# Invesco Global Fixed Income Study 2020

This study in not intended for members of the public or retail investors. Full audience information is available inside the front cover.

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Rollover the content sections above to take you to each of the study's themes. And at the key takeaways, rollover the icons for a richer experience.

# Welcome

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**Welcome to Invesco's third annual Global Fixed Income Study, part of a suite of thought leadership studies including the Global Sovereign Asset Management Study and the Global Factor Investing Study. These are all data-driven studies based on face-to-face interviews that add depth, color and context to the findings.**

In 2019, the number of respondents grew from 145 to 159 fixed income professionals, to incorporate the views of 121 institutional and 38 wholesale investors that are together responsible for managing over $20 trillion in assets (as of 31 December 2019). It is a uniquely large and in-depth examination of global fixed income investing.

These investors are employed by pension funds (both defined benefit and defined contribution), sovereign wealth funds, insurers and wholesale investors, including private banks, diversified fund managers, multi-managers and model builders. They are located across all the major regions of North America, Europe and Asia-Pacific.

This year's interviews were conducted in October and November 2019, before the onset of the COVID-19 crisis. The Study offers insights into asset allocation decisions, strategies, and methods of implementation, as well as future

**Theme 1**

"The definition of a bubble is that it will pop, and I don't see how that can happen with rates so low."

Insurer, EMEA

**Theme 2**

"The low interest rate environment means we have included more alternative fixed income."

Insurer, APAC

intentions of investors within the fixed income asset class, and reveals how they were positioned in the lead-up to the market turmoil arising from the COVID-19 pandemic.

Although the continued widespread use of unconventional monetary policy and low levels of inflation meant that for many the cycle was seen as hard to compare to those of previous decades, the Study reveals an underlying increase in risk aversion among respondents as they anticipated that a record run in fixed income markets might be coming to an end. This underlying risk aversion likely better positioned many investors for an unprecedented exogenous shock than have otherwise been the case.

The behavior of markets since the onset of the crisis suggests that the caution displayed by many of our respondents was not universal. Quantitative easing initially sent US government bond yields lower as intended. However, yields subsequently rose at the short and medium areas of the curve with less cautious investors likely forced to sell their most liquid positions in order to meet withdrawals, as well as to close out riskier positions and strategies.

At the time of writing in April 2020, a halt to economic activity from global shutdowns generally remains in place and there is still some way to go before we will know the full impact of this crisis on the economy, markets and portfolios, or the timing of the recovery. The quick, emergency interventions by central banks, including widespread quantitative easing, massive securities purchases and the reopening of finance windows have accelerated already tumbling yields in some markets.

This will have compounded problems for some respondents such as defined benefit pension funds whom the Study found were already straining to match their liabilities. They were among respondents increasing allocations to less liquid alternative credit assets such as emerging market and high yield debt despite wariness at the impending end of the cycle. A notable exception to the allure of US high yield was US investors themselves, who had been selling down exposures, motivated by concerns over rich valuations and the late stage of the cycle.

One concern firmly on the radar of respondents was bond market liquidity. While regulations that followed the global financial crisis such as Dodd-Frank were seen as adding stability to the financial system, they have also led to banks holding less inventory on their balance sheets and playing a reduced role as market makers. The slack has been picked up by customer-to-customer platforms managed through intermediaries, such as ETFs and credit portfolio trading. However, this model had previously not been tested by significant market stress, with questions arising over the difference between the liquidity of ETFs and their individual constituents.

**Theme 3**

"Credit portfolio trading reduces market risk. The basket of bonds being traded has also gone through an assessment and this also reduces your risk to some extent."

Insurer, APAC

**Theme 4**

"Emerging markets are a lot less correlated than they used to be as they have become better developed."

DB Pension Plan, EMEA

**Theme 5**

"It's even more important for a fixed income investor to consider ESG than an equity investor."

Wholesale, US

Volatility arising from COVID-19 has led to regular price discounts between fixed income ETFs and their component securities. But by facilitating continued trading during a period of significant uncertainty, ETFs have acted as a key source of price discovery and played an important role in keeping markets moving. As such, this model can be said to have passed its first significant test.

In our penultimate theme, the Study focuses on allocations to emerging market debt and Chinese debt, with the rise in interest and allocations we observed in our 2018 Study continuing to grow at a rapid pace in 2019. Overall, we found a continuing shift away from viewing emerging market debt as a monolithic asset class and growing interest in more country-specific allocations. We found APAC and EMEA investors were most inclined to be allocating to emerging markets, with US investors less likely to be making active decisions and generally following benchmark weights. That said, the rationale among EMEA and APAC investors for these allocations and the way they are being implemented differ widely with a mix of local currency, dollar and euro-denominated exposures and varying preferences for regional and single-country allocations.

In our final theme, we continue the review of ESG's evolution in fixed income portfolios from our previous studies and find investors continuing to move beyond performance concerns relating to ESG, to a recognition that managing issuer-related ESG risks has the potential to enhance returns. Very few respondents now view ESG as hindering performance. This evolved thinking is taking investors from niche approaches such as using ESG-specific products and securities to more thorough integration into core fixed income mandates. The majority are anticipating making new/additional investments in the future, with interest extending beyond green bonds, the most common instrument, to include social and sustainable bonds.

The economic upheaval induced by the global COVD-19 pandemic brought the end of the cycle to the forefront much more quickly than the soft landing most had anticipated. Over half of our investors believed any sell-off in bond markets would be short lived. While the accuracy of this view remains to be seen at the time of writing, the Study provides a unique window into the attitudes, asset allocations and strategies of fixed income professionals in a record-long cycle just prior to its historical climax.

We hope you find the Study useful in understanding how fixed income is developing and the evolving approaches of this asset class's professionals.

Theme 1

# Greater caution in advance of market turmoil

**The Study's interviews, conducted before the appearance of COVID-19, revealed a strong sense of caution among fixed income investors prior to the turmoil unleashed by the pandemic.**

Almost half (43%) believed the end of the record-long economic cycle was a year or less away, with the consensus for a soft landing. 23% identified a bond market bubble with just 29% fearing a major collapse in bond prices. Central bank easing had led to low and negative yields encouraging some to take on additional risk to bolster returns and meet objectives. This was a market plagued by fear: fear of losing but also fear of losing out. Despite some late cycle risk-taking, the confluence of end-of-cycle concerns and fears of trade wars may have translated into portfolios that were better protected from an unprecedented exogenous shock than otherwise may have been the case.

The Study's interviews, conducted in October and November 2019 before COVID-19, reveal increasing risk aversion that will have potentially positioned many investors better for an unprecedented exogenous shock than may have otherwise been the case.

Investors were more cautious than a year earlier. In addition to trade war concerns, nearly half thought the cycle would end in a year or less, truncating the assumed runway to the end of the cycle, pointing to economic softening and lack of monetary flexibility.

However, few were positioned for rates to fall much further, with only 8% predicting negative rates in the US.

Tumbling yields are particularly problematic for funding levels of defined benefit (DB) pensions straining to match the duration of their liabilities. Most defined contribution (DC) pensions and insurers were responding by moving up the risk spectrum and exploring new asset classes; wholesalers were doing likewise.

Investors were mindful of high levels of volatility and a breakdown in the negative correlation between fixed income and equities that has existed since the 1990s, prompting some to rethink the role of fixed income within their portfolios.

**Even before the dramatic falls in markets globally in Q1 2020, fixed income investors were becoming increasingly risk averse.**

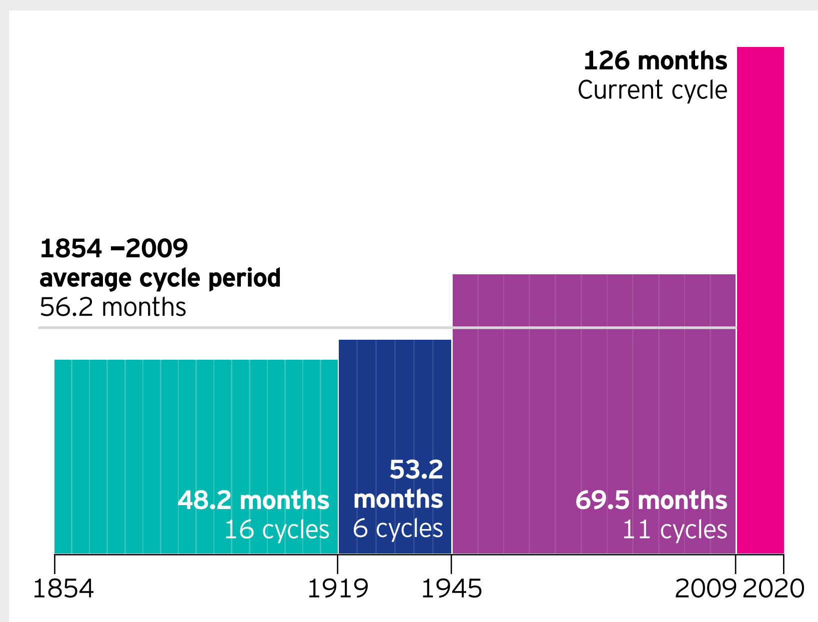
Almost half (43%) of respondents, when interviewed in late 2019, thought the economic cycle had a year or less to run. They were faced with a dilemma. Did they keep dancing while the music played, as a well-known commentator once put it, just as the jukebox was being pushed out of a fifth-floor window on the cusp of the financial crisis in 2007? Or should they make their excuses and leave the party?

"We are obviously late in the cycle," acknowledged one North American DB pension we spoke to, who summed up the fixed income investor's dilemma: "We know where we would move if we enter a more distressed period but at the same time we remain fully invested and still want to have a bit of risk on the table."

This was a market plagued by fear: fear of losing, and fear of losing out.

It's not hard to see why, as the same factors that had delivered strong returns to most fixed income investors also signalled problems ahead. Last year's trade-war tensions and tariffs prompted the Federal Reserve (the Fed) to reverse its tightening policies, cutting interest rates three times in the second half of the year. This ushered in a period of easing by central banks globally and contributed to the largest drop in fixed income yields since the financial crisis, generating outsized returns from most fixed income asset classes.

Figure 1.1
**Length of US economic cycles (months)**




Source = NBER Note: Trough from previous trough

A year further into this record-long cycle (**Figure 1.1**) many investors were increasingly cautious. The average investor believed the end of cycle was closer but approaching more slowly than they had expected twelve months ago, when on average they predicted its conclusion within nineteen months. Twelve months on, with most again displaying conservatism towards predictions, the runway had shortened to sixteen months (**Figure 1.2**).

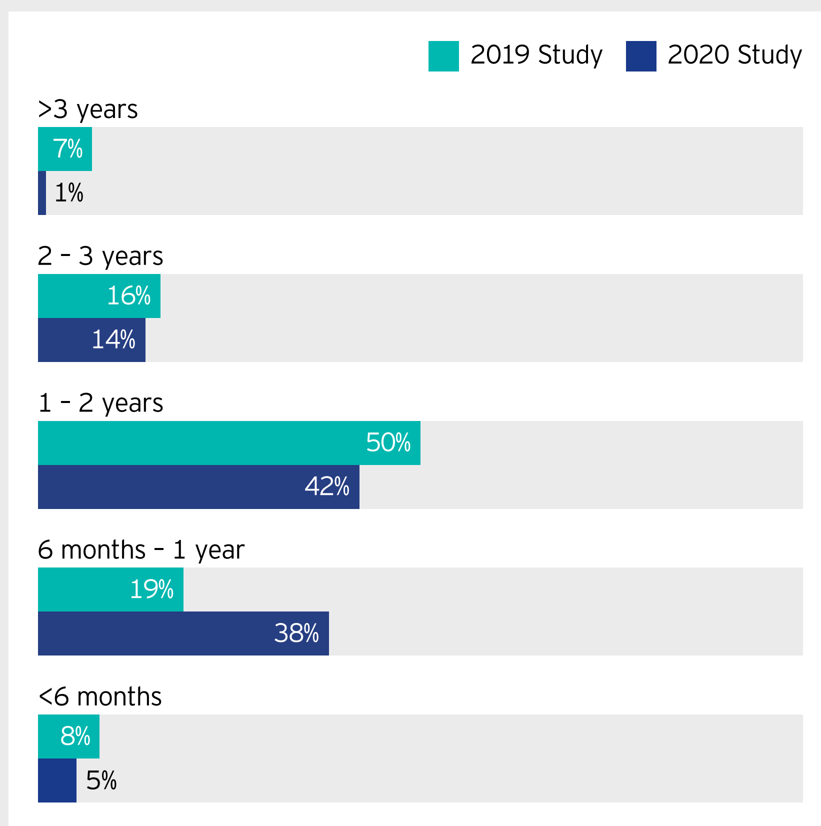
Many investors believed low inflation and the continued widespread use of unconventional monetary policy made this cycle harder to compare to previous cycles, leading to a diverse range of opinions on how and when the cycle would come to an end, with trade wars being the most cited reason.

The response to the effects of the COVID-19 pandemic has pushed this scenario even further, with the Fed lowering the target range for its federal funds rate by 100bps to 0-0.25 percent and launching a $700bn quantitative easing program in mid-March 2020[1].

This was a market plagued by fear: fear of losing, and fear of losing out.

[1] https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315a.html

Figure 1.2
**Expected time until end of economic cycle (% citations, global)**




How much longer do you expect the current global economic cycle to last?

Sample size: 2019 = 100
2020 = 151

In a positive light, professional institutional investors' caution is potentially beneficial for them, since a bias towards limiting risk over the past year will have helped better protect portfolios, providing a more defensive anchor.

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Caution over trade wars may have translated better into some protection from the unanticipated risk of a global pandemic than may otherwise have been the case.

At the time of writing, however, it appears this caution wasn't universal. Quantitative easing initially sent US government bond yields lower as intended, however yields subsequently rose at the short and medium areas of the curve with the likelihood less cautious investors were forced to sell positions in order to meet mounting client withdrawals, as well as to close out riskier positions and strategies.

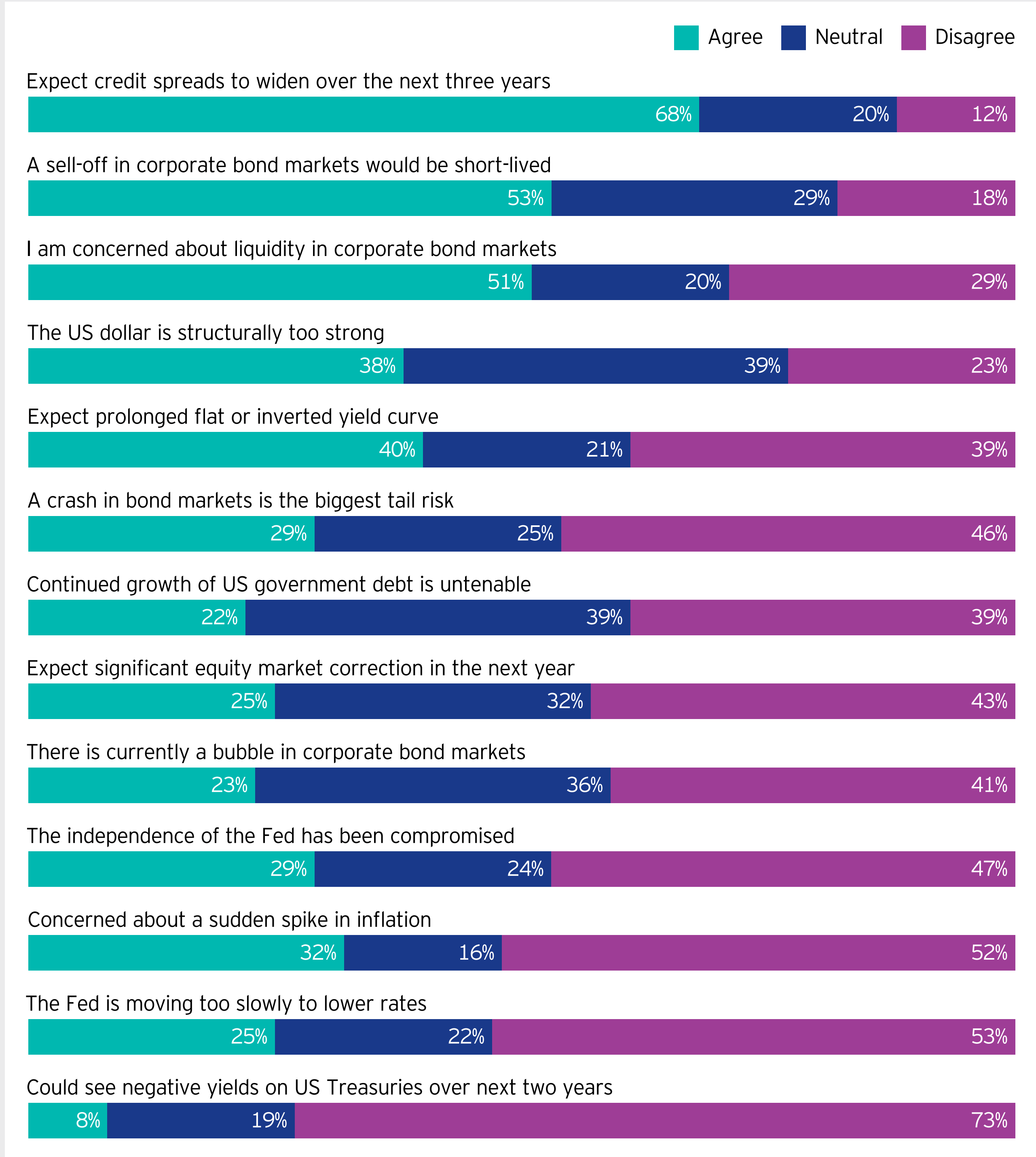
**Average time to end of cycle (months)**

| | 2019 Study | 2020 Study |
|---|---|---|
| Total | 19 | 16 |
| APAC | 19 | 16 |
| EMEA | 21 | 18 |
| North America | 18 | 13 |

How much longer do you expect the current global economic cycle to last?

Expectations for the end of the cycle varied depending on location, with North American investors typically more cautious, expecting an end in 13 months, down from 18 in the 2019 Study, while those in APAC and EMEA were slightly more optimistic (**Figure 1.2**). While there were a variety of views expressed on how close the end of the cycle was, the fastest growing cohort was those who expected to see the end of the cycle reached in between six months and one year.

Figure 1.3
**Agreement with macro statements (% citations, global)**




To what extent do you agree with the following statements?

Sample size: 152

Concerns mainly focused on credit spreads and liquidity, areas that have been significantly tested across the market by the COVID-19 crisis. Widening spreads were the biggest macro concern, with spreads close to post-financial crisis lows at the time of the survey and room for significant widening in the event of deteriorating conditions. However, most anticipated a soft landing, with only a minority identifying current bond market conditions as a bubble, few fearing a major collapse in bond prices (**Figure 1.3**) and most believing that any sell-off in corporate bonds would be short-lived.

## Fortune favors the cautious, as duration switches from net shortening to lengthening, and investors turn spotlight on liquidity

The largest – and most defensive – consensus positioning illustrated in **Figure 1.3** was reflected in the overwhelming 68% of respondents who expected spreads to widen over the coming three years. This has come to the fore quickly, with sectors experiencing widening spreads and steepening curves. Those sectors most exposed to COVID-19, such as consumer goods, autos, oil & gas and travel have seen particularly stark moves. Those who took precautionary actions in expectation of economic deterioration further out will have been relieved they did.

Just over half of investors were concerned over liquidity, and this has certainly been tested in the opening months of 2020. A sell off, particularly in high yield (HY), has seen spreads increase markedly. However, when surveyed earlier about their concerns over a sell-off, 53% said they believed it would be short lived. Whether this will be the case remains to be seen at the time of writing.

This increased pessimism was reflected by intentions for duration. Around 60% of investors expected to maintain duration over the coming year; of those making a change, compared to one year ago, the bias was towards lengthening rather than the marginal bias to shortening (**Figure 1.4**). Despite a record fall in yields, expectations were that yields could fall even further. Given central bank actions this year, and with the Financial Times speculating on a return of 'quantitative easing to infinity – and beyond', that pessimism may well be rewarded.[2]

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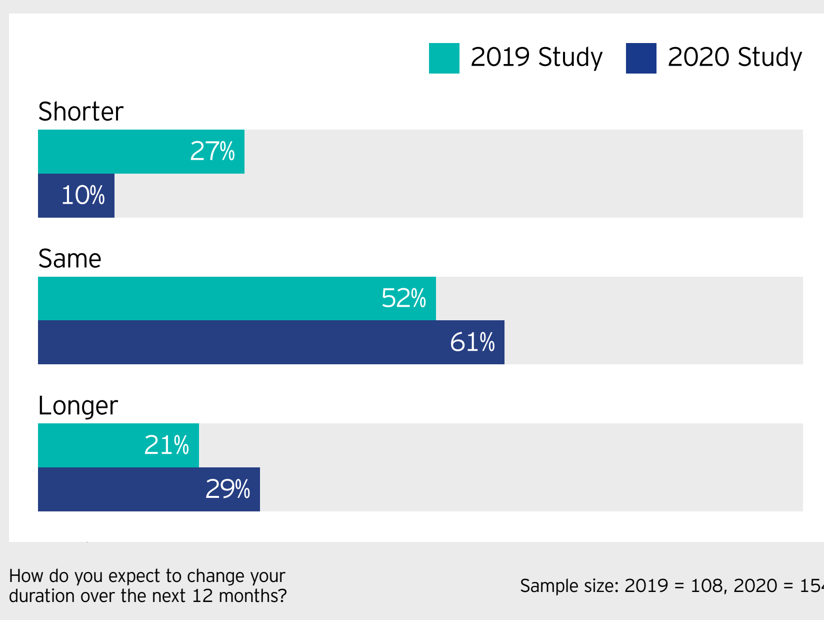
Figure 1.4
**Expected change in duration over next 12 months (% citations, global)**




How do you expect to change your duration over the next 12 months?

Sample size: 2019 = 108, 2020 = 154

The consensus was for a softening economy – and a soft landing, when it comes – along with lower interest rates. On the other hand, additional risks reflected in a further and more rapid economic deterioration were given less weight.

### 1 Interest rates fall further than expected

Despite very low US interest rates, few investors thought a continuation of their multi-decade downward trend likely. Only 8% believed that US rates could turn negative (**Figure 1.3**). In the light of recent events, negative rates in the US have become a more realistic possibility. This would bring about unprecedented change in global fixed income markets – not least for USD-denominated emerging market debt (EMD) – and potentially reshape the traditional portfolio construction around a US-Treasury risk-free rate. With the expectations of a gradual slowdown last year, this seemed very much a tail risk. While still a low probability, it's now more likely US rates will turn negative and it's notable that investors had not given weight to this scenario in their list of possibilities.

