiquid assets ramp-up

Giles BEDFORD
Emerging Markets Business Development
& Investment Specialist

Emerging markets: unlocking the next wave of opportunities

When considering the long-term prospects for the Emerging Markets asset class, the twin drivers of long-term returns – demographics and improving governance – can form a sustainable source of performance in our view.

Today's EMs are wealthier than ever before.

Since 2000, the developing world's share of global financial wealth has expanded from less than 10% of the total to more than 30%. In U.S. Dollar terms, the area's wealth stands at $75 trillion versus the developed world's $175 trillion. GDP growth alone cannot explain this achievement. For the mature world, the emerging world's economic expansion, and subsequent consumption, present an attractive solution to pension deficits. For the emerging world, the mature world represents a source of capital and end demand. As a result, emerging financial markets have broadened and deepened, with today's community reflecting this development in both size and sophistication.

EMs remain highly dependent on foreign capital

While delivering real progress, EMs remain highly dependent on foreign capital for further growth and development. The challenges that EM policymakers face differ in character from those in the mature world. There is no scarcity of potential growth sources. Instead, EMs are contending with issues around the management of expansion. EM savings systems' development has sometimes lagged headline growth, to the general detriment of those populations. This lag can reflect weak policy choices, and helps to explain disappointing rates of new issuance in some markets, and weak human capital retention in others. In order to continue to attract competitively priced capital from foreign investors, developing countries need to pursue meaningful and lasting reform. However, investors also need to participate in this push toward higher standards of stewardship in both sovereign and corporate governance. Exponential demographic growth can act as a catalyst for change. For fast growing, rapidly urbanising economies, employment growth can challenge governments to both deliver and sustain higher standards of living for larger numbers of people. Thanks to cheap technology, a rising awareness of western living standards is further elevating pressure on weaker governments. Armed with better information, populations are becoming increasingly more empowered and less tolerant of inequality than previous generations (which might have accepted weaker, less transparent local government) and thus logically seek better governance in order to secure their future.

Attracting Capital in EMs

Variability of return has been a consistent characteristic of EM investing. As a net importer of capital, the asset class' valuation has generally reflected external risk appetite. This variability raises costs for EM issuers, and can impede economic development, thus raising the cost of capital. In our long-term view, we see a possibility that domestic efforts to deepen pensions and savings systems may result in less demand for external capital in the very long term, while delivering an improved governance. In the meantime, the sheer scale of EM demand for capital keeps the asset class fully engaged with foreign investors.

Improved governance will help deepen local markets

Governance, innovation, competitiveness, and access to capital are linked. Multinationals can threaten a domestic market through competition and acquisition, local businesses can respond through innovation, attracting capital through competitiveness and governance. For many locally listed businesses, governance and competitiveness are areas for improvement. Growing local mutual funds and pension funds helps this process in two important ways. First, an increasing amount of dedicated local capital improves domestic depth and liquidity, which in turn opens the market to larger levels of international capital. This leads directly to a second important feature: greater amounts of capital brings demand for more efficient corporate governance. Lower cost of capital and therefore more rapid growth attributes to corporates that improve governance. What is changing is that those investors are frequently pension or mutual funds rather than family groups or oligarchs. The need to respond to new, well-funded multinational competitors has required companies to seek larger amounts of capital, in effect outgrowing the domestic bank finance (Koepke, 2015).

Investors should not shy away from rising to the challenge of accessing Emerging Markets growth, and recognise the importance of imposing discipline. Improved governance can help address mature market pension funding while creating greater security and stability in our world.

Fostering private market development with impact benefits – The IFC/Amundi partnership

Efforts to fight against long-term climate change-related risks have progressively evolved from top-down policy initiatives to bottom-up civil society participation and private sector implementation. Public and private institutional investors have both the capacity and the appetite to deploy massive amounts of capital to finance the green transition in emerging countries, but are hindered by a lack of scalable investment vehicles which meet those objectives.

