AGF INSIGHTS

# Evolving Investor Preferences for Fixed Income Investments

RO: 20220512-2194853

## Executive Summary

Canadian institutional investors remain deeply committed to having fixed income assets in their portfolios, but their exposure to government and investment-grade corporate bonds continues to wane in comparison to less traditional sources of yield that offer the potential of higher returns like private credit and Emerging Market (EM) debt.

Although asset owners – from public and corporate pension plans to endowments and foundations – believe the primary goals of fixed income are to preserve capital and manage volatility in a diversified portfolio that includes equities, they also cite income generation as a growing priority in a low-interest rate environment that is not expected to change, even as central banks tighten monetary policy in the short term.

The same institutions also agree that allocations to higher-yielding fixed income must be weighed carefully given the potential peril of investing in them. For some, liquidity is the most critical factor in determining the appropriate mix of private versus public investments, while others seem more concerned with how to manage credit, duration and/or geographic risks that may be associated with their portfolios.

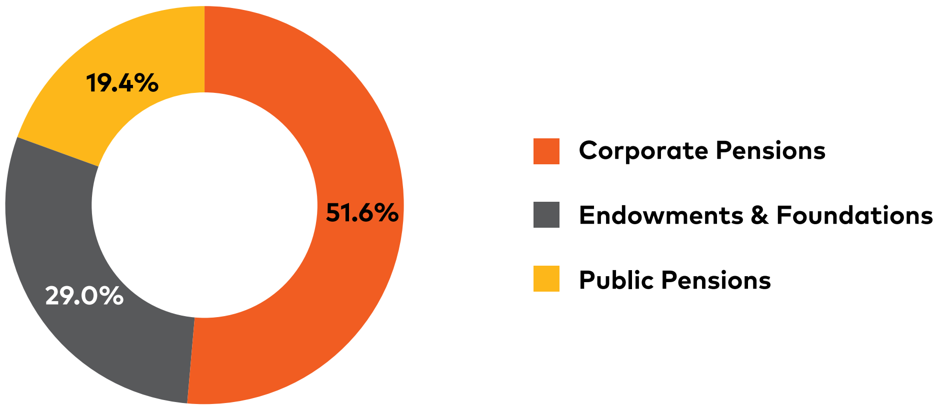
Beyond these considerations, asset owners recognize the importance of incorporating environmental, social and governance (ESG) criteria into their investment processes and portfolios, but it's still "early innings" on this front when it comes to their fixed income holdings, and many say future adoption will be slow.

Granted, how much progress is made going forward may largely depend on the advice and recommendations of investment consultants, for whom asset owners overwhelmingly rely on to fill a new fixed income mandate. Even so, what seems to matter most to Canada's pension plans, endowments and foundations is the experience, stability and track record of the investment team(s) employed to manage their fixed income portfolios.

## Methodology

Coalition Greenwich conducted 31 telephone interviews targeting corporate pensions, public pensions, and endowments and foundations based in Canada to examine investors' evolving sentiment toward fixed income investments and current thinking about portfolio implementation. The interviews took place during February and March of 2022. The study that this report is based on was commissioned by AGF Investments and conducted by Coalition Greenwich, a division of CRISIL.

