June 10, 2022

PUBLIC FIXED INCOME

On the Curve

Investing in Intermediate Corporate Fixed Income

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. For much of the past decade and a half, the primary strategies used 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. It worked.

As of 3/31/2022, MIM's Pension Tracker estimated the average funded status of the Russell 3000 to be 102.5%. 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… but the question now is where on the curve?

MetLife Investment Management

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, 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, has lengthened in duration as interest rates have dropped and issuance has favored longer tenors. We discuss this transformation of Long Credit in our paper The Evolving Long Credit Universe. 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.

Which brings us to intermediate corporate credit. We believe adding this strategy offers the following benefits:

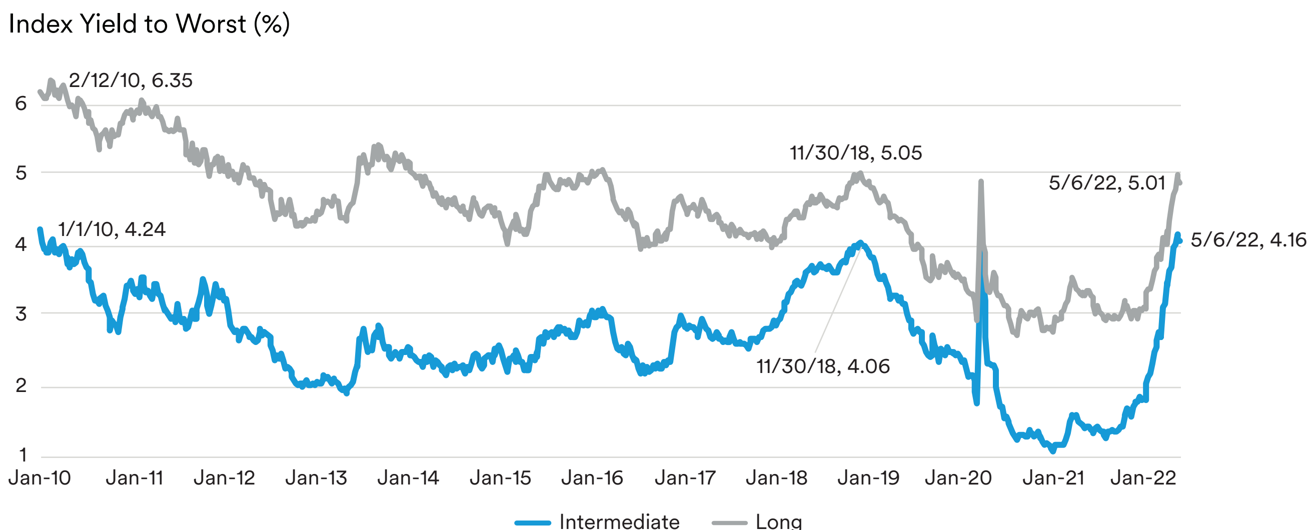
- Improved focus on asset allocation with a similar risk and maturity profile as liabilities
- Ability to take advantage of attractive opportunities and new issuance at the belly of the curve
- Access to a broader investment universe with greater diversification

We expect that long duration will 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, 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.

With the shift in the Fed's monetary policy, we have seen a significant flattening of the US Treasury curve with the 5s30s curve closing April at four basis points after reaching a trough of -12 basis points during the month. The notable bear flattening of the Treasury curve led to a sharp rise in yields on shorter dated corporates, which we feel provides an opportunity for a relatively cheap entry point and attractive carry. In addition, supply and demand technicals have kept corporate credit curves flat, further enhancing the relative value of intermediate corporates. As the April ended, the Bloomberg Intermediate Corporate Index Yield to Worst broke 4% and reached 4.16% in early May. As reflected in Figure 1, the Intermediate Corporate Index yield has surpassed levels not seen since 2010 (with the exception of March 2020), while the current Long Corporate Index yield is just under its 2018 levels and well below 2010 levels.