### 2 Popping of a corporate bond market 'bubble'

Despite a strong market for bonds, rising prices and negative nominal yields on $12 trillion of global debt (including around $1 trillion of corporate debt) as of January 2020[3], less than a quarter of investors described conditions in corporate bond markets as a bubble. One EMEA-based insurer explained: "The definition of a bubble is that it will pop, and I don't see how that can happen with rates so low." Only 29% believed a sharp decline in bond prices was an exigent threat (**Figure 1.3**). This could change quickly if defaults start to rise and test the liquidity of riskier fixed income securities receiving some late-cycle attention – particularly in those sectors more exposed to COVID-19 referred to above. Even before this danger became apparent, over half of fixed income investors were worried about liquidity in corporate bonds markets, and some pointed to the possibility of an 'illiquidity bubble' in certain asset classes, with one EMEA wholesaler stating that they were steering away from high yield, because of its illiquid profile. Theme 3 of the Study contains a more in-depth exploration of liquidity issues.

In summary, investors torn between fear of losing and fear of losing out have rotated rapidly to the former in the first quarter of the year, although for reasons no one was expecting a few short months earlier.

[2] https://www.ft.com/content/f1ea5096-6531-11ea-a6cd-df28cc3c6a68

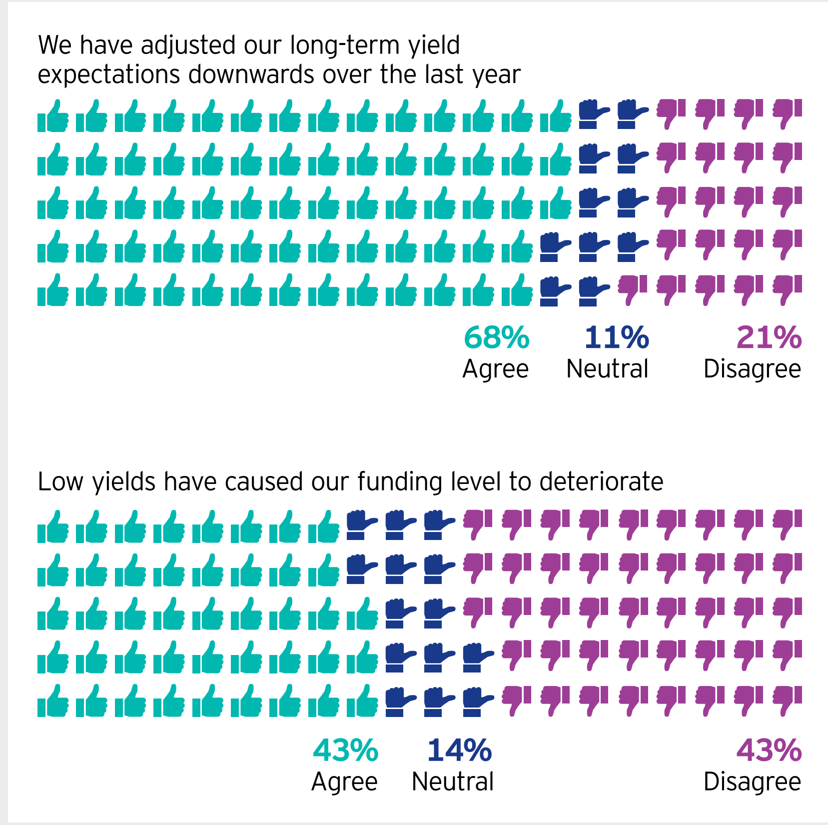
[3] Bloomberg L.P. data

## Record low yields drive changes across segments

For many, the stellar performance of fixed income allocations contributed to a strong year of overall performance, coming alongside rising global equity prices. However, it wasn't widely anticipated and proved to be problematic for liability-driven investors failing to match the duration of those liabilities. Many DB pensions experienced a decline in funding ratios (**Figure 1.5**). Low yields prompted some to take on more risk within their portfolios, with those experiencing a decline in funding levels much more likely to have responded in this way.

The drop in yields also left investors worrying they would miss their return objectives over the coming year. Among DC pensions, with those in North America generally reporting that their fixed income investments continued to perform well. However, in EMEA, where European nominal yields are now commonly negative, there was more dissatisfaction (**Figure 1.6**) with a significant minority contemplating introducing substitutes to take on the role of fixed income.

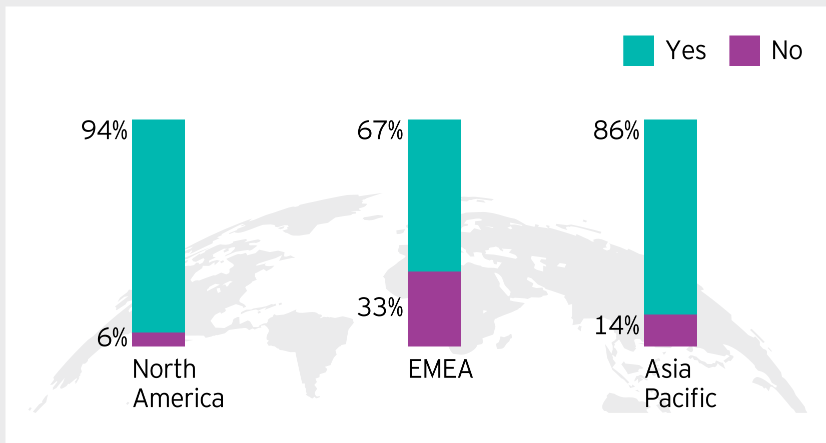
Figure 1.5
**Impact of low yields on DB pensions (% citations, DB pensions)**




To what extent do you agree with the following statements

Sample size: 53

Figure 1.6
**Fixed income fund line-up meeting performance expectations (% citations, DC pensions)**

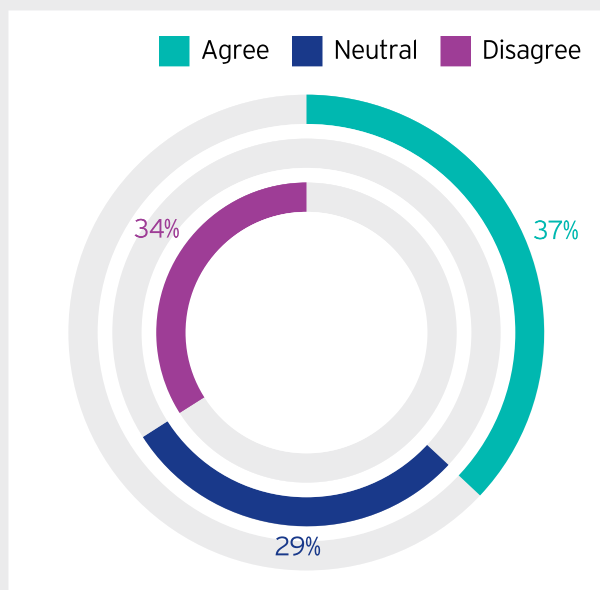



Are the fixed income fund(s) in your plan's fund line-up meeting performance expectations?

Sample size: North America = 16
EMEA = 15, Asia Pacific = 7

Among DC pensions, those in North America generally reported that their fixed income investments continued to perform well. However, in EMEA, where European nominal yields are now commonly negative, there was more dissatisfaction (Figure 1.6) with a significant minority contemplating introducing substitutes to take on the role of fixed income.

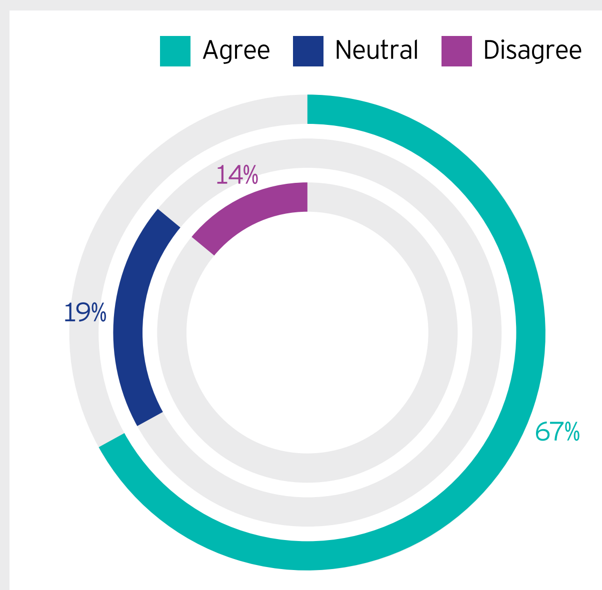
Figure 1.7
**Finding it difficult to stay within regulatory capital limits (% citations, insurers)**




We are finding it difficult to stay within our (regulatory) T1 capital limits

Sample size: 35

Figure 1.8
**Concerned about generating returns without raising investment risk (% citations, insurers)**




We are concerned about our ability to generate forecast returns without significantly raising our investment risk

Sample size: 36

Low yields force insurers to move up the risk spectrum to match future liabilities. However, insurers have the additional complication of regulations such as Solvency II in the European Union (the EU), the US equivalence legislation, and China's Risk Oriented Solvency System, that incentivize them to hold more liquid and less risky assets to benefit from lower capital charges. This has left two-thirds of insurers concerned about their ability to generate forecast returns without significantly raising investment risk, with a substantial minority finding it difficult to stay within regulatory capital limits (**Figures 1.7 and 1.8**). This has led to demand for alternative fixed income asset classes that have a favorable capital weighting, such as secured direct lending and liquid bank loan strategies.

Wholesalers, particularly private banks, can view negative real yields favorably, finding them helpful in persuading clients to move from deposits into more volatile assets with greater expected returns, where they can demonstrate more value. "This is actually a good environment for us as clients increasingly realize it's better for them to be invested," explained one EMEA-based wholesaler. Many were also moving up the risk spectrum through the introduction of new asset classes (**Figure 1.9**). This has led to model portfolios being reshaped and the closure of some of the lowest-risk portfolios to new capital. These often have high allocations to low-risk fixed income assets that currently offer little or no yield, not to mention the risk of capital losses if yields were to increase.

These changes, and the specific asset classes that investors within different segments have allocated to, are discussed in more detail in Theme 2.

"This is actually a good environment for us as clients increasingly realize it's better for them to be invested," explained one EMEA-based wholesaler.

Figure 1.9
**How helping clients deal with low yield environment (% citations, wholesale)**

**59%**
Introducing new assets/products into model portfolios

**55%**
Recommending new asset/product

**28%**
Creating new model portfolios

**17%**
Not doing so

Are you assisting advisers/clients in dealing with the low yield environment?

Sample size: 29

## Increased volatility of fixed income set to persist

The pattern of 2019 proved to be almost the exact inverse of 2018, when a sharp increase in yields and a drop in equity markets left investors nursing losses across their portfolios. High levels of volatility within fixed income are partly a function of ultra-low real and nominal interest rates, with any change in prevailing rates having a magnified impact on asset prices. This, as one EMEA wholesaler noted, is a two-edged sword, with "an increase in risk but also in opportunity".

Alongside a breakdown in the negative correlation between fixed income and equity asset prices – entrenched over decades – this changing landscape is prompting a rethink of the role of fixed income within portfolios, with a recognition of new risks but also new opportunities – a theme that we explore throughout this Study.

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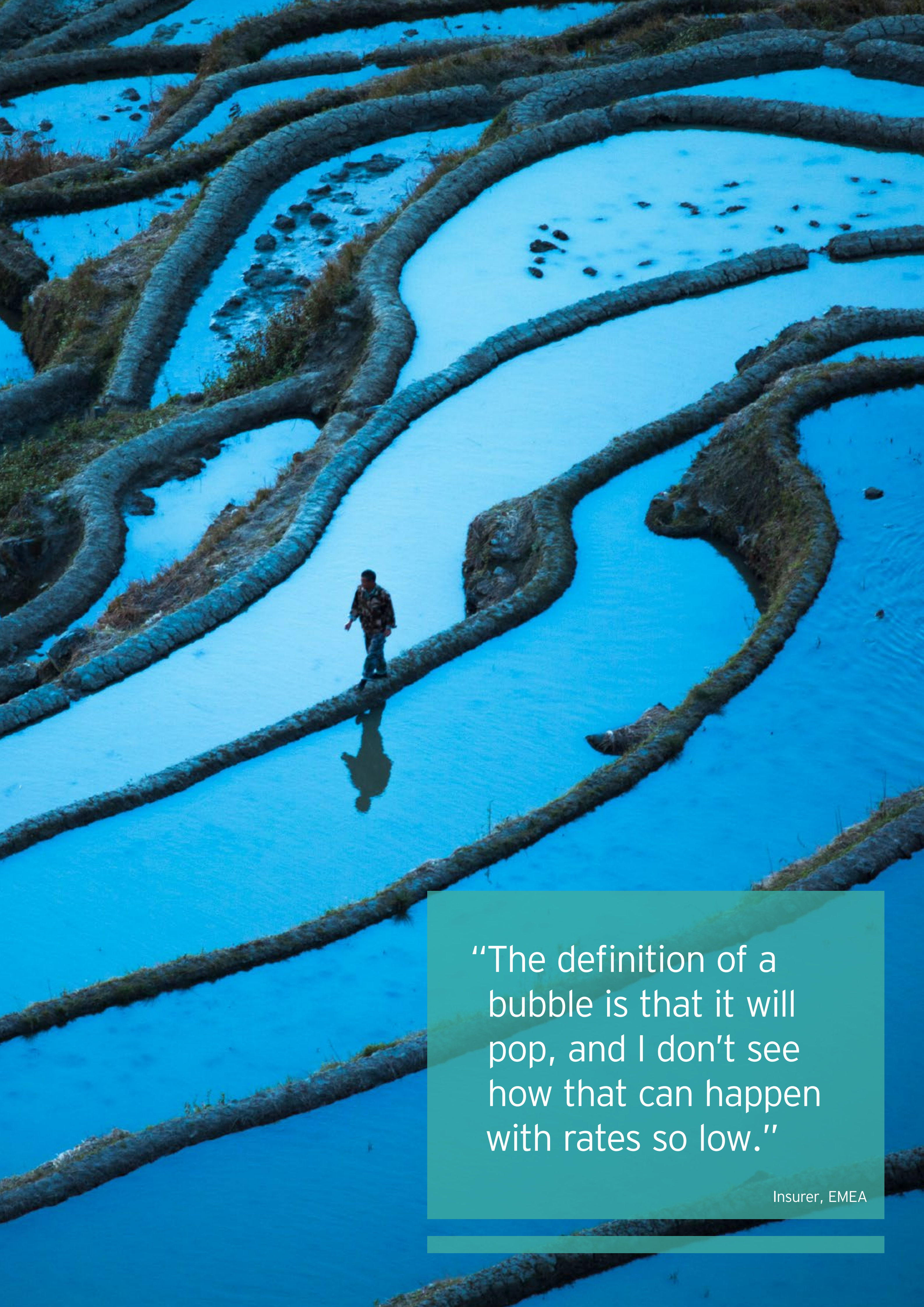


"The definition of a bubble is that it will pop, and I don't see how that can happen with rates so low."

Insurer, EMEA

# Contrast between cautious and yield-seeking investors grows

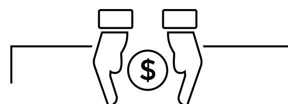
**Low yields have led to steadily increasing allocations to alternative credit, despite the strong sense of caution highlighted in Theme 1.**

Among those migrating to higher yielding credit, some asset owners remain more defensive than others, particularly those identified as having a more 'cautious' risk profile. They have been more selective than peers with a more adventurous risk profile and are more likely to be increasing allocations to assets such as asset-back securities (ABS) (12%) and Real Estate Lending (15%), while maintaining higher core fixed income allocations. More adventurous investors are more likely to have been utilizing the full range of alternative credit securities to increase allocations to less liquid sub-asset classes in greater numbers: direct lending (26%), high yield debt (24%) and emerging market (EM) Debt (29%).

Investors reacted to concerns about the end of the cycle in different ways based on their risk tolerance, with 54% of investors identifying themselves as 'cautious' and 46% as 'adventurous'.

Some 63% of cautious investors were retrenching in core asset classes, particularly well-funded pension funds and insurers. Those experiencing greater pressures on returns were increasing yield through lowering credit requirements, especially North American insurers.

US investors were selling out of high yield, motivated by concerns over rich valuations and being late cycle. Non-US investors, hungry for yield and attracted by the strengthening dollar, increased their allocations.



Both cautious and less risk-averse investors were reaching for alternatives. Lower-risk investors were boosting asset-backed lending, such as real estate debt (RE debt) and ABS, as they offer diversification and low correlations with US Treasuries. For the more adventurous, sub-asset classes such as distressed lending offered enhanced yields.

Emerging Asia is the place to be – a third of investors have increased allocations over the past three years. We address this trend in depth in Theme 4.

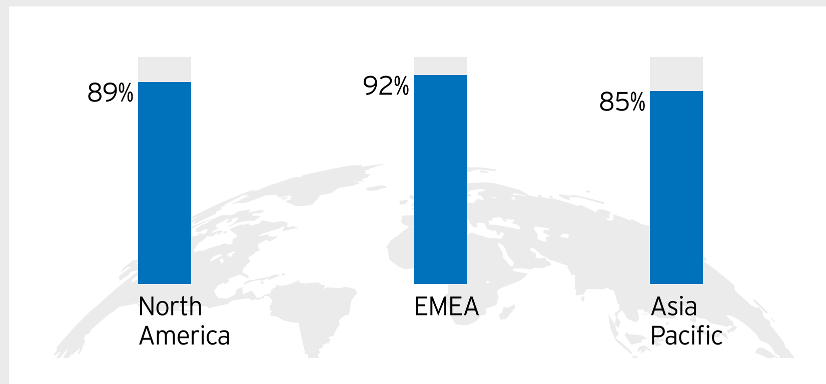
## Yield is a driving force. Most investors have moved past the point where they can continue to ride out low yields.

Low and long is influencing allocation decisions for almost all asset owners with capital to deploy (**Figure 2.1**).

Since our first Study was published in 2018, the trend has been to allocate towards alternative sub-asset classes: those with the highest yields have grown the most – notably EMD and HY (**Figures 2.2 and 2.3**). But the trend has been across the alternatives spectrum.

The background for this has become increasingly polarized. On the one hand, investors saw asset prices reach staggering levels, made more dramatic by a rate cut that boosted returns on longer duration portfolios, and leaving many sitting on tidy profits for 2019. On the other, yields remained stubbornly low throughout the year, despite a rapidly changing environment that saw a potential trade war, several near-conflicts, and the winding down of some monetary stimulus programmes.

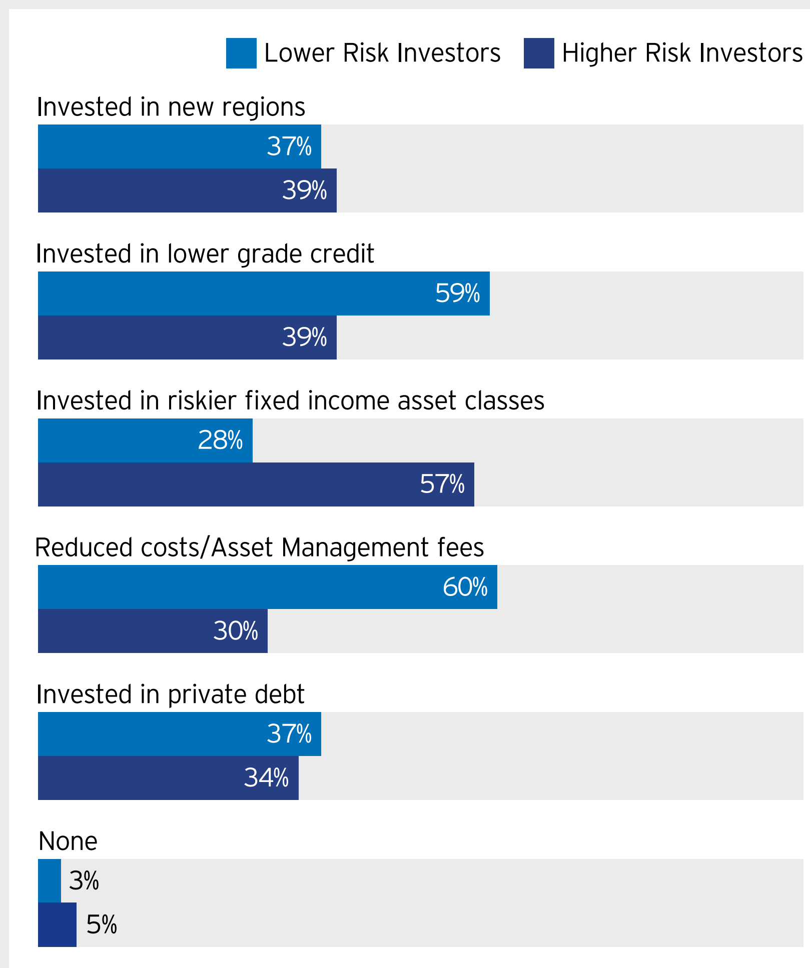
Figure 2.1
**Low yields influencing asset allocation (% citations, global)**




Which of the following are influencing asset allocation decisions within your fixed income portfolio?

Sample size: North America = 53 EMEA = 59, Asia Pacific = 39

Figure 2.2
**Response to low yields by risk segment (% citations, global)**




Over the past three years have you done any of the following to respond to low yields?

Sample size: 134

Figure 2.3
**Allocation to sub-asset classes (average %, global)**

What is the current allocation between asset classes within your fixed income portfolio?

Sample size: 2019 = 85, 2020 = 104

"The low interest rate environment means we have included more alternative fixed income."

