December 2020

Demystifying Secured Income Assets

How Secured Income Assets are helping defined benefit pension funds in their "end-game" planning

Introductions

UK and European pension funds are displaying an insatiable appetite for so-called secured income assets (SIAs). This demand can be traced back to the early noughties when investing in so-called "long-lease property" became mainstream. Whilst the last decade was characterised by a headlong rush into fixed rate and inflation-linked government bonds to match liabilities, it would seem like the next decade may see at least some of these gilt holdings substituted for SIAs. This could be especially true because maturing pension funds, in need of income to pay benefits, are increasingly embracing cashflow driven investing (CDI). Further demand may come from a rotation out of listed equity markets into private markets as investors recognise that the former hold increased risk if one subscribes to the view that their valuations may have been, and will continue to be, distorted by central bank stimulus policies.

The term SIA has been used to refer to a wide range of different investments so newcomers to the term could be forgiven for being confused about precisely what is meant by SIAs; not least because the term "secured" may be confused by some as implying "guaranteed". In this article, we aim to demystify SIAs by proposing a definition which we hope will be of some use in discussions between trustees, investment consultants and asset managers. Next, we outline why SIAs may be useful for pension funds and some of the considerations for trustees when considering how best to include SIAs in their investment portfolios.

What are secured income assets (SIAs)?

We have noticed a wide array of strategies being described as offering Secured Income. For this reason we prefer a definition which is broad in scope and would encourage investors to dig deeper into individual strategies to determine whether the label of "Secured Income", meets their specific investment objectives;

> **Secured income assets** are expected to offer a return in excess of government bonds. The distinguishing characteristic of a SIA is that both its overall return and future cashflows are expected to be stable, predictable and robust despite expected and unexpected idiosyncratic and systematic risks.

The table on the next page expands on this definition.

Shalin Bhagwan
Managing Director
Head of Pensions Advisory and
EMEA Consultants
E-mail: shalin.bhagwan@dws.com

Characteristic	Description
Returns	A common feature across different types of SIAs is that they are expected to deliver a return in excess of that of comparable risk-free instruments such as government bonds. The expected return, after allowing for all risks, is expected to be delivered with a high degree of certainty and to be resilient to unexpected market and economic shocks.
Interest rate and inflation hedging	Many UK pension funds wish to access the broadest possible opportunity set for yield enhancement. Two reasons for this are: 1) to improve diversification and 2) to avoid chasing up prices by focusing on a very narrow opportunity set. As an example, non-gilt, sterling long-dated, inflation-linked cashflows are highly sought after by both pension funds and insurers, creating a supply/demand imbalance that can drive up prices. However, by splitting the need for inflation hedging (which can be sourced through a liability driven investment programme (LDI)) from the need for yield enhancement, a broader opportunity set can be accessed. It follows, then, that SIAs need not offer interest rate and/or inflation hedging exposure. Cash flow amounts may be fixed, or vary in a manner specified in the contract; for example, linked to an inflation index or a floating interest rate index. Both long-dated and short-dated investments are included so that SIAs need not necessarily be a source of duration since duration is easily sourced through LDI programmes.
Cashflows	Cashflows are expected to be: _ predictable, _ resilient to market and economic cycles, _ either contractual in nature (as is the case of debt instruments) or with linkage to revenue backed by long-term contracts with high quality counterparties, for example, equity in regulated infrastructure businesses with long-term purchase agreements with government or long-term property leases with investment grade counterparties, and _ in many, but not all, cases underpinned by a security call on assets. For contractual cashflows, the timing of cash flows will not be expected to change over the term of the contract, unless specifically allowed for at the outset of the contract. For example, the contract may allow for early or late repayments at the option of one or more party.
Security	The use of the term "secured" does not imply that the income received by the investor is guaranteed. Nor does it imply that the income, or the total return from both income and capital gain, is necessarily secured by way of a security package on underlying assets. However, where income on a debt instrument is secured on underlying collateral (e.g. property, a collateral pool, an infrastructure asset or other tangible or intangible asset) then we would expect this income to exhibit a higher level of security than a traditional corporate bond of similar credit quality, which is typically unsecured. This is because investments secured on underlying (high quality) assets are expected to display greater resilience during times of market stress; in the case of debt this can be seen through higher recovery rates on default in the event of a stress event (e.g. the COVID pandemic or the global financial crisis). The use of the term "secured" to describe these assets emphasises that stability, predictability and robustness of returns and income is as important as the absolute level of return.
Correlation with traditional investments	Whilst it is preferable for SIAs to display low correlation to traditional listed market investments, it is not strictly essential, as may be the case for asset-backed securities and collateralised loan obligations.
Liquidity	Both private market and listed investments can be considered as SIAs, with more readily transferable assets likely to cater to liquidity needs.
Economic exposure	Investments could come from a wide variety of economic sectors. Some examples include: private corporates, public sector, social and other infrastructure projects, real estate and real estate debt and ground rents.
Capital structure	All parts of the capital structure (equity*, mezzanine, sub-ordinated and senior debt) could be considered to offer secured income.

