Avon Pension Fund

Tactical switch from Gilts to corporate bonds

Proposal

This paper proposes that the Avon Pension Fund (the "Fund") undertake a tactical switch from UK government bonds ("gilts") to UK corporate bonds ("credit").

The proposed amount to switch is £80million or 3.2% of the Fund. It is proposed that this position be reversed when the spread of credit yields over gilt yields falls to 1.2%.

The expected benefit of the tactical switch is £6 million. The risk of the tactical switch is that spreads widen further and do not subsequently fall.

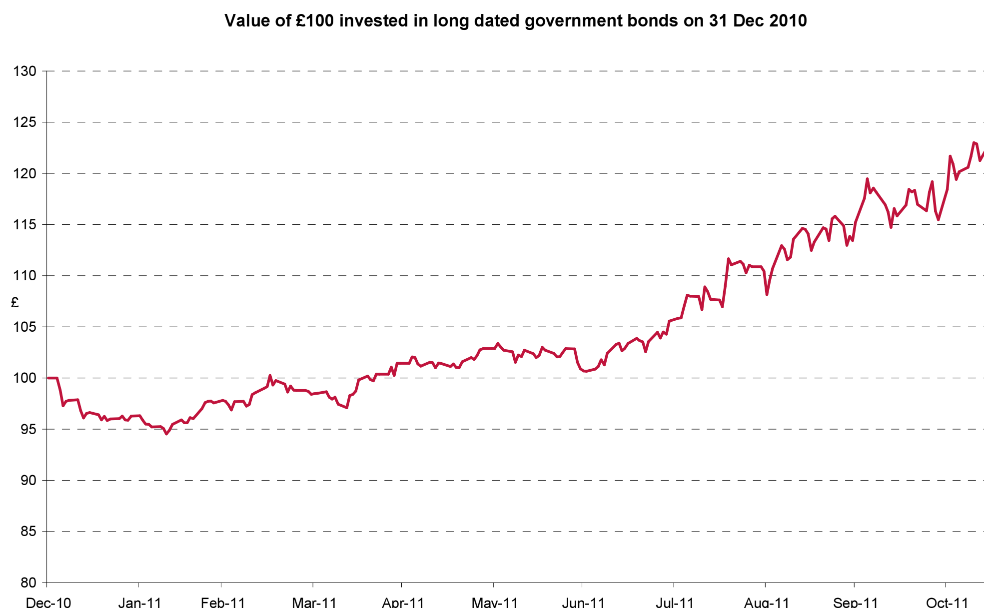
Background

In July 2009, the Fund switched approximately 2% of the Fund's total assets from Gilts to corporate bonds to take advantage of a widening of corporate bond yields relative to Gilt yields.

The position was reversed in January 2010. The benefit to the Fund of holding the tactical position out of Gilts and into credit was approximately £4 million (net of all trading costs).

