White Paper

Expanding horizons

How institutional investors can mitigate domestic bias in their allocations

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HSBC
Global Asset Management

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Expanding horizons

In brief

- Over the last few years, institutional investors had to readjust their fixed income allocations to lower-for-longer interest rates
- The resulting hunt for yield has naturally led to an extension of their investment universe outside their historical comfort zone, notably through higher yielding credit segments like high-yield and emerging-market debt
- Diversifying allocations to non-domestic markets revealed profitable outcomes and significantly improved their risk / return profiles
- Going one step further, less liquid and more complex asset classes – e.g. private debt, infrastructure debt, and structured credit – are also being progressively considered to help institutional investors with their liability matching challenge
- Despite this trend, recent surveys show that the majority of their assets remain allocated to domestic markets, primarily because of local regulations but also because integrating new segments, strategies and asset classes can prove challenging in practice
- Extending investment universes outside domestic markets that remain difficult to analyze and price requires extensive research, strong investment, governance and analytical resources to add value

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Expanding horizons

Introduction

For the last several years, institutional investors have struggled to generate sufficient returns from their traditional fixed income investments of domestic government bonds. Moreover, European developed-market sovereign bond yields seem likely to remain at historically low levels for the years to come. This “low-yield” environment – and its related impact on inflating the value of liabilities for pension funds – has been a key catalyst for institutional investors to consider a wider universe of fixed income assets which may provide more attractive risk-adjusted-return profiles. While European institutional investors have already begun to diversify their fixed income allocations outside of their traditional comfort zone, mainly through higher yielding credit segments like high-yield bonds and emerging-market debt, the majority of their fixed income assets remain allocated to domestic markets.

There are many reasons for this domestic bias though; historically, regulation and institutional investors’ preference for familiar asset classes were the major catalysts. More recently, the Great Financial Crisis and euro crisis, followed by central banks’ quantitative easing measures, have played in favor of institutional investors integrating more exotic fixed income segments.

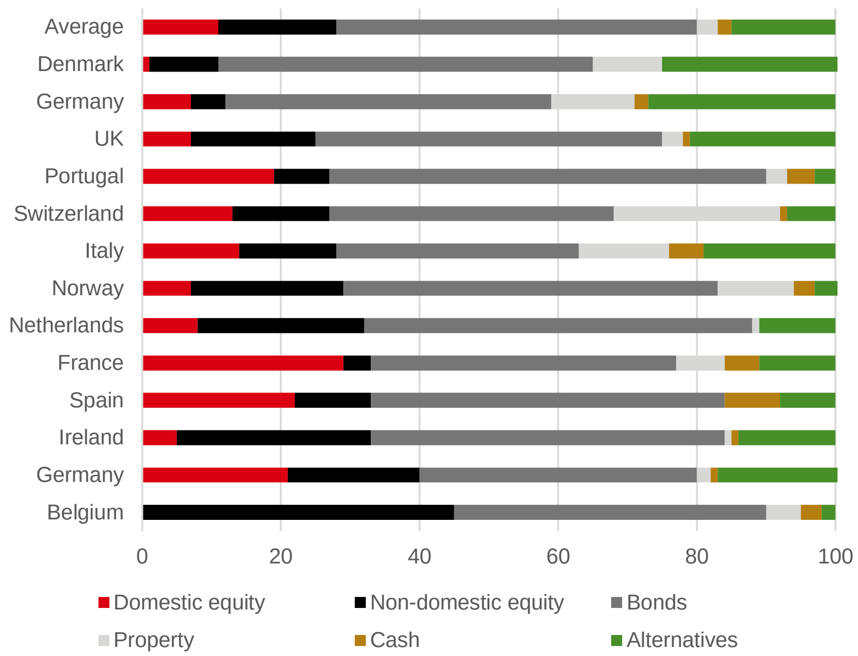
What will come next? Institutional investors will continue to look for preservation of capital combined with sufficient income, but also for diversification from their fixed income allocations. The list of potential segments institutional investors could consider in their fixed income allocation gets longer every year, and some of the niche markets of yesterday have now become mainstream. Each new segment comes with its own set of specific characteristics, pros and cons, and idiosyncrasies. Combining these segments may improve diversification – since they may be lowly correlated with each other and with traditional fixed income assets. Yet, more importantly, these segments also provide asset allocators with more options to capture risk premia they are keen to carry and manage the risks they want to mitigate – such as interest rate, default or credit-event risks.

For institutional investors, optimizing their allocation within their specific constraints and maximizing the field of opportunities is a challenging but familiar exercise. Extending their investment universe successfully, and in line with their risk and governance budgets and mandate, may better equip them to achieve their mission.

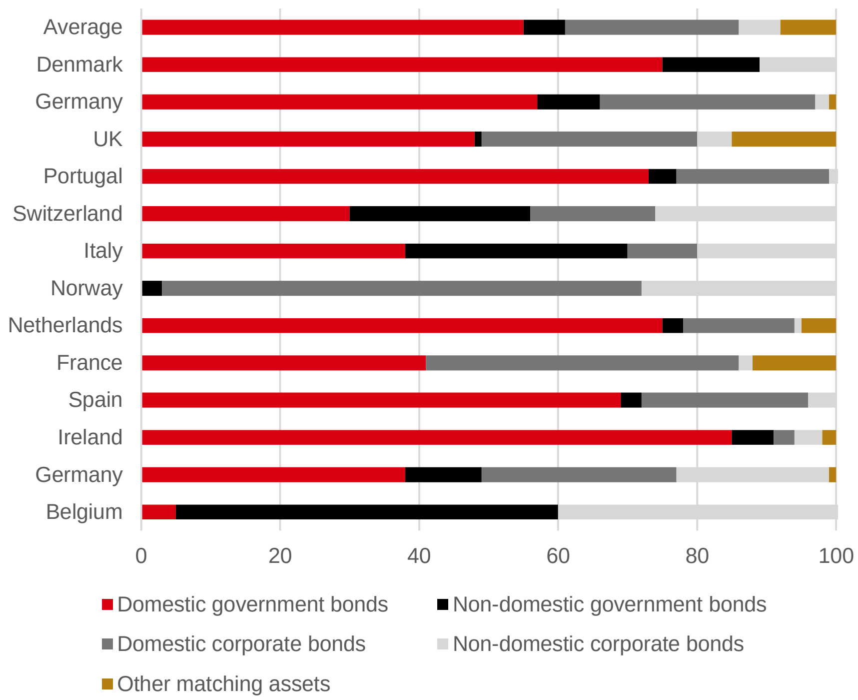
In this paper, we review the current situation regarding institutional investor fixed income asset allocations and explore possible investment efficiency benefits out of expanding from a domestic to a global universe, and by considering a wider range of strategies beyond sovereign bonds and investment grade credit.

Institutional investors' asset allocations

Strategic asset allocation by country (%)



Bond portfolio allocation by country (%)



Source: Mercer LLC European Asset Allocation Survey, 2018.

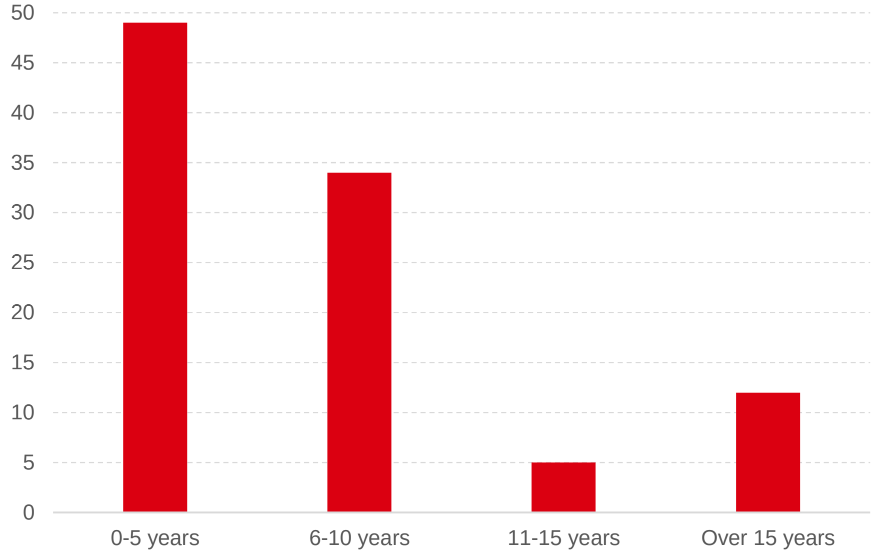
Current allocations

As shown by the 2018 European Asset Allocation survey by Mercer, both overall and fixed income allocations for Defined Benefit plans tend to be country-specific. The allocation to domestic assets is still very prominent, with an average exposure of 80% of fixed income – but varies significantly from one country to another. This shows that, while liability matching and regulation likely explain the majority of allocation decisions, they can also be influenced by other domestic factors, including local yield levels and market depth. Yet allocations are also driven by objectives and challenges which are common to all pension plans.

