

PUBLIC FIXED INCOME

On the Curve Carries On

Investing in Intermediate Corporate Fixed Income

Last year we highlighted the relative attractiveness of the intermediate part of the corporate curve. And a year later, we believe we continue to see value in the intermediate corporate credit space. In this paper, we highlight the potential opportunities for investors amidst the current valuations in high grade fixed income strategies across the curve.

For much of the past decade and a half, the primary strategies used for pension liability hedging were long dated (i.e., Long Duration Government Credit, Long Credit, STRIPS, etc.). These strategies served as an effective tool to match pension liabilities, and enabled plans to achieve their duration targets efficiently while maintaining a significant allocation to return seeking assets. In our view, it worked.

We note that with fixed income maturities ranging from 1-month to more than 40 years, there are a wide range of strategies designed to help meet the specific liability hedging needs of corporate plan sponsors. As of 3/31/2023, MIM's Pension Tracker estimated the average funded status of the Russell 3000 to be 105.2%, 0.5% above the end of the fourth quarter.

We see this improvement in funded status has served as an opportunity for plans to continue de-risking, which usually means to sell equities and buy fixed income and consider moving in shorter on the curve.

Since the Pension Protection Act of 2006, many corporate plan sponsors have taken a number of steps to de-risk. Some of these steps have shortened liability duration (e.g., closing the plan to new participants, freezing accruals) while others have lengthened duration (e.g., lump-sum buyouts, retiree only risk transfer). In total, however, we believe these actions and the passage of time have reduced pension liability duration significantly over the past 16+ years.

Conversely, Long Credit, the most prevalent LDI hedging strategy, lengthened in duration as interest rates declined in 2020, although most recently, the trend has reversed as multiple rate hikes ensued over '22/'23 period. We discuss the transformation of Long Credit in our paper *The Evolving Long Credit Universe*. We believe the combination of shorter pension liabilities, longer primary hedging assets, and meaningful funded status improvement will likely influence the next phase of liability driven investing whereby higher fixed income allocations will increase the need for key-rate matching to further reduce surplus volatility and refine the hedge.

These aforementioned changes in liability attributes amongst other factors bring us to intermediate corporate credit. We believe adding this strategy offers the following benefits:

- Improved focus on asset allocation with a similar risk and maturity profile as liabilities
- Ability to take advantage of attractive opportunities and new issuance at the belly of the curve
- Access to a broader investment universe with greater diversification

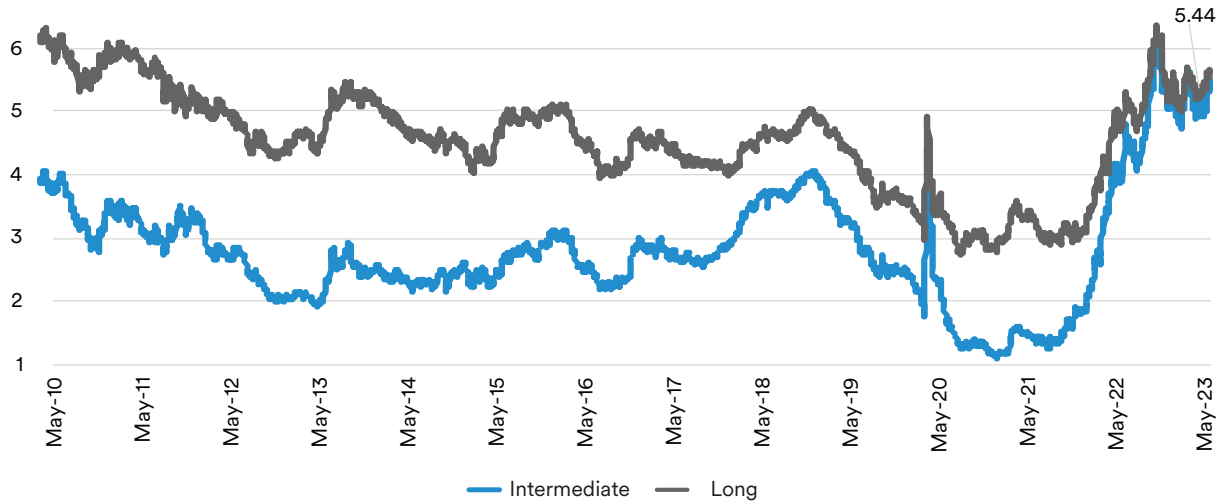
We still expect long duration to remain a staple in most plans' LDI asset allocation. However, we have noticed a trend of incremental allocations into intermediate credit. In the same way that long duration investment grade strategies tracked pension overall liabilities, we believe intermediate strategies have been a good fit for the first ten-year segment of pension liabilities. Adding intermediate credit is really just a natural extension of traditional LDI strategies as funded status improves. And at current levels of all-in yield, we believe investors are compensated to own bonds in the intermediate part of the curve, at least in the near-term. Discernment is warranted, however, along with careful portfolio construction, which we discuss further below.