*A significant part of the SIA universe is comprised of infrastructure and real estate projects where future revenue streams are of a contractual nature. The asset owner owns the equity (and any debt) of that project. The contractual nature of the revenue as well as the tangible assets upon which that revenue is secured are amongst the key distinguishing features that allow these assets to be considered as secure income assets. Typically, "unleveraged infrastructure" is considered to be closer to a SIA rather than "leveraged infrastructure".

What problem are Secured Income Assets trying to solve?

Secured income assets are a vital part of a defined benefit pension fund's de-risking journey. This is because SIA's can help to:

1. Reduce pension fund deficits: SIAs offer returns, which are expected to be higher than those of risk-free government bonds and so can help close pension fund shortfalls (see later for more detail on how SIAs achieve this).
2. Meet cash outflows: the income delivered by SIAs can assist in meeting cashflow obligations, especially for pension funds that are cashflow negative.

   Pension funds are faced with a multitude of cashflow challenges:
   _ longevity improvements that are tapering off, thereby shortening the duration of the fund's liabilities;
   _ changes in legislation have allowed members of defined benefit pension funds the flexibility to transfer their pots out of the fund earlier;
   _ closure to new entrants and future benefit accrual has reduced new contribution income;
   _ low yields/changes in the outlook for dividends on some assets has reduced the amount of investment income available to meet near-dated cashflow commitments and
   _ the search for yield has led some pension funds to invest in longer-dated assets to earn a term premium and this reduces the amount of cashflow being paid into the fund from capital redemptions.

An appropriately constructed portfolio of SIAs can help mitigate these risks and address these challenges. When used as part of a cashflow matching strategy, SIAs can be useful in avoiding being a forced seller of risky assets in unfavourable market conditions.

So what are some practical examples of secure income assets?

A variety of investment strategies have been launched over the last few years under the so-called "Secured Income" label. We list below some of the asset classes that have been used in constructing these portfolios:

_ structured finance (asset-backed securities, collateralised loan obligations, leveraged loans and commercial mortgage backed securities);
_ direct lending to small and medium-sized companies;
_ senior, secured bank loans;
_ infrastructure debt;
_ operating infrastructure;
_ direct property let on long-term leases to investment grade tenants;
_ commercial real estate debt (senior, whole loan, mezzanine);
_ social housing;
_ student accommodation;
_ private sector rentals;
_ sale-and-leaseback transactions;
_ long-lease property and
_ trade finance and receivables.

Which SIA's should a pension fund invest in?

Pension fund investment into SIAs can be traced back to the early noughties when many pension funds invested in long-lease property funds. These leases were with high quality, investment grade counterparts, including government and government-related entities. Unlike conventional property funds, long-lease property funds set themselves a performance target that was unrelated to property market returns; returns were benchmarked to UK governments bonds, with the performance objective being to outperform a portfolio of medium to long-dated gilts with similar modified duration to those of the lease cashflows.

Whilst long-lease property continues to be a mainstay of secured income investing, today there is a strong move towards considering other asset classes. A multi-asset approach, where different SIAs are combined into a single vehicle, is considered to offer the following benefits for small to medium-sized pension funds:

_ diversification across asset classes and investment sectors to reduce the reliance on any one asset class or sector;
_ diversification allows investors to access a wider range of illiquidity and complexity premia;
_ the ability to rotate investments to take advantage of those asset classes or sectors considered to be offering the best risk-adjusted returns and, conversely, avoid those sectors that are considered to be overvalued. Given the illiquid nature of many SIAs, this is typically about rotating investment at the point of entry rather than by divesting existing investments.