Rationale for the switch

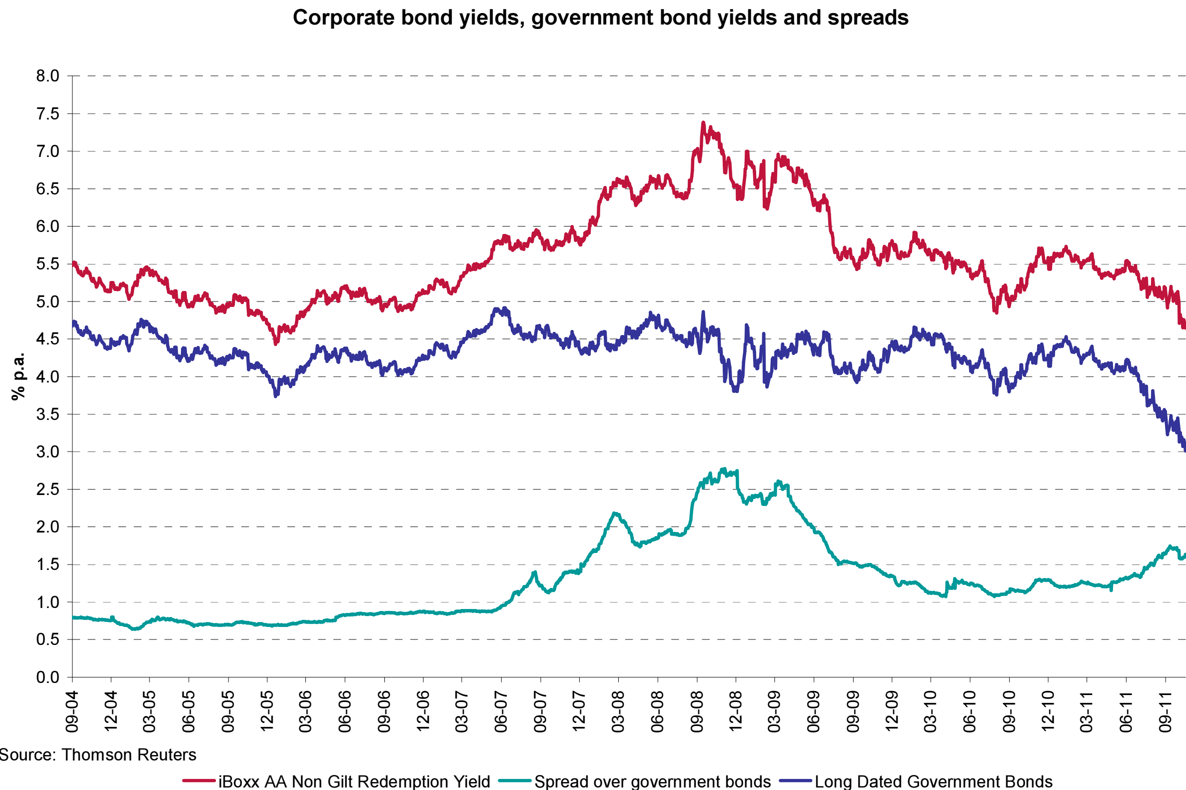
The chart below shows the increase in government bond prices and that there has been a particularly sharp rise over the past few months as a result of the Eurozone debt crisis. Consequently, this has led to government bond yields being at historic lows.



Source: Thomson Reuters

Returns on corporate bonds have also been positive over the year but not by the same extent. This has led to an increase in the additional yield available from corporate bonds relative to gilts (the spread). By taking a tactical position of switching into corporate bonds relative to gilts, the Fund is expected to benefit from any narrowing in the spread. The Fund would also gain from the increased income available from corporate bonds (due to their higher yield).

The chart below shows the yield from corporate bonds, yields from gilts, and the spread between these. The time period shown is from 30 September 2004 to 24 November 2011.



Over the period shown in the chart, the spread of corporate bond yields over gilts was at its lowest of 0.6% in February 2005 and its highest point of 2.8% in December 2008. Over the period shown in the chart, the average of the spread of corporate bond yields over gilts was 1.3%, albeit heavily influenced by the period between Q3 2008 and Q2 2009. As at 24 November 2011, this was 1.7%.

When the tactical position was taken in July 2009 the spread was at 1.6%. When it was reversed in January 2010 the spread was 1.2%. As can be seen from the chart, the current spread has only recently increased to this level.

Narrowing of the spread

When the tactical switch was undertaken in 2009, gilt yields and corporate bond yields were both higher than they are today. The expectation was that the majority of the narrowing of the spread would occur through a fall in corporate bond yields.

The increase in spread in the current market has occurred, by contrast to in 2008 and 2009, due to the fall in government bond yields, which has been driven by the debt crisis in the Eurozone: UK government bond yields have become a 'safe haven' for investors which has driven the bond yields down. Indeed, corporate bond yields have also fallen as investors feel that companies have relatively sound financial health (compared to 2008 and 2009). As such, there is a greater expectation that any narrowing of the spread on this occasion will occur primarily through a rise in government bond yields due to their yields currently being at historic lows.