As the Federal Reserve continues to focus their monetary policy efforts on fighting inflation, we have seen, at times, significant inversions of the U.S. Treasury curve. For example, the 5s30s curve was as inverted as -45 basis points in early March 2023.¹ This inversion has remained relatively rangebound and only recently reversed providing investors with a marginal 11 basis point risk premia, as of April 21, 2023. The notable shifts in the curve have led to a sharp rise in yields on short-dated corporates, which we feel provides an opportunity for a relatively cheap entry point coupled with attractive carry. Additionally, we believe supply and demand technicals have played a unique role this year on corporate credit curves flatness, further enhancing the relative value of intermediate corporates. Notably, financial issuance—a larger sector of the intermediate corporate index, has lagged expectations across the curve. In February 2023, the sector represented only 14% of total issuance in a month where IG issuers printed \$152 billion in new issuance, a record amount for that calendar month relative to historical issuance.²

As of March 2023, the Bloomberg Intermediate Corporate Index Yield to Worst remained above 5% and even reached as high as 6.02% peaking in early October.¹ As reflected in Figure 1, the Intermediate Corporate Index yield has surpassed levels not seen since 2009, as the current Long Corporate Index yield of 5.44% remains at levels not seen since 2011.

Figure 1 | Intermediate and Long Corporate Index Yields Have Increased This Year

Index Yield to Worst (%)