Insurer, APAC

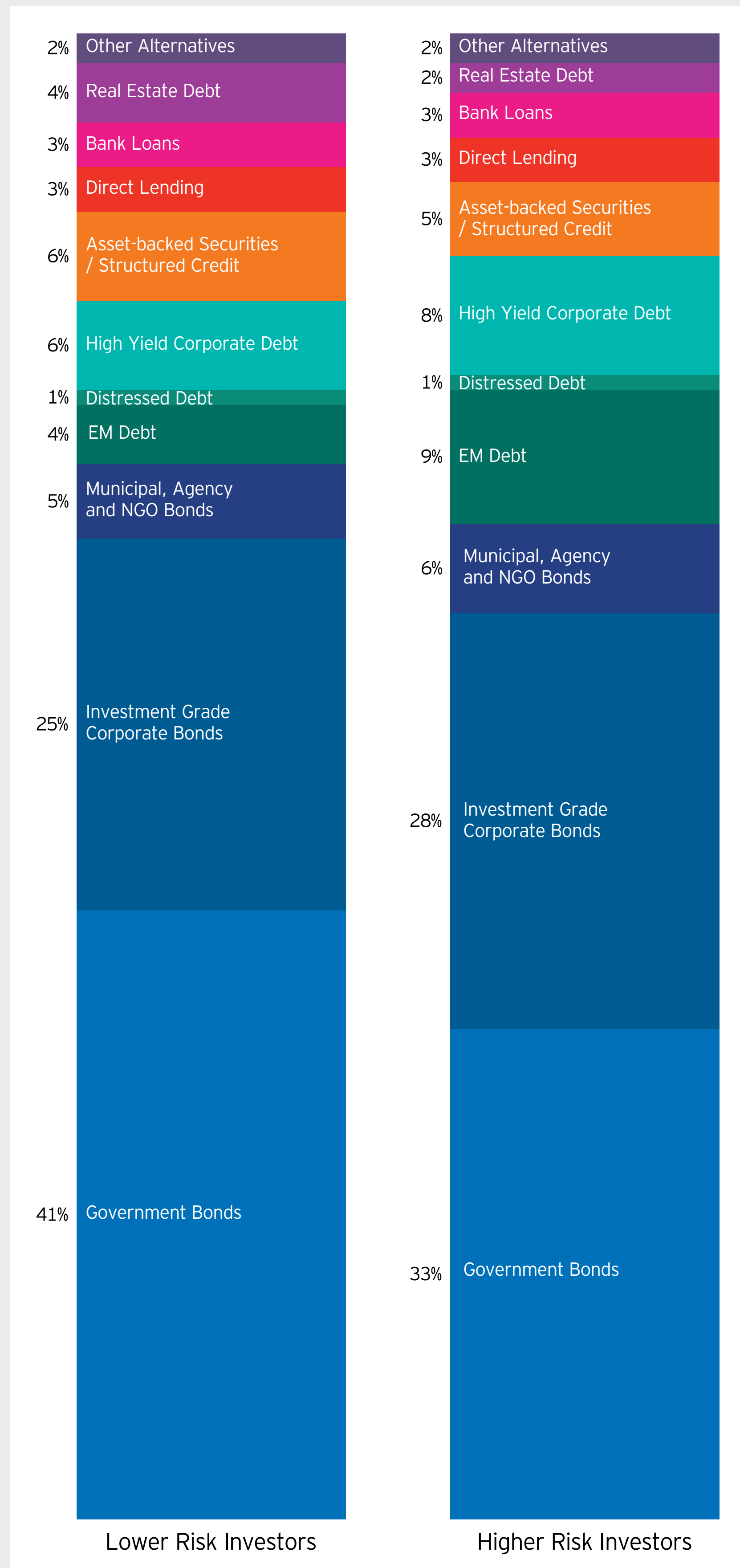
## Breaking up: cautious and adventurous investors diverge, with active management high on the agenda

Investors have responded to this situation in an increasingly polarized – or at least, divergent – fashion. While there will always be a distinction between cautious and adventurous investors, the difference in their approach to fixed income investing is becoming more pronounced.

We identified this by allowing investors to self-score their risk appetite and then validated this against observed behaviors, which produced two relatively cohesive and well-defined risk-appetite groups (**Figure 2.4**). Some 54% of respondents identified as 'cautious' and 46% as 'adventurous'. Interestingly, this division cuts relatively evenly across segment, region and size, although underfunded pension funds and insurers are slightly more likely to be 'adventurous'.

While there will always be a distinction between cautious and adventurous investors, the difference in their approach to fixed income investing is becoming more pronounced.

Figure 2.4
**Allocation to sub-asset classes by risk segment (average %, global)**




What is the current allocation between asset classes within your fixed income portfolio?

Sample size: 138

We run through the characteristics and allocations of the two groups below:

## Risk-averse investors

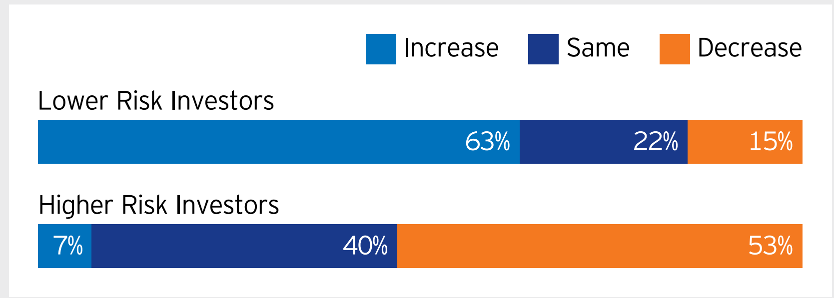
Many in this group have spent the past three years winding down their exposure to alternatives (63%), with government bonds the most attractive replacement (**Figure 2.5**).

A fifth expected to continue allocations to government bonds, although with spreads exceptionally low in US Treasuries and other core sovereign bonds, 26% were also looking to increase investment grade corporates as well.

Liquidity was a major concern for 63% of these investors – although this concern was shared across the risk profiles (**Figure 2.7**). It remains a core issue for investors, and one we explore more thoroughly in Theme 3.

Figure 2.5

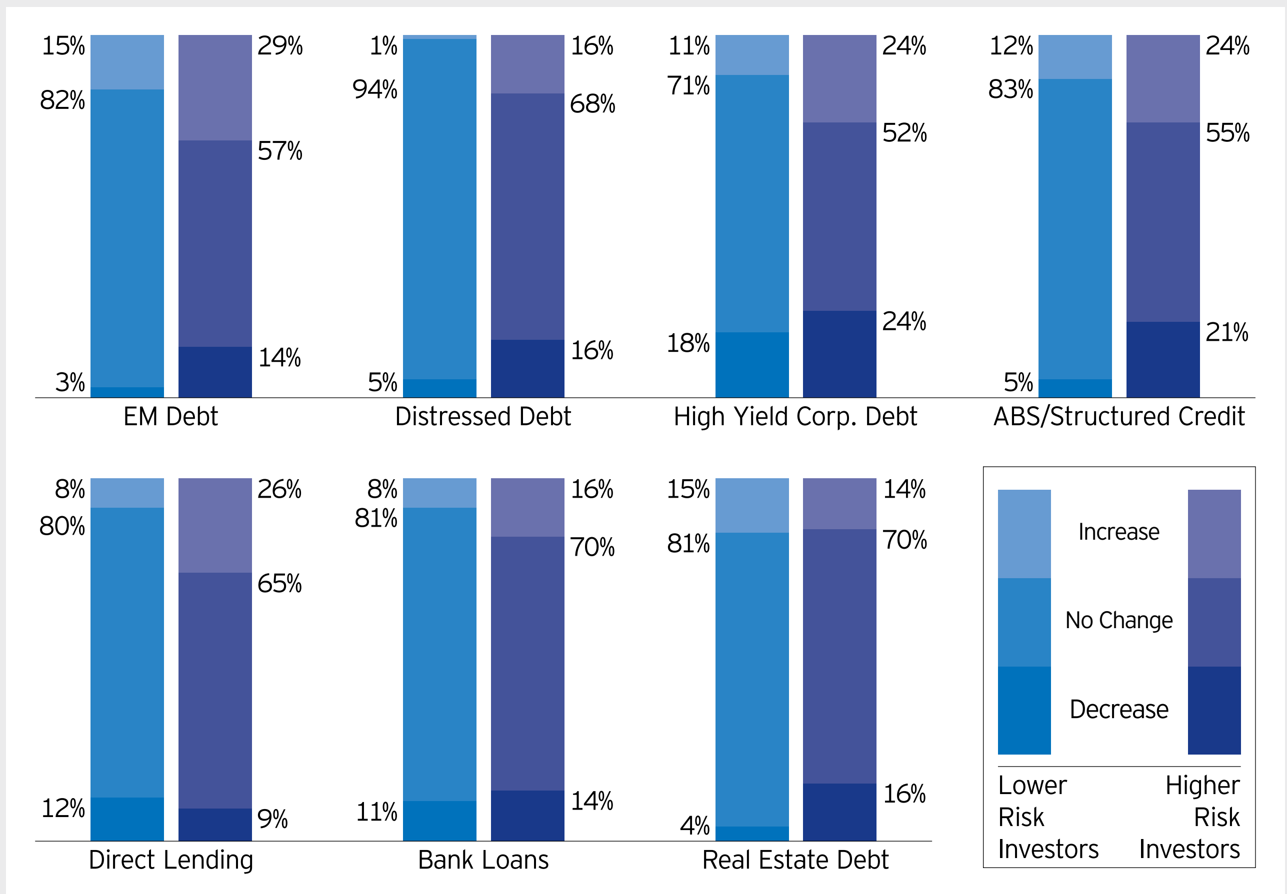
**Changes in allocation to core fixed income (vs alternative) by risk segment (% citations, global)**




How has this allocation changed over the past three years? Sample size: 110

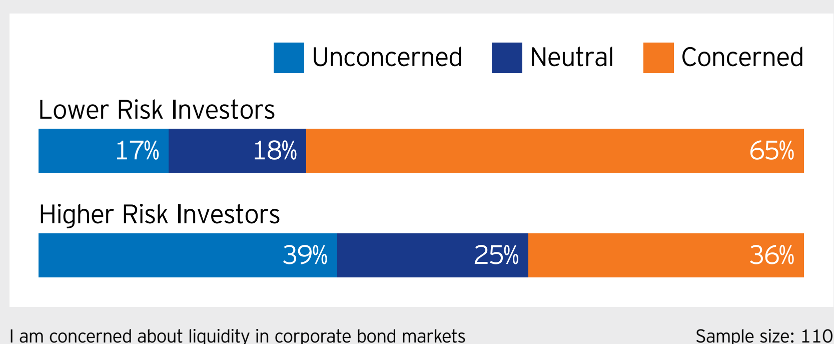
Figure 2.6

**Planned change in allocations to alternative FI in next three years by risk segment (% citations, global)**




How will this allocation change over the next three years? Sample size: 138

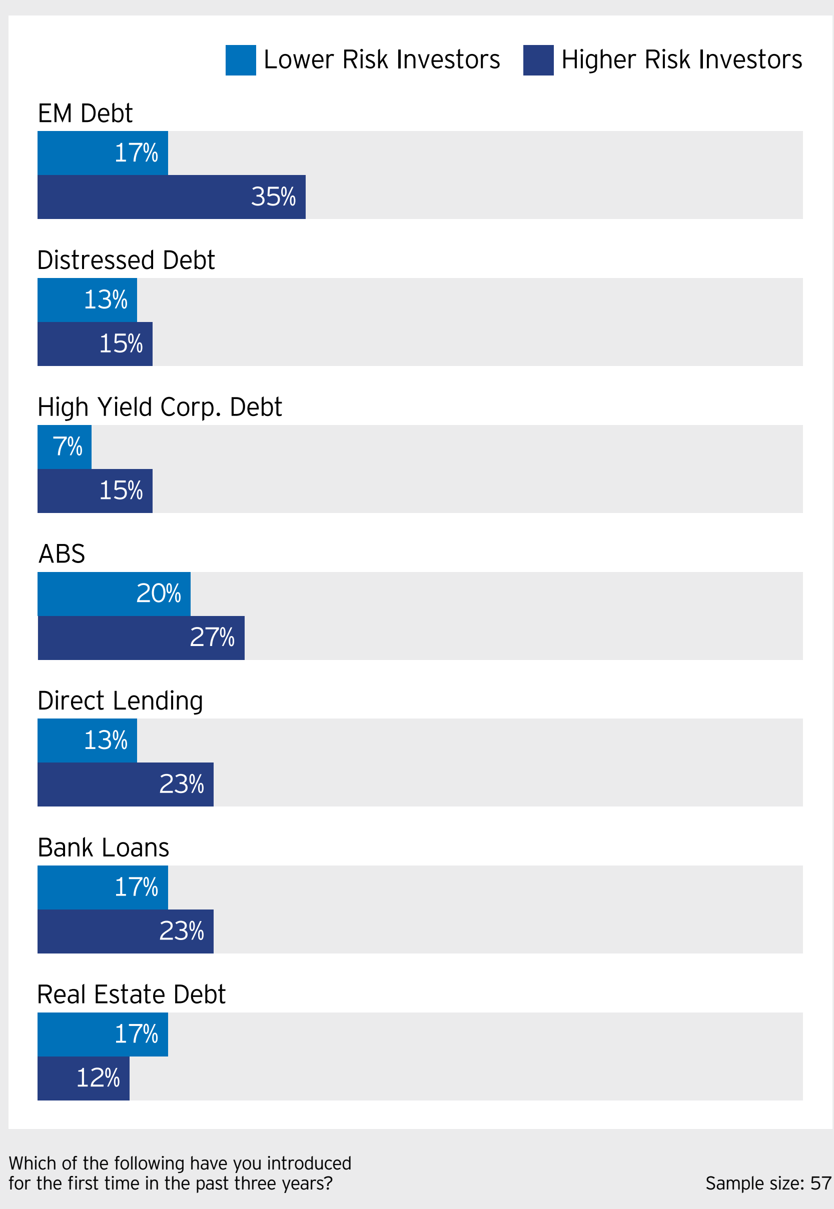
Figure 2.7
**Concern about liquidity by risk segment (% citations, global)**




I am concerned about liquidity in corporate bond markets

Sample size: 110

Figure 2.8
**New sub-asset classes introduced in past three years by risk segment (% citations, those introducing new asset classes)**




Which of the following have you introduced for the first time in the past three years?

Sample size: 57

As a result, many are increasing the active management of their bond portfolios as a means to navigate uncertainty. 49% of 'cautious' investors reported plans to increase allocations to active management over the next two years (compared to 15% of 'adventurous' investors), with one representative of a lower-risk DB pension in the US explaining: "Our international team, which considered a passive mandate, didn't do so after studying the market." This move to active management is likely to be spurred on by the uncertainty arising from the COVID-19 pandemic and is taking place from an already high base, with investors typically allocating 84% of their fixed income portfolios to active management.

## Adventurous investors

These investors describe themselves as able to bear more risk, either because they have longer time horizons (such as sovereigns), or because they are under significant pressure to make returns.

They face a quandary: while liquidity is still a concern, they are increasing and introducing allocations to less liquid sub-asset classes – if somewhat reluctantly at times (**Figure 2.8**). "We have introduced distressed debt, but generally prefer more liquid solutions," explained one North American Asset Consultant who identified as 'adventurous'.

Some 26% have increased allocations to direct lending, 24% to high yield credit, and 29% to EM Debt (**Figure 2.6**). For these investments, while the upside might be significant (e.g. from a strong US dollar when investing in US dollar-denominated EMD), there is significant risk as well – only palatable given the faith in low inflation and bond market stability, the latter being thoroughly tested in the months following the survey.

Given regulatory limits, insurers have found it particularly difficult to maintain target returns. The answer, for 57% of them, has been to diversify into highly rated tranches of 'riskier' debt, particularly direct lending and bank loans – sub-asset classes that require significant management and capability (e.g. systems and reporting). In the US, many insurers have also lowered credit ratings in order to meet return targets.

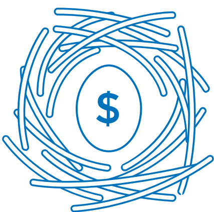
## Nowhere else to go: all roads lead to alternative fixed income

While investors are diverging along risk-tolerance lines, both groups are making increasing use of alternatives within fixed income. The specific instruments, and what they're being used for, differ widely however. Only 42% of investors have broadened the investment landscape as their central approach to dealing with low yields – these investors are often mid-size, following their larger peers as they upgrade capability. Others are finding other uses for the asset class:

Asset-backed securities (ABS) have been introduced by 31% of **wholesale** investors, as even 'low risk' portfolios are pushed up the risk curve to avoid guaranteed losses resulting from negative rates on cash deposits in some regions. Many clients were being pushed to take more risk in order to realize real return.

For **insurers**, bank loans and direct lending offer a chance to gain additional long-term yield through an illiquidity premium, while also exerting control and remaining within solvency limits. For risk-averse insurers, RE debt has proven to be an attractive means to boost yields without taking on too much additional risk, due to the relative ease of recovery.

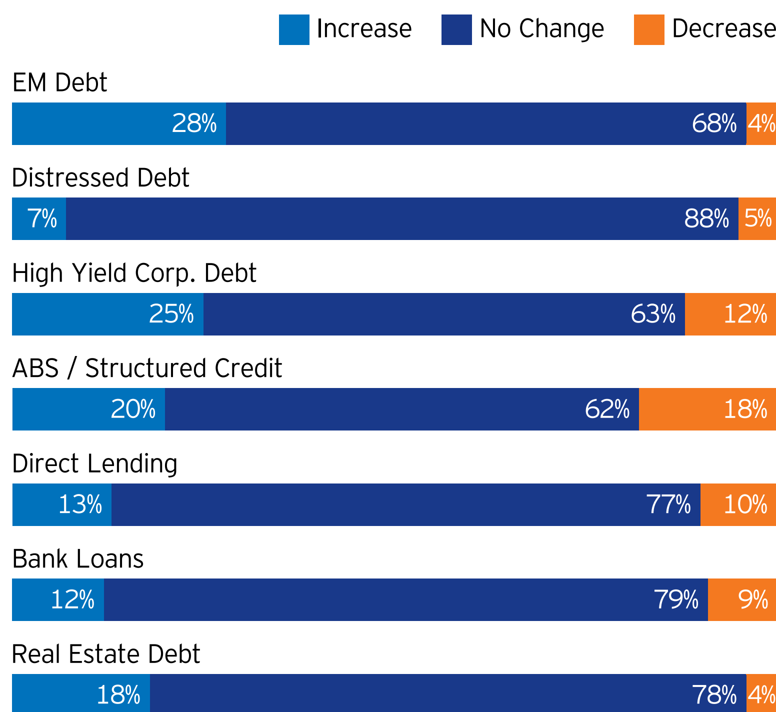
In North America, fixed income has performed well for **DC plans**, yet in Europe and APAC, low returns prompted investors to boost allocations to ABS, as well as the HY referred to above, as plans moved to boost returns.



**DB pension** funds were also looking to boost allocations to HY corporate debt, especially if coverage ratios had declined as a result of inadequate hedging.

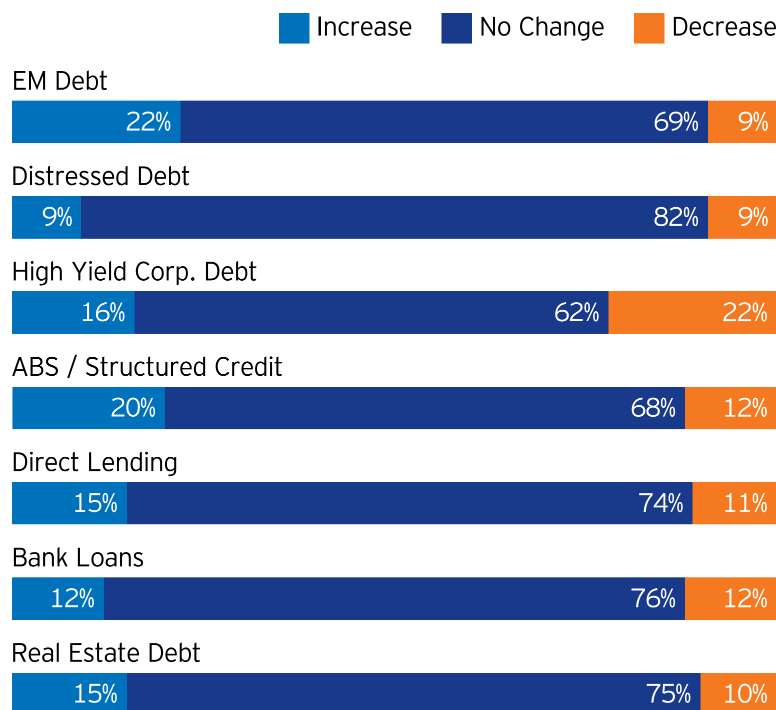
Figure 2.9
**Change in allocations to fixed income sub-asset classes (% citations, global)**

**Past three years**




How has this allocation changed over the past three years? Sample size: 138

**Next three years**




How do you expect this allocation to change in the next three years? Sample size: 138

## High yield trade winds: what the US sells, the rest are buying

A quarter of investors have increased allocations to HY Debt over the past three years (**Figure 2.9**), a strategy that has generally proved effective as USD HY has made an annualized return of 7.2% since 2005[4], topped only by US dollar-denominated EMD[5].

Those with greater appetites for risk, or greater need for yield, were staying in and increasing allocations to alternatives – 29% of investors fall into this group. The demand for USD HY was especially prevalent in EMEA and APAC, propelled by the need to generate some return. Under-funded pension schemes are especially prominent in this cohort. Years of low yields have impaired funding levels and hedging, meaning that there is little room for manoeuvre – especially in EMEA. However, it's worth noting that whereas HY had seen the second-largest increase over the past three years, with 25% of investors indicating an increased allocation, it was top of investors' list to reduce exposure over the next three (**Figure 2.9**).