There are of course a number of ways in which the spread could narrow but the above shows that the expectation is that the benefit to the Fund will be through selling assets (gilts) that will fall in value, rather than the previous switch where the expectation was for the corporate bonds being bought to increase in value. Corporate bonds may also fall in value on this occasion given that they have recently experienced increases, but this is expected to be by less than the fall in government bond prices (and hence the yield spread narrows) due to the large relative increases which have been seen in government bond prices compared to the increase in corporate bond prices.

Options to be considered

The previous chart shows that the spread has been as low as 0.6% over the period considered. However, in the current environment we do not expect the spread will move below 1%. Furthermore, there remains a risk that spreads could widen.

The following table illustrates the potential monetary benefit and cost of undertaking a tactical switch should spreads widen or narrow by 0.5%. For these calculations, we have assumed that gilts have a duration of 15 years, and that the corporate bonds have a duration of 8 years. We have included in the table different scenarios for the spread between yields compressing, as there are a number of different possibilities.

1. Spreads narrow: if this occurs then the Fund is expected to benefit.
2. The spread between corporate bond yields and gilt yields remains the same: the Fund will again be expected to benefit in this situation due to the increased income or yield that will be received on the corporate bonds.
3. The final scenario is that the spread will widen and remain wide. If this occurs then the Fund is expected to incur a loss as a result of the switch.

Amount switched out of gilts and into corporate bonds	Impact of 0.5% narrowing of spread		Impact of 0.5% widening of spread	
Assumed reason for change in spread	gilt yields rise	corporate bond yields fall	gilt yields fall	corporate bond yields rise
3.2% of Fund assets (c. £80m)	£6,000,000	£3,200,000	-£6,000,000	-£3,200,000
1.6% of Fund assets (c. £40m)	£3,000,000	£1,600,000	-£3,000,000	-£1,600,000

Assumes that government bonds switched are long dated, with a duration of 15 years, corporate bonds are all maturities with a duration of 8 years.

Amount to switch: with respect to the amount to be transferred, to be able to take advantage of the benefits of a tactical switch, it is important to consider switching assets at a meaningful level whilst still having regard to practicalities and not unduly exposing the Fund to perceived risk. The Fund's strategic allocation to fixed interest gilts is 6%. We recommend the transfer of 3.2% of the Fund's assets, or approximately one half of the current gilt exposure, in order to achieve these objectives. We have shown the impact of switching a similar amount to the previous switch, and the impact of doubling that amount.

Corporate bonds to purchase: it makes sense to apply the proceeds from the gilts sale to the Royal London Corporate Bond Fund that the Fund currently manages. RLAM are an active corporate bond manager, and will aim to avoid potential defaults and those bonds that will be downgraded and therefore avoid being a forced seller within the corporate bond market (very few bonds go direct from investment grade status to defaulting). This is clearly an attractive feature. The charts at the end of this note show that there are significant differences in yields depending on credit quality. An active manager is expected to be able to take advantage of these differences. Furthermore, Royal London may be able to take the gilts "in-specie", thus saving on transaction costs of the switch.

When to implement: given the current level of spreads it would be desirable to make the switch as soon as possible. However, it may not be possible to undertake the trade before Christmas and it is not advisable to trade close to or over the Christmas period due to lack of liquidity. It may therefore be necessary to undertake the trade in the new year, taking account of any changes in conditions between the date of this report and implementation.

The trigger for reversal: as noted above, we believe spread will not fall below 1% in the foreseeable future. We therefore believe a fall to 1.2% as a trigger for discussion and reversal of the trade allows a material profit to be banked on the switch. Whilst spreads may fall further, waiting for this could mean missing an opportunity to reverse the trade.

Summary of recommendations

1. That a tactical switch from fixed interest gilts to UK corporate bonds be undertaken.
2. That the gilts be transferred, ideally in-specie from BlackRock's portfolio and invested with RLAM.
3. That 2% - 3% of the assets of the Fund be transferred.
4. That the Committee consider setting the trigger for reversing the tactical switch to when spreads fall to 1.2%.