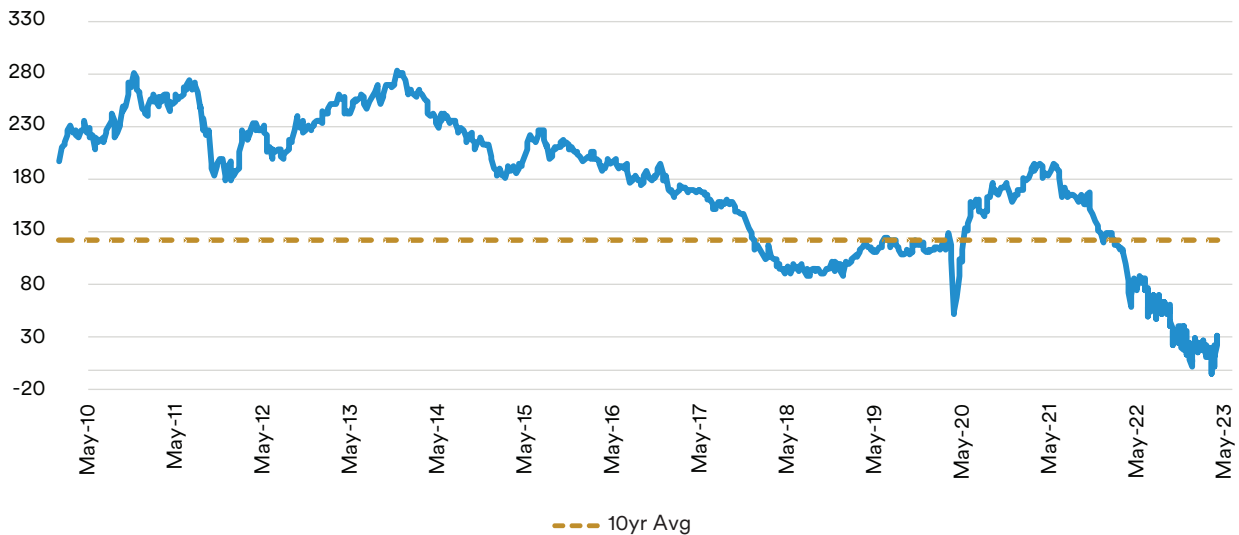


Source: MIM, Bloomberg, as of May 2023

Comparing further, the yield differential between the Intermediate and Long Corporate indices is 30 basis points as of May 31, 2023, which is significantly lower compared to the 10-year average of 121 basis points, suggesting that intermediate corporates have meaningfully cheapened relative to long corporate credit.

Figure 2 | Intermediate and Long Corporate Index Yield Differential

Intermediate & Long Yield Differential (bps)



Source: MIM, Bloomberg, as of May 2023

When comparing corporate indices across the curve, we observe a number of similarities, such as average credit quality, but also key differences, notably duration and the number of issuers.

Figure 3 | Bloomberg Corporate Indices Characteristics

Characteristics 5/31/2023	Bloomberg Intermediate Corporate Index	Bloomberg Corporate Index	Bloomberg Long Corporate Index
Average Price (\$)	93.35	90.53	85.49
Yield (%)	5.33	5.39	5.52
Effective Duration (yrs)	4.16	7.22	13.18
Average Quality	A-	A-	A-
Issuers	744	862	558
Credit Quality (%)			
AAA/AA	6	8	11
A	46	45	42
BBB	48	47	47

Source: MIM, Bloomberg, Aladdin as of May 31, 2023

“The yield differential between the Long and Intermediate indices compressed significantly this year providing plan sponsors opportunities to evaluate their key rate allocations.”

—Stephen Mullin, CFA

Head of Long Duration and LDI Strategies

The Bloomberg U.S. Long Corporate Index comprises over 550 issuers, while the Intermediate Corporate Index is broader with over 740 issuers, enabling investors to access a more diversified liquid universe of bonds. While the overlap between the Intermediate and Long Corporate indices is over 435 issuers, there are 300+ issuers unique to the Intermediate Corporate Index as certain issuers are more prone to come to market in the intermediate part of the credit curve.¹

Drilling into the index components, a key difference between the Intermediate and Long Corporate benchmarks are sector weightings, with a heavier Financials allocation in Intermediate Corporate at 41.0% versus 16.3% in Long Corporate.¹ As noted, not all issuers will issue bonds across all tenors, and in our view, Banking issuers are often trying to match issuance with their asset profiles with a large proportion of supply residing in the belly of the curve. Financials issuance was robust in 2022 and the first month of 2023, however, the sector’s issuance has lagged expectations since January 2023. The average tenor in 1Q23 for Financials issuance was 6.8 years compared to non-Financials at 12.3 years.²

While the Intermediate Corporate Index provides access to a broader array of corporate credit, especially some debut issuers that we have seen surface during the pandemic, it does potentially pose an issue of concentration at the top. Both indices face concentration issues with just ten issuers comprising over 18.5% and 16.5% of the Intermediate and Long Corporate indices, respectively. The sector concentration is different however, as Banks represent nine of the top 10 issuers in the Intermediate Corporate Index, but only two of the top 10 in the Long Corporate Index, as shown in Figure 4. This issue has been even more magnified this past quarter as Banks have been under intense pressure, especially in the regional and Yankee bank cohorts.

Figure 4 | Top 10 Issuers by Market Value**Bloomberg Intermediate Corporate Index**

Ticker	MV%	YTM	Duration
BAC	3.27%	5.58	4.13
JPM	2.90%	5.42	3.82
MS	2.41%	5.50	4.12
C	2.02%	5.52	4.20
GS	1.76%	5.46	3.76
WFC	1.67%	5.51	3.76
HSBC	1.57%	5.93	3.94
MUFG	1.08%	5.52	3.69
AAPL	1.08%	4.25	3.93
SUMIBK	0.90%	5.31	3.89