**Respondents**



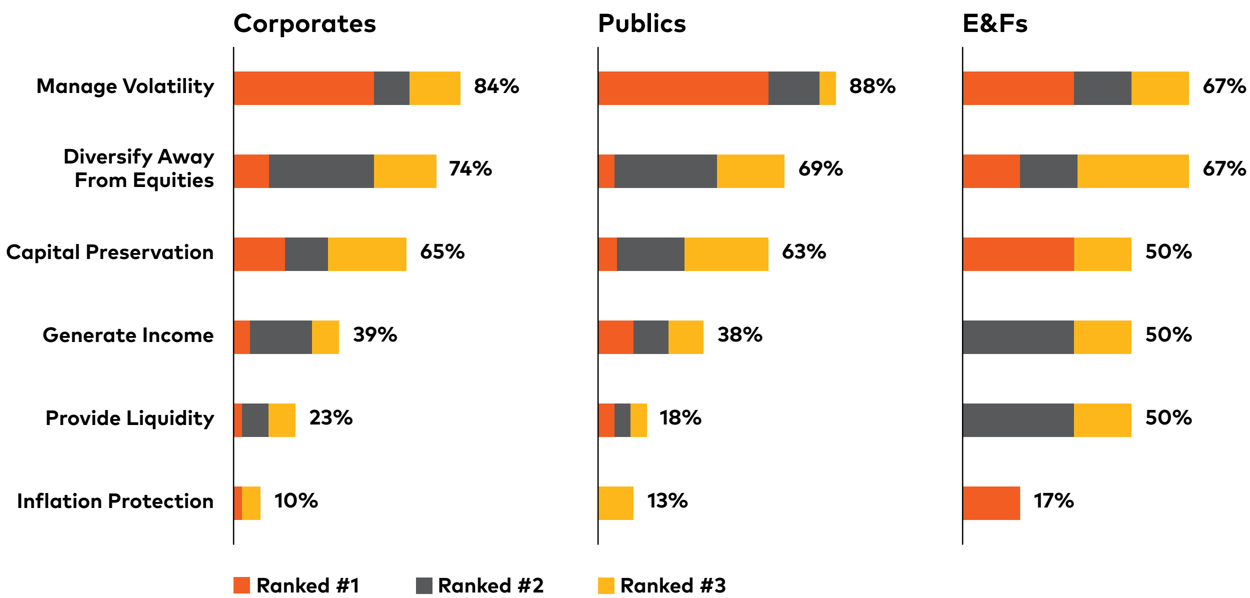

Note: Based on 31 respondents
Source: Coalition Greenwich 2022 Fixed Income Investing Study, March 25, 2022

## The Role of Fixed Income

*Managing volatility* is the primary role of fixed income, according to most asset owners participating in the study. This is especially true for corporate and public pension funds, but less so for endowments and foundations that rank fixed income's role as a *diversifier from equities* as equally important.

More than half of those surveyed also identify *capital preservation* as an important aspect of fixed income, while the asset class's ability to *generate income* is clearly important – yet not quite to the same degree across each type of respondent. *Liquidity and inflation protection*, meanwhile, are generally considered less central to fixed income's role, with endowments and foundations placing more emphasis on these characteristics than do corporate and public pension funds.

### Primary Reasons to Own Fixed Income

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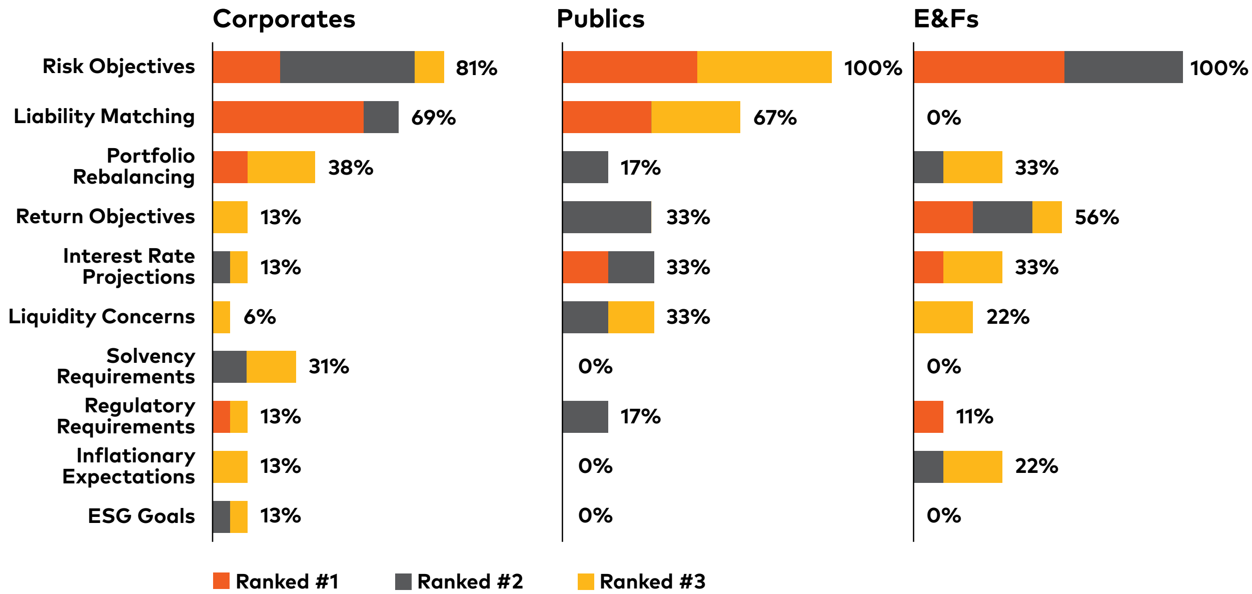
Not surprisingly, most asset owners allocate to fixed income assets with a goal very much aligned to the role(s) outlined above. Of note, nearly 40% of those surveyed rank *risk objectives* as their top reason for owning fixed income, while 90% include it in their top three factors. *Liability matching* is also high on the list of objectives, at least for corporate and public pension plans, followed by *portfolio rebalancing* and *return objectives*, which is particularly important to endowments and foundations.