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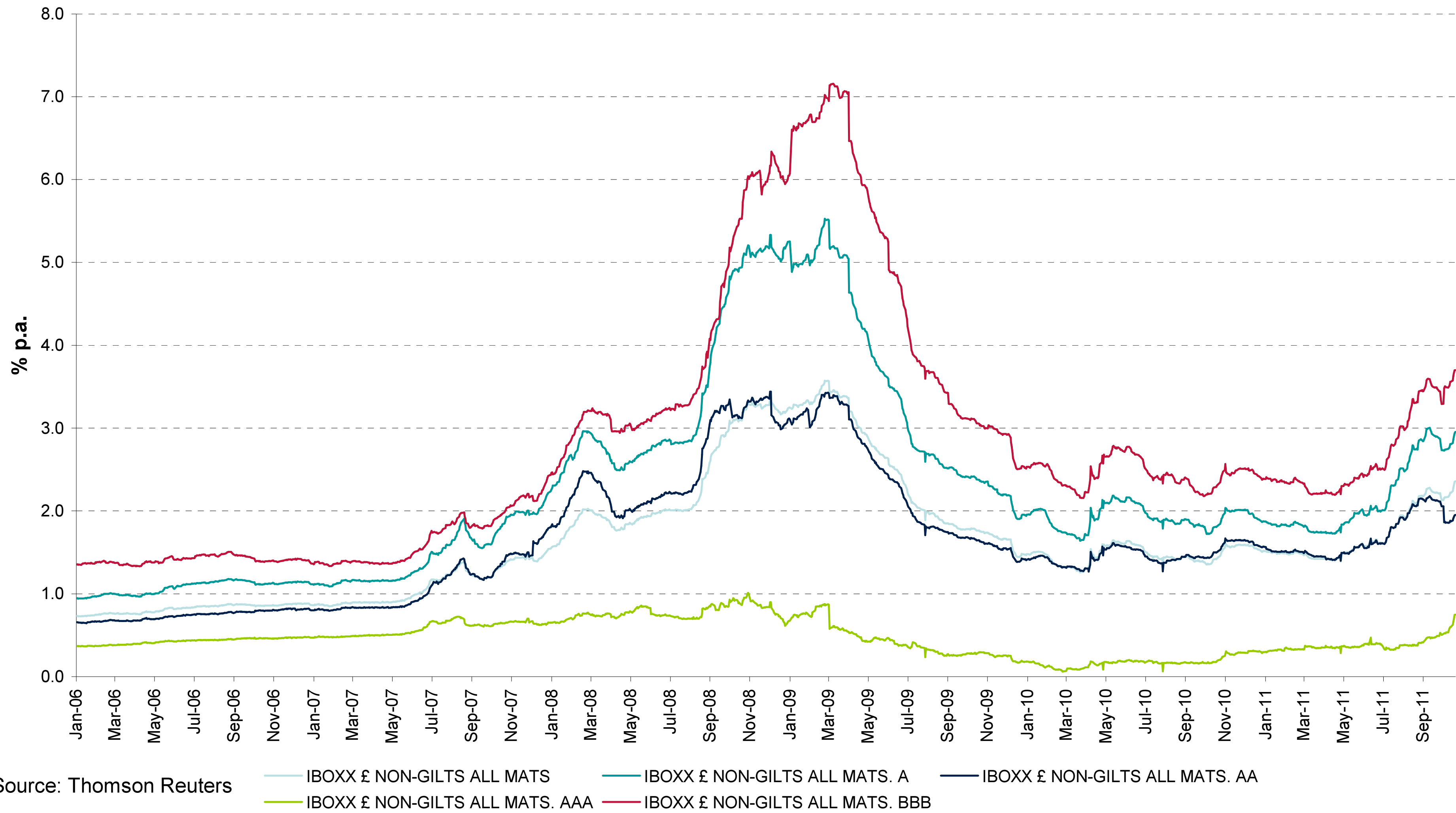