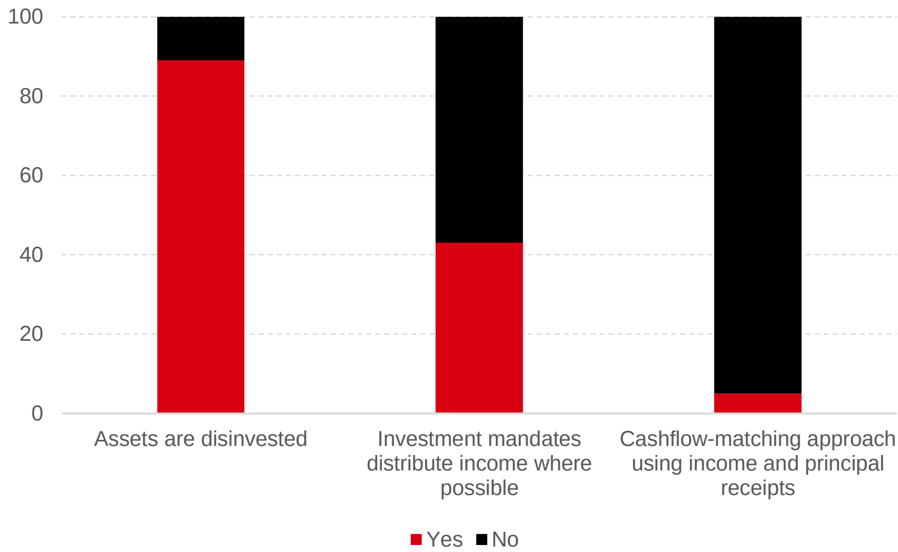
The current challenge: managing cash flow-negative plans

According to the 2018 European Asset Allocation survey by Mercer, a majority of European pension funds are already cash flow negative, with more than another third due to become so in the next ten years. Only a small proportion of these have adopted a cash flow-matching approach, with most having to divest assets to meet their obligations, and 43% using income distribution where possible to reduce transaction costs. Defined benefit funds will have to think carefully about their approach as more defined benefit plans mature.

Expected time for cash flow-positive plans to become cash flow negative (%)



Methods of meeting cash flow-negative outgoings (%)



Source: Mercer LLC European Asset Allocation Survey, 2018.

How allocations have been changing

The global picture

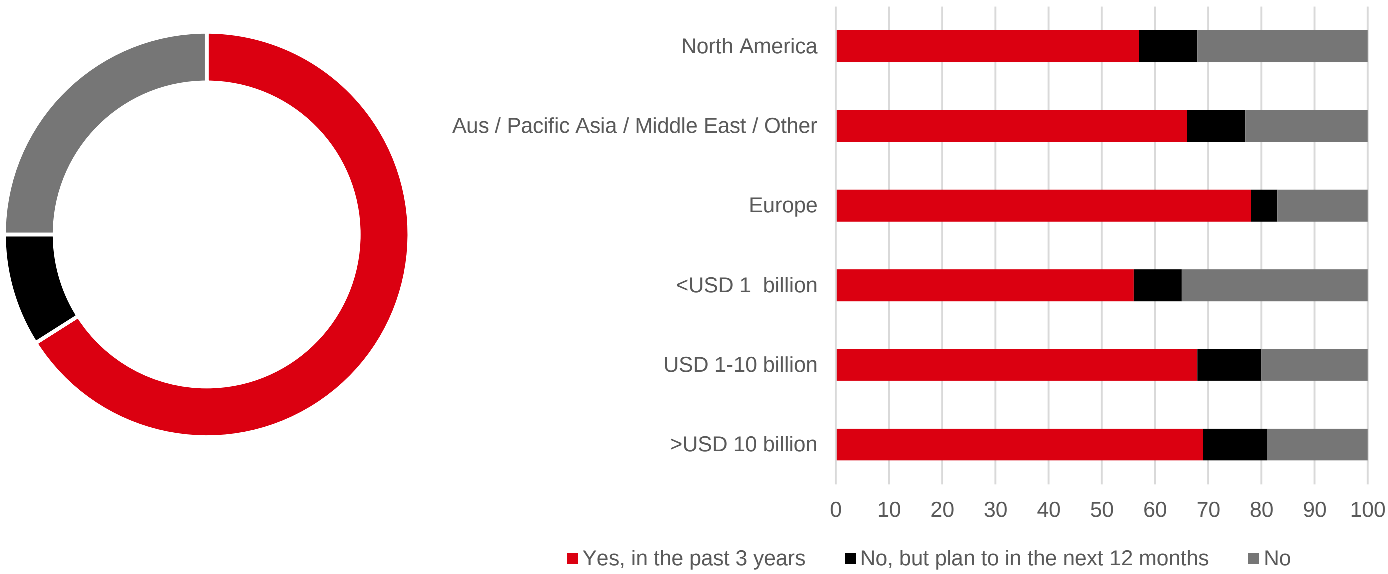
Although institutional investors have fared decently over the last ten years, 2018 proved difficult, particularly for the largest markets. It is interesting to note, however, that performance would have been even lower last year without the positive impact of private markets and alternative investments. Those allocations are relatively new for most institutional investors and challenging in terms of governance, costs, expertise and access.

Despite these considerations, average allocations to real estate, private equity and infrastructure have increased from around 4% to more than 20% in the last 20 years.

As illustrated by the bfinance Asset Owner Survey published last year, this trend has proven particularly true over the recent past, and should continue, as two-thirds of institutional investors – especially in Europe – have added one or more new asset classes or strategies to their portfolio in the last three years, and another 9% are planning to do so within the next 12 months. The largest winners of these allocation decisions are alternative credit, infrastructure, real estate, emerging market equity and alternatives – where actively managed strategies are perceived to better contribute to return and income generation.

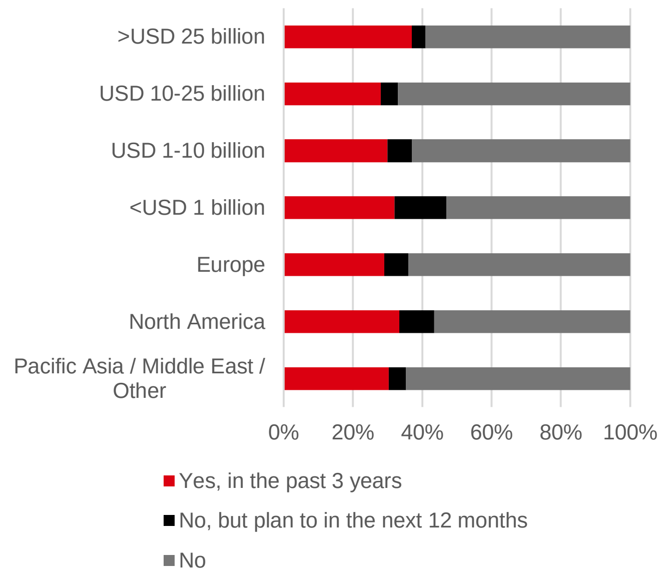
Conversely, the shift to passive in more traditional allocations continues, supported by a continuous pressure on costs driven in part by lower expected returns across asset classes – and potentially a lack of trust in active managers' ability to persistently outperform benchmarks in the more traditional asset classes. 31% of institutions surveyed have shifted towards passive management over the last three years and 20% towards smart beta, or investment approaches where portfolios are determined by rules which consider characteristics other than market capitalization for equities or value outstanding for bonds. Another 15% plan to do one or the other in the coming year.

