LGIM America

# Making Your LDI Portfolio Work Harder

## The Case for Incorporating Investment Grade Private Credit

### Executive summary

- Investment grade private credit can improve a pension plan's LDI strategy by enhancing returns, increasing diversification and adding downside protection.
- Now is a good time to access the asset class, where the opportunity set has significantly broadened, and illiquidity premiums are elevated after the regional banking crisis in 2023.
- The breadth and depth of the market means that capital can be deployed relatively quickly across different sectors.

### Introduction

The historic rise in Treasury yields over the past 2 years has had dramatic effects across financial markets. The impacts were felt across market participants, but perhaps no investor felt the ramifications as much as corporate defined benefit (DB) plans. We have seen significant improvements in funded status across DB plans, especially those who were under-hedged to interest rates. As of December 31st, 2023, our Pension Solutions Monitor, which aims to track the average funding ratio across the corporate DB landscape, hit a high watermark of 104%.[1] Given this backdrop, we highlight the importance of US LDI investors evolving with the market.

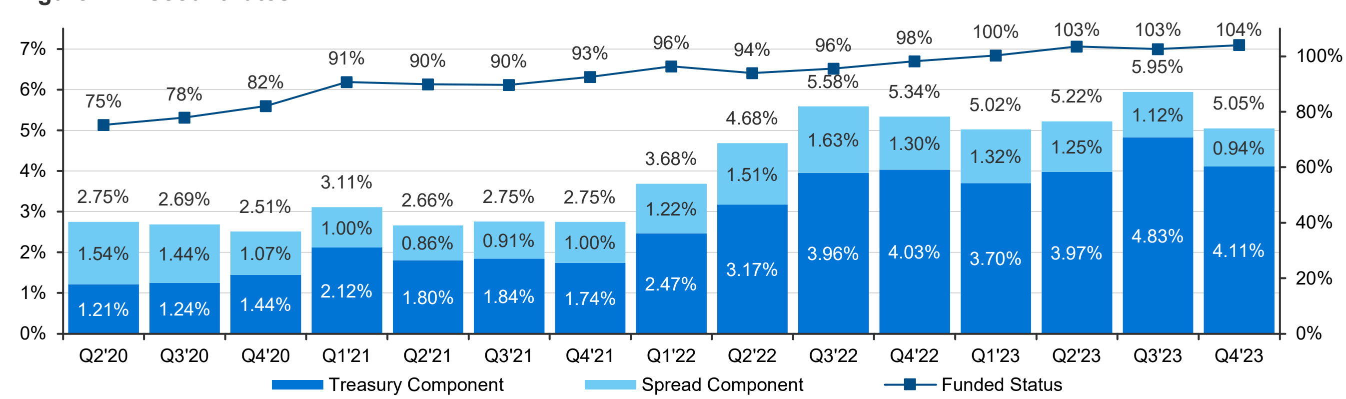
### The case for investment grade private credit

Investment grade (IG) private credit is an asset class that is very much under the radar, overshadowed by its riskier counterparts such as direct lending which have experienced strong growth in recent years. For a long time, IG private credit has been the domain of insurance companies, particularly those from the US, who have looked to diversify their portfolios by investing globally in unlisted, high quality debt assets. Over recent years the pension sector (plan sponsors and pension insurers), notably in Europe, have increased their involvement.

"Private" does not mean a private company but is rather the nature of the investment, i.e., unlisted. The investments can come in loan or note format and span four core verticals: corporates, alternatives, infrastructure and real estate debt. Thus, the opportunity set is much broader than the public corporate bond market. We estimate these markets combined exceed $500 billion in issuance per annum.

According to Cerulli Associates, interest in public and private fixed income strategies has picked up significantly throughout the year as relatively higher yields attract institutional investors to the space. 68% of plans surveyed plan to increase their fixed income allocation and 47% expect to allocate to private debt over the next two years.[2]

**Figure 1: Discount rates**




Source: LGIM America, ICE indices and Bloomberg. Data as of December 29, 2023.