[4] JP Morgan US Aggregate Credit Corporate High Yield Index

[5] JP Morgan EMBIG Diversified Index

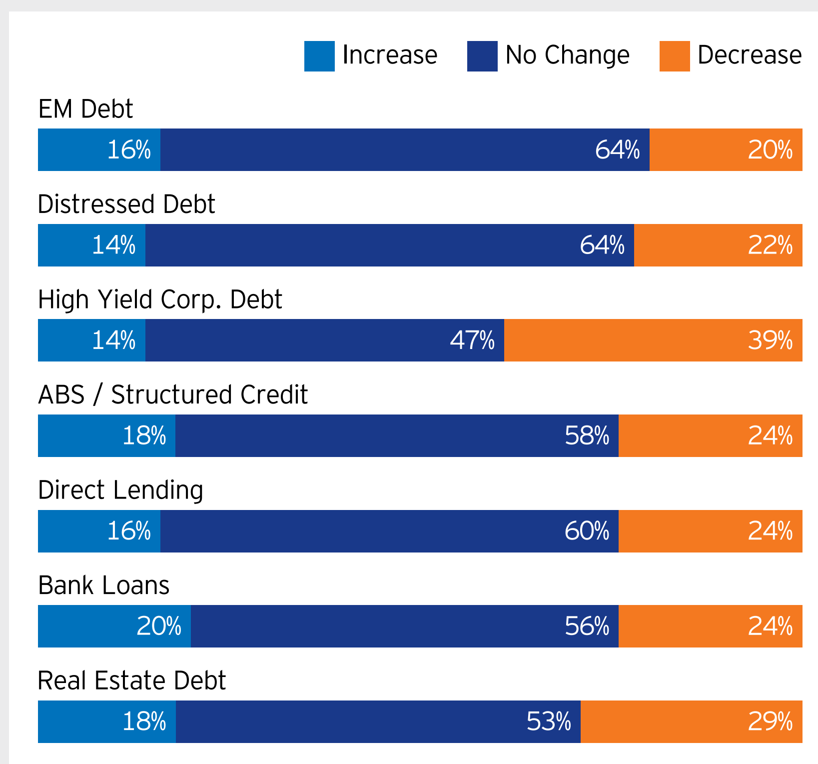
If EMEA investors were eager buyers – or even reluctant but yield-hungry ones – they seemed to be finding willing sellers within the US, where investors were reducing their exposure to risk in preparation for the end of the cycle.

If EMEA investors were eager buyers – or even reluctant but yield-hungry ones – they seemed to be finding willing sellers within the US, where investors were reducing their exposure to risk in preparation for the end of the cycle.

There was a big shift away from HY positions in the US (**Figure 2.10**), with the rediscovery of a deep faith in more secure bonds such as US Treasuries. Last February, "We got out of bank loans entirely, reduced high-yield exposure and swapped it for investment grade floaters," said one North American wholesaler. Similarly, a DB pension representative noted that they had sold their entire HY strategy.

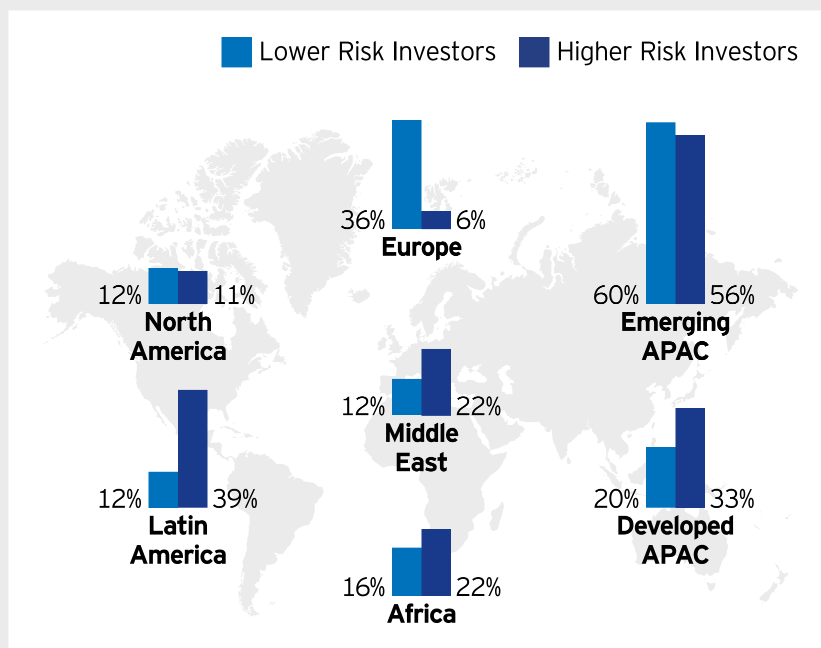
With spreads very tight, and pricing very high, such investors believed that they were not being well compensated for the risk they were taking. Increasingly these niche, less-liquid markets were proving cause for concern – and not only for US investors. 51% of investors globally expressed concern about the liquidity of corporate bond markets. These concerns have been significantly elevated by the market instability seen in early 2020 resulting from the COVID-19 pandemic.

Figure 2.10
**Planned change in allocations to fixed income sub-asset classes in next three years (% citations, North America)**



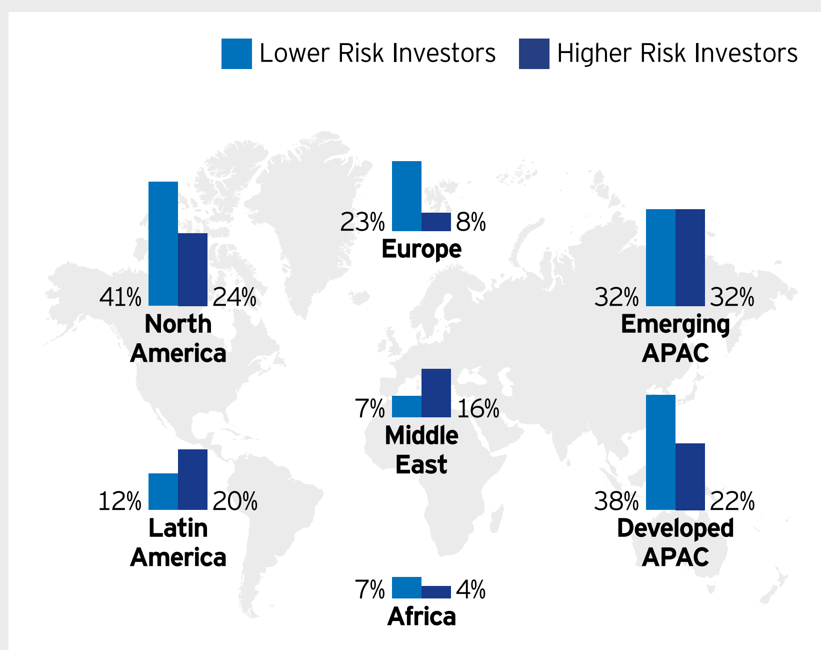

How do you expect this allocation to change in the next three years? Sample size 49

Figure 2.11
**Allocations to new regions by risk segment**[6]
**(% citations, those investing in new regions)**




In which of the following regions have you made new allocations? Sample size: 43

Figure 2.12
**Increase in allocation to regions by risk segment**
**(% citations, past three years)**




For each region how has this changed over the past 12 months? Sample size: 124

## Opportunities in the East: new regions for difficult times

Increased ease of access, growing index inclusion and greater awareness have driven increased interest in investing in Asia over the past few years. Low yields have accelerated this trend, making traditionally niche markets much more attractive to more adventurous investors. Whereas traditionally an EM mandate was a specialized and niche proposition, 39% of higher-risk investors who were making allocations to new regions said they were increasing allocations to Latin America, and over a fifth to Africa. (**Figure 2.11**) We will take a deeper dive into how and why this is being executed in Theme 4.

However, for more risk-averse investors, the trend has been to go the other way. Concerned by liquidity, these investors were retreating to the relative safety of deep and broad capital markets in the US (**Figure 2.12**). This is especially true in APAC, where 42% of investors had already boosted North American allocations.

[6] MSCI Definitions: Developed APAC = Australia, Hong Kong, Japan, New Zealand, Singapore; Emerging APAC = All other Asia including China, Taiwan, India, Korea, Indonesia

# New approaches help to address a bond market liquidity paradox

**Asset owners were extending allocations to illiquid asset classes late in the cycle.**

Yet the majority (51%) expressed concern around bond market liquidity, uncertain how bond markets would behave during more challenging periods with the introduction of regulations such as Dodd-Frank and the retrenchment of traditional market makers that followed the GFC. The response in part has been increased interest in strategies that can help improve liquidity and reduce market risk, such as block trading directly between customers via ETFs (used by 59% of investors), credit portfolio trading (used by 30%) and wider adoption (56%) of fixed maturity strategies.

Even as investors highlighted liquidity as one of their biggest concerns, many continued to make late-cycle bets for return by increasing allocations to more illiquid securities.

Fixed income markets have evolved significantly since the GFC, shaped in part by the retrenchment of traditional market makers and the rise of block trading directly between customers via ETFs and credit portfolio trading (CPT), and wider adoption of fixed maturity investing strategies.

Some 59% of investors use fixed income ETFs. They are valued for providing liquidity alongside the convenience of instant diversification. This is facilitating a range of new strategies, with just under 40% of investors using ETFs for tactical trading.

Credit portfolio trading is used by 30% of respondents, rising to 42% for the largest investors. This approach is valued for the ability to reduce market risk exposure and improve liquidity in harder-to-target parts of the market.

Investors see fixed maturity strategies as a good way of harnessing additional illiquidity premiums as well as reducing costs and generating more predictable returns. Some 56% of investors are using this approach, which accounts for around 40% of the portfolios of these investors.

**Despite concern around the looming end of the cycle, many investors had increased allocations to riskier and more illiquid asset classes.**

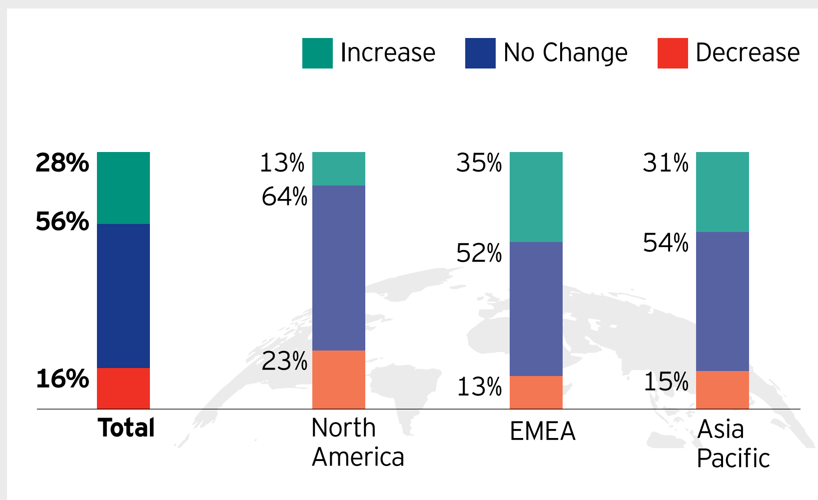
This put them in a potentially precarious situation, as many were painfully aware: "We are moving up the risk spectrum. However, we have concerns about liquidity risk as we are moving into more esoteric parts of the market" said one EMEA insurer.

This looked set to continue – over the next three years, 28% of investors planned to increase their allocations to alternative fixed income asset classes, led by Asia Pacific (31%) and EMEA (35%) (**Figure 3.1**). Only in North America were there signs of a retrenchment, with just 13% increasing compared to 23% planning a reduction. Many investors were therefore continuing to make late cycle bets for return and, in some cases, to close widening liability funding gaps.

At the same time, investors across all segments highlighted liquidity in fixed income markets as one of their biggest concerns (**Figure 3.2**). This paradox is explained by the very nature of liquidity, with it prone to disappear at times when it's most needed. In times of crisis, liquidity often dries up quickly and leaves investors holding securities in a rapidly shrinking price window, unable to exit their positions and subsequently being hit by outsized losses.

"We are concerned about liquidity in high yield bonds, as these are not marked-to-market daily. It is deceptive for investors that care about daily prices," reported one EMEA insurer.

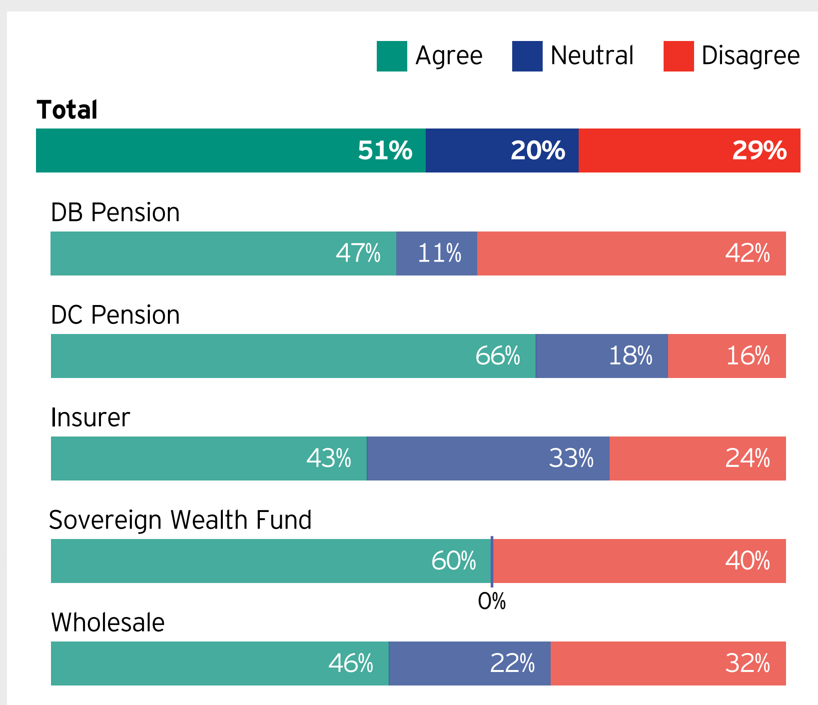
Figure 3.1
**Change in allocation to alternative fixed income (vs core fixed income) in next three years (% citations, global)**




How has this allocation changed over the past three years?
How do you expect this allocation to change in the next three years?

Sample size: North America = 30
EMEA = 54, Asia Pacific = 26

Figure 3.2
**Concerned about liquidity (% citations, global)**



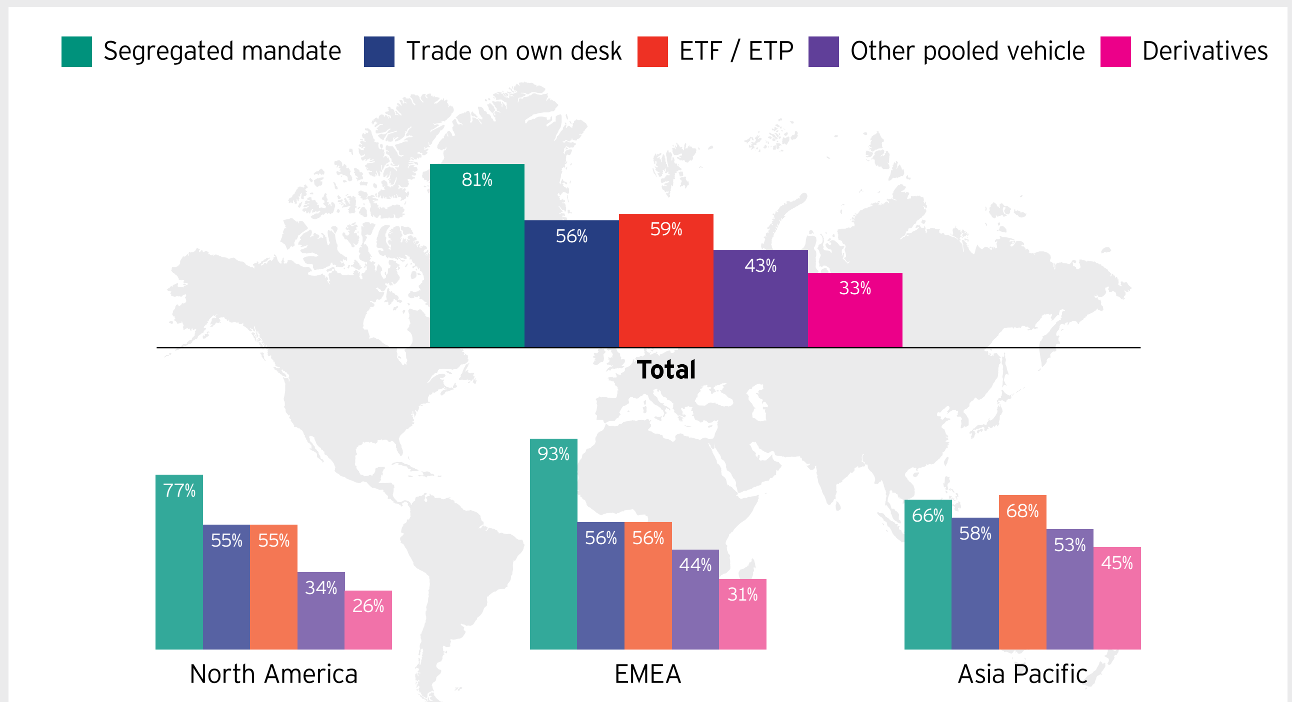

To what extent do you agree with the following statements?

Sample size: Total = 152, DB Pension = 38
DC Pension = 32, Insurer = 37, SWF = 5, Wholesale = 37

"We are moving up the risk spectrum. However, we have concerns about liquidity risk as we are moving into more esoteric parts of the market" said one EMEA insurer.

> “We are concerned about liquidity in high yield bonds, as these are not marked-to-market daily. It is deceptive for investors that care about daily prices,” reported one EMEA insurer.

Figure 3.3
**Vehicles used in fixed income (% citations)**

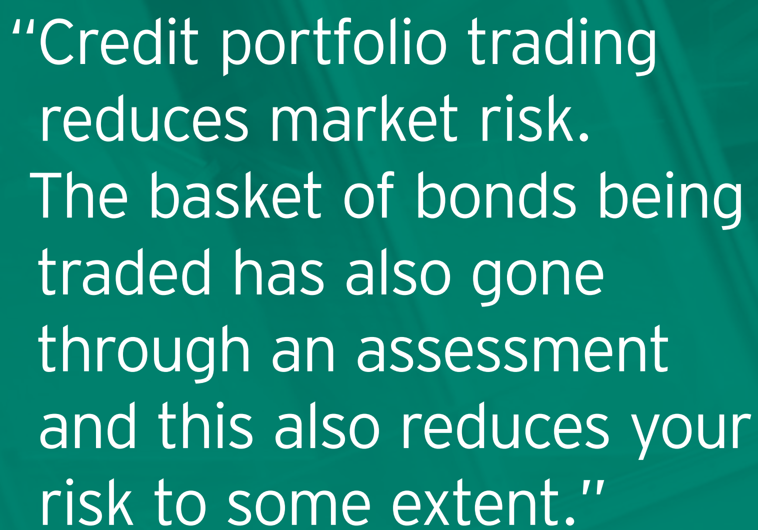



Which vehicles do you use in your fixed income portfolio?

Sample size: Total = 152, North America = 53, EMEA = 61, Asia Pacific = 38

Such concerns around liquidity are ubiquitous, with the radical reshaping of the market since the global financial crisis (GFC) leaving investors questioning whether markets are now more or less exposed to liquidity risk than they have been in the past. The answers to some of these questions will have been provided by the testing conditions of the first few months of 2020, with economic fallout from the COVID-19 pandemic and resulting surge in volatility putting the new model of liquidity to perhaps the ultimate test.

Since the GFC, regulations such as Dodd-Frank have been introduced to reduce the risk of systemic bank collapses. These have increased reserve requirements and led to banks holding reduced amounts of marketable securities on their balance sheets. In turn, this has limited their traditional market-making role and has had a negative impact on their ability to provide liquidity. Fixed income markets have been reshaped as a result, with much of the slack picked up by customer-to-customer platforms managed through intermediaries. By facilitating the trading directly between customers, this model has helped bring down spreads and reduce costs. Volatility in the opening months of 2020 is proving the first serious test of this model, and the ecosystem of products and trading strategies within it.



"Credit portfolio trading reduces market risk. The basket of bonds being traded has also gone through an assessment and this also reduces your risk to some extent."

Insurer, APAC

## Of liquidity and convenience: fixed income ETFs find favor

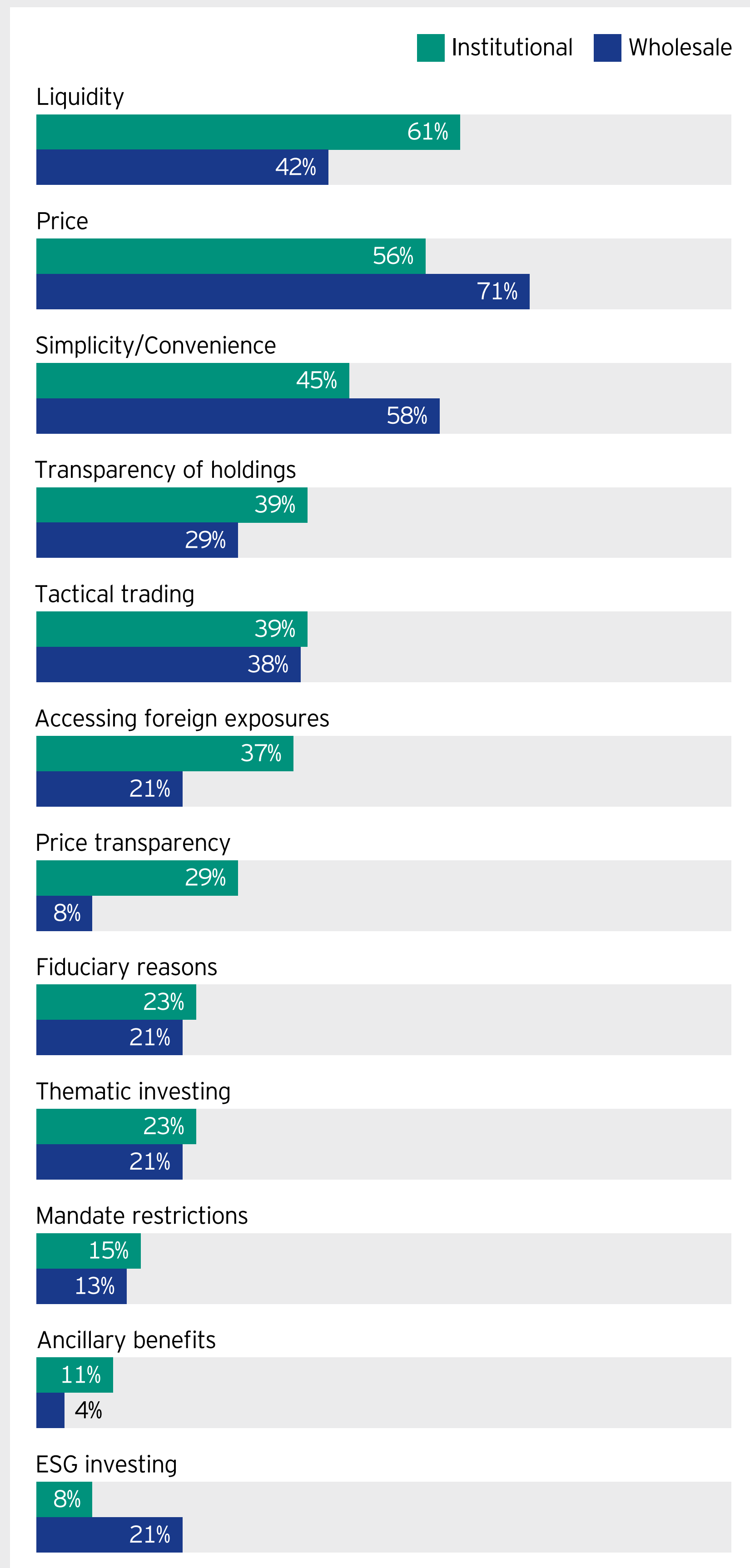
This transformation has been aided by the development of exchange traded funds (ETF). ETFs within fixed income are now widely used across the sample, with 59% of respondents employing them in their portfolios (**Figure 3.3**). Providing immediate exposure to a basket of bonds, ETFs are valued for offering liquidity alongside the convenience of instant diversification at relatively low cost (**Figure 3.4**). ETFs enable investors to quickly target a diverse range of interest-rate and credit risks, facilitating a range of new strategies, with just under 40% of investors using ETFs for tactical trading.