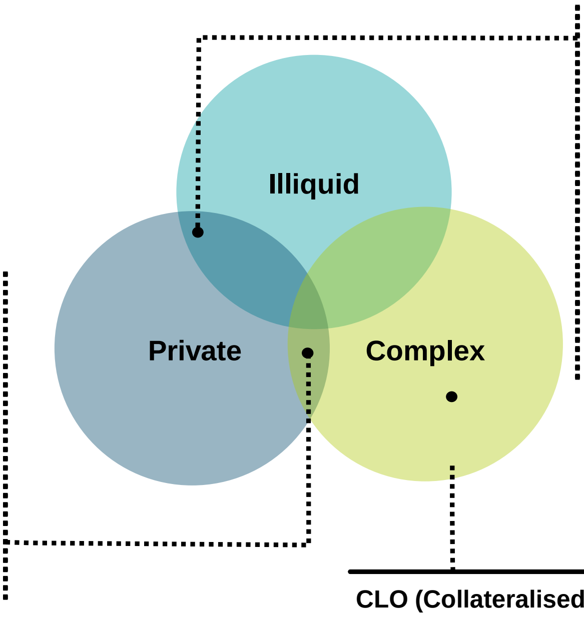
When a multi-asset approach is implemented with a single asset manager, who is given a broad remit to invest across as many different types of SIAs as any single manager can credibly offer, then further benefits may accrue to the investor including:

_ reducing the governance burden on trustees to choose any single asset class or sector by leaving this decision to the manager;
_ nimbleness to take advantage of attractive spreads in a particular asset class or sector at a point in time and conversely avoiding unattractive market segments;
_ economies of scale from appointing a single asset manager to manage a larger asset portfolio at a lower fee.

The largest pension funds will still invest in specific sectors and asset classes and build their own diversified portfolios but this requires scale and strong internal governance.

For most small to medium-sized pension funds, the governance burden on trustees that comes with having to choose amongst different investment opportunities across multiple asset classes and then also respond to changing market dynamics, means that there is a preference to appoint a single fund manager with a broad remit to choose amongst the different types of SIAs, and actively manage that allocation on an ongoing basis.

As an example, the chart below illustrates the types of asset classes that may be considered under the SIA banner.



Trade receivables / factoring

The sale of the claim to outstanding invoices on already delivered goods and services, at discount

Trade finance

Short-term loans to support the physical flow of goods between buyers and sellers

Real estate and infrastructure debt

Debt secured on commercial real estate or an infrastructure asset

Bank loans

Secured floating-rate debt instrument, structured, syndicated and administered by a bank

Private debt

Direct lending, often to smaller/midsize companies, to finance acquisitions or expansions

CLO (Collateralised Loan Obligations)

Tradeable structured credit backed by corporate loans

ABS (Asset Backed Securities)

A mixed pool of loans including residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS)

Source: Mercer

In summary, SIAs can offer enhanced security of income because of the contractual nature of the asset cashflows, the expected resilience of the underlying assets to different economic cycles and being secured against underlying high quality collateral.

How do Secured Income Assets help close pension fund deficits?

Many UK pension funds are underfunded, with insufficient assets to meet their liabilities. In these circumstances, there are only two routes available to restore solvency levels:

_ additional contributions by the pension fund sponsor;
_ investment returns that exceed the discount rate used to place a present value on the liabilities. Put differently, discounting the future liability cashflows at a higher discount rate would result in a smaller present value of the liabilities, thereby improving the solvency level.

SIAs offer the type of returns which can allow the actuary to increase the discount rate used to place a present value on the liabilities thereby reducing the contribution strain on sponsors.

Choosing an investment manager for Secured Income

Background

As we have previously noted, the term Secured Income Assets is used to describe a variety of investments, including:

_ structured finance (asset-backed securities, collateralised loan obligations, leveraged loans and commercial mortgage backed securities);
_ direct lending to small and medium-sized companies;
_ senior, secured bank loans;
_ infrastructure debt;
_ operating infrastructure;
_ direct property let on long-term leases to investment grade tenants;
_ commercial real estate debt (senior, whole loan, mezzanine);
_ social housing;
_ student accommodation;
_ private sector rentals;
_ sale-and-leaseback transactions;
_ long-lease property and
_ trade finance and receivables.