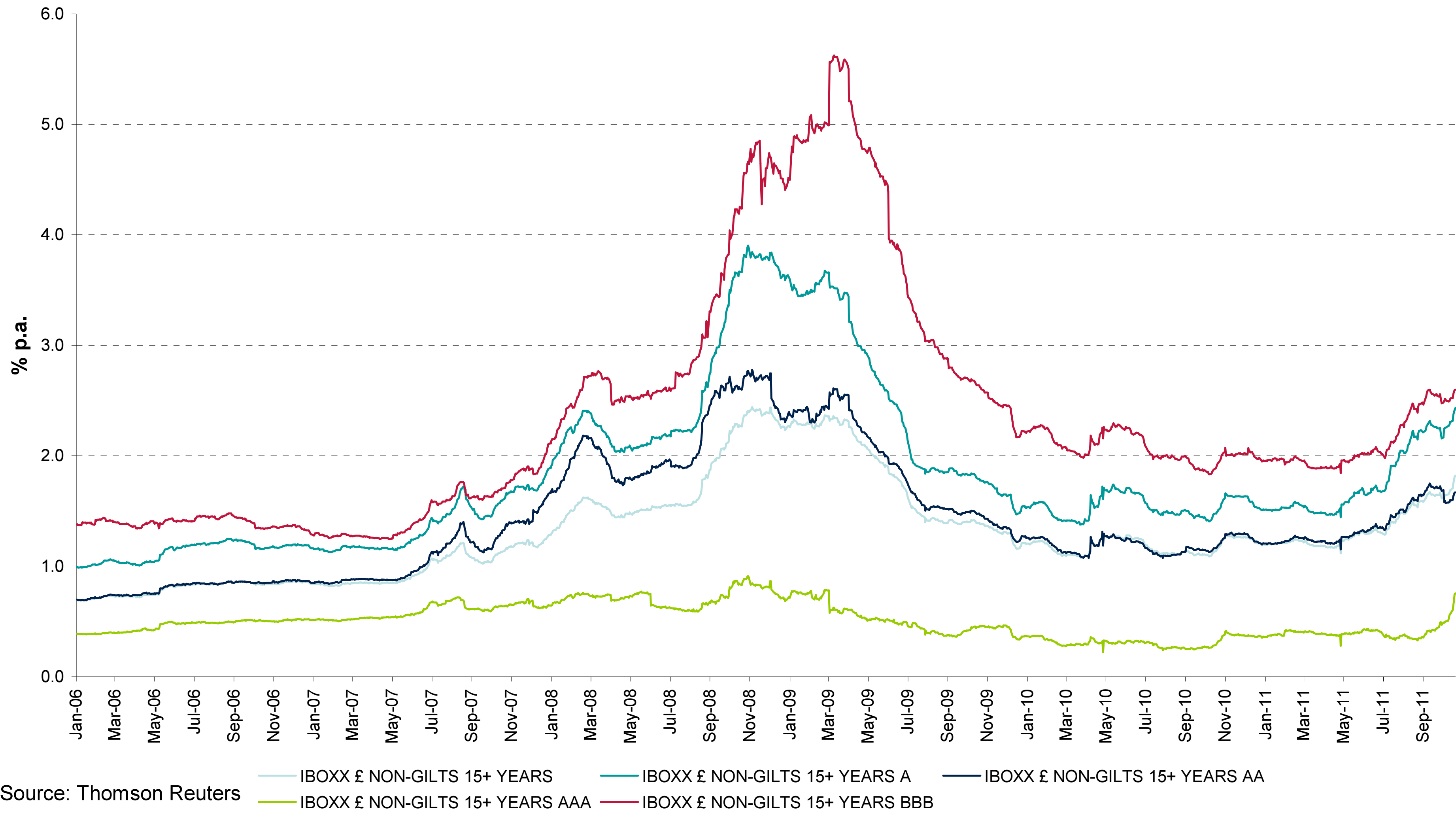


Source: Thomson Reuters



Source: Thomson Reuters