In the face of volatility arising from the COVID-19 pandemic, this liquidity is being tested – with questions arising over the difference between the liquidity of these instruments, compared to the relative illiquidity of their individual constituents. Volatile conditions have led to regular price discounts between fixed income ETFs and their component securities. However, by facilitating continued trading during a period of significant uncertainty, ETFs have acted as a key source of price discovery in markets that might have otherwise entirely seized up.

ETFs within fixed income are now widely used across the sample, with 59% of respondents employing them in their portfolios (Figure 3.3).

Figure 3.4

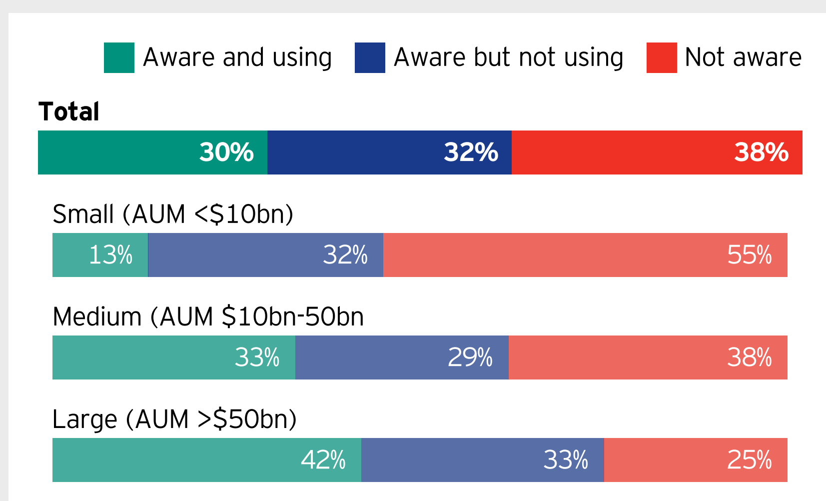
**Reasons for using ETFs (% citations, global)**




Why do you use ETFs?

Sample size: Institutional = 62, Wholesale = 24

Figure 3.5
**Use of credit portfolio trading (% citations, global)**




Are you aware of credit portfolio trading and do you currently use it?

Sample size: Small = 38 Medium = 40, Large = 48

"Credit portfolio trading reduces market risk. The basket of bonds being traded has also gone through an assessment and this also reduces your risk to some extent," explained one APAC insurer.

## Credit portfolio trading offers large investors more liquidity with less risk

Innovations around algorithmic third-party pricing developed to price fixed income ETFs have also been pivotal in the development of credit portfolio trading (CPT).

By facilitating the sale of a bespoke basket of securities between two counterparties, CPT has quickly found a role among fixed income investors, particularly among larger asset owners, with 42% of investors with assets of more than $50 billion making use of this approach (**Figure 3.5**).

"Trading in this way reduces market risk. The basket of bonds being traded has also gone through an assessment and this also reduces your risk to some extent," explained one APAC insurer.

By giving investors a lower cost and more efficient way of making very large trades, and to move quickly in and out of more exotic parts of the market, credit portfolio trading is seen as valuable for reducing market risk exposure and improving liquidity (**Figure 3.6**).

Figure 3.6
**Advantages of credit portfolio trading (% citations, global)**

**37%**
Reducing market risk exposure

**30%**
Accessing increased liquidity in illiquid securities

**16%**
Improved best execution

**13%**
Match an index or strategy more quickly/accurately

**4%**
Reduced visibility of own market activity

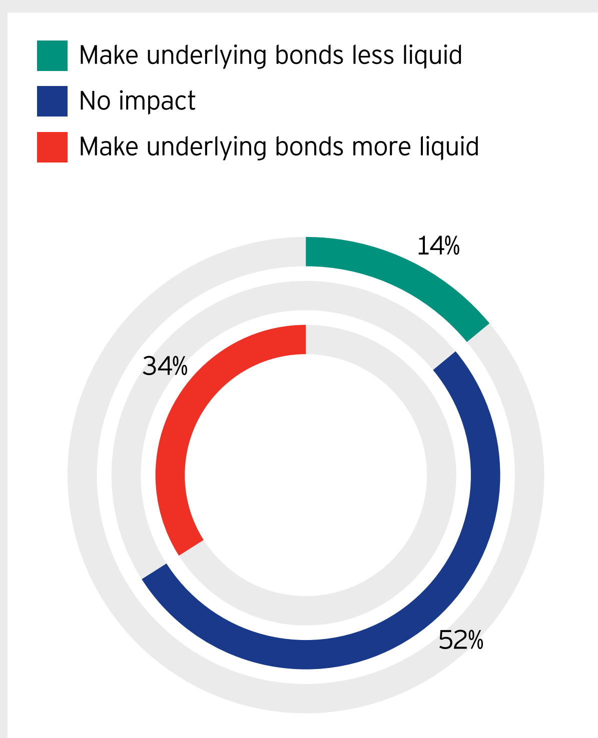
What do you see as the main advantages?

Sample size: 67

## ETFs, CPT and liquidity: fears vs experience

Both ETFs and CPT have provided additional liquidity and made previously harder to access parts of the market available to a wider range of investors. For example, they are valuable instruments when making smaller allocations to sub-asset classes such as China's debt markets, making it possible to gain access much more easily than setting up an account with the People's Bank of China. One DB pension representative in APAC stated: "We found value in using ETFs where traditional investing would have had too much of an exhaustive impact on resources."

Figure 3.7
**Impact of ETFs on underlying bond markets (% citations, global)**




Do you think ETFs make the bond markets more or less liquid?

Sample size: 134

"We found value in using ETFs where traditional investing would have had too much of an exhaustive impact on resources." DB pension plan, APAC

Despite growing use, there continues to be occasionally sensationalist media coverage around the disconnect between the pricing of ETFs and their underlying securities, as well as the reduced trading in underlying bond markets when compared with before the GFC.

As many bonds trade infrequently, the price of underlying securities within an ETF is generally set by third-party pricing services rather than actual trades. This has led to suggestions that the liquidity provided by these instruments may change during tougher periods, with one APAC wholesaler stating: "They dry up liquidity in bad times and provide too much in good times – that's why I don't like them."

However, there is a strong argument that these innovations have fundamentally improved liquidity. While they have not eliminated the liquidity risk that has previously plagued fixed income markets during times of distress, they have facilitated continued trading during the very challenging conditions arising from the COVID-19 pandemic. This can be attributed to several advantages stemming from this model:

- By opening up fixed income markets to a wider range of investors, ETFs and credit portfolio trading have increased demand and hence the number of market participants.
- By establishing a way to provide real-time pricing in thinly traded markets, these innovations have created a way to maintain liquidity during more challenging periods when trading is reduced and pricing becomes harder.
- By reducing the reliance on market makers in the forms of banks holding inventory on their books, these tools have left markets less vulnerable to a handful of actors withdrawing from trading and creating a spiral towards complete illiquidity, such as during the GFC.

One EMEA DB pension representative commented positively on their "ability to track pricing that helps us with daily portfolio snapshots" in this context.

Such positive liquidity effects are generally supported by recent experience (at least to date). Many survey respondents shared this view, with 34% seeing ETFs as improving liquidity in underlying bonds and only 14% regarding them as having a negative impact (**Figure 3.7**).

## Investors target liquidity premiums with fixed maturity strategies

Buying and holding securities until maturity offers another route to alleviate liquidity concerns. Such fixed maturity strategies are popular, with 56% of investors using them, including 72% of DC pensions and 66% of insurers (**Figure 3.8**). For those investors with a fixed maturity allocation, they account for an average of 40% of fixed income portfolios, rising to 47% for insurers (**Figure 3.9**).

Figure 3.8
**Use of fixed maturity strategies (% citations, global)**

| | |
|---|---|
| 56% | **Total** |
| 57% | DB Pension |
| 72% | DC Pension |
| 66% | Insurer |
| 57% | Sovereign Wealth Fund |
| 36% | Wholesale |

Do you currently use Fixed Maturity/Buy and Maintain strategies?

Sample size: Total = 142
DB Pension = 35, DC Pension = 25
Insurer = 35, SWF = 7, Wholesale = 36

Figure 3.9
**Average allocation to fixed maturity strategies if used (% of fixed income portfolio, global)**

| | |
|---|---|
| 40% | **Total** |
| 42% | DB Pension |
| 37% | DC Pension |
| 47% | Insurer |
| 23% | Sovereign Wealth Fund |
| 33% | Wholesale |

What proportion of your fixed income portfolio is in Fixed Maturity/Buy and Maintain strategies?

Sample size: Total = 74
DB Pension = 18, DC Pension = 18
Insurer = 21, SWF = 3, Wholesale = 13

This popularity can in part be linked to the additional returns on offer – liquidity premiums are seen as one of the key drivers of alpha within fixed income (**Figure 3.10**). Buying longer-dated securities and holding them until maturity allows investors to take full advantage of these market inefficiencies. "We are too large to change allocations frequently. This strategy is also attractive because the securities are not mark-to-market and you benefit from illiquidity premiums," reported one APAC insurer, half of whose fixed income portfolio was in such instruments.

However, this is not the only benefit, with fixed maturity strategies also valued for reducing costs, controlling interest rate risk and delivering predictable returns (**Figure 3.11**). "Costs are low and minimum returns can be forecasted. For managing credit, it can be expensive to trade due to liquidity concerns, so buy and maintain is a way to address this," stated one APAC sovereign wealth fund.

For the same reason, fixed maturity strategies often play an important role for insurers and DB pensions looking to match specific liabilities.

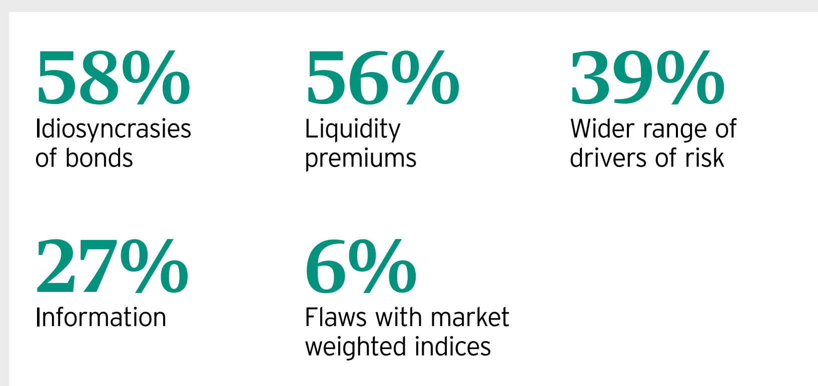
For wholesalers, the use of fixed maturity strategies is less prevalent than among institutional investors (**Figure 3.8**). However, zero or negative yields on cash deposits in some regions, alongside the recent volatility in fixed income asset prices, have led to increased consideration of their merits and the development of new client products built around this approach. Short-term fixed maturity strategies often match well with the time horizons of clients and are sometimes seen as a good substitution for cash, given the predictable nature of returns.

### Credit Portfolio Trading: An Explainer

Credit portfolio trading (CPT) is essentially the practice of trading a basket of corporate bonds simultaneously with one counterparty, either at an average basket price/yield or with a price/yield for each bond. It enables parties to transfer diversified corporate bond risk more quickly and efficiently than in the past. In CPT, an investment manager shows a list of bonds to a broker-dealer and requests a quote to either buy or sell those securities. The dealer then engages its dedicated CPT trading professionals to place live quotes on the securities in the basket. The CPT desk sources prices and liquidity from its own bond desk, the dealer's ETF desk or other dealers. CPT currently only exists at a handful of larger dealers with active ETF desks and specialists. The dealer distributes risk among its desks, allowing the investment manager to receive improved liquidity and pricing.

When prompted for a CPT quote, a dealer utilizes new technologies to price the securities quickly and return a live, executable quote on the basket within about 30 minutes. A CPT trade basket can be shown to one dealer or multiple dealers, which puts them in competition with one another and allows the trader to select the best price. In some cases, the dealer will not be able to price each security in the basket and this is discussed with the trader. The spirit of CPT is to execute the list as a whole, and not to "cherry pick" the best and worst quotes on the bonds. The goal of the trader is to engage in a portfolio trade that provides a lower overall execution cost than the traditional method of trading each security individually.

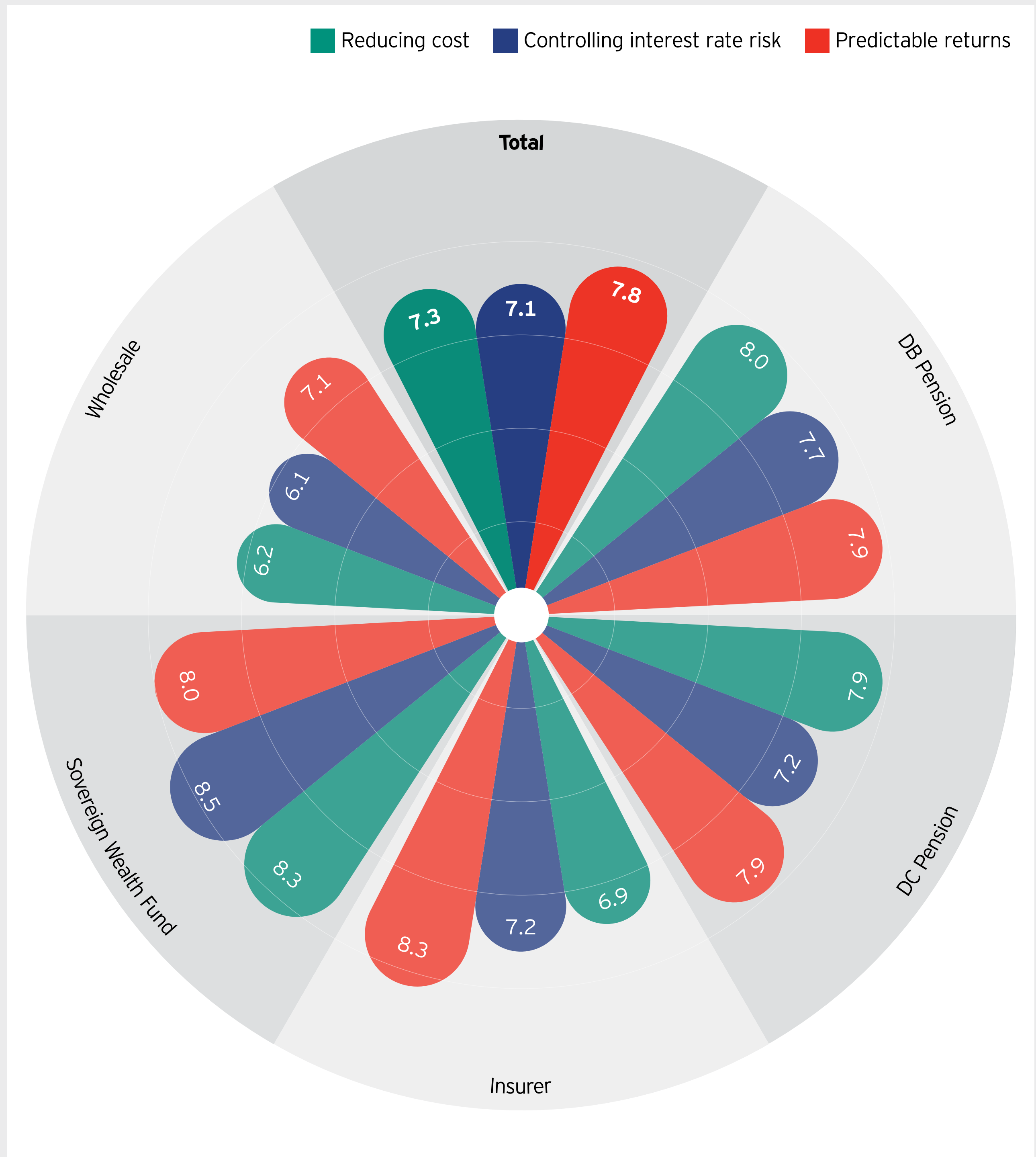
Figure 3.10
**Drivers of alpha within fixed income (% citations, global)**




Why do you think it is easier to deliver alpha in fixed income than equities? Sample size: 62

This popularity can in part be linked to the additional returns on offer – liquidity premiums are seen as one of the key drivers of alpha within fixed income (Figure 3.10). Buying longer-dated securities and holding them until maturity allows investors to take full advantage of these market inefficiencies.

Figure 3.11
**Effectiveness of fixed maturity strategies in meeting objectives (average score /10, global)**




How effective are fixed maturity strategies at achieving the following objectives? Score each 1-10 with 10 being very effective

Sample size: Total = 79, DB Pension = 20, DC Pension = 18 Insurer = 20, SWF = 3, Wholesale = 17

Theme 4

# Being picky in emerging market debt – investors abandon broad mandates for country allocations

**This year's Study finds another year of rising interest in emerging market (EM) debt.**

72% of investors now have an allocation versus the 49% observed in our 2018 Study. Specialisation is also on the rise, especially among investors attracted by returns (rather than diversification), who prefer country-specific allocations (63%). One such discrete allocation, China, is of interest to the 42% of investors that now have an allocation, emboldened by the belief that the Chinese economy and political system offers unique diversification benefits and the lowering of barriers to investment. 62% of investors believe access is less challenging than two years ago.

EM debt's strong run has generated rapidly growing allocations – from 49% of investors allocating in our 2018 Study to 72% in this year's Study. This is led by investors in APAC (89%) and EMEA (80%), in comparison to just over half of those in North America.

The highest growth has come from APAC, with EMEA increasing at a steadier rate. US investors lag, more motivated by diversification and benchmarks than their yield-driven EMEA/APAC counterparts.

Individual market allocations have replaced diversified mandates; return-seekers are increasingly likely to be making allocations to specific countries (63%). This approach is seen as requiring deep expertise with specialist teams that can access and understand each market.

The opening up of Chinese markets is attracting foreign investors. However, almost half of US investors cited market access as a major challenge. Investors are also sceptical over pricing of default risk – again, something needing local expertise.

## There has been a two-speed allocation to EM debt over recent years, with APAC investors leading the charge.

Their North American counterparts, able to rely on better domestic yields, have also moved in, but at a more measured pace. Overall, the proportion of investors allocating to EM debt has risen rapidly and very substantially, from 49% in our 2018 Study to 72% in 2020 **(Figure 4.1**)

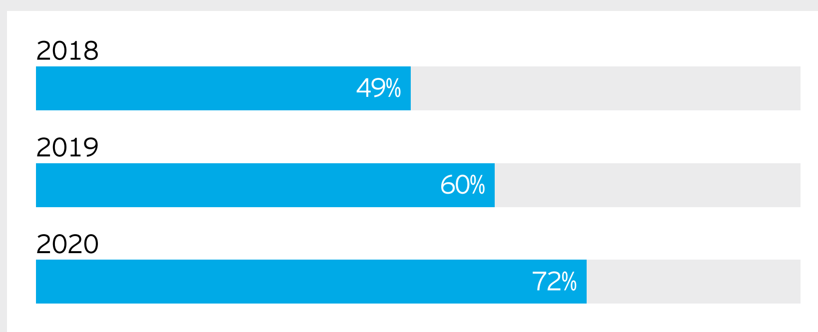
While the preference is generally for hard currency investments, significant numbers of investors in all three regions were happy to take on local currency risk. (**Figure 4.2**) Nevertheless, dollar-denominated debt outperformed local-currency EM debt, in dollar terms, at 15.04% versus 13.47% during 2019.

As well as benefitting from attractive returns and low correlations against 10-year US Treasuries (**Figure 4.3**), those making this move benefitted from emerging market central bank rate cuts, and the supply of emergency liquidity as a response to geopolitical tensions.

Adventurous investors are also looking once more at regions that have fallen out of favor. Some 39% reported making new allocations to South America, hoping to take advantage of recent political change and new opportunities, especially in Brazil. Slightly fewer reported new allocations to the Middle East.

Overall, the proportion of investors allocating to EM debt has risen rapidly and very substantially, from 49% in our 2018 Study to 72% in 2020 (Figure 4.1).

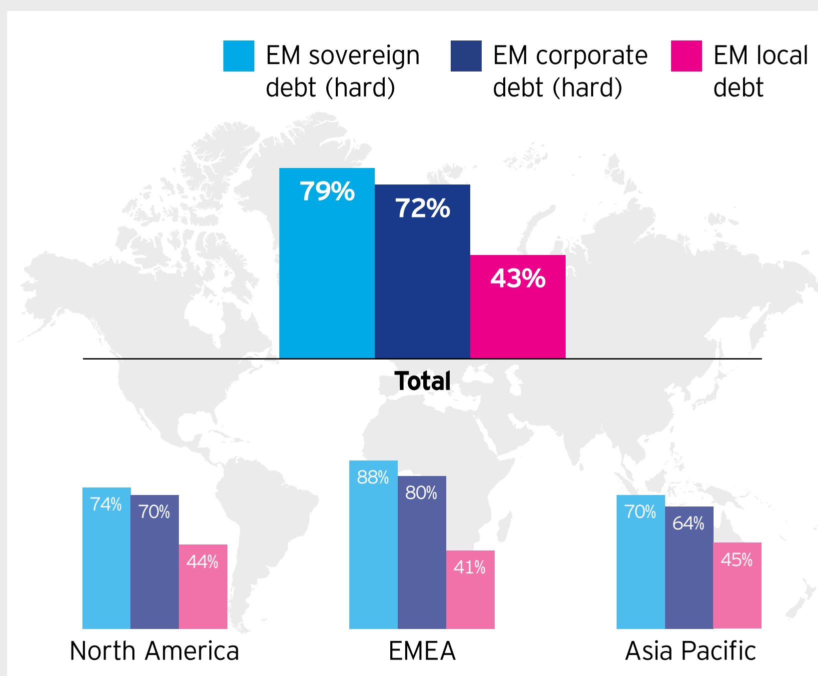
Figure 4.1
**Investors with allocations to EM debt (% citations, global)**




Do you have exposure to EM debt within your fixed income portfolio?