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

Index Yield to Worst (%)



Source: MIM, Bloomberg, as of May 2022

Comparing further, the yield differential between the Intermediate and Long Corporate indices is 85 basis points as of May 6, 2022, which is significantly lower compared to the 10-year average of 173 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 2022

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	Bloomberg Intermediate Corporate Index	Bloomberg Corporate Index	Bloomberg Long Corporate Index
Average Price ($)	95.36	94.44	92.83
Yield (%)	4.03	4.31	4.80
Effective Duration (yrs)	4.35	7.74	13.84
Average Quality	A-	A-	A-
Issuers	744	859	555
Credit Quality (%)			
AAA/AA	6.8%	8.5%	11.4%
A	43.4%	41.5%	38.0%
BBB	49.8%	50.0%	50.6%

Source: MIM, Bloomberg, Aladdin as of April 30, 2022

The Bloomberg U.S. Long Corporate Index comprises 555 issuers, while the Intermediate Corporate Index is broader with 744 issuers, enabling investors to access a more diversified liquid universe of bonds. While the overlap between the Intermediate and Long Corporate indices is 439 issuers, there are over 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.

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% versus 17% in Long Corporate. As noted, not all issuers will issue bonds across all tenors, and 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 has been robust in 2022, with the average tenor year-to-date for IG Financials at 7.7 years compared to non-Financials at 14.2 years.[1] We believe the large, liquid new issuance in Financials with a bias towards the intermediate tenors has created an attractive opportunity set in that space via both the primary and secondary markets.

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 pose an issue of concentration at the top. Both indices face concentration issues with just ten issuers comprising over 19% and 18% of the Intermediate and Long Corporate indices, respectively. The sector concentration is different however, as Banks represent seven 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.

Figure 4 | Top 10 Issuers by Market Value

Top 10 Issuers	MV%	YTM (%)	Duration (yrs)
Intermediate Corporate Index	19.4%	3.9	4.2
Bank Of America Corp	3.5%	3.9	4.4
Jpmorgan Chase & Co	3.1%	3.8	4.1
Morgan Stanley	2.3%	3.9	4.4
Citigroup Inc	2.2%	4.0	4.2
Goldman Sachs Group Inc/The	2.0%	3.9	4.1
Wells Fargo & Company	1.7%	3.9	4.0
HSBC Holdings PLC	1.5%	4.1	4.0
Apple Inc	1.3%	3.2	3.8
General Motors Co	1.0%	4.3	3.5
Verizon Communications Inc	1.0%	4.1	5.8

Top 10 Issuers	MV%	YTM (%)	Duration (yrs)
Long Corporate Index	18.2%	4.9	14.0
AT&T Inc	2.7%	4.9	14.8
Berkshire Hathaway Inc	2.2%	4.6	14.2
Comcast Corporation	2.0%	4.6	15.0
Anheuser Busch Inbev NV	2.0%	5.0	13.2
Verizon Communications Inc	1.8%	4.7	14.5
Charter Communications Inc	1.7%	6.1	12.5
Bank of America Corp	1.6%	4.8	12.4
Wells Fargo & Company	1.4%	4.8	12.9
Oracle Corporation	1.4%	5.7	13.3
Apple Inc	1.4%	4.2	16.2

Source: MIM, Aladdin, as of April 2022

Given over 15% of the Intermediate Corporate Index is concentrated in just seven Banking issuers above, a cap on the sector (e.g., 25%) or issuer (1.5%) could be warranted to help mitigate the overall risk in Financials. While the Financials concentration is much higher in Intermediate, the defensive Utilities sector exposure in the Long Corporate Index is double that of the Intermediate Corporate Index at 11.9% and 5.8%, respectively. 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 ~13% (versus 6.3% for Intermediate Corporate) 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.

Recently we have seen a number of our clients also adopt a dedicated Intermediate allocation, and in some cases, a broad IG Corporate strategy, in addition to a standalone Long Duration mandate. Most of these additions have taken place in 2021, coinciding 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. Intermediate mandates can also provide in-kind assets for annuity buy outs of retirees. 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.

Endnote

[1] JP Morgan. US Corporate Credit Issuance Monthly: April 2022.

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