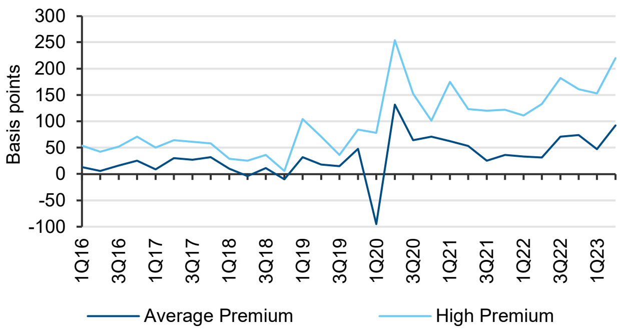
So why should LDI investors consider adding IG private credit to their fixed income allocation?

**Out-earn liabilities**

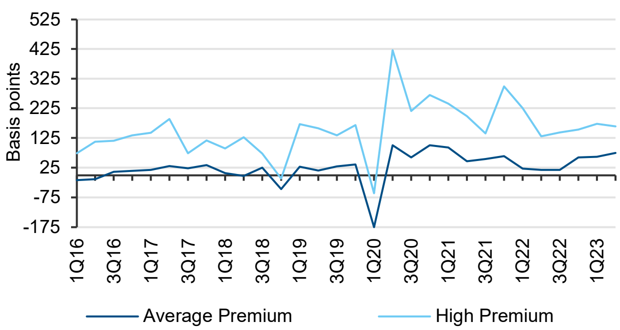
Simply put, better returns increase the probability an investor achieves their funding objective. Investment grade private credit offers a premium for illiquidity given its private nature. This premium has historically averaged between 50-100 basis points spread to public equivalents but has increased in recent months, as more borrowers tap the investment grade private credit market following tighter bank lending conditions. Premiums can be higher depending on the issuer and deal terms as highlighted in the charts below.

**Figure 2: Credit premiums**

A- or better credit premium (NAIC-1)




BBB credit prmium (NAIC-2)




Source: BAML – public index references ICE BAML corporate indices (C0A3 & C0A4). Data as of June 30, 2023.

**Diversification: Issuers**

IG private credit spans a wider range of sectors and asset classes than the public credit market and provides access to opportunities unavailable elsewhere (e.g. infrastructure and real estate debt). With significantly higher yields than we've seen in the past 10 years, many investor types are increasing their allocations to fixed income. According to the 2023 Corporate Pension Funding Study by Milliman, pension fixed income allocations have grown from 28% in 2005 to over 51% at the end of 2022.[3] As allocations to fixed income, and thus credit, increases, diversification within the credit portfolio becomes critical to avoid concentration risk.

As seen in Figure 3, private markets offer a much broader opportunity set than public credit, diversifying the plan's fixed income may be a prudent step for many sponsors.

**Diversification: Maturities**

The investment grade private credit market is quite flexible in terms of loan structure since it is not bound by public bond listing rules and maturity can range from 3 months to 40 years. In 2023, borrowers focused on shorter maturities to avoid locking in higher debt costs. As a result, recent issuance is concentrated in the <10-year bucket, which is ideal for LDI investors looking for a more precise hedge in the middle of the curve where public benchmarks see less issuance.

For many DB plan sponsors, liability durations have fallen as Treasury yields soared. To illustrate the magnitude of the change, we can look at our own client base. From December 2020 to December 2023, the average liability duration for our LDI clients has fallen from over 12 years to 9.9 years.[4] As plans' liabilities evolve, so have their LDI investment programs. We have seen heightened demand for short and intermediate duration strategies to complement longer duration assets.