Sample size: 2018 Study = 79
2019 Study = 85, 2020 Study = 156

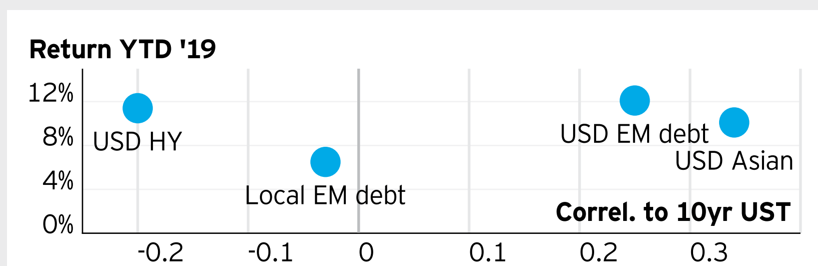
Figure 4.2
**Allocation to categories of EM debt (% citations, EM debt investors)**




What types of EM debt do you invest in?

Sample size: Total = 109, North America = 27
EMEA = 49, Asia Pacific = 33

Figure 4.3
**Performance and correlation of fixed income sub-asset classes (as of September 2019)**




Source: Bloomberg L.P. Past performance does not guarantee future results.

> “Emerging markets are a lot less correlated than they used to be as they have become better developed.”
>
> DB Pension Plan, EMEA

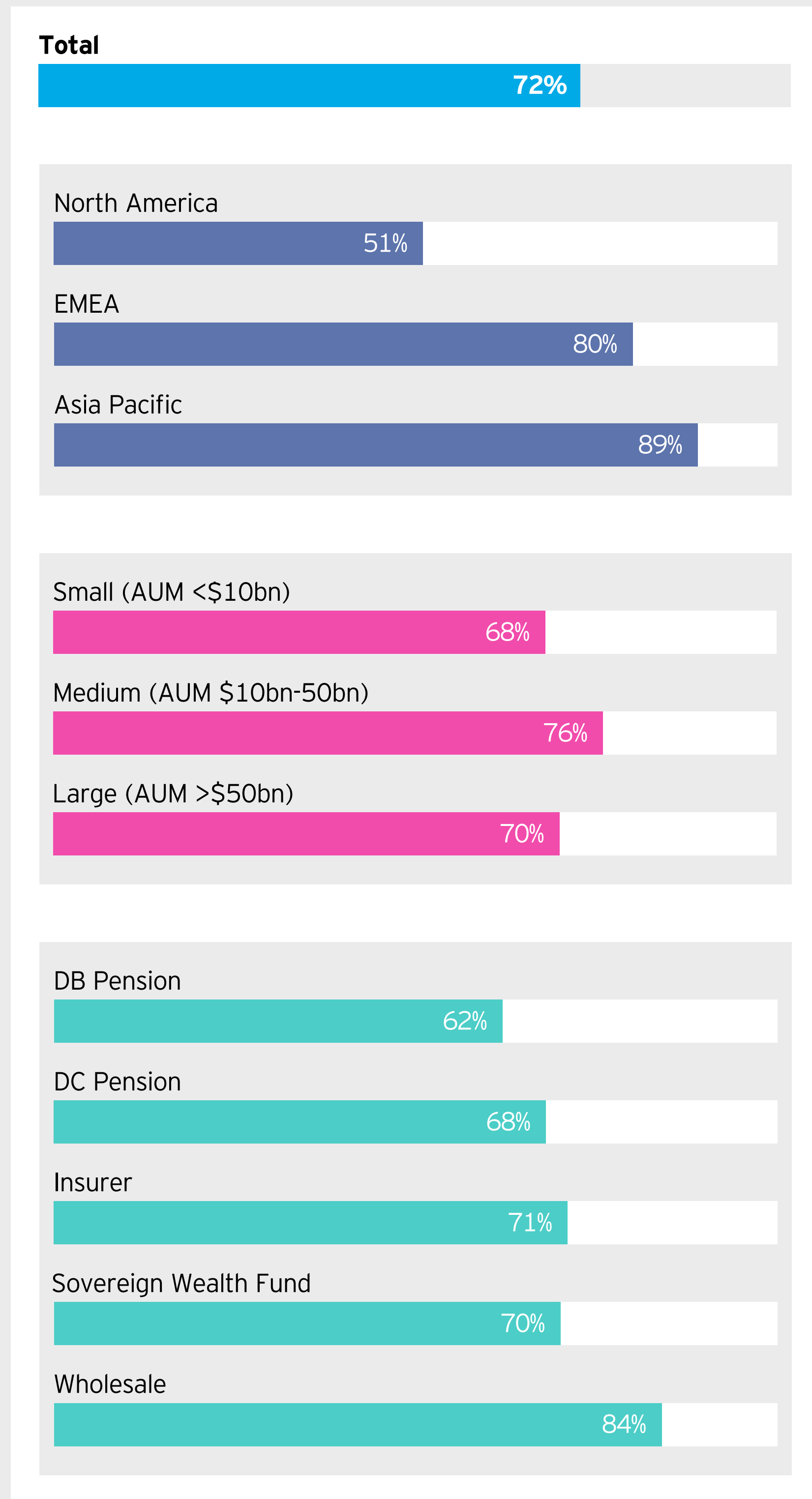
## APAC and EMEA load up on EM debt: North Americans more tepid

However, demand has not been uniform – indeed stark regional differences exist. In EMEA and Asia, investment is both frequent and driven by return. Some 80% of EMEA-based investors and 89% of APAC-based investors had allocations to EM debt. (**Figure 4.4**).

For investors based in North America, the situation was very different; only 51% of investors had made allocations to EM debt, and many of those allocations were small and represented only a minor fraction of the portfolio.

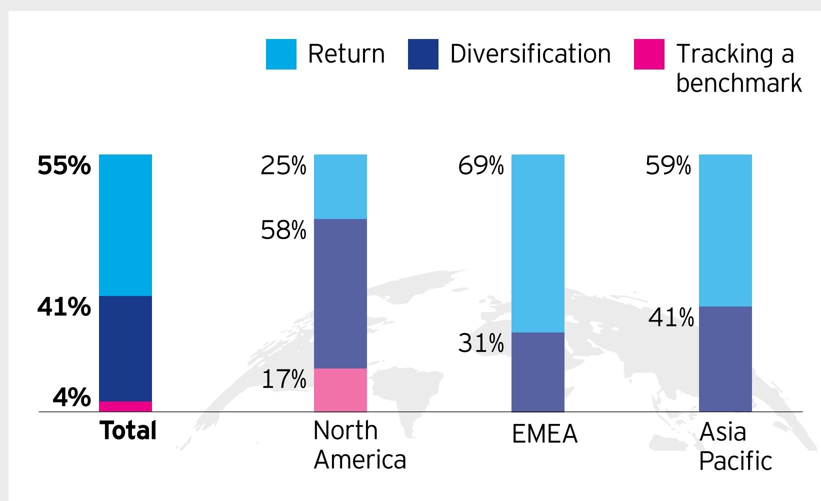
For investors based in North America, the situation was very different; only 51% of investors had made allocations to EM debt, and many of those allocations were small and represented only a minor fraction of the portfolio.

Figure 4.4
**Investors with allocations to EM debt (% citations, global)**




Do you have exposure to EM debt within your fixed income portfolio?
Sample size: Total = 156, Asia pacific = 38, EMEA = 61, North America = 57, Small = 41, Medium = 50, Large = 60, DB Pension = 39, DC Pension = 31, Insurer = 38, SWF = 7, Wholesale = 37

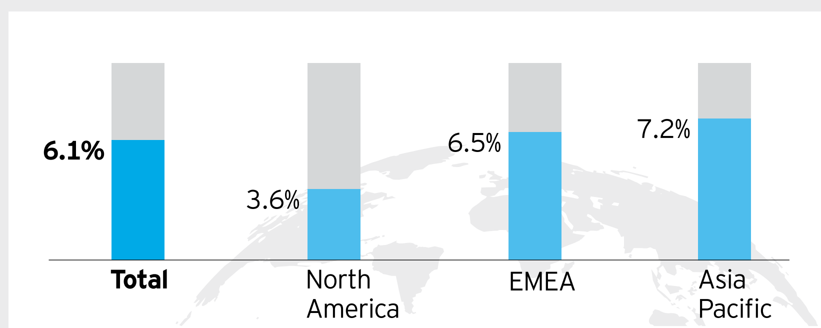
Figure 4.5
**Primary reason for investing in EM debt (% citations, EM debt investors)**




Is your decision to invest in EM debt driven primarily by diversification, return or the result of tracking a particular benchmark?

Sample size: Total = 98
North America = 24 EMEA = 45
Asia Pacific = 29

Figure 4.6
**Average allocation to EM debt (%, EM debt investors)**




What is the current allocation between asset classes within your fixed income portfolio?

Sample size: Total = 104, North America = 23
EMEA = 51, Asia Pacific = 30

This difference is likely to be due to APAC and EMEA investors trying to make up for low yields in the core portfolio: 69% of investors in EMEA cited return as the primary driver. (**Figure 4.5**).

The average portfolio allocation also varies by region, with EM debt accounting for an average of 7.2% of portfolios for investors in Asia Pacific, 6.5% for those in EMEA and 3.6% for those in North America (**Figure 4.6**).

For North American investors, 58% saw their allocations as motivated primarily by diversification rather than return – unsurprising given the relatively higher yields generated by a US core portfolio (**Figure 4.7**).

Nevertheless, 68% of North America EM debt investors saw these allocations as core investments, rather than satellite – way ahead of their EMEA and APAC peers – suggesting such allocations fulfilled long-term stable objectives (**Figure 4.8**).

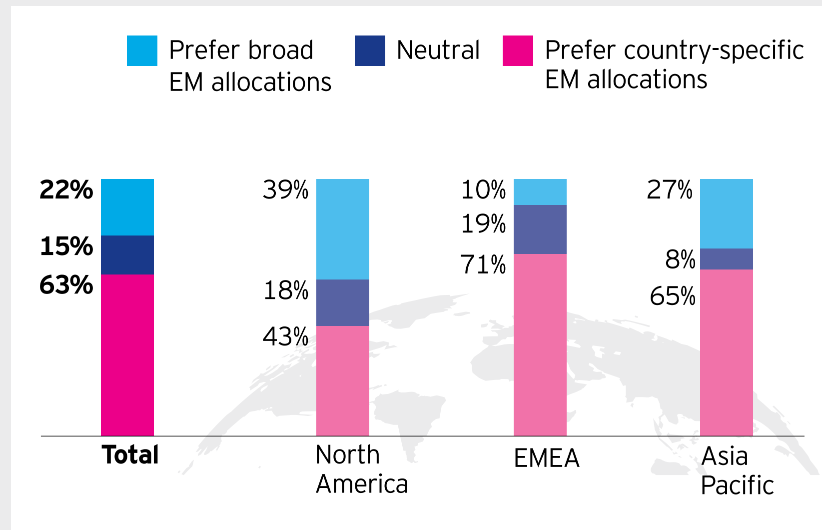
The prospect of higher returns associated with EM debt was especially attractive to insurers. Not only were they slightly more likely to be investing in EM debt (71% had some exposure), but insurers were overwhelmingly doing so for return, as opposed to diversification (73% primarily motivated by return against an average of 59%). For many insurance companies struggling to generate returns in the context of solvency regulation, hard currency EM debt is an obvious choice. Hard currency corporate EM debt frequently offers enhanced yields compared to domestic bonds at the same rating.

"I can find a lot of value in Asia and the Middle East just by knowing the market and understanding the dynamics at play," commented one EMEA insurer. "I get better results than if I just looked to the usual markets."

If one is using internal models, and is prepared to manage the portfolio actively, EM debt offers broad scope for alpha, exploiting rating systems and other market inefficiencies.

Figure 4.7

**Country allocation preference (% citations, EM debt investors)**

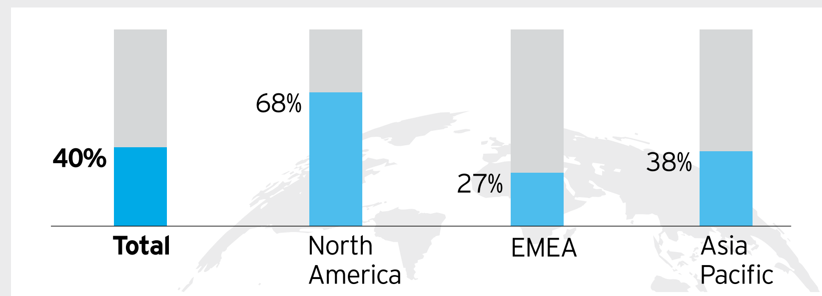



It's now preferable to take individual country allocations rather than broader EM allocations

Sample size: Total = 97, North America = 23
EMEA = 48, Asia Pacific = 26

Figure 4.8

**EM debt considered part of core fixed income (% citations, EM debt investors)**




Do you see EM debt as part of your core fixed income portfolio or your alternative fixed income portfolio?

Sample size: Total = 107, North America = 25
EMEA = 48; Asia Pacific = 34

"I can find a lot of value in Asia and the Middle East just by knowing the market and understanding the dynamics at play," commented one EMEA insurer. "I get better results than if I just looked to the usual markets."

## Country-specific allocations drive need for external active expertise

For many, part of the appeal of EM debt is the potential to utilize specific knowledge advantages in particular markets (**Figure 4.9**). This has spurred a move towards country-specific allocations and away from broad regional mandates.

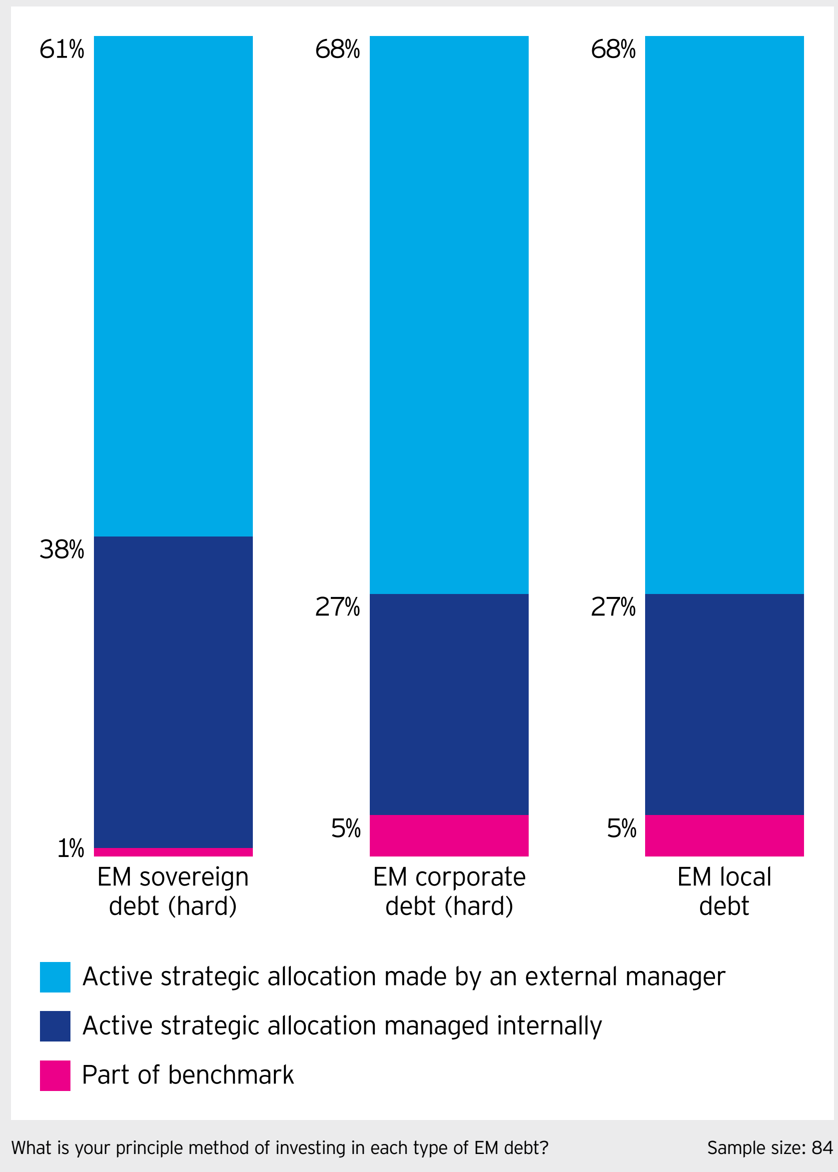
With the freedom to make active allocations to specific countries, it is possible to exploit inefficiencies and mispricing. However, this approach requires a deep immersion in each market, requiring specialist teams that can access and understand the best information.

One APAC insurer said they were internally "building knowledge, connections and awareness and from a pretty high base," but for investments were still principally outsourcing.

The exception to this trend is North America, where broad EM investors remain more frequent. Almost four in every ten North American investors with EM debt exposure preferred this approach, while in EMEA only 10% of investors preferred making broad allocations (**Figure 4.7**).

This is likely to be a consequence of lower perceived correlations between EM countries. Some 41% of investors agreed that EM markets are increasingly disconnected. "EM markets are a lot less correlated than they used to be as they have become better developed. We are treating each market more independently," said one EMEA-based DB pension representative, adding: "Big problems are now usually well signalled and have a good rationale."

Figure 4.9
**Primary approach to managing EM debt allocations (% citations, EM debt investors)**




This new reality was reflected by the relative containment of the Argentine crisis early in 2019. Compared to 20 years ago, when EM debt crises generally spilled over to other countries (such as the contagion resulting from the 1994 'tequila crisis'), investors seeking returns are now more likely to evaluate the credit risk of individual countries.

One APAC insurer said they were internally "building knowledge, connections and awareness and from a pretty high base," but for investments were still principally outsourcing.

## Increased allocation to China driven by benchmark inclusion and better market access

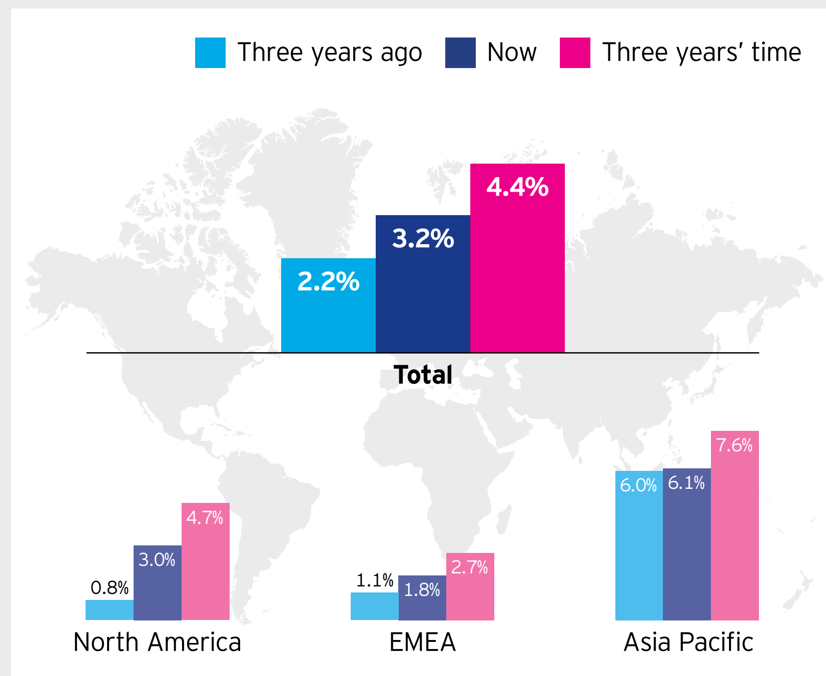
In 2019, we identified Chinese fixed income as an area of increased interest, as investors responded to benchmark inclusion, the growth of Chinese debt issuance (which now accounts for nearly 60% of EM debt[7]), and a gradual opening up of the Chinese market, especially onshore. This year's Study showed continued growth in allocations to China, and this could be further underpinned by the further slashing of rates by developed market central banks. Allocations by APAC-based investors were the most significant, at an average of 6% for those with exposure. However, this has remained broadly unchanged over the past three years, with investors reporting an average change to allocations of only 0.1%.

In EMEA and North America, average allocations have been growing more quickly. In EMEA allocations have grown by 68% from 1.1% to 1.8%, while in North America allocations have grown to 3% from 0.8% three years ago. However, it should be noted that while the growth rates are significant, they are from a very low base, reflecting the fact that many investors are allocating for the first time after a prolonged period of limited interest (**Figures 4.10 and 4.11**).

Chinese corporates are by far the most popular category of bond among China investors, with access to the corporate market opening up since 2016, facilitating a rapid uptake. Nearly three-quarters of investors now have at least some exposure (**Figure 4.12**).