Are asset owners adding new asset classes/strategies?

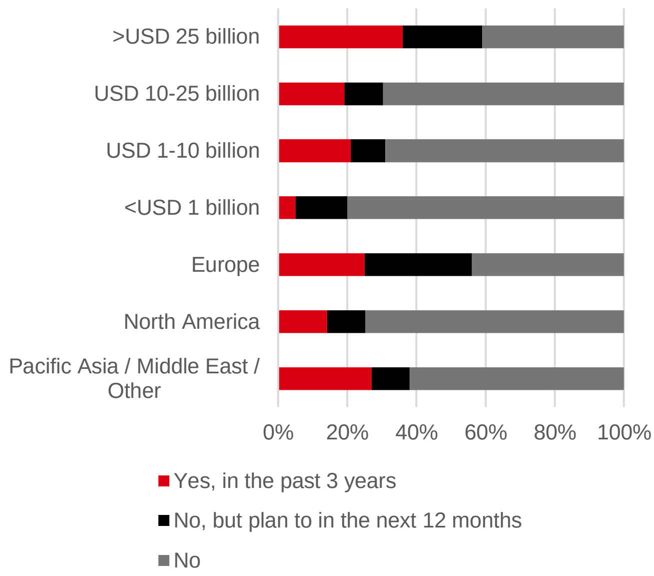


Source: bfinance Asset Owner Survey, Innovations in Implementation, 2018.

Cost reducing measures: Shift to passive



Shift to smart beta



Source: bfinance Asset Owner Survey, Innovations in Implementation, 2018.

The European view

Specifically in Europe, allocations to private markets and alternatives are also increasing. Mercer's survey has grouped these asset types into five larger groups:

- Private equity
- Growth-oriented fixed income, including Emerging Market Debt (EMD) and High Yield (HY)
- Real assets, such as real estate, infrastructure and natural resources
- Hedge funds, including funds of hedge funds
- Multi-asset such as diversified growth funds, diversified beta funds and risk parity

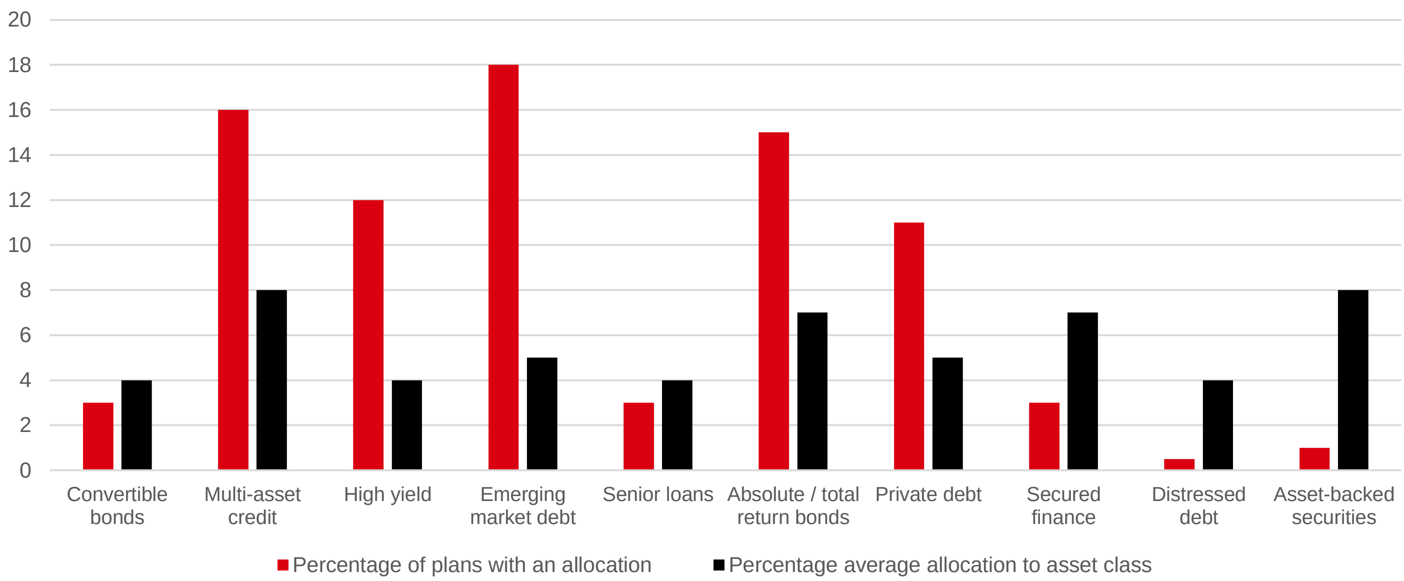
Whilst the largest proportion of European pension funds have an allocation to real assets, followed by growth-oriented fixed income and hedge funds, the segment with the largest actual allocation across European pensions is multi-asset. The report explains this is due to the "one-stop shop" nature of the asset class to deliver diversification and liquidity benefits, particularly for pension funds of more limited size and which have more constraints in terms of governance and fees.

Looking at the recent evolution of allocations, over the past year, private equity, growth-oriented fixed income and multi-asset have risen while allocations to real assets and hedge funds have decreased.

The rise in fixed income allocations is in line with pension funds' growing matching requirements, while the fall in allocations to real assets reflects a mix of de-risking, liquidity constraints and profit-taking (the latter in real estate especially).

Looking at allocations to growth-oriented fixed income in more detail, the largest share of pension funds have an allocation to EMD (18% of European pension plans), multi-asset credit (16%) and absolute or total return fixed income. Throughout the last year, the proportion of DB pension funds allocating to private debt and secured finance has risen the most. Overall allocations to these assets remain limited, averaging 4 to 8% of total investments.

Strategic Allocation to Growth-Oriented Fixed Income (%)



Source: Mercer LLC European Asset Allocation Survey, 2018.

Keeping your house in order

Before looking ahead and thinking about potential shifts to strategic allocations, investors might benefit from asking themselves if their current investment approach allows them to make the most of their existing fixed income investment universe. In other words, are allocations to traditional fixed income (domestic, EM and HY) optimal?

Valuation framework and volatility control

Between strategic asset allocations (including risk budgeting and rebalancing) and other parts of the investment process (e.g. security selection), we believe that asset allocation is the overwhelming driver of returns. To get this right and make optimal allocation decisions, valuation of asset classes and their sub segments is crucial.

The challenge therefore, is to find a way to compare asset classes against each other in a flurry of very different valuation metrics. There is value in developing a framework enabling investors to assess asset-class attractiveness across the opportunity set, and in the economic context. We give an overview of the approach.