To understand the capabilities that an investor should look for when implementing such a strategy we start by considering the perspective of an investor when implementing a secured income mandate.

Client considerations when investing in Secured Income Assets

1. Strategic asset allocation

The implementation of a SIA mandate typically starts with an understanding of how an investment in SIAs will assist the client in improving the probability of being able to meet all their liability cashflows in full. This requires consideration of the cashflows that the SIA investment can be expected to generate and the certainty attached to those cashflows. The nature of the SIA cashflows determines which of two investment portfolio “buckets” the SIA allocation will form part of.

a. Liability matching

SIAs that generate contractual, fixed, floating or inflation-linked cashflows will typically be considered for their usefulness within a client’s liability matching bucket.

b. Return seeking

SIAs that generate cashflows that are not contractual in nature (e.g. infrastructure equity) will be considered within a client’s return seeking portfolio.

2. Portfolio construction

The next step is to define the investment parameters for the SIA portfolio. These investment parameters will include (amongst others):

_ types of SIAs considered eligible for investing in (likely based on the client’s knowledge, familiarity and perception of the suitability of the SIA’s being considered);
_ split between fixed vs floating vs inflation-linked;
_ target return, possibly set as a spread over a risk-free rate;
_ maximum maturity;
_ target modified duration;
_ credit quality and
_ target income yield vs total return.

3. Manager selection

As outlined above, in choosing which SIAs to invest in, many client-specific factors will play a role and these are often driven by the client’s risk-return preference as well as their specific liability cashflows. For example, some pension funds may well have a preference for SIAs that offer long-dated contractual income to hedge long-dated liability cashflows. Some investors will prefer SIAs offering explicit linkage to inflation to match inflation-linked liability cashflows and yet others may prefer fixed or floating rate exposure. Having determined these parameters, investors then turn their attention to choosing an investment manager or product.

Market cycles mean that, at any one point in time, not all SIAs will offer equivalent risk-adjusted returns. Supply and demand dynamics will also contribute to the relative value offered by different SIAs.

The largest institutional investors will have the expertise and resources to set, and dynamically manage, their allocation to the different types of SIAs over time. These clients will feel comfortable choosing which specific SIAs (i.e. a single-asset approach) they will invest in and will then run manager selection exercises per SIA type.

For many small to medium-sized pension funds it is easier to outsource this decision, about which SIAs to invest in, to an asset manager by investing in a multi-asset secured income strategy.

It follows that the capabilities needed to be a credible asset manager for Secured Income Assets varies depending on whether the investment manager intends to offer capabilities/products in a single asset or "sleeve" from the list above or to offer a blend of two or more of the SIA types listed above.

Specialist managers vs asset allocation skills

Investment managers with products/capabilities in individual SIA types from the list above will need to demonstrate to investors that they can compete with the best specialist managers in that particular category. In the next section we cover the criteria that investors are likely to use to assess these specialist managers.
Small to medium-sized pension funds requiring a low-governance, multi-SIA approach, where the manager takes responsibility for dynamically managing the allocation to the various SIA sleeves, will be looking for managers capable of running a multi-asset approach.

We list below the capabilities that investors should evaluate for each approach.

SINGLE ASSET APPROACH

Does the manager have deep expertise in a specific SIA and a long track record and commitment to that SIA?

The criteria for choosing a manager is therefore centred around the manager's capabilities and track record in the specific SIA with successful managers scoring highly across all criteria.

_ Investment approach: a well-articulated approach and dedication to the asset class. Sources of differentiation (e.g. sourcing) are critical.
_ Track record: an exceptional and sufficiently long track record of successfully managing investments.
_ Team: experienced, well-established team where key principals have worked together over a number of years and incentives are aligned to the success of the strategy and the business.
_ AUM: garnered significant AUM from a number of different investors but still able to offer investors comfort that their mandate will have access to assets within an aceptable timeframe.

MULTI-ASSET APPROACH

Here investors should assess the manager on three key attributes:
i) the ability for investment teams to work across their areas of specialism to make asset allocation decisions that access the best risk-adjusted returning SIAs and for this process to be dynamic and responsive;
ii) an above average capability in the majority of SIAs included in the product;
iii) capabilities across a wide range of SIAs.

