CORE DATA research

Income Investing in a New Age

How institutional investors are navigating a changed and challenged landscape

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Contents

FIVE KEY **TAKEAWAYS**

1

The hunt for yield in the wake of Covid-19 has propelled global institutional investors into more risky areas of the fixed income market. Eight in 10 investors say the current low yield environment is forcing them to look for opportunities in income-generating alternative investments. And more than half agree it is compelling them to look at distressed debt and high-yield bonds. The increasingly urgent search for yield demonstrates how the fixed income landscape is being reshaped by evolving attitudes to risk and an ongoing shift from public markets to private markets. This evolution underscores the need for investment solutions that can both capture new sources of returns and protect against new sources of risk.

2

Fixed income is becoming a core element of the sustainable landscape as investors increasingly assess the ESG credentials of companies they lend to. Nearly a third of global institutional investors plan to increase allocations to ESG fixed income over the next 12 months. This proportion jumps to more than half of European investors. Demand is particularly high for green bonds and sustainable bonds.

3

Nearly three-quarters of global investors say integrating ESG into fixed income investments can improve performance and credit risk management. Furthermore, the majority disagree that ESG risk factors are less relevant to the investment performance of fixed income strategies. This demonstrates how institutions are relying on ESG metrics to boost fixed income returns and manage risk. The findings also highlight the need for investors to have access to robust and transparent data to help identify and evaluate these ESG factors.

4

But investors are struggling to access such information. About seven in 10 agree that a shortage of ESG risk ratings and data is holding back greater adoption of ESG bonds. Concern about a lack of ratings and data is especially pronounced among investors in Europe. This indicates that difficulties assessing and benchmarking the ESG credentials of fixed income investments is presenting a significant barrier to further growth. Investors therefore need more data and better data to help them adopt and integrate ESG into fixed income portfolios. And they also need to interrogate this data and overlay it with their own qualitative research.

5

The income landscape has been transformed by the pandemic. But despite this challenging outlook, opportunities remain for investors taking an active, unconstrained and flexible approach. Of key importance will be the ability to build diversified portfolios with exposure to different income-generating and risk-mitigating assets. And this favours the outsourcing of fixed income to specialist active managers able to navigate and take advantage of an increasingly fragmented and complex income universe. Investors see a growing role for active managers, with three in 10 set to increase allocations to active fixed income over the next year.

Methodology: CoreData Research surveyed 200 institutional investors in Europe, North America and the Asia Pacific during February 2021.

Background

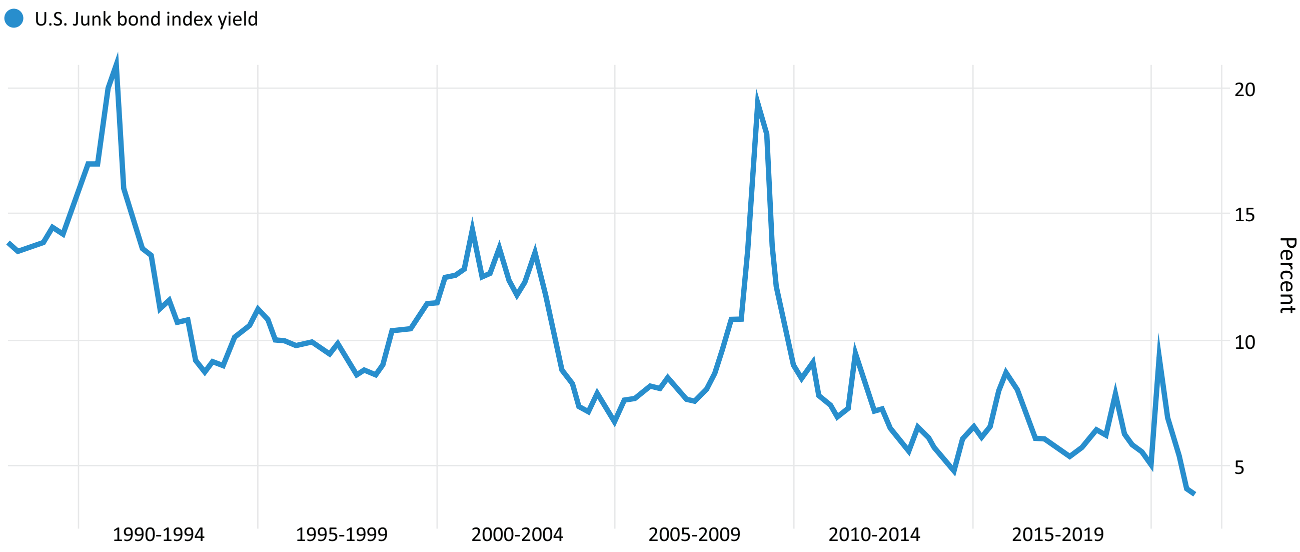
Warren Buffett, regarded as one of the most successful investors in history, had a grim warning for fixed income investors in his annual letter to Berkshire Hathaway shareholders. "Fixed-income investors worldwide – whether pension funds, insurance companies or retirees – face a bleak future," wrote Buffett in his letter published at the end of February 2021.[1]