"A strategy that captures a higher risk-adjusted return over the long term and reduces the correlation to the market environment," says a study participant when asked about the type of fixed income strategy that meets their plan objectives.

**Objectives Driving Fixed Income Allocation**

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## The Search for Higher Yield

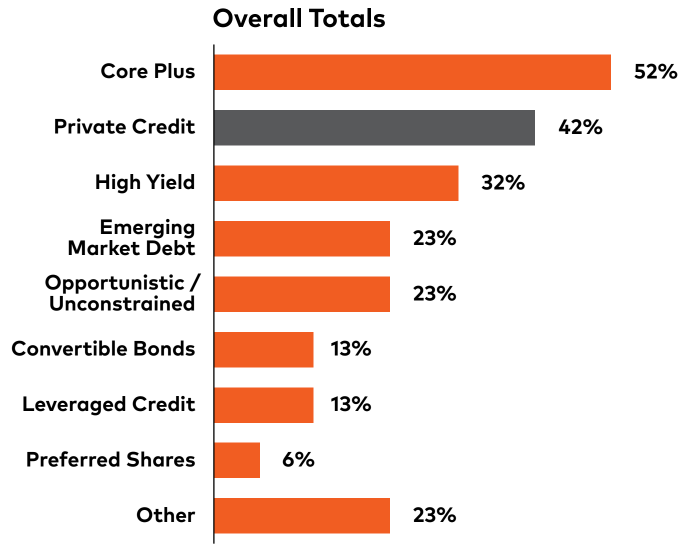
Asset owners recognize a need to diversify their fixed income portfolios beyond government and investment-grade corporate bonds, but are cognizant of the risks associated with higher-yielding assets and want to strike the right balance between them. As one study participant said, the current low-rate environment is forcing their public pension fund to "accelerate the search for alternative return streams in the fixed income space to manage risk and generate income."

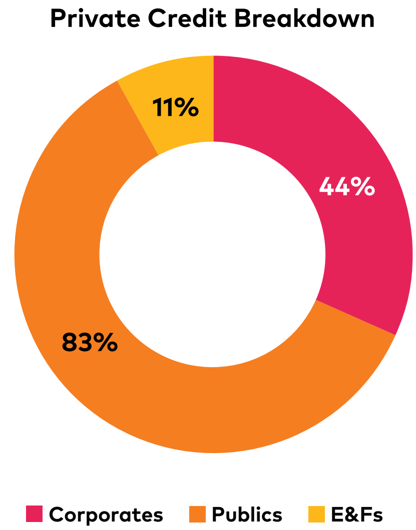
Given the choice of several options known to provide higher potential yields, the majority of respondents cited *core plus* strategies that typically invest in a mix of government and investment-grade corporate bonds that are complemented by smaller allocations to high-yield, global and Emerging Market debt. Moreover, this preference is just as evident in the relatively high percentage of responses mentioning both *high yield* and *EM debt* more specifically.