**Downside protection: Funded Status Preservation**

In contrast to public credit (unsecured) and sub-IG private credit (increased covenant-lite transactions), IG private credit benefits from robust structural protection. This is typically achieved by high tranche seniority, covenants on key financial metrics (e.g., leverage and coverage), and

**Figure 3: Private markets opportunity set**

| Corporate debt | Infrastructure debt | Real estate debt | Alternative debt |
|---|---|---|---|
| • Traditional corporate sectors<br>• Quasi-government institutions such as higher education, healthcare systems, and social housing | • Economic infrastructure (water, electricity distribution, transport)<br>• Renewables (wind, solar etc)<br>• Digital (fiber, data centres)<br>• Social infrastructure (education, healthcare) | • Industrials (distribution and logistics)<br>• Offices (prime assets in core locations)<br>• Residential<br>• Alternative sectors including data centres, self-storage | • Capital calls<br>• Supply chain financing<br>• Structured financing<br>• ESG-specific transitions, e.g., blue bonds |

Source: LGIM America. For illustrative purposes only.

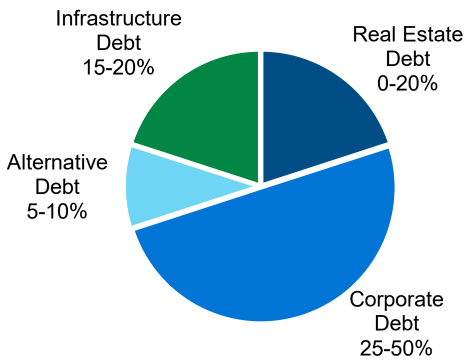
security over assets/cashflows. Since inception in March 2017, LGIM America's private credit portfolio has experienced zero defaults or credit losses.[4]

IG private credit provides better protection against macroeconomic uncertainty. There are several risk reduction measures plan sponsors can take to protect against a potential market correction – from hedging more interest rate risk to adopting equity protection strategies. Within the credit component, we believe incorporating private credit can increase the resilience of the credit portfolio in the event of a market downturn. To highlight, 44% of total IG private credit issuance in 2023 was in the utility and infrastructure sectors, which tend to be more defensive given the regulated nature of their industries.

## Implementation and allocation considerations

Here we illustrate a well-diversified model portfolio based on recent transactions we observed. In practice, the portfolio structure will depend on the prevailing market condition and the investor's objectives with respect to return, risk, duration, transferability, diversification and ESG. The USD market is by far the largest and includes both US and non-US issuers. For maximum diversification investors could consider adding other currencies (CAD, EUR, GBP, AUD).

**Figure 4: Illustrative portfolio**




*Average duration: 8-10 years*
*Average credit rating: BBB+ / A-*
*Average credit spread: 175- 200 basis points*
Source: LGIM America as of January 2024.

The market is busy with a strong pipeline already expected for Q1 2024. To give an idea of pace of deployment, currently we think it is feasible to fully invest a $250-500 million mandate over 12 months. It is possible to deploy faster, but we think flexibility is important and are mindful of the implications including sector concentration and being forced to invest when market conditions are not advantageous.

Where to source the funds for a new IG private credit mandate will be plan specific. One must consider the time horizon to ramp up the portfolio, potential transaction costs, liquidity and market conditions.

- For those on a de-risking glidepath that are currently transitioning out of return-seeking assets, opportunistically adding to the IG private credit portfolio as funds come available may be straightforward.
- For others who are looking to diversify their current fixed income sleeve, rotating out of publics into privates as new deals surface may be the most appropriate path.
- As sponsors weigh liquidity and cost factors, one alternative could be to initially invest in a short-dated, high-yielding diversified credit strategy to pick-up yield versus public comparables, while the private credit portfolio is ramping up.

## Conclusion

Interest in IG private credit strategies has been growing in recent years. Proponents of the asset class have always pointed toward the potential for yield enhancement, availability of structural protections and added diversification. 2024 could be the year where attractive market conditions intersect at the right moment within the evolution of DB plan sponsor's LDI programs. The opportunity set within IG private credit has significantly broadened after the banking crisis in Spring of 2023, increasing the illiquidity premium available in the market. Additionally, pension plans' growing fixed income allocations and falling liability durations are propelling plan sponsors to explore shorter-dated, diversified credit strategies. Market developments and the pension plan landscape has set the stage for a strong argument to include IG private credit within institutional portfolios, especially in an LDI context.