The risk premium framework

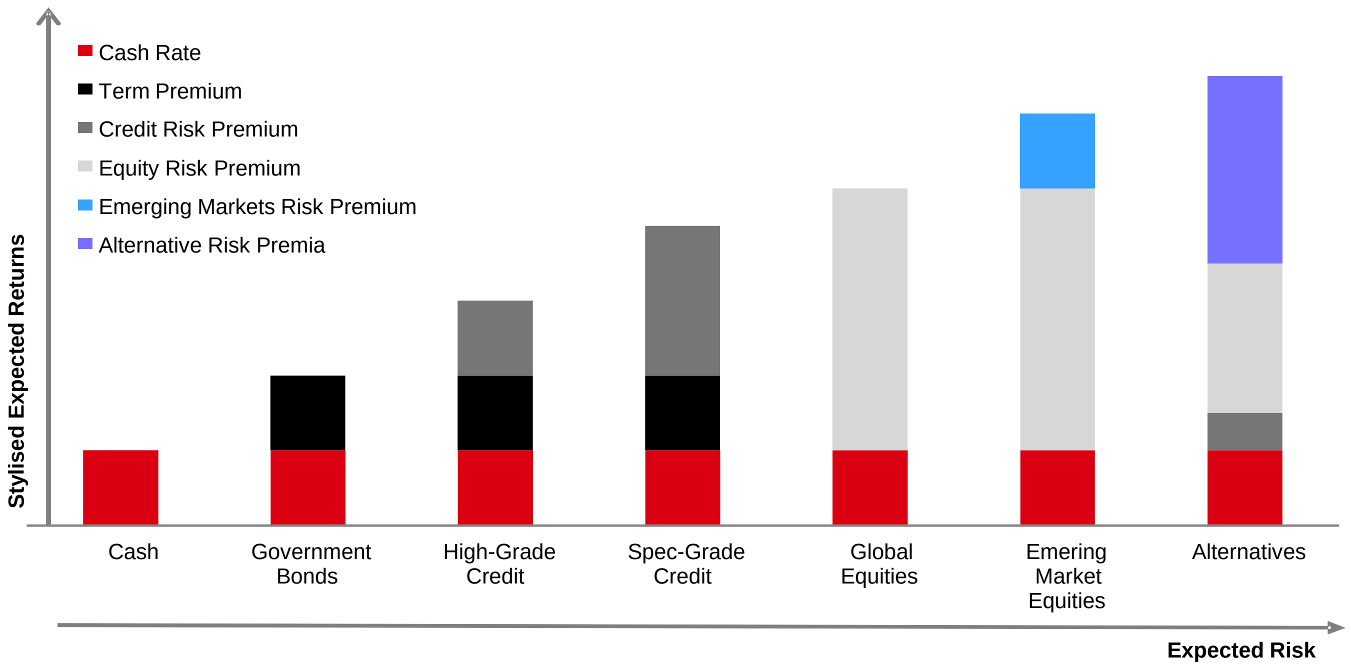
We build a scenario for policy interest rates across major advanced and emerging economies, which we combine with our assumptions for asset class fundamentals to deduce a risk premium for each asset class based on market pricing (see illustration below). This framework allows us to systematically assess the relative attractiveness of assets across the investable universe, as they evolve through market cycles.

Risk premia are then updated on an ongoing basis to account for their variations over the course of market cycles. They can also be measured against underlying asset-class risks, as determined by market cycles, structural changes and policy regimes. This creates opportunities to identify anomalous valuations, and thus to be contrarian where risks are over- or under-rewarded.

Using our long-term (10-year) expected return assumptions. We constructed a "pecking order" of risk premia across the main asset classes (illustration on next page).

This illustrates how a robust valuation model can provide clarity on strategic allocations. However, it does not preclude also adding value over shorter timeframes through tactical management, for example with total return strategies.

Building asset class expected returns



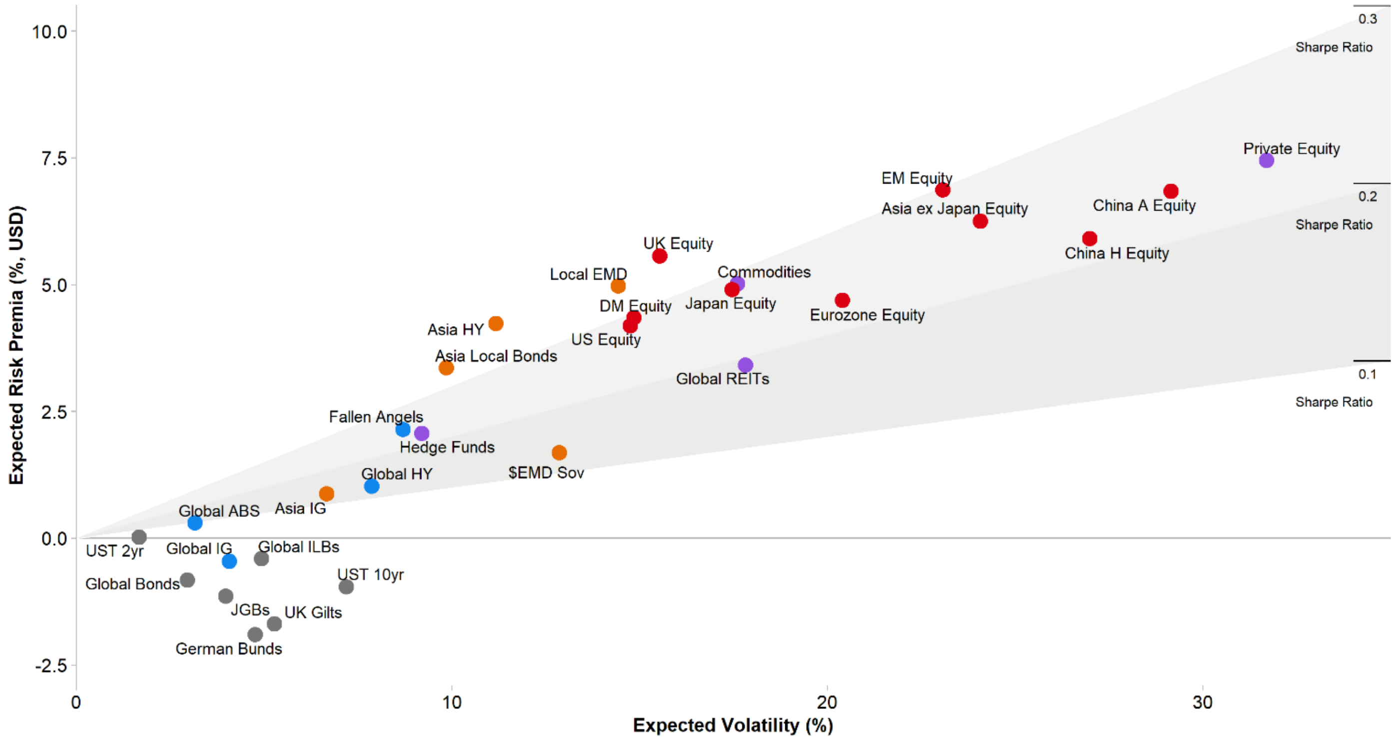
Source: HSBC Global Asset Management, September 2019

Total return strategies

Fixed income total return strategies aim to maximize returns whilst seeking to limit exposure to the downside. Spanning a wider range of sectors, credit ratings, and instruments (bonds, futures, swaps, CDS, etc.), these strategies use valuation dynamically within a chosen investment universe – from global fixed income to EMD. They seek to generate returns not only through the selection of individual securities but also through currency positioning, as well as duration and yield curve positioning and may readjust allocations tactically to seize market opportunities in most market cycles.

Total return strategies are not benchmark-constrained, meaning they can take defensive positions, using high levels of cash, cash equivalents and derivatives to mitigate exposures to duration, or to broaden the investment universe in a controlled manner. In a nutshell, for a chosen asset class, total return strategies can constitute effective fulfilment solutions, looking to provide investors with higher Sharpe ratios.

Current pecking order of asset classes



Source: HSBC Global Asset Management and Bloomberg, as at end of August 2019. Global Fixed Income assets are shown hedged to USD. Local EM debt, Equity and Alternatives assets are shown unhedged. Forecasts are indicative only and not guaranteed in any way.
The commentary and analysis presented in this document reflect the opinion of HSBC Global Asset Management on the markets, according to the information available to date. They do not constitute any kind of commitment from HSBC Global Asset Management . Consequently, HSBC Global Asset Management will not be held responsible for any investment or disinvestment decision taken on the basis of the commentary and/or analysis in this document.

Global bond strategies

Global bond strategies encompass a heterogeneous range of fixed income securities across developed and emerging markets. The Bloomberg Barclays Global Aggregate Bond Index demonstrates this diversification, as it is representative of the global investment grade bond market and regroups issuers within over more than 25 countries.

To illustrate the expanding geographic diversification, it is worth noting that in March 2018, Bloomberg announced the inclusion of onshore Chinese government and policy bank bonds into the Bloomberg BGA Index from April 2019, for a 20-month period. As of now, China represents 1.90% of the index.

In practice, the global nature of strategies means that risk-minimizing investors with lower domestic interest rates may want to hedge their currency risk, and vice-versa. As seen historically, currency-hedged strategies have demonstrated to be less volatile for institutional investors.

Bloomberg Barclays Global Aggregate Bond Index (%)

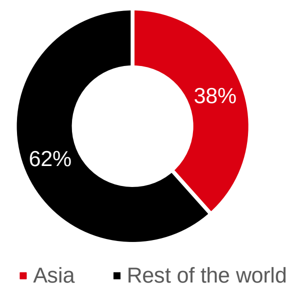
Source: HSBC Global Asset Management and Bloomberg, as at September 2019.

