100 HYMANS # ROBERTSON

Case study

An 'RI-aware' buy-and-hold credit portfolio

What did the Scheme want?

One of our clients, a financial services company, had made great strides in improving their funding position by 2019, significantly ahead of schedule. Building on that success, they agreed that a full buy-in of the Scheme would be a great long-term target. The Trustees set a target date of 2027 for this outcome, on a view that the Scheme would take no more risk than necessary to allow it to close the funding gap over that timeframe.

What actions did the Scheme take?

We advised the Trustees to undertake a comprehensive review of the Scheme's investment strategy. As part of this work, they considered their allocation to secured finance assets and its future within the strategy.

The Scheme's secured finance portfolio was in 'run-off', meaning income and maturity payments are distributed as cash to help meet the Scheme's ongoing cashflow requirements (mainly paying pensions). The portfolio had been designed to distribute cash organically to help pay the benefits as they fall due, rather than the Scheme being compelled to sell assets (potentially at inopportune times). This removes the risk of having to sell illiquid assets below their market value.

A key part of our advice to the Trustees was to implement a new segregated 'buy-and-hold' corporate bond mandate, which was launched in the first half of 2021. This would initially be funded through a cash transfer from the Scheme's LDI collateral pool and the in-specie transfer of the Scheme's existing (small) allocation to corporate bonds.

The proceeds from the run-off of the secured finance mandate would also be recycled into the new corporate bond portfolio, until the desired 25% allocation to the new corporate bond mandate was achieved. In the meantime, the Scheme's ongoing cashflow requirements would be met using the cash collateral held in the LDI portfolio.

The new credit mandate – what's important?

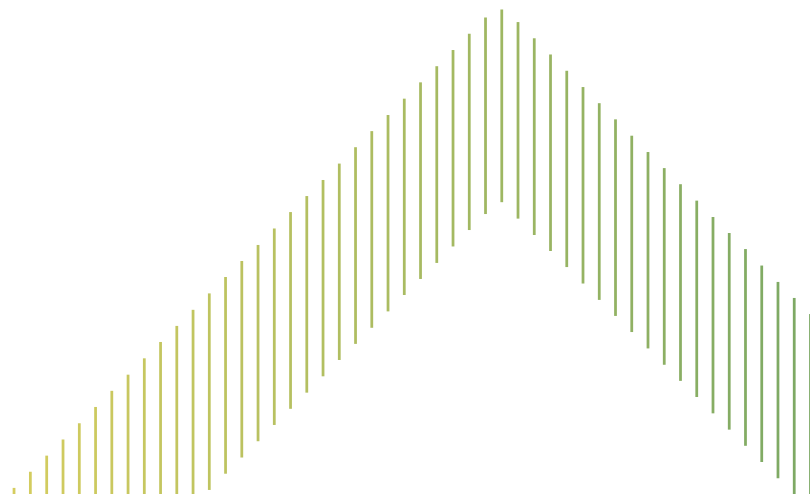
Given the segregated nature of the corporate bond mandate, the Trustees spent time carefully considering the investment guidelines in the context of credit quality, concentration risk and target duration.

The Trustees were particularly interested in responsible investment (RI) considerations in developing this mandate, given the potential for a material financial impact. We were pleased to note that the Trustees were enthusiastic and engaged when it came to exploring these issues.

Integrating responsible investment into the credit mandate

Initially, the Trustee considered setting explicit RI guidelines, such as a minimum proportion of 'green' bonds or an explicit preference for sustainable issuers. But further analysis threw up some problems with this approach.

Firstly, the quantity and quality of data available to credit managers from bond issuers can be patchy and inconsistent. This data would be needed to define restrictions in the guidelines (e.g. around carbon intensity of issuers to be excluded). That made it very hard, if not impossible, for the investment manager to adhere to very strict limits. Also, best practice when it comes to RI metrics is changing rapidly and the Trustees were wary of adopting metrics that could become obsolete in the future, requiring them to frequently review and update the guidelines as industry thinking evolves. ▶



The second issue we identified was one of the costs and portfolio turnover, associated with the active management that would be required to adhere to strict, explicit RI guidelines over time. An actively managed portfolio would involve higher management fees and higher transaction costs (due to greater portfolio turnover) than the desired 'buy and hold' approach. It could also compromise the manager's ability to hold bonds to generate the desired cashflows to broadly match the Scheme's benefit payments. This would be undesirable, as meeting their medium-term cashflow requirements in an efficient manner remains the key priority for the Scheme.