Elaborating on point (ii), it is worth recognising that a manager would not be expected to score as highly as a best-of-breed, specialist manager when ranked on the criteria for assessing their capabilities in any one specific SIA. Investors in a multi-asset approach may have to accept a trade-off between ease of access to a variety of SIAs through a single manager versus being best-of-breed in a single SIA. That said, the manager would still be expected to have a capability that was considered to be well above average.

_ Dynamic asset allocation: a demonstrable process for making asset allocation decisions across multiple SIAs to deliver the best risk-adjusted return over the life of the product.
_ Breadth of SIA offering: all else being equal, higher rated managers would have access to a broader range of SIAs. Ability to offer diversification across private and listed assets would be an advantage.
_ Team: experienced team in each of the SIAs on offer
_ Currency hedging: ability to currency hedge any non-sterling exposures

SIA strategies for pension funds

To help illustrate our points we consider the different types of SIA products that have come to market over the last few years in the table below. Given the demand for SIAs, the number of funds on offer are still too few. Many funds are also closed to new investors and so access to high quality managers remains a challenge.

Fund name	Investment objective	Investment strategy/range of asset classes	Security	Dealing
Fund A	UK inflation + 4% p.a. over the medium to long term	Diversified portfolio of UK real estate assets let to investment grade tenants on inflation-linked, long-term leases.	_ Investment grade tenants _ Ownership of operating assets	_ Quarterly _ Both Income and accumulation options available
Fund B	UK inflation + 1.5 - 2% p.a.	Sale-and-leaseback transactions with UK corporate/government/universities. Property typically let on inflation-linked, long-leases of 25 years or more. Property reverts to lessee at expiry. Targets investors able to invest outside of Solvency II constraints to access enhanced relative value.	_ Investment grade tenants _ Ownership of operating assets without uncertainty of residual value	_ Quarterly _ Income and accumulation options available
Fund C	UK RPI + 2.5% p.a.	Index-linked gilts, ground rents, long-lease property, social housing, student accommodation, income strips, private rental sector, infrastructure, solar power. Duration of 15-20 years.	_ Senior secured _ Bespoke covenants	_ Quarterly
Fund D	Index-linked gilts + 2-3% p.a. (over 5 years)	A combination of real estate, infrastructure and real asset debt. Utilising primary fund investments, segregated mandates, secondary acquisitions of units in funds and direct assets, and co-investments.	_ Secured	_ Open-ended with annual liquidity
Fund E	10-year gilts plus 2-3% p.a. Cash yield of 5% p.a.	Delivering long-term contractual cash flows with inflation linkage, to provide investors access to a diversified portfolio of private secure income assets with a single investment.	_ Senior _ Secured	_ Semi-open ended with liquidity window every year following an initial 4-year lock-in _ Capital deployment within 1-1.5 years of each close
Fund F	3m GBP LIBOR + 3-4% p.a. gross of fees	Investing in a globally diversified portfolio of Secured Finance assets Seeking to allocate ≈ 60% in public investments (ABS/CLO) & ≈ 40% in private investments. Weighted average maturity of 4-7 years. Average rating of BBB.	_ Senior _ Secured	_ Monthly (subscriptions) _ Quarterly (redemptions)
Fund G	SONIA + 4.25% p.a. gross of fees	Investing in a globally diversified portfolio across private debt and listed credit markets. Seeking to allocate ≈ 40% in Structured Finance investments (ABS/CLO/Leveraged Loans) & ≈ 60% in private credit such as infrastructure debt, real estate debt and direct lending. Weighted average life of 7 years Average rating of BB.	_ Senior and Junior _ Secured	_ Closed-ended with 8-year term

Conclusion

Secured Income Assets are an invaluable part of the de-risking journey for defined benefit pension funds. They can help to close funding deficits whilst simultaneously helping maturing pension funds meet their need for income to pay benefits. There are a variety of investments options available to investors to meet a wide spectrum of needs.

Building a diversified portfolio of Secured Income Assets may require a different implementation approach depending on the total amount available for investment, with smaller pension funds likely to benefit from a multi-asset approach.