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Breaking up with TINA?

The case for revisiting fixed income

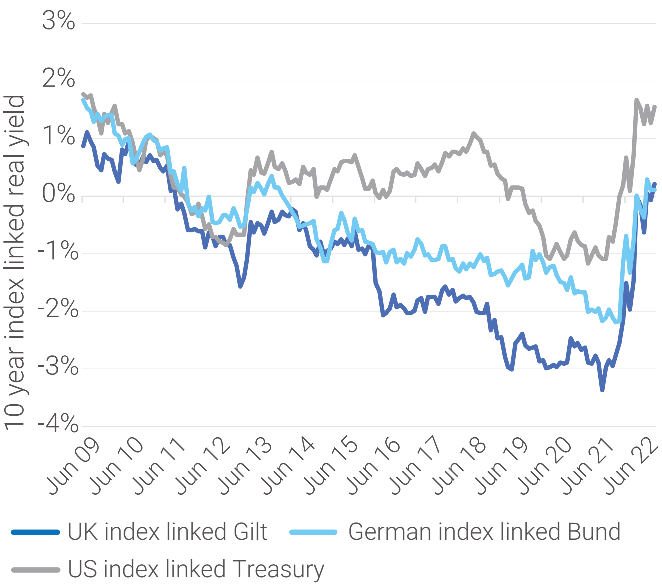
Ian Hutchinson
Head of Active UK Credit

Richard Lubbock
Charities Client Director

Jonathan Joiner
Senior Solutions Strategy Manager

For many investors over the past decade, equity has been king. With interest rates at or near zero for much of this period and government bond yields offering little more, arguing to allocate to fixed income has been a challenge for growth-orientated investors.

Figure 1: Real developed market government bond yields have generally been on a downward trajectory



Source: Bloomberg as at 28 February 2022

This idea is particularly true for investors such as charities with an inflation-plus target. As Figure 1 highlights, real yields (nominal bond yields minus expected inflation) have been in low or negative territory for much of the past 12 years.

As such, holding fixed income meant that the remaining assets were required to work very hard to achieve return objectives. In many cases this led to the targets being unachievable with high-quality fixed income as part of the portfolio. This, in turn, led to the mantra 'there is no alternative' (TINA) to equities. But with the rise in nominal and real bond yields seen since the start of 2022, is now the time to say goodbye to TINA?

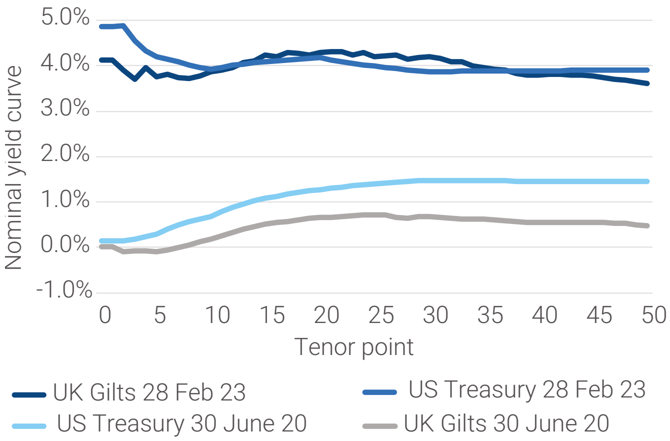
LGIM

Why has fixed income turned heads?

What has led to this sharp repricing in fixed income? Following the reopening from lockdown, inflation began to pick up as consumers spent the historically large excess savings they had built up on average. Covid and the Ukraine war led to breakdowns in the global supply chain, which were compounded by the energy crisis and tight labour markets.

This sequence of events created some of the ugliest inflation figures seen in the past 40 years and required central banks to act. Sharp rises in central bank base rates pushed bond yields up (and prices down) aggressively, as the narrative of the 'Japanification' of Western bonds disappeared, and the prior environment of negative real yields was generally left behind. 2022 will go down as one of the worst years for fixed income returns in history. However, as Figure 2 highlights, we believe this has led to the yield available now on developed government bonds looking significantly more attractive.

Figure 2: Fixed government bond yields have risen sharply since June 2020



Source: LGIM as at 28 February 2022

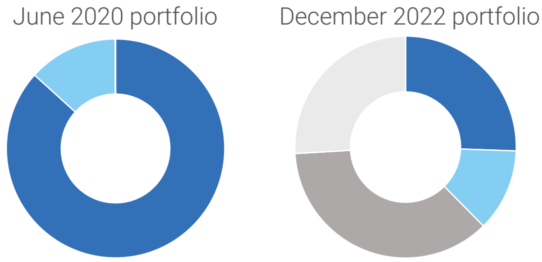
This is particularly true for investment grade corporate bonds, which offer a return premium over government bonds (known as the credit spread) to compensate for default and liquidity risk. Historical analysis highlights how investors are typically overcompensated for the fundamental default risk of the asset class, which is often low.[1] Credit spreads are currently around 50% wider than was the case as recently as 2021. Factoring in the higher underlying yield from government bonds, yields of 6% or higher are no longer uncommon in parts of the sterling investment grade universe. Whilst this does reflect that we are in a period of economic uncertainty, we believe the attractions of fixed income are clear.