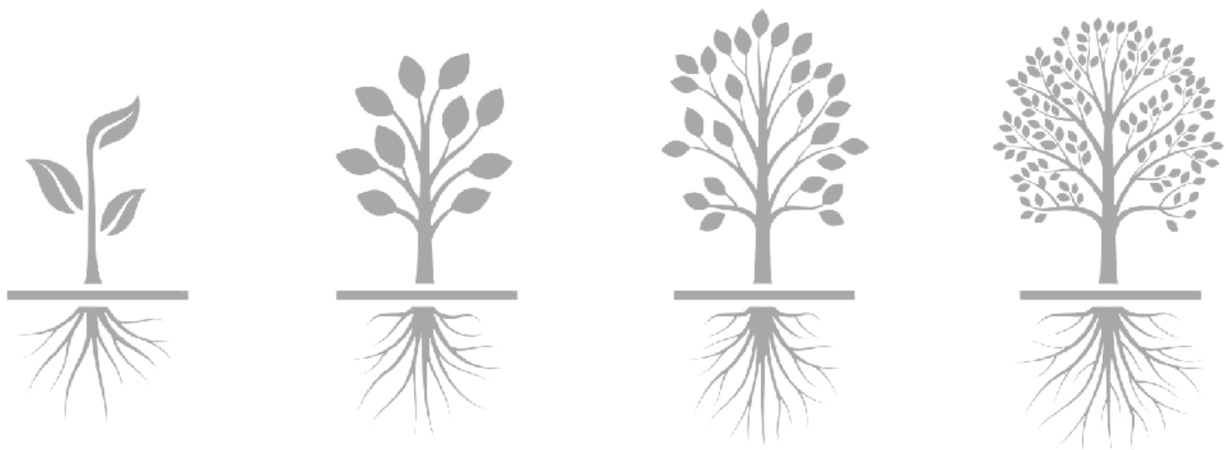
The International Finance Corporation (IFC) and Amundi partnership tackles these issues through an innovative platform and a pragmatic approach to unlocking private capital flows for climate finance in developing countries. The new platform combines both Amundi's deep expertise in asset management and IFC's in-depth knowledge of private sector development in emerging market. The ultimate objective of the platform will be to support developing countries achieve sustainable growth.

As long-term investors, pension funds are subject to the risks posed by climate change in the long-run as the latter might affect their ability to pay off their liabilities. The $2billion green bond initiative is a unique way for them to manage their exposure to climate risks while fostering sustainable returns with an additional layer of protection stemming from IFC's first loss absorption mechanism. It aims to create the largest green bond fund dedicated to emerging markets by deepening local capital markets and expand the financing for climate investments.

First, the strategy's focus on financial institutions will have the added benefit of developing local financial markets by targeting players financing the real economy.

Second, with $23 trillion of climate-smart financing needs and emerging markets representing only a small proportion of the total outstanding green bond market, emerging markets clearly lack solutions for financing the global energy transition. By targeting 100% green bond portfolio at the end of the investment period, the $2bn green strategy will have the additional benefit of financing energy transition projects with real positive environmental impacts, while spreading green bond issuance and reporting best practices in these nascent green bond markets.

Hence, by stimulating both supply and demand, this game-changing project sits at the crossroads between financial expertise and innovation. It is designed to transform aspiration to implementation. With the objective of creating the largest green bond fund dedicated to emerging market, the $2billion initiative is only the first of several funds to be launched through the partnership.



IFRS 9: 3 main accounting impacts

Although some insurers may defer application of IFRS 9 to coincide with the application of IFRS 17 on their liabilities, most of institutional investors will apply the new standard to financial assets in 2018, as a replacement to the rules of IAS 39.

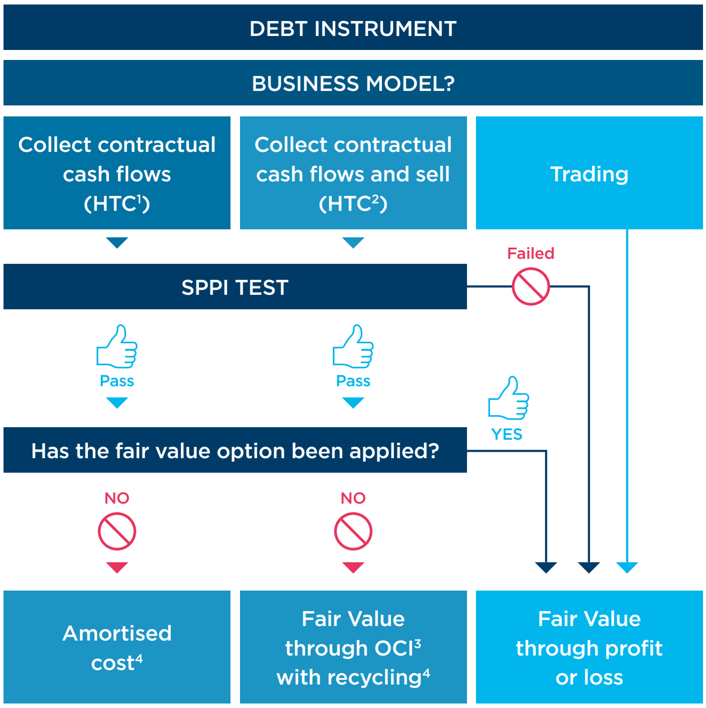
IFRS 9 changes the classification of financial instruments, applicable impairment rules, and the approach to hedge accounting. Although the business model is still a critical factor in determining the classification of a financial asset, the characteristics of the instrument held, especially the contractual provisions that define the cash flows it generates, have become essential to this classification.