Indeed, the Covid-19 pandemic has created the perfect storm for institutional investors looking for income. On the one hand, extraordinary monetary policy packages put in place by central banks to stimulate Covid-ravaged economies has sent bond yields plummeting to all-time lows. And on the other hand, dividends have been cancelled or suspended as companies look to repair balance sheets damaged by pandemic-related disruption.

According to Janus Henderson's global dividend index, global shareholder payouts declined 12% in 2020 to $1.26 trillion.[2]

This hostile climate has turned the income landscape into a barren wilderness with slim pickings for income-starved investors. We live in an age of negatively-yielding debt – meaning investors have to pay to hold some bonds. And investors are even struggling to find suitable rewards in the junk bond market. The average yield on the Bloomberg Barclays U.S. Corporate High-Yield index dropped below 4% for the first time in February 2021 as investors flocked en masse to junk bonds. This illustrates how the pandemic has altered the whole risk-reward dynamic for fixed income investors.

The Bloomberg Barclays U.S. Corporate High-Yield index



Source: Bloomberg Barclays index

[1] https://berkshirehathaway.com/letters/2020ltr.pdf
[2] https://cdn.janushenderson.com/webdocs/Janus+Henderson+Global+Dividend+Index.pdf

As central banks pursue a lower for longer policy, with the Fed pledging to keep rates at near zero until at least the end of 2023, investors see few prospects on the horizon. And with the US yield curve recently steepening on expectations of higher inflation, the outlook does indeed seem ‘bleak’ for fixed income investors.

While the search for yield takes on more urgency, questions have also been raised over whether bonds have lost their defensive and diversifying properties in today’s artificially inflated market. Record low yields and high prices have curtailed the ability of bonds to offer levels of protection afforded in previous crises. In addition, there have been instances during the pandemic when the negative correlation between equities and bonds has broken down. As the pandemic helps redefine the nature of defensive assets, investors need to redefine and re-examine their whole approach to fixed income.

But despite this challenging outlook, opportunities remain in the fixed income market for investors taking an active, unconstrained approach. The fixed income sector is vast and varied, offering access to different segments that can help manage risk and generate diversified sources of yield. While investment grade bonds can provide a degree of protection from credit risk and default risk, inflation-linked bonds can protect against rising inflation. And the likes of high yield, structured credit, private debt and infrastructure debt offer the potential for superior yields and uncorrelated returns.

In addition, Covid-19 has created opportunities in areas like distressed debt as companies hit hard by the pandemic look to grow, restructure and rebuild. According to data compiled by Bloomberg, the size of the US distressed debt market surged to almost $1 trillion in March 2020.[3]

The pandemic has also acted as a force for innovation in the green bond market as countries look to support sustainable economies and drive growth. The ESG fixed income sector is evolving rapidly, offering investors a wider subset of income-generating sustainable options. According to Moody’s Investor Service, global issuance of green, sustainability and social bonds will surge to a record $650 billion in 2021.[4]

This growing fragmentation of the fixed income market means it is no longer enough to be diversified between different asset classes. Investors must now look to be diversified within fixed income itself. Amid this growing complexity, institutional investors will increasingly outsource the fixed income component to specialist active managers better able to identify performance drivers and manage credit risk.

