Positive real yields are back: The case for revisiting fixed income

For many investors over the past decade, equity has been king. But with the recent rise in yields and associated improvement in scheme funding levels, has the time come for the LGPS to revisit fixed income?

James Sparshott
Head of Local Authorities, Distribution

Jonathan Joiner
Senior Solutions Strategy Manager

With interest rates at, or near zero for much of past decade and government bond yields offering little more, arguing to allocate to fixed income has been a challenge for growth-orientated investors. This idea is particularly true for investors with an inflation-plus target like many local government pension scheme (LGPS) funds.

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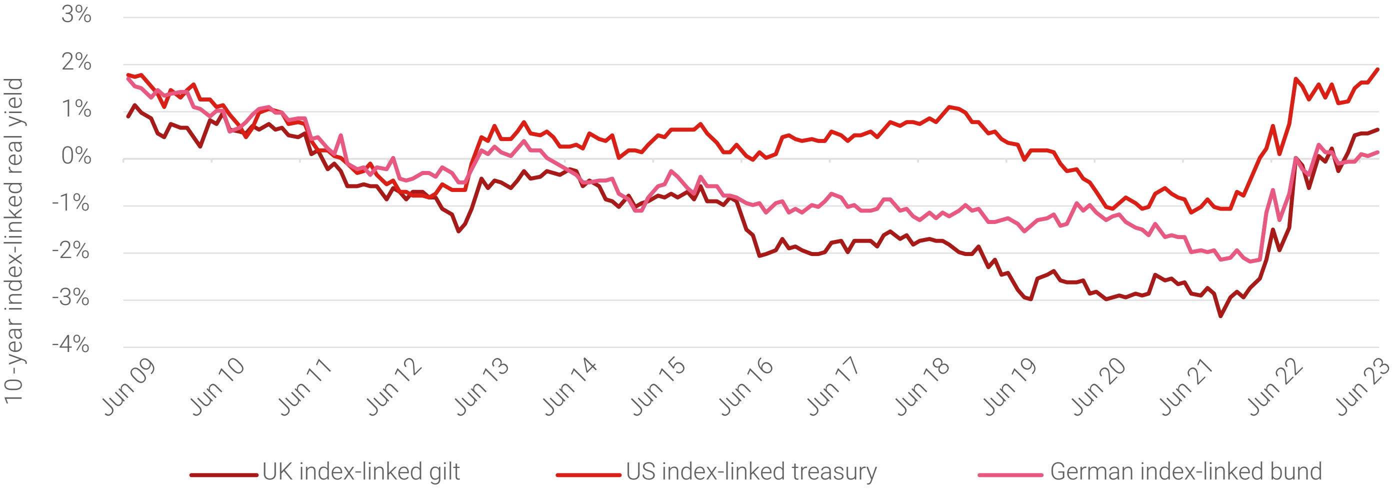
As Figure 1 highlights, real yields (nominal bond yields minus expected inflation) have been in low or negative territory for much of the past 13 years.

Figure 1: Developed market government bond real yields have generally been in a downtrend



Source: Bloomberg as at 31 August 2023.

Past performance is not a guide to the future. The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested

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. But with the rise in nominal and real bond yields seen since the start of 2022, is now the time to reassess?

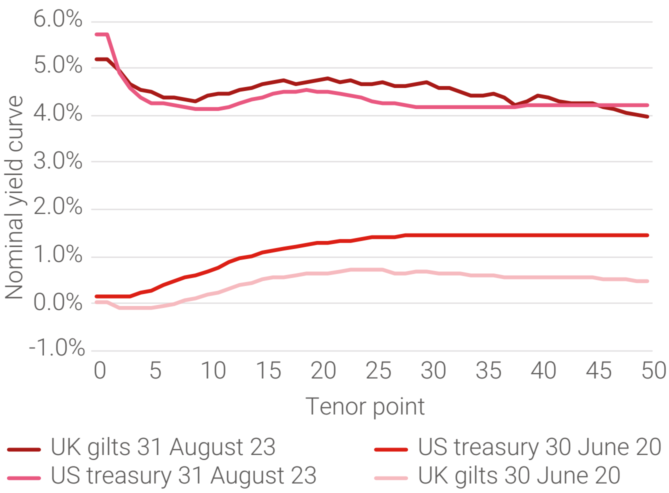
What has happened in fixed income markets?

To understand the sharp repricing in fixed income, we need to consider the events of recent years. Following the reopening from the COVID-19 lockdown, inflation began to pick up as consumers spent the historically large excess of savings they had built up. The pandemic and the war in Ukraine 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 readings 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 '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 now available on developed government bonds looking significantly more attractive. The continues as you move down the credit spectrum where investors can seek additional yield, albeit with additional credit risk.

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



Source: LGIM as at 31 August 2023.

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How could this alter my portfolio?