1. For illustrative purposes only. LGIM America prepares the Pension Solutions Monitor data assuming a typical liability profile using an approximate duration of 12 years and a 50% MSCI AC World Total Gross Index / 50% Bloomberg US Long Government/Credit Index investment strategy, incorporating data sourced from LGIM America, ICE, MSCI and Bloomberg. These results are based on simulated or hypothetical assumptions that have certain inherent limitations. Unlike the results in an actual performance record, these results do not represent actual trading. Because these trades have not actually been executed, these results may have under or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to these being shown. Prior to January 2023 the funded ratio of a typical US corporate defined benefit plan was calculated using an approximate duration of 12 years and a 60% MSCI AC World Total Gross Index / 40% Bloomberg US Aggregate Index ("60/40") investment allocation strategy incorporating data from LGIM America research, ICE indices and Bloomberg. The change to a "50/50" asset allocation reflects our understanding that most US corporate defined benefit plans have extended the duration of their fixed income as funded status has improved for the broader market. Furthermore, we believe that the duration of a typical plan's fixed income portfolio is better represented by the Bloomberg US Long Government/Credit Index compared to the Bloomberg US Aggregate Index.
2. Source: Cerulli Associates.
3. Source: Milliman: 2023 Corporate Pension Funding Study.
4. Source: LGIM America. As of December 31, 2023.



Risks of Investing in Private Credit-Like all investments, there are risks associated with investing in a portfolio of private placements. Below is a description of the primary risks of investing in private placements. The description is not all-inclusive, and before making an investment in a portfolio of private placements, investors should carefully consider such an investment.

The primary risk to an investment in private placements is credit risk. Credit risk is the risk of non-payment of scheduled interest or principal payments on a debt instrument. In the event a borrower fails to pay scheduled interest or principal payments on its debt, a portfolio of private placements would experience a reduction in its income and a decline in market value.

Private credit generally involve less risk than unsecured or subordinated debt and equity instruments of the same issuer because the payment of principal and interest on private placements is a contractual obligation of the issuer that, in most instances, takes precedence over the payment of dividends or the return of capital to the borrower's shareholders and payments to public bond holders. In the event of the bankruptcy of a borrower, a creditor could experience delays in receiving regular payments of interest and principal and may not receive the full repayment of its principal.

As described above, portfolios of private placements are also subject to interest rate risk. One risk related to interest rates is the potential for changes in the interest rate spreads for private placements in general. To the extent that changes in market rates of interest are reflected not in a change to the base rate, the U.S. Treasury, but in a change in the spread over the base rate which is payable on loans of the type and quality in which a portfolio invests, a portfolio of private placements could also be adversely affected. This is because the value of a debt is partially a function of whether it is paying what the market perceives to be a market rate of interest, given its individual credit profile and other characteristics. However, unlike changes in market rates of interest for which there is only a temporary lag before a portfolio reflects those changes, changes in a placement's value based on changes in the market spreads on loans may be of longer duration.

If spreads rise as described above, for example, in response to deteriorating overall economic conditions and/or excess supply of new loans, the principal value of private placements may decrease in response. On the other hand, if market spreads fall, the value of private placements may increase in response, but borrowers also may renegotiate lower interest rates on their debts or pay off their debts by refinancing at such lower rates. In that case, the borrowers would be required to pay a make-whole amount, which would mitigate the risk.

Private placements trade in a private, unregulated market directly between loan market participants; although most transactions are facilitated by broker-dealers affiliated with large commercial and investment banks. As a result, purchases and sales of private placements typically take longer to settle than similar purchases of bonds and equity securities. In addition, because private placement transactions are directly between investors, there can be greater counterparty risk.