Bloomberg Long Corporate Index

Ticker	MV%	YTM	Duration
T	2.34%	5.62	13.64
CMCSA	1.86%	5.25	14.57
ABIBB	1.85%	5.18	12.54
VZ	1.66%	5.46	13.52
ORCL	1.65%	5.93	12.90
AAPL	1.52%	4.69	15.53
UNH	1.51%	5.16	14.11
BAC	1.47%	5.53	11.23
JPM	1.45%	5.37	11.34
PFE	1.37%	5.04	13.35

Source: MIM, Aladdin, as of May 31, 2023

Given over 17% of the Intermediate Corporate Index is concentrated in just nine Banking issuers above, investors may look for ways to avoid concentration risks. And when distilling the Financials exposure in the Index further, over 30% comprises Banking with 60+ unique issuers, representing not only the large GSIBs but also Regional and Euro Yankee bank players (together standing at ~11%). Commonly, guidelines could include an issuer cap (1.5%), however, there may be unintended consequences with such a constraint. For example, an issuer cap on the Intermediate Corporate index by the math introduces a larger weight to regional banks relative to GSIB banks; which we would debate introduces other risks even though at the surface addresses concentration. In our view many would agree, the GSIBs are often viewed as a “safe-haven” relative to smaller US banks given their global profile, systemic importance (implied by GSIB), and more stringent regulatory framework they operate within. As such, we would suggest that sector constraints (e.g., 25% financial sector) more appropriately capture the intent around reducing concentration risks while mitigating an introduction of unintended risks. Ultimately, our goal in partnering with clients on these thoughtful engagements is to ensure the proper solution is carefully crafted.

While the Financials concentration is much higher in Intermediate, the defensive Utilities sector exposure in the Long Corporate Index is almost double that of the Intermediate Corporate Index at 12.6% and 6.6%, respectively.¹ Regulated utilities are owners of durable assets that provide a necessary service, and, in many places, operate as a regulated monopoly. The higher-quality Electric issuers tend to issue bonds with longer-dated tenors as investors are comfortable seeking longer maturity investments to match their own longer-maturity liabilities. Similar to Utilities, the Communications sub-sector’s outsized share of the Long Corporate market at ~12.7% (versus 6.7% for Intermediate Corporate)¹ is largely the result of its ownership of essential long-lived assets including mobile networks (4G/5G) and broadband (cable/fiber). Building out these systems requires large capital outlays to fund infrastructure such as mobile towers, radio equipment, and data centers. Historical M&A is also partially attributable for the sector’s share of long duration maturities given that consolidation results in fewer competing networks with more effective deployment of capital.

The Allocation Decision

As plans continue on their de-risking path, we often get asked whether a blended Intermediate/Long Corporate benchmark or standalone Intermediate Corporate and Long Corporate allocations are the best route. We believe there are merits to each approach and appreciate

that each client's needs are unique to their portfolio. We have seen a number of our clients also adopt an Intermediate allocation, and in some cases, a broad IG Corporate strategy, in addition to a standalone Long Duration mandate. A number of these additions have coincided with improvements in funded status and expectations for higher rates.

While we manage portfolios to blended benchmarks, we believe managing mandates on a stand-alone basis offers advantages to plan sponsors. First, stand-alone mandates permit portfolio management specialization with deep expertise and focus on specific market segments. Second, they enable plan sponsors to better compare performance within strategy peer universes. Third, stand-alone mandates simplify liability matching. As plans mature, they can rebalance from long to intermediate to maintain the match. In addition to the rebalancing decisions and benefits, the rebalancing execution can be just as important in today's volatile environment. This execution decision leads us to suggest exploring opportunities for in-kind transitions from Long Credit mandates to Intermediate Credit mandates to reduce the round-trip transaction costs of trading select credits amongst volatile periods. Similarly, Intermediate mandates can also provide in-kind assets for annuity buy outs of retirees. In our view, segregating intermediate and long allocations provides plan sponsors a lever to fine-tune the key rates in the way that works best for their plan. This ultimately results in not only enhanced precision in refining the hedge, but also when trying to reposition the portfolio over time.

Endnotes

¹ Bloomberg, L.P.

² JP Morgan. US Corporate Credit Issuance Monthly: May 2023.

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