Lastly, there was a risk of unintended concentration in some sectors or regions if explicit RI guidelines were implemented. For example, there could be a significantly overweight allocation to financials, given their relatively lower carbon intensity, if only Scope 1 and 2 emissions were considered.

The solution

Having weighed up all the options, the Trustees decided to adopt high-level environmental, social and governance (ESG) guidelines and to design an 'RI aware' buy-and-hold corporate bond portfolio. This option means the manager must take into account various RI factors, but they have more flexibility in how these considerations are reflected in the portfolio. For example, the Trustees decided that the sub-portfolio would not buy bonds issued by companies that:

- Sit within certain sectors, such as tobacco, defence and gambling;
- The manager deems to be highly carbon intensive;
- The manager deems to have a material exposure to thermal coal or unconventional oil or gas extraction (e.g. fracking); or
- The manager deems to be materially exposed to climate-change risk.

As an exception, the manager can buy bonds issued by companies that otherwise breach these ESG restrictions, if they believe the company has a clearly defined and tangible long-term plan of improvement – i.e. they will be part of the climate solution over time, rather than part of the problem. This has ensured that the manager is not overly constrained and can adapt their definitions of the above to reflect industry best practice over time.

Conclusion

At a recent meeting, the Scheme's investment manager noted that the guidelines are pragmatic and not overly restrictive, having been implemented in May 2021. One key benefit achieved so far has been an immediate reduction of c50% in the portfolio's carbon intensity compared to the prior strategy, before the new 'RI aware' guidelines were implemented.

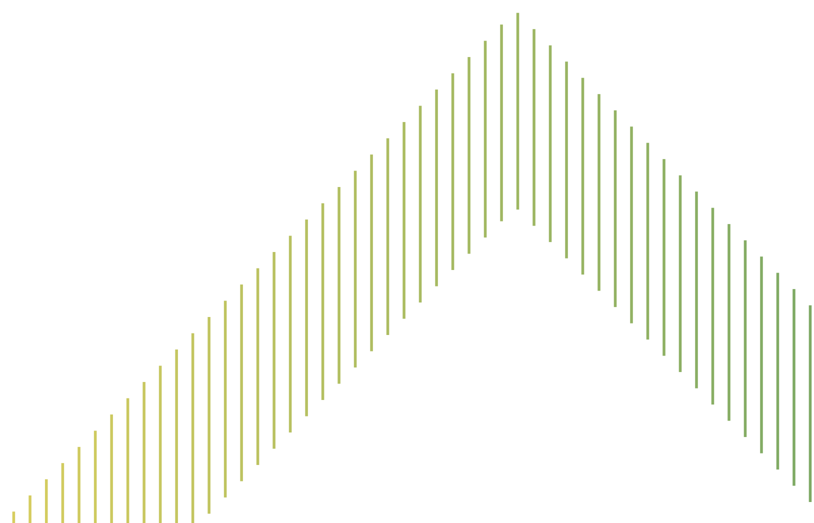
The Trustees are pleased with the new approach, believing that it addresses key ESG risks, while allowing the manager to construct a portfolio that meets the Scheme's broader strategic requirements, and where the investment manager has enough freedom to add value over the long term.

For more information

If you would like to understand how we can help your scheme integrate a responsible investment strategy please contact us, or your usual Hymans Robertson consultant.

Simon Jones
Head of Responsible Investment
simon.jones@hymans.co.uk
0131 656 5141

Ben Farmer
Senior Investment Consultant
ben.farmer@hymans.co.uk
0141 566 7959



Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities. A member of Abelica Global.

© Hymans Robertson LLP. Hymans Robertson uses FSC approved paper.