Meanwhile despite the Covid-19 dividend crunch, opportunities also present themselves in the equity income sector. Companies that have had to cut or suspend dividends due to the impact of the pandemic have seen their valuations fall. But this provides opportunities for investors to buy dividend-paying stocks at good prices before distributions are resumed or increased. And this has already started in earnest, with big banks including Lloyds, Standard Chartered and Barclays resuming payouts and oil major Shell raising its dividend.

“Fixed-income investors…face a bleak future.”
Warren Buffett, Berkshire Hathaway CEO

[3]https://www.bloomberg.com/news/articles/2020-03-25/distressed-debt-balloons-to-almost-1-trillion-nears-2008-peak
[4]https://www.moodys.com/research/Moodys-Sustainable-bond-issuance-to-hit-a-record-650-billion--PBC_1263479

Conclusion

The role of fixed income in portfolios has been transformed over recent years as persistently low rates encourage investors to search for higher yields in non-traditional assets. But the pandemic has exacerbated these trends, further encouraging investors to accept more risk in the pursuit of attractive income.

The whole culture and philosophy towards fixed income is changing amid evolving attitudes to risk and an ongoing shift from public markets to private markets. It is no longer about 60/40 portfolios and paying to hold bonds in a sub-zero environment. The mindset of investors is changing as they gravitate away from traditional, defensive products towards higher-yielding and more exotic investments offering uncorrelated sources of return.

And this evolution means manufacturers need to place an emphasis on imagination and innovation when designing new sets of solutions for a new breed of investor. Product providers are tasked with developing a more diverse set of strategies better aligned with the constraints and opportunities of the new age of volatility.

Institutional investors in turn will need to expand their income horizons and cast their nets wide to capture an expanding set of opportunities. While traditional fixed income is challenged, the wider income universe is dynamic and exciting, with new alternative, sustainable and liquid offerings giving investors more options and more possibilities.

CORE DATA research

About **Us**

CoreData Research is a global specialist financial services research and strategy consultancy. CoreData Research understands the boundaries of research are limitless and with a thirst for new research capabilities and driven by client demand; the group has expanded over the past few years into the Americas, Africa, Asia, and Europe.

CoreData Group has operations in Australia, the United Kingdom, the United States of America, Spain, Malta, and the Philippines. The group's expansion means CoreData Research has the capabilities and expertise to conduct syndicated and bespoke research projects on six different continents, while still maintaining the high level of technical insight and professionalism our repeat clients demand.

With a primary focus on financial services CoreData Research provides clients with both bespoke and syndicated research services through a variety of data collection strategies and methodologies, along with consulting and research database hosting and outsourcing services.

CoreData Research provides both business-to-business and business to- consumer research, while the group's offering includes market intelligence, guidance on strategic positioning, methods for developing new business, advice on operational marketing and other consulting services.

The team is a complimentary blend of experienced financial services, research, marketing and media professionals, who together combine their years of industry experience with primary research to bring perspective to existing market conditions and evolving trends.

CoreData Research has developed a number of syndicated benchmark proprietary indexes across a broad range of business areas within the financial services industry.

- Experts in financial services research
- Deep understanding of industry issues and business trends
- In-house proprietary industry benchmark data
- Industry leading research methodologies
- Rolling benchmarks

The team understands the demand and service aspects of the financial services market. It is continuously in the market through a mixture of constant researching, polling and mystery shopping and provides in-depth research at low cost and rapid execution. The group builds a picture of a client's market from hard data which allows them to make efficient decisions which will have the biggest impact for the least spend.

Whitepaper compiled by CoreData

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