Asian Fixed Income strategies

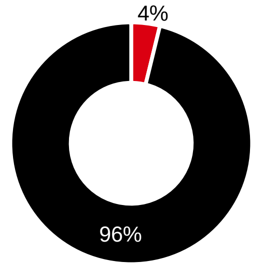
Asian Fixed Income strategies offer a diverse range of investments, in one of the fastest developing markets in the world. This market includes rapidly developing countries such as China, South Korea, India, Hong Kong, Thailand, Malaysia, Singapore, Indonesia and the Philippines. Asian dollar bonds provide obvious diversification benefits, and tend to offer a yield premium when compared to US and Euro credit, usually with a shorter duration.

For now, Asia's economic stake and its growth potential is not fully recognized within global or emerging market bond indices and as a result the continent is underrepresented. Asia's global presence accounts for 38% of the world's GDP but only 4% of Barclays Global Aggregate Index, even in spite of the recent integration of Chinese fixed income instruments. Asian Fixed income strategies provide an opportunity for investors to access high yield returns and diversification in fast growing markets.

Asia accounts for about 38% of the world's GDP



Asia only accounts for about 4% of Barclays Global Aggregate



Source: HSBC Global Asset Management and Bloomberg, as at September 2019.

Diversification in practice

Using a robust framework to manage strategic allocations can also give institutional investors a framework to optimize their exposure to less mainstream asset classes offering attractive return and income opportunities.

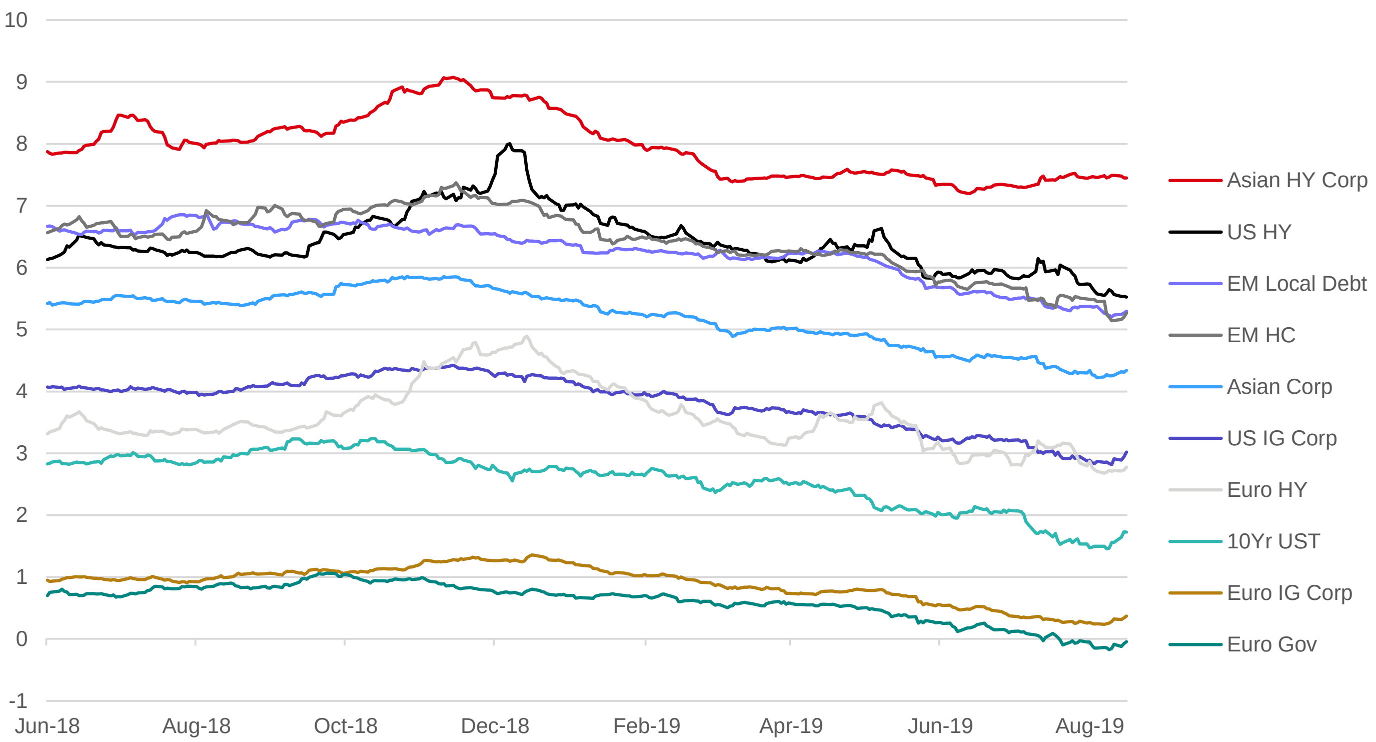
In a previous paper, we demonstrated that different EMD sectors (hard currency, local currency, corporate) are exposed to various systematic risk factors. We also showed that these risk factors are not diversifiable, earning a long-term premium. In particular, emerging markets' exposure to global interest-rate risk, equity risk and credit risk ensures solid prospective premia and Sharpe ratios over the long run. We found a similar result for global high-yield (HY) credit.

This suggests that a portfolio combining EMD and global HY sectors should deliver a higher Sharpe ratio than each of the segments taken individually. Adding combinations of segments would therefore not only improve a portfolio's risk diversification, but also reduce the volatility coming from non-remunerated risks, improving the portfolio's overall Sharpe ratio.

Confirming this hypothesis, the yield to worst in the graph below shows the significant premium of most high-yield (HY) and emerging market debt (EMD) segments over developed-market government bonds and investment-grade credit. In addition, at 2-3%, default rates remain very low (see graphs on next page), and although valuations are less compelling than their historical averages, the asset classes benefit from stable to improving fundamentals.

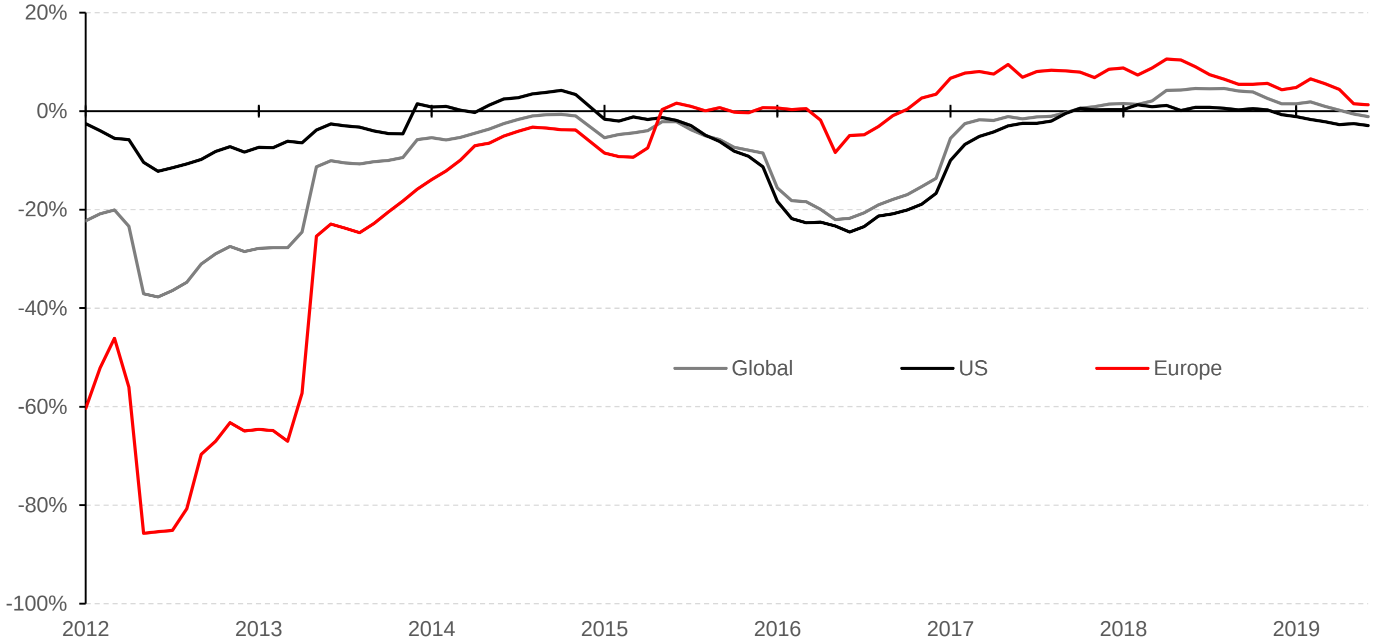
Risk premia are then updated on an ongoing basis to account for their variations over the course of market cycles. They can also be measured against underlying asset-class risks, as determined by market cycles, structural changes and policy regimes. This creates opportunities to identify anomalous valuations, and thus to be contrarian where risks are over- or under-rewarded.