*Private credit* is another highly sought-after investment of institutions seeking more yield. In fact, a very large number of corporate and public pension plans had it right at the top of their preferred options.

"Our plan includes seeing how well private credit fits in with our other two strategies within fixed income and looking at any possible opportunities to improve yield and diversifications," said one public pension fund respondent.

### Investment Options to Increase Yield

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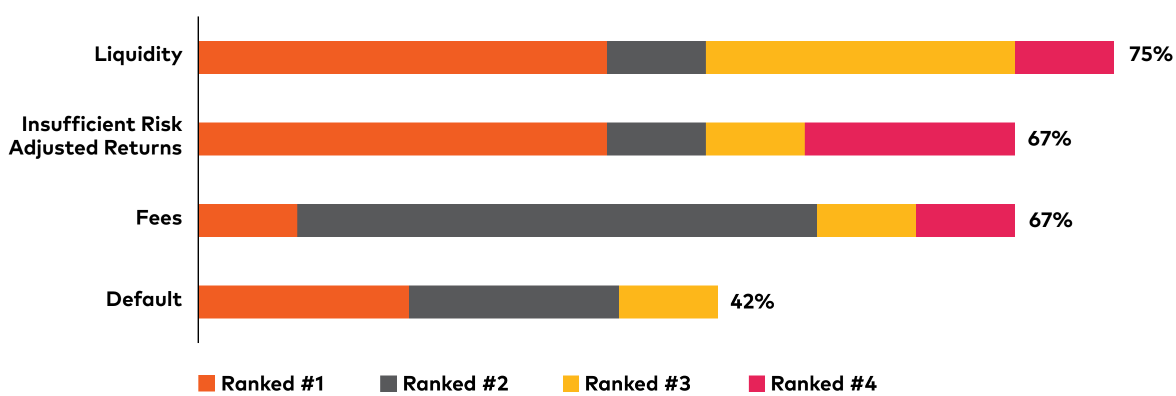
Still, some asset owners are hesitant about allocating to private credit, mostly due to *liquidity concerns* and *insufficient risk-adjust returns*. That said, *fees* are also a primary deterrent, especially amongst endowments and foundations surveyed in the study.

Interestingly, when asked about their existing fixed income portfolios, only 3% of respondents say they are highly reliant on it to satisfy short-term liquidity needs. Meanwhile, the risk factors they identify with most include exposure to global markets, credit defaults, interest rate cycles and the duration of the portfolio.

### Reasons for Not Investing in Private Credit

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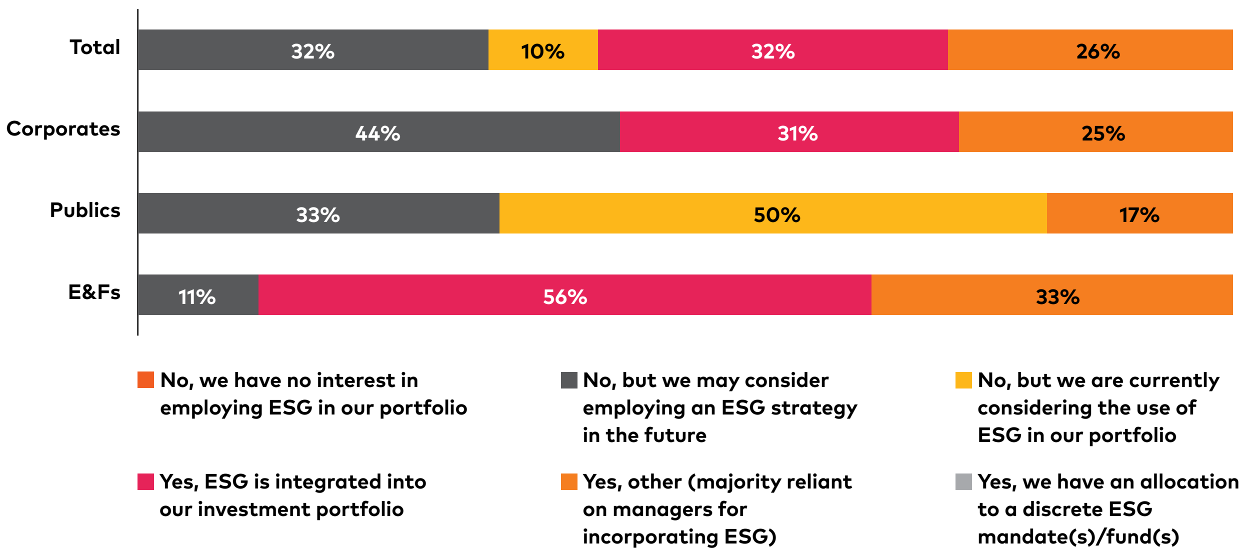
## What About ESG?