Figure 4.10

**Average allocation to China (%, investors in China)**



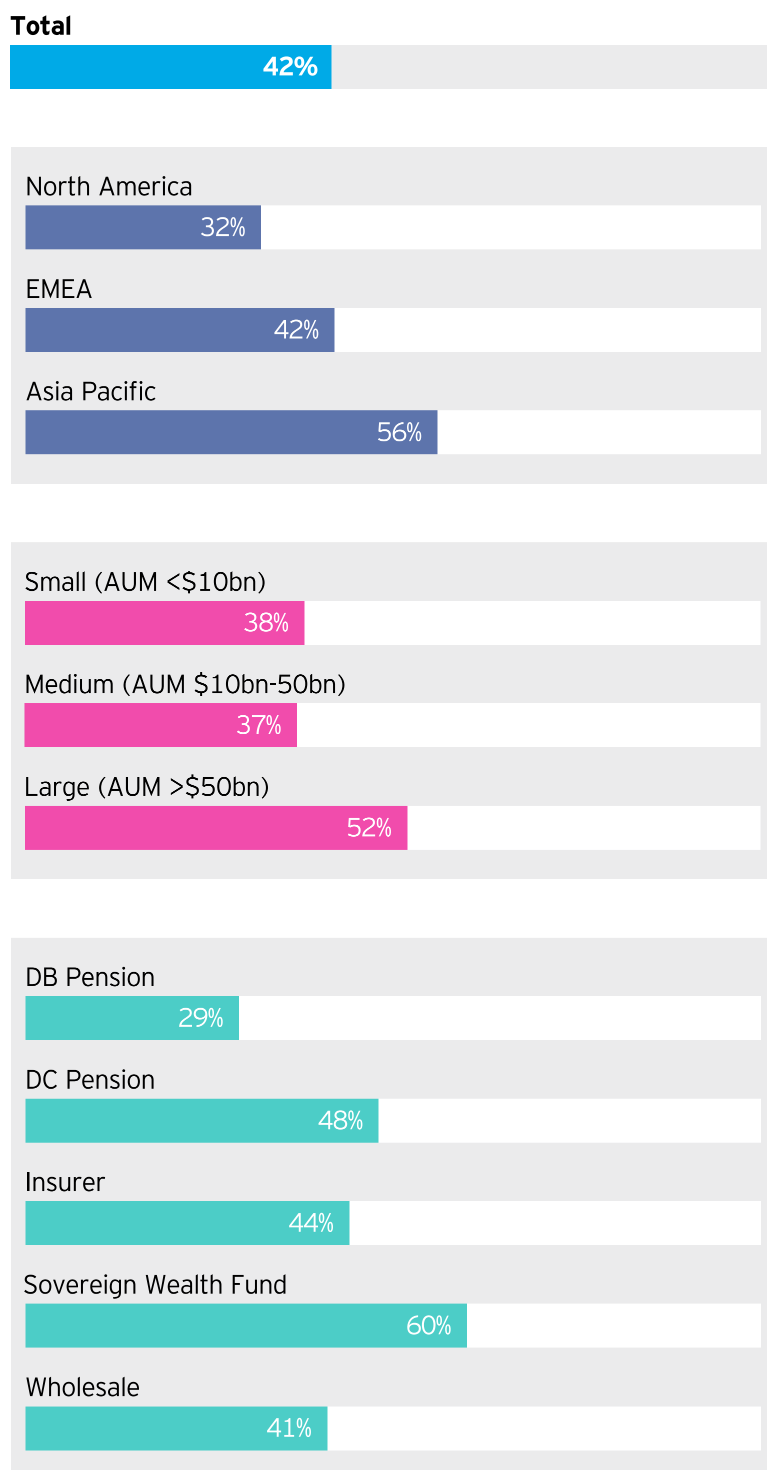

What % of your fixed income portfolio was invested in China three years ago? What % of your fixed income portfolio is currently invested in China? What % of your fixed income portfolio do you expect to be invested in China in three years' time?

Sample size: Total = 43, North America = 13, EMEA = 20, Asia Pacific = 10

This overall popularity results from the benefits investors ascribe to the region. Almost half of EM investors believe that the Chinese economy and political system offer unique diversification benefits, especially in APAC (68%) and North America (43%). Initiatives such as Shanghai Connect are broadening the universe, while simultaneously increasing China's share of global bond indices. "China opening up its market and inclusion in indexes means that passive managers will have to buy," commented one EMEA wholesaler.

[7] "Don't fret about the big build-up in emerging market debt," Financial Times, 26 February 2020.

Figure 4.11
**Investors allocating to China (% citations, global)**

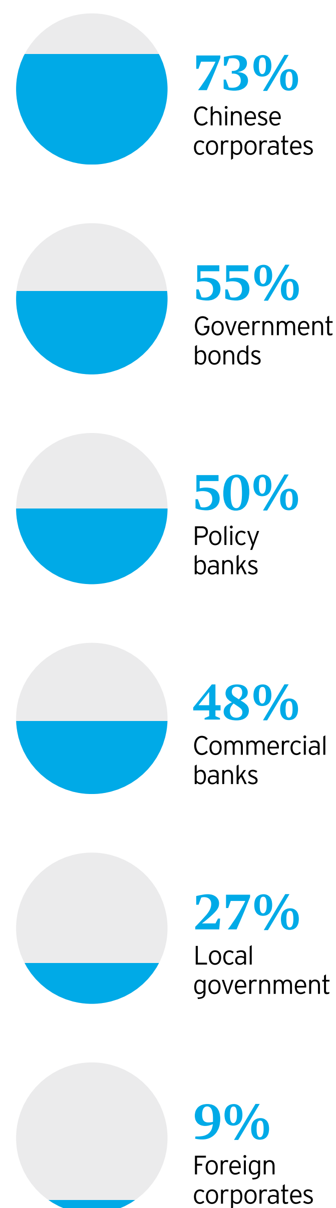



Do you have exposure to China within your fixed income portfolio?

Sample size: Total = 125, Asia pacific = 34, EMEA = 50, North America = 41, Small = 32, Medium = 43, Large = 46, DB Pension = 28, DC Pension = 23, Insurer = 32, SWF = 5, Wholesale = 34

In EMEA and North America, average allocations have been growing more quickly. In EMEA allocations have grown by 68% from 1.1% to 1.8%, while in North America allocations have grown to 3% from 0.8% three years ago.

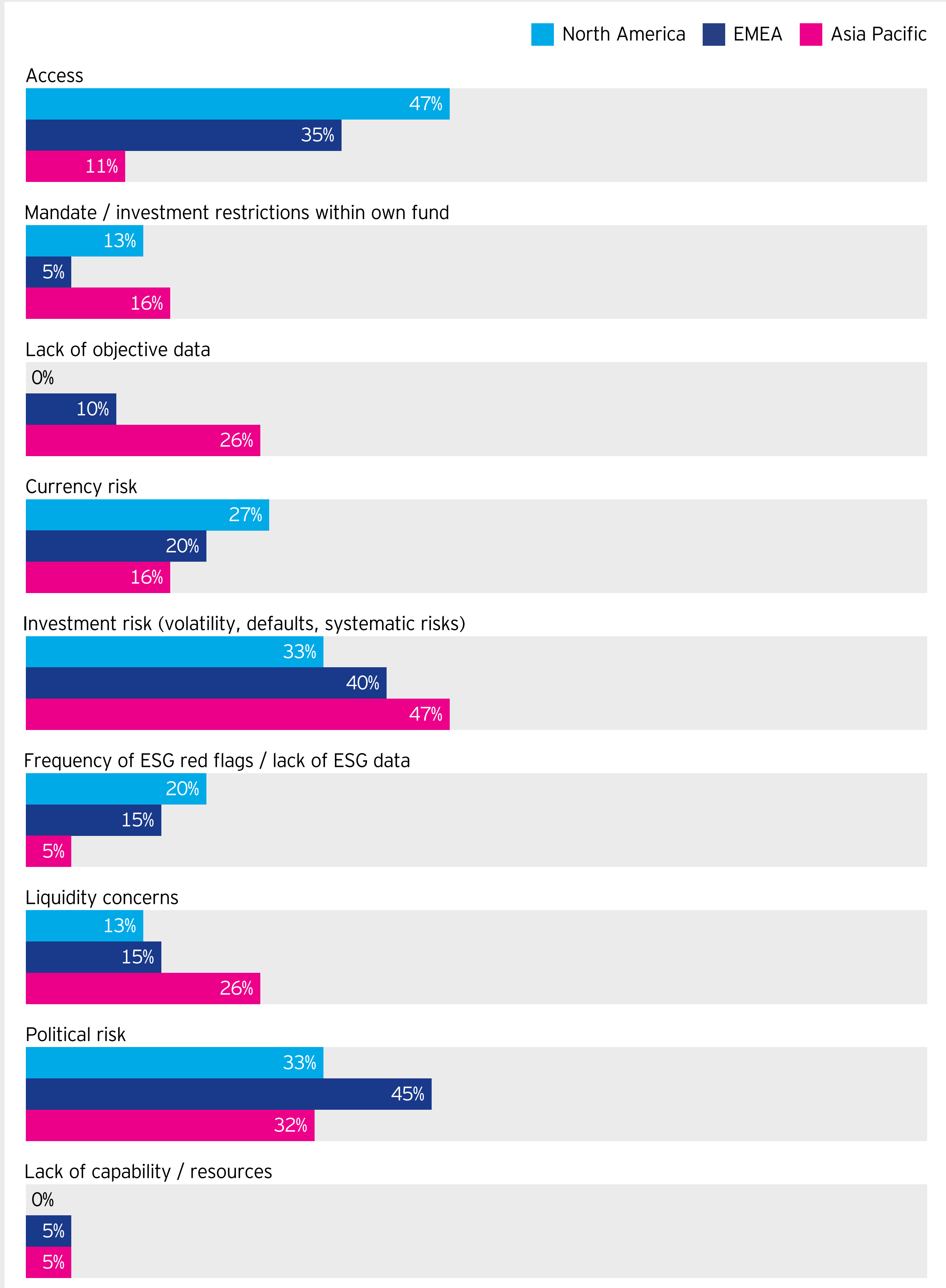
Figure 4.12
**Types of China FI invested in (% citations, China investors)**




Which types of issuers do you invest in?

Sample size: 44

Figure 4.13
**Perceived obstacles to investment in China (% citations, investors in China)**




What do you see as the top challenges when investing in China? (Select top two)

Sample size: Asia pacific = 19 EMEA = 20; North America = 15

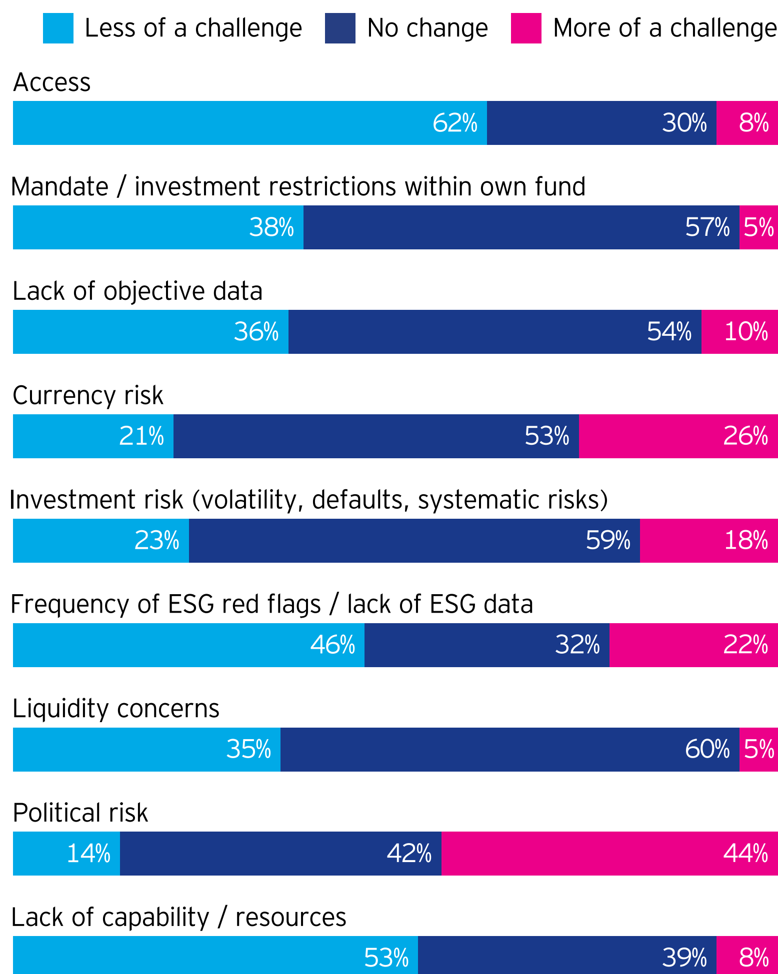
## US investors find access the main obstacle; APAC cite investment risk, and EMEA political

Investment risks figure highly, especially in EMEA and APAC (**Figure 4.13**). Some 40% of respondents invested in China cited the specific characteristics of investments as a major concern, while market access was still a worry for a third of investors. However, these risks are broadly seen to be declining in significance. Recent moves to open up the Chinese market (especially the launch of the China Interbank Bond Market Direct programme in 2016, and the China Bond Connect programme in 2017) have had some effect; 62% of investors perceived access as less of a challenge than two years ago.

"Access is getting easier. We have set up Bond Connect to trade onshore; the process took about six months. However, we will continue to trade offshore," said an EMEA-based asset consultant.

North American investors were again an exception, with a fifth perceiving access a greater challenge, and one DB pension representative stating: "EM debt is a place where you can exhibit skill, but for China we don't have that yet." (**Figure 4.14**).

Figure 4.14
**Challenges of investing in China: changes over past two years (% citations, China investors)**




For each challenge how has this changed over the past two years? Sample size: 43

Significant improvements were also perceived in the quality of information. While 62% felt it was poor, these obstacles were believed to be decreasing. It's also likely that benchmark inclusion has made investment significantly easier for foreign investors, especially those investing through ETFs.

However, it is possible that some investors are understating some risks. Only 18% of investors cite currency risk as a major concern when investing in China. However, given even the recent activity by the government to depress the value of the yuan,[8] combined with tight spreads and high hedging costs, it's likely that many investors are inadequately protected against a devaluation, something that a majority see as highly likely.

The only area of increasing concern was macro/political risk. Many investors saw the latter as having an inevitable impact on fixed income holdings, at least until the signing of a broader trade agreement. "Beijing is acting quite aggressively and there is a slowing economy," said one North American DC pension representative, citing the example of Hong Kong in China's effort to centralize authority.

The emergence of COVID-19 in late 2019 illustrated another potential risk – the disproportionate effect of shocks on EM economies. While the survey took place before the pandemic, the effect of the virus on markets, and the dramatic measures required to moderate those effects, have emphasized risks that perhaps sit outside traditional security analysis.

"Access is getting easier. We have set up Bond Connect to trade onshore; the process took about six months. However, we will continue to trade offshore," said an EMEA-based asset consultant.

[8] As recently as August 5, 2019

## More investors going onshore

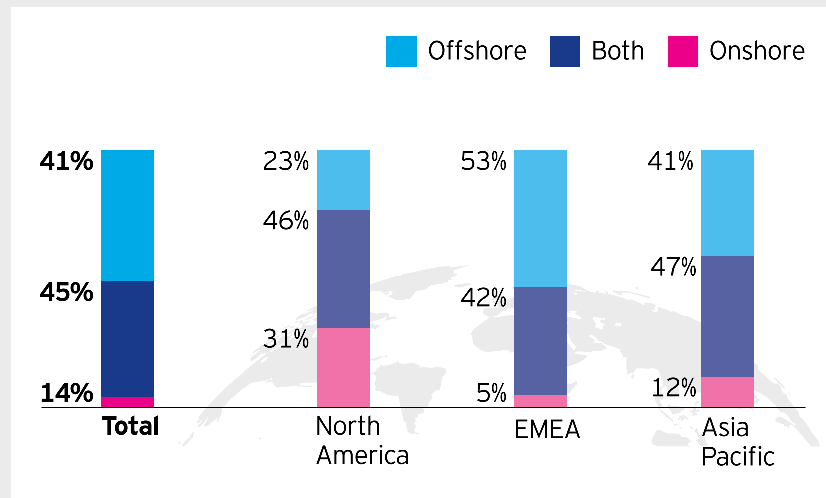
In past editions of the survey, we have noticed a strong preference for offshore access to Chinese investment. However, this appears to be changing with improved understanding and experience. More than half of investors have some onshore experience, and 44% in this year's Study expressed a preference for onshore over offshore (**Figure 4.15**).

Onshore investment is popular, supported by low correlations with core fixed income instruments and significantly higher yields. In addition, it opens up a significantly broader range of issuers than the more limited range available to offshore investors. Many of these issuers are better capitalized than an equivalently rated borrower in a developed market – 81% of those favoring onshore did so due to enhanced access, 56% due to the broader range of issuers, and only 44% on account of enhanced yields (**Figure 4.16**).

For 70% of those investors still favoring offshore, the ease of investment was a major factor. Liquidity (52%) and currency (57%) were also important. Offshore investors (if USD-based) generally do not have to hedge local currency exposure, while for insurers, hard currency EMD is generally counted as equivalently rated domestic securities under most solvency regulations.

Onshore investment is popular, supported by low correlations with core fixed income instruments and significantly higher yields. In addition, it opens up a significantly broader range of issuers than the more limited range available to offshore investors.

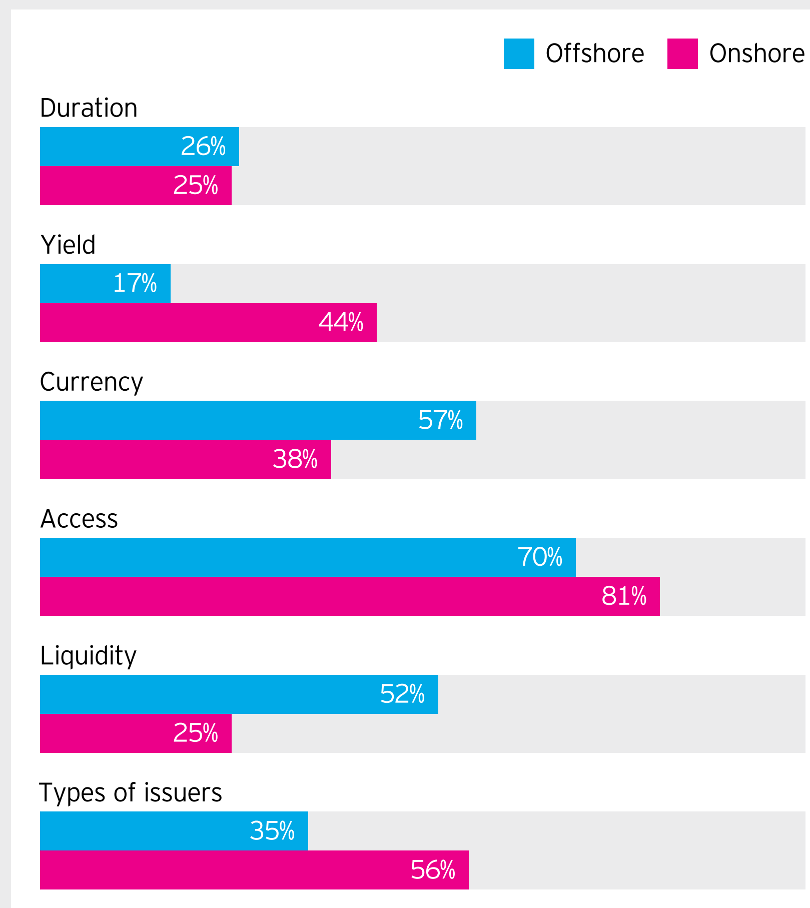
Figure 4.15
**Approach to investing in China (% citations, China investors)**




How do you get exposure to China?

Sample size: Total = 49, North America = 13
EMEA = 19, Asia Pacific = 17

Figure 4.16
**Reasons for choosing a specific approach (% citations, China investors)**



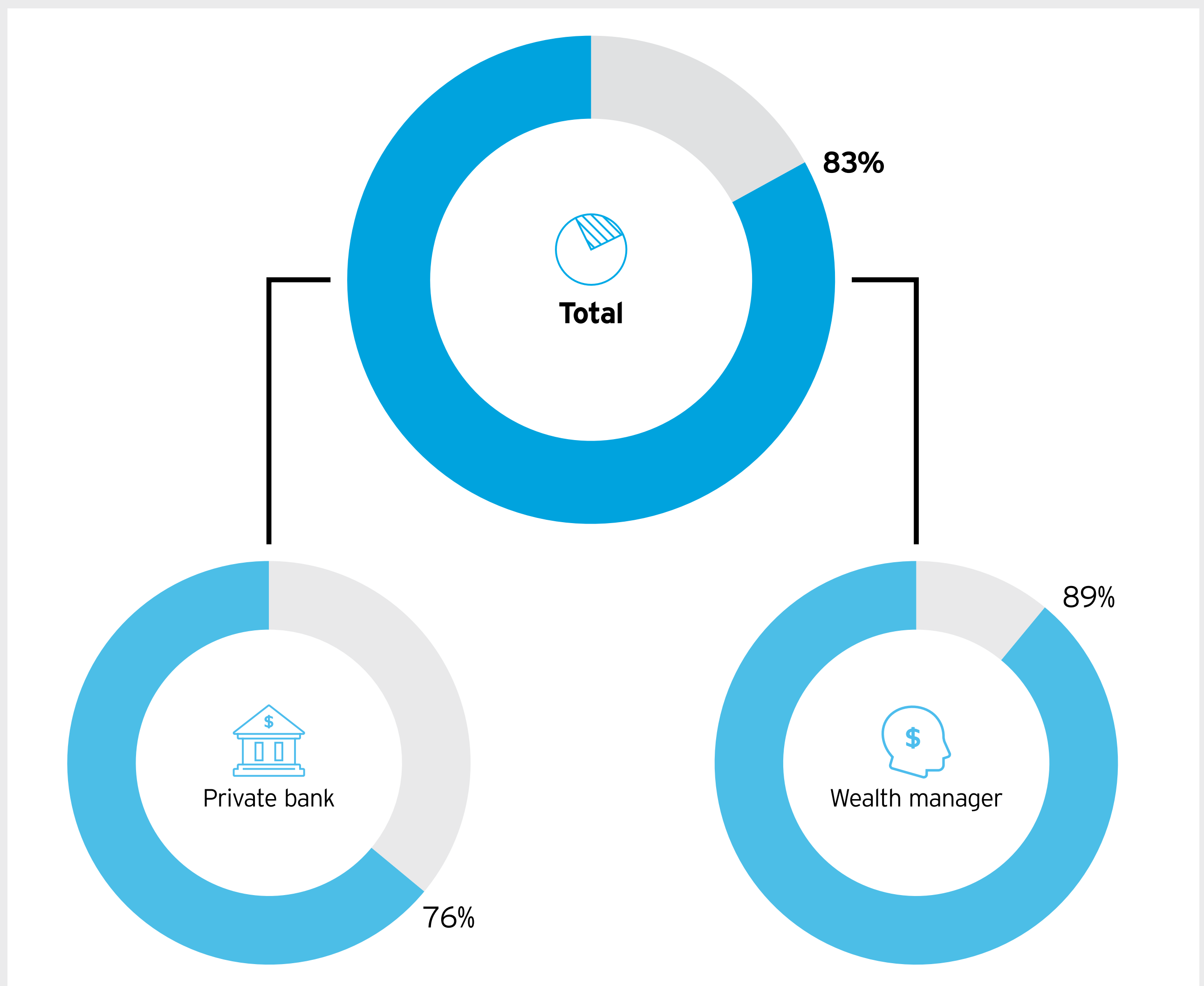

Why do you prefer this method?