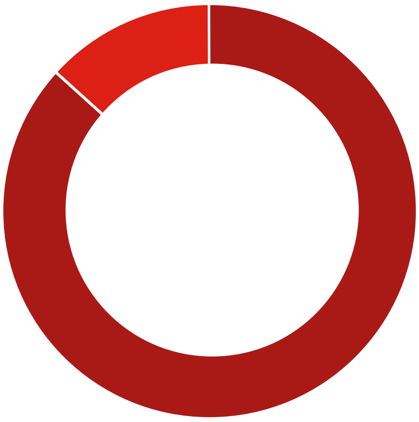
To highlight how significant this yield change is, let's consider an investor who has a long-term target to achieve an expected return in excess of 6%. In Figure 3, we have detailed two portfolios that could achieve that goal, based on LGIM's modelling assumptions, with the key difference being the time 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 achieve 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 three years later, where government bond yields were around 4.5% and investors in investment grade corporate bonds could expect a potential return of c.6.0%. 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 with broadly half the level of risk.[1]

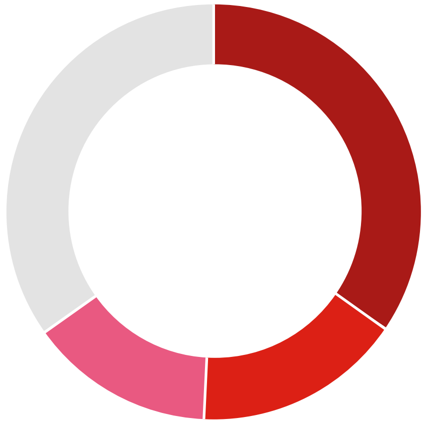
Setting long-term asset return assumptions is an art as much as it is a science and will vary from investor to investor. That said, the implication of the recent moves in fixed income yields remains that if your return target hasn't changed, then the optimal portfolio to meet that target might have.

Figure 3: Beating a 6% target return in June 2020 versus June 2023

June 2020 portfolio



June 2023 portfolio



		Jun-20	Jun-23
Equities	Developed equity	71.7%	29.8%
	Emerging market equity	15.0%	4.8%
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%
Global bonds	Sovereign bonds	0.0%	34.8%
Metrics	10-year expected return	6.4%	7.2%
	1-year volatility	15.0%	7.8%
	1 in 20 1-year downside	26.5%	13.3%

Source: LGIM long-term modelling based on June 2023 and June 2020.

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1. 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.

What roles could fixed income now fulfill in an LGPS fund?

While higher nominal and real yields in fixed income may potentially mean that LGPS funds can achieve their long-term return targets with a lower level of risk, there are also other important roles that fixed income can play.

Diversification

Fixed income encompasses a much wider universe than just government bonds. As highlighted in Figure 3, we believe there are a number of key income markets that could feature in an investor's portfolio, including high yield, emerging market debt and global corporate bonds. While higher yields may potentially make fixed income more attractive, it is also important to ensure multi-asset diversification[2] The diverse nature of the fixed income universe makes it an important tool in this regard and each fixed income asset class should be part of the considered universe in our view.

Meeting cashflows

Another key attribute is in the name: fixed income. The defined nature of cashflows, particularly with higher-quality investment grade credit, potentially means that investors can be relatively certain on the cashflows they are going to receive. Indeed, this has led to investment grade corporate bonds being a staple of annuity providers' portfolios, where it is used to form part of their hedge of liability cashflows. For those LGPS funds that are cashflow negative, the approach of cashflow-matching can help to ensure they have sufficient liquid assets to meet upcoming benefit payments.

Lower return and risk investment strategy

With the rise in real yields, it is estimated that local government pension schemes' funding levels have significantly improved. Indeed, Isio's 'LGPS Low-Risk Funding Index' estimates that the funding position for LGPS funds in England and Wales has risen to 102% funded, as of 31 July 2023. While we stated earlier that: "if a scheme's return target hasn't changed, then their optimal portfolio might have", higher funding levels may offer a potential opportunity to reduce the return target. Fixed income assets can form part of that solution, whether it be simply as part of a diversified, lower potential return portfolio, or explicitly hedging risks associated with the liabilities such as inflation.

Part of the 'ESG' tool kit

Fixed income can also be an important asset in the fight against climate change. 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.

2. Source: As discussed in this blog: Should higher cash rates decrease interest in equities?

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. This presents little issue for the pure value investor, but for those with an eye on long-term returns, we believe 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. We have developed our LGIM 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.

Bonds are back

In summary, after more than a decade of low interest rates, positive real yields are back. Fixed income currently offers yields not seen for almost 15 years, providing potentially beneficial diversification and risk-reduction features. We believe that the substantial moves in bond yields encourage LGPS funds to reassess that their strategic asset allocations are still in line with their targets. The fixed income universe is diverse and offer schemes the opportunity to diversify, meet liability cashflows and reduce 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. In our view, investors can enjoy the attractive entry point corporate bonds potentially have on offer, seek to meet any net-zero or ESG investment goals that they may have and prepare for some of the disruption that a move (either orderly or disorderly) to a world in which our climate is safeguarded may bring.

> **"We believe that allocating to sectors and issuers that are well-positioned to survive this transition could be key in delivering greater return potential, as well as the opportunity for potential long-term outperformance versus benchmarks"**

Contact us

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

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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.

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