When it comes to incorporating environmental, social and governance criteria into their fixed income portfolios, asset owners are clearly taking steps towards greater integration, but they still have a long way to go, and many do not feel as if there is a compelling argument for investing in green bonds or transition financing.

In fact, while every respondent expressed interest in employing ESG to their fixed income portfolio, more than 40% of them admit they are not doing so today. Public pension funds surveyed are the biggest laggards on this front. Conversely, endowments and foundations have clearly made the most progress.

"We have a Board of Directors, so everything is a slow pace at our organization," said one public pension fund respondent. "[ESG] is a fresh, new thing so we will probably look at it in the future."

**ESG Incorporation into Fixed Income Portfolio**

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## Selecting Fixed Income Managers and Filling Mandates

Experience, expertise and stability may be the best way to sum up the selection criteria used by asset owners seeking asset managers to run a fixed income portfolio. More specifically, *team composition & capabilities* and *length of track record* are both considered crucial to respondents rating the attributes of fixed income managers on a scale of importance.

In the same vein, when asked more pointedly what attributes are most important to their evaluation of potential asset manager partners, institutions list *experienced investment team* most often, followed closely by *strong, consistent investment performance, ability to manage investment risk* and *organizational stability*.

Of course, to make that evaluation, resources that highlight the potential strengths and weaknesses of a particular asset manager need to be tapped. For this, asset owners rely heavily on investment consultants, but also gather information from industry databases and company websites as well webinars, events and other published content including white papers.

### Important Attributes of a Fixed Income Manager

| | Average Rating | | | |
|---|---|---|---|---|
| | Total | Corporates | Publics | E&Fs |
| Team Composition & Capabilities | 4.55 | 4.31 | 5.00 | 4.67 |
| Length of Track Record | 4.23 | 4.31 | 4.33 | 4.00 |
| Addresses Regulatory Requirements | 4.16 | 4.19 | 4.17 | 4.11 |
| Has Local Market Expertise & Sourcing Network in The Asset Class | 4.16 | 4.50 | 3.83 | 3.78 |
| Has Global Expertise in The Asset Class | 3.77 | 3.69 | 4.17 | 3.67 |
| Quality of Reporting | 3.74 | 3.63 | 3.67 | 4.00 |
| Investment Team Size Dedicated to Fixed Income | 3.55 | 3.44 | 3.50 | 3.78 |
| Incorporates ESG Requirements | 3.19 | 3.06 | 2.83 | 3.67 |
| Total Private Markets AUM | 2.58 | 2.56 | 2.67 | 2.56 |

**Using a 5-point scale, where 1 is "Not Important" and 5 is "Extremely Important"**

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## Conclusion

Canadian institutional investors understand the important role that fixed income plays in their portfolios. It helps them manage volatility and preserve capital, while also generating income and the potential of more stable returns than equities. But asset owners also recognize that their fixed income portfolios must evolve to be fully worthwhile and meet the changing ESG requirements of their stakeholders.

In today's low interest rate environment, more emphasis than ever is being placed on higher-yielding assets like private credit and strategies that can allocate beyond government and investment-grade corporate bonds towards high-yield and Emerging Market debt.

In doing so, asset owners are carefully weighing opportunities against risks and seeking out the most experienced and knowledgeable asset managers to help them strike the right balance.

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Publication date: May 24, 2022.

FUND1247 04-22-E

RO: 20220512-2194853