Yield to worst by asset class (%)

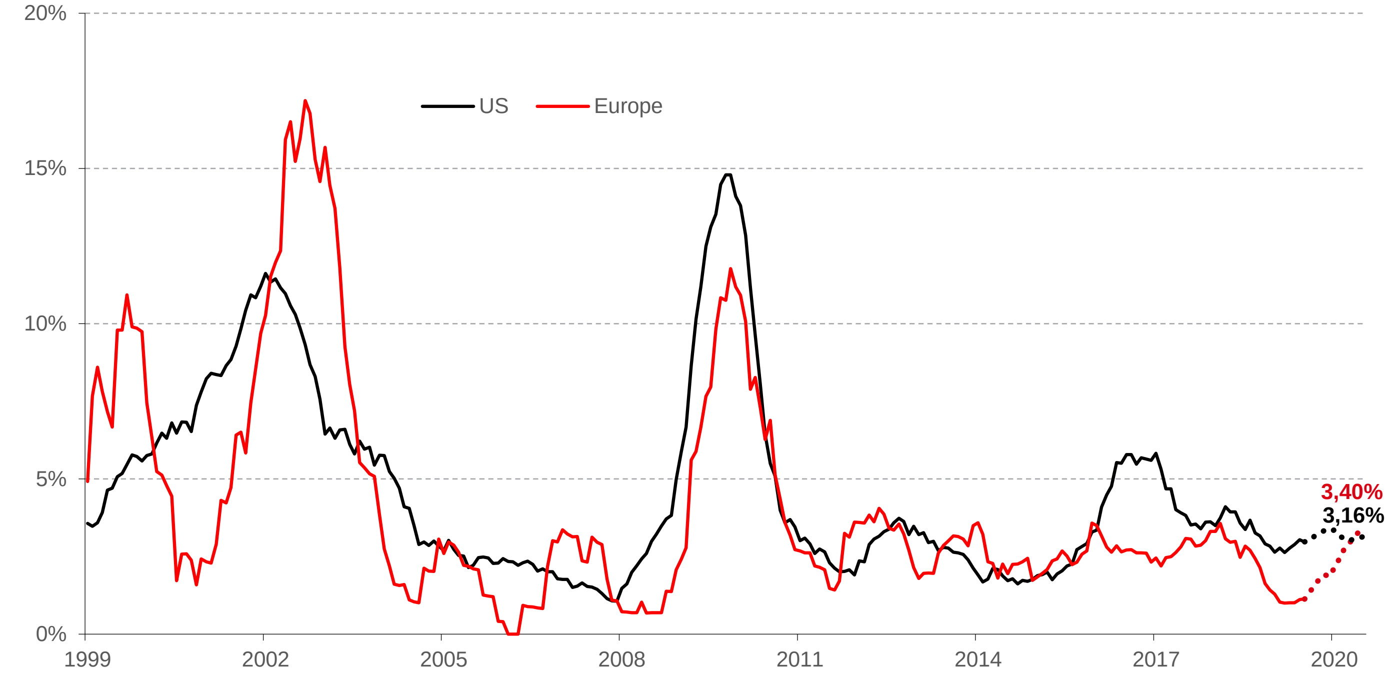


Source: HSBC Global Asset Management and Bloomberg, as at September 2019.
Past performance is not a reliable indicator of future performance

Rating Drift = (notches Upgrades - notches Downgrades)/Rated Issuers (%)



Actual and forecasted default rates in the US and Europe (%)



Sources: HSBC Global Asset Management, Moody's as at 31/07/2019.

Past performance contained in this document is not a reliable indicator of future performance.

Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Improving portfolio efficiency

To get a more precise sense of potential Sharpe ratio improvements, we looked at the contribution of Global HY and EMD to a global reference portfolio with a 70% allocation to domestic fixed income assets, and 30% to other developed market government bonds (see table below). The relative domestic and foreign weights presented in our reference portfolio are consistent with the relative average institutional weights in these assets.

Using commonly used global indices to represent each asset class, we analyzed the impact of introducing other asset classes on the portfolio's risk/return profile, from global investment-grade credit to EM local-currency bonds. For each portfolio combination, we assessed the volatility and the long-term risk premia – against compounded future short-term rates.

Contribution of Global HY and EMD to a typical reference portfolio

	Reference Portfolio	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4	Portfolio 5	Portfolio 6	Portfolio 7
Domestic Fixed Income	**70%**	**60%**	**60%**	**50%**	**50%**	**50%**	**50%**	**50%**
Government + Quasi	32.6%	27.9%	28.0%	23.0%	23.0%	23.0%	23.0%	23.0%
Corporate IG	17.3%	14.8%	15.0%	12.0%	12.0%	12.0%	12.0%	12.0%
Corporate HY	2.7%	2.3%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Covered Bonds	7.4%	6.4%	6.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Government Inflation-Linked	10.0%	8.6%	9.0%	7.0%	7.0%	7.0%	7.0%	7.0%
Foreign Fixed Income	**30%**	**40%**	**40%**	**50%**	**50%**	**50%**	**50%**	**50%**
Government Developed Markets	30.0%	20.0%	15.0%	16.3%	10.0%			
Global Corporate IG		20.0%	20.0%	21.7%	10.0%			
Global Corporate HY			5.0%	5.4%	5.0%	50.0%		12.5%
EM Sovereign Hard Currency				6.5%	8.2%		50.0%	12.5%
EM Sovereign Local Currency					8.6%			12.5%
EM Corp Hard Currency					8.2%			12.5%
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Weighted Eff. Duration	7.0	7.0	6.8	6.8	6.7	5.3	6.9	6.3
Ann. Expected Excess return	0.9%	1.0%	1.0%	1.0%	1.1%	1.0%	1.2%	1.2%
Volatility	3.6%	3.7%	3.6%	3.5%	3.4%	3.3%	3.8%	3.5%
Sharpe-ratio	**0.25**	**0.26**	**0.28**	**0.29**	**0.32**	**0.30**	**0.31**	**0.33**

Source: HSBC Global Asset Management, Bloomberg, as at June 2019. For illustrative purposes only. Any differences in figures are as a result of rounding errors. Reference Portfolio in EUR. Results would be almost identical if the Reference Portfolio were in USD. EM and Global Fixed Income assets are shown hedged to USD. Local EM debt assets are shown unhedged.

Any performance information shown refers to the past and should not be seen as an indication of future returns. *The value of the underlying assets is strongly affected by interest rate fluctuations and by changes in the credit ratings of the underlying issuer of the assets. For illustrative purposes only and is not intended as an offer or solicitation for the purchase or sale of any financial instrument, nor should this be considered a recommendation for any investment or trading strategy.*

We can draw the following conclusions from looking at each portfolio in turn:

Portfolio 1: historically, diversifying through the addition of some global investment-grade credit tends to improve the Sharpe ratio slightly, albeit with a shade more volatility.

Portfolio 2: an allocation of just 5% to global HY credit typically increases expected returns, with a return to the reference portfolio's volatility levels and a slight dip in weighted effective duration.

Portfolio 3: introducing a small allocation to EM hard-currency debt delivers a 4-bp increase in the Sharpe ratio compared with the reference portfolio.

Portfolio 4: with a truly diversified allocation, historical annualized excess expected returns are 20 bps higher than for the reference portfolio, with slightly lower duration and significantly lower volatility, leading to a 7-bp increase in the Sharpe ratio.