1. Classification of debt securities

Debt instruments may be held under one of the following three business models:

- with the objective of collecting contractual cash flows,
- with the objective of collecting contractual cash flows and selling financial assets,
- with the objective of selling financial assets (by default).

However, classification also depends on whether the securities are categorised as SPPI (solely payments of principal and interest) or non-SPPI. A security is categorised as SPPI if its contractual cash flows are solely payments of principal and interest on the principal that is still owed. The IFRS 9 standard proposes three classifications for debt instruments. The entity may choose to measure assets at fair value through profit. By doing so, it will eliminate or significantly reduce accounting mismatches.



2. A new impairment model based on expected credit losses starting at the purchase date

In contrast to the rules of IAS 39, which take an approach that reacts to an event once it has occurred, the IFRS 9 impairment model is based on a forward-looking approach. The new general model distinguishes three stages with different calculation methods depending on the stage. This system is therefore much more complicated to implement. It requires models and parameters to identify when an investment moves from one stage to the next and to estimate provisions in accordance with the new principles.

Initially, the entity recognizes losses due to a possible default event in the following 12 months (stage 1). If credit quality deteriorates significantly, the purchased security or loan commitment is considered to have entered stage 2, and we must then take into account losses on expected cash flows in the event of a default throughout the lifetime of the security or loan. Stage 3 is triggered by the occurrence of a default event. Credit losses to maturity are always taken into account, but the basis for calculation is reduced as the effective interest rate is then applied to the value after impairment.

3. Hedge accounting

The new micro-hedging principles aim at providing a better link with the company's risk management.

As such, the scope of eligible instruments is changing. For example cap+floor combinations are accepted under IFRS 9. Quantitative effectiveness criteria have also been eased, and the quantitative 80%-125% bright line thresholds have been eliminated. The new standard promotes taking the risk management policy into account. The hedging relationship must be documented right from the start (and must be updated if the method changes). Macro hedging is the subject of a specific project, and therefore the provisions of IAS 39 will continue to be applied to some types of hedges.

1. Hold-to-collect
2. Hold-to-collect and sell
3. Other Comprehensive Income
4. Impairment considerations apply

New release:
the Amundi-Create 2017 survey

Today, investors face cross-winds from diverse sources. Central banks are winding down their unorthodox monetary policies. Governments are less hesitant about deficit spending. Populism is on the rise. Geopolitical tensions are lurking in the background. Thus, the global economy is braced for various shifts that are laced with layers of uncertainty. This is the first survey of its kind to look at the nature of the shifts and their consequences. It also shows how pension plans – in this turbulent age – are adapting to the unfolding reality.

As ever, in uncertain times, the dominant tendency is go back to basics. As this decade has progressed, long-term investing has been sidelined, as asset prices have increasingly deviated from their 'fair value'. However, long-term investing is likely to stage a comeback, as investors' transition to a new regime where prices gradually reconnect with their fundamentals as volatility rises. The report also turns the spotlight on how ESG investing and long-term investing are morphing, as pension investors increasingly price in climate change and other long-term risks.

We are pleased to partner with CREATE-Research in this series of annual surveys that look at emerging challenges in the pension landscape and the responses they require. As a regular independent writer on investment management over the past 20 years, Amin Rajan has produced another insightful report on how pension plans are responding to momentous events in the global economy with diligence and patience. We at Amundi hope that you will find the report informative.

Back to long-term investing in the age of geopolitical risk
by Amin RAJAN

> Download the report

To go further: Amundi's Research Center

Research Center

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