What does the future with fixed income look like for my portfolio?

To highlight how significant the yield change is, let's consider an investor who has a long-term target to achieve an expected return in excess of 6%, which is generally akin to a long-term target of CPI+4% p.a. In Figure 3, we have detailed two portfolios that could achieve that goal, based on LGIM's modelling assumptions, with the key difference being when they were set. The left-hand allocation was set in June 2020, when the yield on long-dated UK government bonds was below 1% at all tenor points. To target a return over 6% required nearly 90% of the assets to be in equities, with the residual in alternative asset classes such as property and high yield.

The right-hand allocation was set at the end of the year, where government bond yields were around 4% and investors in investment grade corporate bonds could potentially expect a return of c. 5.5%. It can be seen that the resultant portfolio is far more diversified between equities, alternatives corporate and sovereign bonds, and has an expected return above target and higher than the first portfolio but with broadly half the level of expected risk.[2]

Figure 3: Targeting a 6% return in June 2020 vs. December 2022



		Jun-20	Dec-22
EQUITIES	Developed equity	71.7%	29.7%
	Emerging market equity	15.0%	4.7%
ALTERNATIVES	Property	1.0%	2.0%
	High yield bonds	1.0%	2.5%
	Infrastructure	1.5%	1.3%
	Commodities	3.0%	2.3%
	Global REITs	3.3%	2.8%
	EM debt	3.5%	5.5%
GLOBAL BONDS	Corporate bonds	0.0%	14.5%
	Sovereign bonds	0.0%	34.7%
METRICS	10 year expected return	6.4%	6.6%
	1 year Volatility	15.0%	7.9%
	1 in 20 1 year downside	26.5%	13.6%

Source: LGIM long-term modelling based on December 2022 and June 2020

1. Source: Corporate Finance Institute, 2022 https://corporatefinanceinstitute.com/resources/fixed-income/investment-grade-bonds/
2. Source: The expected returns are calculated using LGIM's proprietary modelling capabilities and are based upon government bond yields at the model date, with assets earning a premium to the prevailing government bond yield. Reflecting this, the expected return on non-fixed income assets such as equities, also has risen over the period as it is set as an equity risk premium over the risk-free rate, e.g. government bonds. For more details on LGIM's modelling please contact your LGIM representative.

Setting long-term asset return assumptions is an art as much as it is a science, and will vary from investor to investor. That being said, the implication of the recent moves in fixed income yields remains that even if your return target hasn't changed, the optimal portfolio to meet that target might have.

Breaking up with TINA in the right way

One of the issues with investment grade corporate debt is the nature of the companies within the benchmark. Unsurprisingly, the types of companies typically issuing corporate debt are large, well-established firms in more traditional industries, with high capital investment requirements. If you are both able to and need to borrow a billion pounds or more on a regular basis, you tend to be both larger and richer in assets.

This means that utility, energy, and resource firms are well represented in bond indices, while newer, cleaner industries such as tech or renewable energy are less well established. While this presents no issue for the pure value investor, but for those with an eye on long-term returns, this universe represents both a threat and an opportunity

The issue of 'stranded assets' is a real one. For oil drillers, refiners and pipeline operators, there is oil in the ground that must never be pumped if the world is to achieve the agreed Paris summit target of no more than 1.5 degrees centigrade of further warming by 2050. Similarly, for gas transmission businesses, or even in the UK housing associations with older, poorly insulated homes heated by gas boilers with food cooked on gas ovens, there are assets that may need to be retired, repurposed or upgraded long before their economic usefulness is spent. Put most simply, the firms that are contributing most heavily and directly to climate change also have the business models most at risk from necessary efforts to combat it. So how to invest safely in this environment?

Increasingly, fixed income specialists are using a range of tools to identify which firms are transitioning most successfully to a lower carbon future and which are not. At L&G, we have developed our 'Destination@Risk' model which powers the investment process behind a wide range of our funds, helping us identify those firms most vulnerable to change and those best positioned to contribute positively to a lower carbon economy. We believe that positioning in the sectors and issuers that are best positioned to survive this transition potentially provides greater security of return and gives the opportunity for long-term outperformance versus benchmarks.

Coupled up with fixed income – There's potential for both value now and security in future

In summary, charity investors have endured a decade of TINA, but now we believe there is an attractive alternative in fixed income, which currently offers valuations not seen for almost 15 years and also provides potentially beneficial diversification and risk reduction features. Investment grade corporate bonds are for many investors the 'sweet spot', historically having typically outperformed government bonds but also carrying relatively low default risk.

For investors keen to access the opportunity that the current market provides, but also seeking to target surety of return for the long term, we believe using a climate-aligned or net zero strategy could provide additional benefits. Investors can enjoy the attractive entry point corporate bonds potentially have on offer, help to meet any net zero or ESG investment goals that they may have and also prepare for some of the disruption that a move (either orderly or disorderly) to a world in which our climate is safeguarded may bring.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. It should be noted that diversification is no guarantee against a loss in a declining market.

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