Portfolio 5: adding one large allocation (50%) to Global HY alone improves the Sharpe ratio by 5 bps, through a reduction in duration and an increase in returns – global HY tends to reduce the portfolio's rate risk whilst improving the Sharpe ratio.

Portfolio 6: a similarly large allocation to EM hard-currency government debt typically has a similar effect, increasing expected excess returns by 28 bps, albeit for significantly higher overall volatility and a small decrease in duration (0.1). Through one single large exposure, hard-currency EMD adds 6 bps to the portfolio's Sharpe ratio.

Portfolio 7: a 50% allocation to domestic fixed income, with the other 50% entirely in global HY and EMD allows the portfolio to achieve the best historical Sharpe ratio in the analysis, at 0.33. What is interesting to note is that whilst its duration is lower, Portfolio 7 achieves a higher Sharpe ratio through significantly higher expected returns and lower volatility.

Institutional investors with low or no exposure to HY and EMD would clearly benefit from increased allocations to these asset classes: the analysis shows that a portfolio 70% invested in domestic fixed income with an expected Sharpe ratio of 0.25 could raise its risk-adjusted returns by up to 30% – without adding volatility – by significantly allocating to global HY and EMD segments.

Expanding investment horizons

Adding illiquidity and complexity premia to the picture

As discussed previously, diversifying assets to non-domestic markets generally brings value to a portfolio. Yet many pension funds tend to complete their allocation to traditional fixed income with less liquid and more complex asset classes. Amongst these, we believe that infrastructure debt, private debt and ABS, notably, have a crucial role to play.

Re-visiting asset-backed securities

There is no doubt that ABS continue to have something of a stigma left over from the financial crisis – with fewer than 1% of European investors allocated to the sector today (Mercer). Yet much has changed, and we think there is merit in exploring the asset class again today.

Partly because of the financial crisis, but also because a well-governed ABS market is as important for investors as for credit originators, policymakers have taken significant steps to improve both transparency and investor protection.

These steps include aligning the interests of originators and investors by requiring originators to have “skin in the game”. They also include reforming the role of credit-rating agencies in securitization markets, which addresses the second key shortcoming revealed by the financial crisis. In light of this, ABS is an asset class in which a number of investors have been increasing their exposure. It looks particularly attractive in an environment of potentially rising rates: most ABS being floating-rate, it can provide some level of protection against interest-rate risk.

In addition, given the underlying asset classes it contains – residential and commercial mortgages, consumer credit, etc. – ABS also provide a good degree of diversification beyond corporate and sovereign fixed income, meaning it can be a good complement to a core allocation.

However, the structural complexity and variable levels of liquidity of ABS make it difficult to access for non-specialist investors. Investing with discrimination requires specialist credit research to ensure the robustness of both the structure and the underlying assets. Minimum investments also tend to be extremely large, so that investors are better off using an asset manager with enough scale to access the full deal flow.

Securitized Credit spreads

United States

Credit Rating	CLO	CMBS	$ Corporates
AAA	130	92	42
AA	185	145	64
A	250	185	95
BBB	365	265	148
Non-IG	670	400	368

Europe excl. UK

Credit Rating	CLO	CMBS	€ Corporates
AAA	111	100	5
AA	180	165	24
A	240	215	59
BBB	360	250	127
Non-IG	635	400	309

United Kingdom

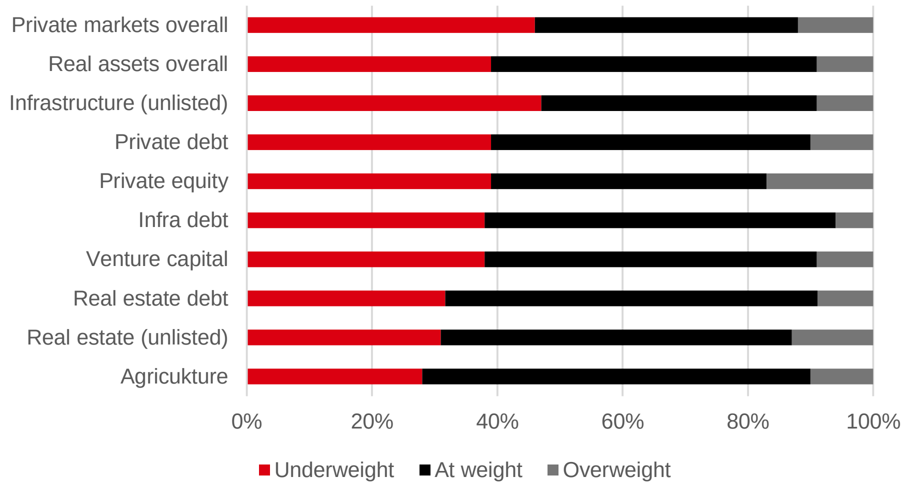
Credit Rating	CMBS	Non-Conforming RMBS	£ Corporates
AAA	145	104	40
AA	180	150	44
A	225	190	105
BBB	260	220	202
Non-IG	450	325	443

Source: Securitized Credit spreads – HSBC Global Asset Management. USD Corporate Bond Spreads AAA to BBB – Bank of America Merrill Lynch 5-7 year US corporate indices AAA to BBB. Non-IG US Corporates – Bank of America Merrill Lynch US High Yield Index. Euro Corporate Bond Spreads AAA to BBB – Bank of America Merrill Lynch 5-7 year Euro corporate indices AAA to BBB. Non IG Euro Corporates – Bank of America Merrill Lynch Euro High Yield Index. Sterling Corporate Bond Spreads AAA to BBB – Bank of America Merrill Lynch 5-7 Year Corporate Indices AAA to BBB. Non-IG Sterling Corporates – Bank of America Merrill Lynch Sterling High Yield Index. As at end of June 2019.

Gaining exposure to private markets

Over time private markets have been gaining in popularity among institutional investors. Nevertheless, 46% remain underweight versus their long-term strategic asset allocation, as investing is proving difficult, in private infrastructure especially, but also in other real assets, private debt, private equity, infrastructure debt and venture capital.

If you invest in the asset class below, are you underweight or overweight versus your strategic asset allocation

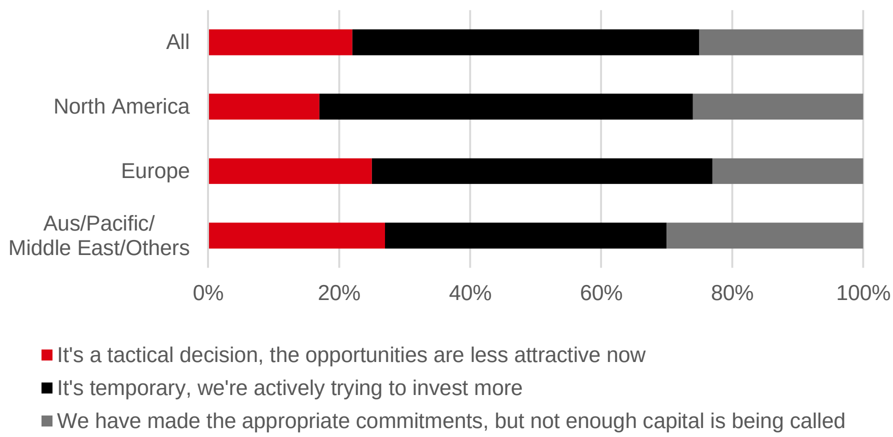


Source: bfinance Asset Owner Survey, Innovations in Implementation, 2018.

Of those investors which are underweight in private markets, 53% are trying to invest more but, overall, respondents cite access challenges, slow capital calls on what should be an appropriate volume of commitments (for 25%) and a lack of attractive opportunities.

Many of the specific difficulties cited revolve around governance, costs, expertise, and access. Finding the right manager, one that can facilitate access and deliver real expertise to manage the complexities of these asset classes, is a key issue for investors.

For underweight positions in Private Markets, which of these most closely describes your reasons?



Source: bfinance Asset Owner Survey, Innovations in Implementation, 2018.

Alternatives: stepping up allocations

As institutional investors have specific profiles and investment objectives, looking at alternative investments generally is interesting, and shows to what extent this asset class has been gaining in importance. As discussed earlier, alternatives represent around 15% of average institutional allocations in Europe, while private markets and alternatives together represent 20% of allocations globally (sources: Mercer and bfinance respectively).

Alternative credit

Alternative credit is itself a diverse set of strategies, in which we include event-driven credit hedge funds, private debt, real-estate debt, distressed debt and infrastructure debt, all of which deliver an illiquidity premium over traditional sovereign and corporate fixed income investments. For institutional investors, we believe they can be of interest as complementary strategies. Reduced liquidity in bond markets is making it more interesting to diversify allocations to alternative credit. In addition, the financing requirements of the real economy have increased significantly across corporates, infrastructure and real estate. OECD and McKinsey reports from last year estimate that USD50-90 trillion of infrastructure spending will be required between now and 2030.

This means investment opportunities in this space may increase over the coming years. For investors seeking higher returns, alternative credit can deliver superior risk-adjusted returns through illiquid betas, alternative betas and underlying asset selection from a variety of independent sources and factors – but this requires manager skill and access to the right assets.

Alternative credit can also provide stable cash flows and low correlations to traditional asset classes. These investments are made on diverse, illiquid private markets which mark to model and not to market, so their very nature gives them an advantage to diversify a core allocation.

Finally, in an interest-rate environment which may potentially turn (and similarly to ABS which we discussed earlier), the majority of alternative credit assets can offer protection against interest-rate rises thanks to their floating-rate format.

Infrastructure debt

The characteristics of infrastructure debt make this asset class a good tool for liability matching and yield enhancement through the illiquidity premium, which is a key component of returns. It's an interesting candidate for long-term pension liabilities in particular, because the assets have a long life, as senior debt maturities can reach forty years or more. It also offers higher yields than government debt, with an illiquidity / complexity premium between 35 and 75 bps.

In terms of defaults, infrastructure debt has, historically, lower cumulative default rates than corporate bonds of equivalent credit quality[1].

It also offers structural protections not generally found in listed corporate bonds, such as long-term contractual cash flows, a strong covenant structure, and strong security for senior tranches. Many of these characteristics underpin the resilience of the asset class, and partly explain its lower correlation with both business cycles and other markets.

Governance and transparency are essential, especially in less traditional asset classes, and an issue investors commonly cite as an impediment to investing. For infrastructure debt investments in particular, institutional investors need a partner with a robust understanding of infrastructure projects, because operational due diligence is as important as investment due diligence to determine a project's ability to create sustainable value.

Characteristics of private and infrastructure debt

Strategy	Credit Quality	Yield expectations	Investment Horizon
Syndicated Loans	BB/B	Libor + 3.5% - 4.5%	3 – 7 years
Direct Lending	Unrated (equivalent to BB/B)	Libor + 5% - 7%	3 – 7 years
Commercial Real Estate Debt	AA to BB	Libor + 1.00% - 3.25%	5 – 10 years
Infrastructure Debt	A to BBB- Unrated (equivalent to BB/B)	UST + 1.5% - 3% 6% - 8%	10 - 30 years

Source: HSBC Global Asset Management, Bloomberg, as at end of September 2019

[1]Source: Moody's Investors Service, 2018.

Private debt

Spanning leveraged loans to direct lending, private debt offers different seniority tranches and various levels of credit quality. While this means there is benefit in investing with an expert manager to navigate risk exposures, private debt typically boasts robust amounts of collateral and strict covenants to mitigate against capital losses. It also offers a wide range of economic, industry and geographic exposures that are a good complement to corporate bonds.

For investors requiring greater access to their capital, tradable leveraged loans are more liquid and flexible.

Over the past several decades, lending to middle market companies in the U.S. and Europe has shifted due to structural changes and evolving risk tolerances in each respective banking system.

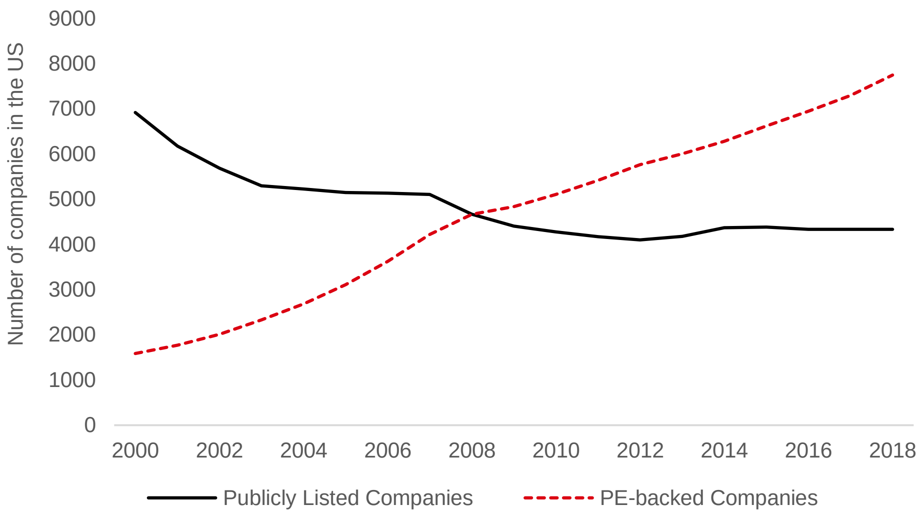
Private credit/Direct lending allows freeing-up capital to more borrowers especially after the Great Financial Crisis when banks had to increase their capital requirements.

Approximately a third of investors surveyed by Preqin plan to invest more in private debt in 2019 than in 2018, with nearly half intending to boost their allocation long-term. Capital raised for private debt strategies reached $110 billion in 2018, following a record of $129 billion the previous year, according to Preqin, with 41 percent of the money secured to direct-lending funds. The average size of direct lending funds raised in 2017 more than doubled to US$1bn from US$478m in 2016.

Since 1997 the number of companies listed in the US has declined 45%, driven by a combination of factors that have made life less attractive as a public company[1]. The number of IPOs has declined from around 400 per year in 2000 to around 100 per year, in recent years, as companies prefer to remain private[2]. As a result, the average listed company is getting larger and older. The average size of a listed firm has increased 4x over this period and the average age of that firm has increased from 12 years to 18 years[2]. The delisting process means the number of companies in the Wilshire 5000 Total Market Index[3] currently stands at just 3,4863.

Capital raising by private companies surpassed that of public companies in 2012, and has stayed that way in every year since[2]. Most private-debt opportunities are issued to help funding acquisitions of middle market companies through PE transactions. For private debt funds, a key consideration is sourcing deals. Strategies differ on achieving this. Long-established firms have developed relationships with private equity firms, working alongside them to finance new deals, whilst some bank-owned asset manager have the opportunity to source deals internally.

A greater universe of private, not public opportunities



Sources: World Bank, Pitchbook, as of June 2018

[1] World Bank, 2018
[2] Pitchbook, as of June 2018
[3] Wilshire Associates - Wilshire 5000 Fact Sheet

Conclusion

Liability matching challenges are encouraging pension funds to invest outside traditional asset classes and broaden perspectives outside their domestic markets. As a consequence, non-domestic fixed income sector have progressively been taking up a larger proportion of strategic allocations in institutional investors' search for yield. As illustrated by the contributions of both high-yield and EMD investments in improving Sharpe ratios over the last few years, implementing a robust valuation framework to determine the allocation based on the long-term expected returns of different assets has the potential to bring value to a portfolio.

Although this trend has been gaining ground, investors still could benefit from extending their portfolios further, especially to less liquid markets. At current exposure levels, increased diversification has the potential to improve their risk / returns profiles, within the limits of their respective investment constraints.

In order to extend the limits of the investment universe even further, more alternative credit strategies are also progressively being integrated into the landscape. They are considered complementary investments to bolster returns and potentially protect against interest-rate risk. Complexity is a further difficulty to expanding horizons into less traditional asset classes, as these markets remain difficult to research and price. Nevertheless, this can also be seen as an opportunity for asset allocators who have access to the necessary research, analytical resources and deal flow access, to take advantage of less saturated markets.

For those institutional investors which lack the governance or resources to access these strategies via direct investments, the challenge lies in selecting trusted partners with the necessary capabilities to implement these investment strategies on their behalf.

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