Sample size: 41

## Most wholesalers avoid China, but those who allocate go big and broad

With yields low, and a traditional tendency towards wealth preservation leading to overweight fixed income allocations, it can be difficult for wholesale managers to provide a positive real return. The answer for 83% has been to make significant allocations to EM debt, often in the form of broad multi-asset class mandates (**Figure 4.17**).

Figure 4.17
**Wholesale investors allocating to EM debt (% citations, wholesale)**




Do you have exposure to EM debt within your fixed income portfolio?

Sample size: Total = 35, Private Bank = 17, Wealth Manager = 18

However, with China the story is different. As observed last year, wholesale investors are generally less likely to allocate to China, especially given that a sizable section of some markets is made up by investors trying to move money out of China. But for those wholesalers who do allocate, the growth has been rapid, moving in three years from an average of 0.6% to today's average of 2.1%. This is not far from the expected three-year target (3.1%), suggesting that investors have been especially quick to allocate capital. These investors are generally more concerned by currency risk in China, and consequently 90% hold hard currency bonds.

Theme 5

# ESG widely seen as beneficial to returns, as focus turns to shortage of product and implementation

**Investors continue to move beyond performance concerns relating to ESG, instead recognizing that managing issuer-related ESG risks has the potential to enhance returns.**

Specifically, investors who fail to address environmental and governance concerns may face higher borrowing and refinancing costs, with clear implications for the valuation of these securities for investors. 50% of investors that have incorporated ESG within their fixed income portfolios cite return enhancement as a key driver. 46% of investors that have incorporated ESG within fixed income believe that it has been beneficial to their returns with just 3% seeing a negative impact.

Investors continue to move beyond performance concerns relating to ESG, recognizing that managing issuer-related ESG risks has the potential to enhance returns (50% of respondents). Only a very small proportion still believe ESG hinders performance.

APAC is rapidly integrating ESG: now at 69%, up from 38% last year, and overtaking North America. Moves such as China's mandatory ESG disclosure and uptake by large regional asset owners such as Japan's Government Pension Investment Fund (GPIF) could see APAC leapfrog to the forefront of ESG adoption.

Availability of suitable product is the largest impediment to further implementation. While this is a general complaint, it is felt most keenly in APAC, with 40% of investors there reporting that a lack of availability of ESG bonds hinders their efforts.

This need for relevant product itself indicates that investors are becoming more specific in their ESG approach, looking for quantifiable outcomes. Some 68% now invest in ESG-specific products, 55% require their managers to integrate their ESG guidelines, and 62% have ESG factors integrated within their credit models.

## The debate about the impact of ESG on performance within fixed income has shifted rapidly.

In our 2019 Study, many investors were adamant they would not give up returns to integrate ESG considerations. A year later, most investors believe ESG investing enhances, or at least has no impact, on returns (**Figure 5.1**).

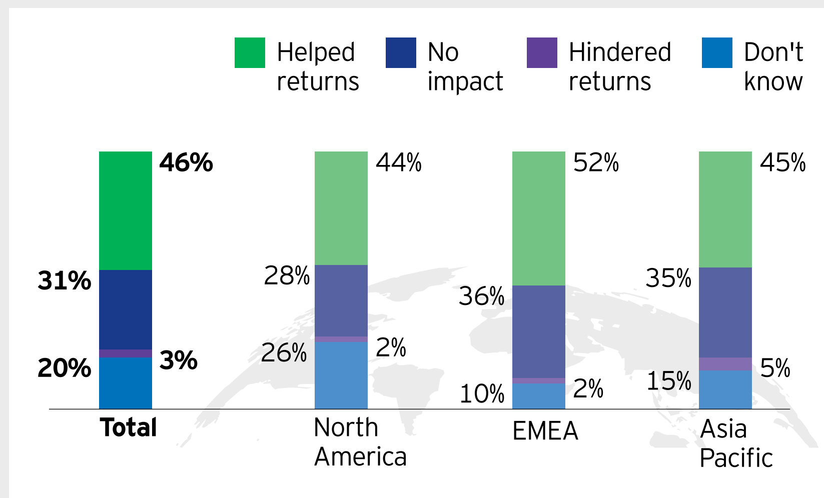
"We've been doing ESG for 23 years. But it is easier now to make the case that it's promising for returns," said one EMEA DB pension representative, referencing the lengthening and positive track records and market research to support the case.

One North American wholesaler explained: "I was earlier sceptical of ESG, but as a fixed income investor you want all the information you need. And so far, thinking about ESG and further incorporating it throughout most of our portfolio has been beneficial for returns."

Half of investors that have adopted ESG within their fixed income portfolios cite return enhancement as a key driver (**Figure 5.2**). However, other drivers remain more prominent, with social responsibility (75%), stakeholder demands (67%) and a desire to align with beneficiary beliefs the top motivating factors.

One North American wholesaler explained: "I was earlier sceptical of ESG, but as a fixed income investor you want all the information you need. And so far, thinking about ESG and further incorporating it throughout most of our portfolio has been beneficial for returns."

Figure 5.1
**ESG impact on performance (% citations, ESG investors)**




Has embedding ESG principles into your fixed income portfolio had any impact on returns?

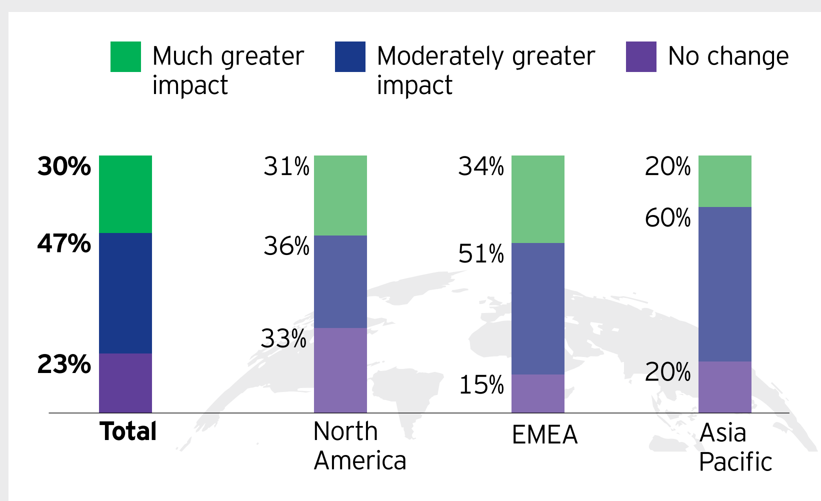
Sample size: Total = 112, North America = 43 EMEA = 48, Asia Pacific = 21

Figure 5.2
**Motivations for incorporating ESG factors within fixed income (% citations, ESG investors)**

What was your main motivation for considering ESG factors within your fixed income portfolios?

Sample size: 100

Figure 5.3
**Influence of ESG over next three years (% citations, ESG investors)**

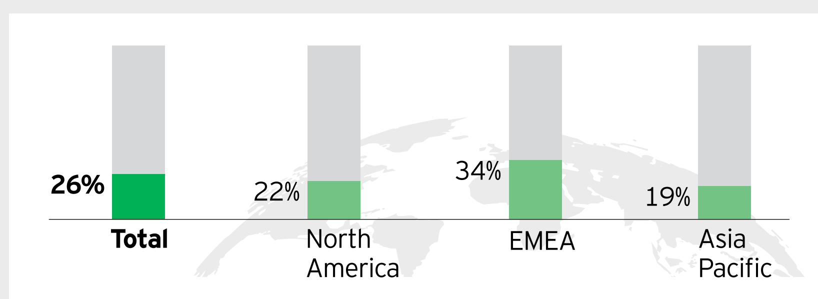



How do you expect this to change in the next three years?

Sample size: Total = 117, North America = 45 EMEA = 47, Asia pacific = 25

Asset owners are still adapting to this new age of ESG integration but as its impact evolves from potential to credible, investors are responding by reshaping their debt portfolios (**Figure 5.3**). Today, around a quarter of fixed income assets are ESG-integrated (**Figure 5.4**).

Figure 5.4
**Average allocation to ESG within fixed income portfolio (%, ESG investors)**




What proportion of your fixed income portfolio is represented by ESG investments?

Sample size: Total = 103, North America = 40 EMEA = 41, Asia Pacific = 22

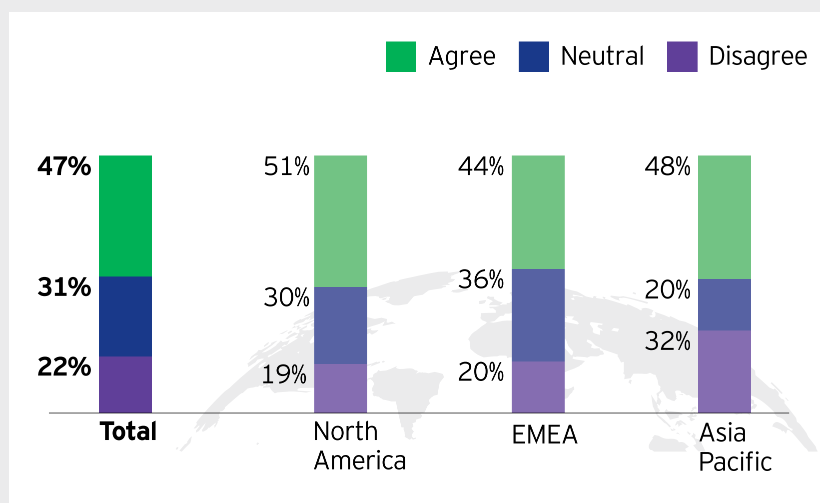
## Enhancing performance and risk management

Issuer-related risks are increasingly seen as translating into returns, and many investors are considering the impact of potential physical risks due to climate change on bond pricing; for example, the possible impact that floods, hurricanes and fires may have on bonds in the real estate and infrastructure space.

"It's even more important for a fixed income investor to consider ESG than an equity investor," said one North American wholesaler. "Debt instruments are far more impacted by climate change and governance issues than stocks."

"It's even more important for a fixed income investor to consider ESG than an equity investor," said one North American wholesaler: "Debt instruments are far more impacted by climate change and governance issues than stocks."

Figure 5.5
**Belief that ESG presents material credit risk (% citations, global)**




Does ESG present material credit risk (for corporate and sovereign debt)?

Sample size: Total = 127, North America = 47 EMEA = 55, Asia Pacific = 25

The additional information generated by ESG engagement provides investors with what they increasingly recognize as a valuable risk-management tool, moving ESG considerations to the mainstream. North America is at the forefront of using ESG for risk management, with half of the investors in the region using it in this way – ahead of EMEA (38%) and APAC (48%). For example, respondents seeking debt capital or refinancing options are increasingly concerned about borrowing costs that stem from insufficiently analysing climate-related risks, such as transitional, physical and stranded assets (**Figure 5.5**).

There has been a shift from investors who see the value of ESG in equity but not appreciating how the approach can be applied to fixed income, to seeing ESG as a significant fixed income strategy. This is especially the case given the connection between credit impairment and risks associated with issuers that can be highlighted by a robust ESG process.

After years of education, investors are increasingly comfortable with ESG and more alert to the consequences of owning a bond from an issuer who fares poorly through an ESG lens. There is a growing understanding of the impact of governance matters on bond prices in the secondary market, where the market is no longer ignoring borrowers' oversight on ESG issues. Those issuers that fail to address environmental and governance concerns are likely to see their borrowing and refinancing costs rise, with clear implications for the valuation of these securities for investors holding them.

While our interviews took place before the outbreak of COVID-19, the crisis will likely add to the already growing scrutiny of company policies and practices observed in the Study findings, further emphasising the importance of ESG analysis.

"There is a growing understanding of the impact of governance matters on bond prices in the secondary market, where the market is no longer ignoring borrowers' oversight on ESG issues."

> "It's even more important for a fixed income investor to consider ESG than an equity investor."
>
> Wholesale, US

## APAC leapfrog: ESG adoption

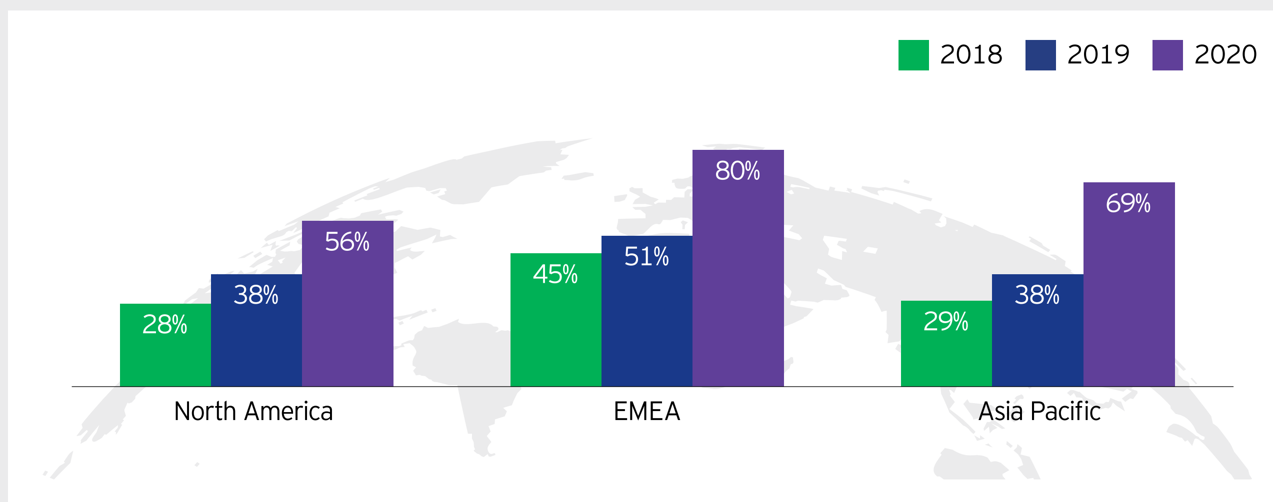
APAC has witnessed the most significant uptick in ESG adoption over the past three years, with investors in that region overtaking their North American peers and catching up on EMEA (**Figure 5.6**).

While Australia and New Zealand sovereigns and pension funds have long been at the forefront of ESG, the rest of the region is catching on fast. Starting in 2020, all Chinese listed companies will be required to disclose ESG information.[9] Large regional asset owners are also taking a lead through the adoption of ESG policies across their portfolios and promoting this to their regional peers. For example, Thailand's Government Pension Fund is drawing together the country's stock exchange, regulator, social security fund and fund managers to develop a coordinated ESG strategy. Regulatory action by governments and exchanges such as the Hong Kong Monetary Authority are also moving up a gear.

By way of contrast, while more North American investors are willing to integrate ESG – seeing it as a way to complement traditional analysis of prospective investments with additional nuance – they are still cautious in their implementation. Some 15% of North American investors utilize ETFs for ESG. ETFs present a first step on the ESG ladder for some investors, providing exposure with minimal work. However, while North American green bond investment lags behind EMEA, it is ahead of APAC and suggests that North American investors are starting to move beyond an initial, more conservative approach (**Figure 5.12**).

North American fixed income investors are also using ESG factors to redesign their portfolios, with 32% stating their allocation decisions are influenced by risks and opportunities in climate change.

Figure 5.6
**Incorporate ESG in fixed income (% citations, global)**




Do you currently incorporate ESG within your fixed income portfolio?

Sample size: 2018 = 79, 2019 = 107, 2020 = 147

North American fixed income investors are also using ESG factors to redesign their portfolio, with 32% stating their allocation decisions are influenced by risks and opportunities in climate change.

[9] https://www.cdsb.net/sites/default/files/ciff_policy_briefing_china.pdf

## Undersupply hinders uptake

One thing that may be preventing faster ESG adoption – particularly in APAC – is the perceived absence of suitable instruments (**Figure 5.7**).

"In 2019, we invested in our first green bond," said one DC pension representative from APAC. "We have tried to expand our investments in this space, but it has been difficult to find options that align with our mandate and are different from what we have."

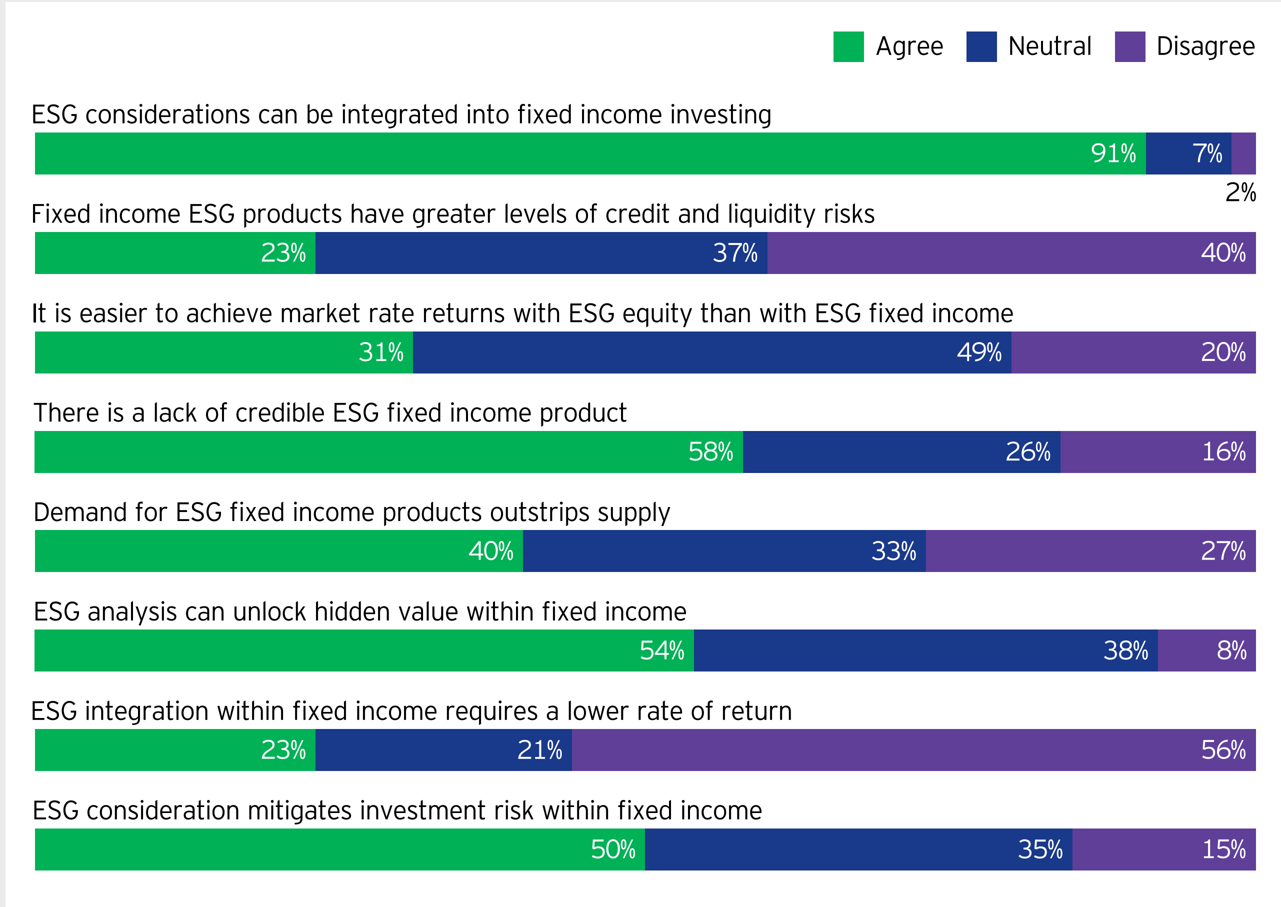
Figure 5.7
**Limited availability of ESG bonds hurting ESG initiatives (% citations, ESG investors)**

Does a lack of availability of these types of securities hinder your efforts to meet your ESG objectives?

Sample size: Total = 97, North America = 30
EMEA = 47, Asia Pacific = 20

"In 2019, we invested in our first green bond," said one DC pension representative from APAC. "We have tried to expand our investments in this space, but it has been difficult to find options that align with our mandate and are different from what we have."

Figure 5.8
**Attitudes to ESG within fixed income (% citations, global)**

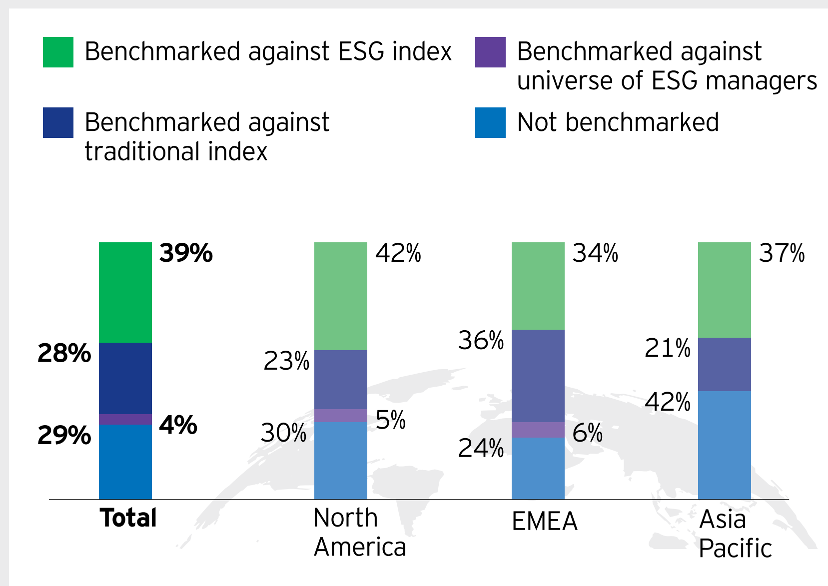



Please state the extent of your agreement or disagreement with each of the following statements when it comes to ESG fixed income investing

Sample size: 129

Over half of investors believe there is a lack of legitimate product in the market, with interest in ESG bonds exceeding supply. Availability and liquidity are commonly cited as obstacles (**Figure 5.8**). That this is a particular problem in APAC can be seen by the fact that the region has the lowest uptake of ESG-specific products, at 57%, whereas both EMEA and North America exceed 70% (**Figure 5.10**). This is further exacerbated by the fact that four out of ten APAC investors have no benchmark for their ESG allocations (**Figure 5.9**).

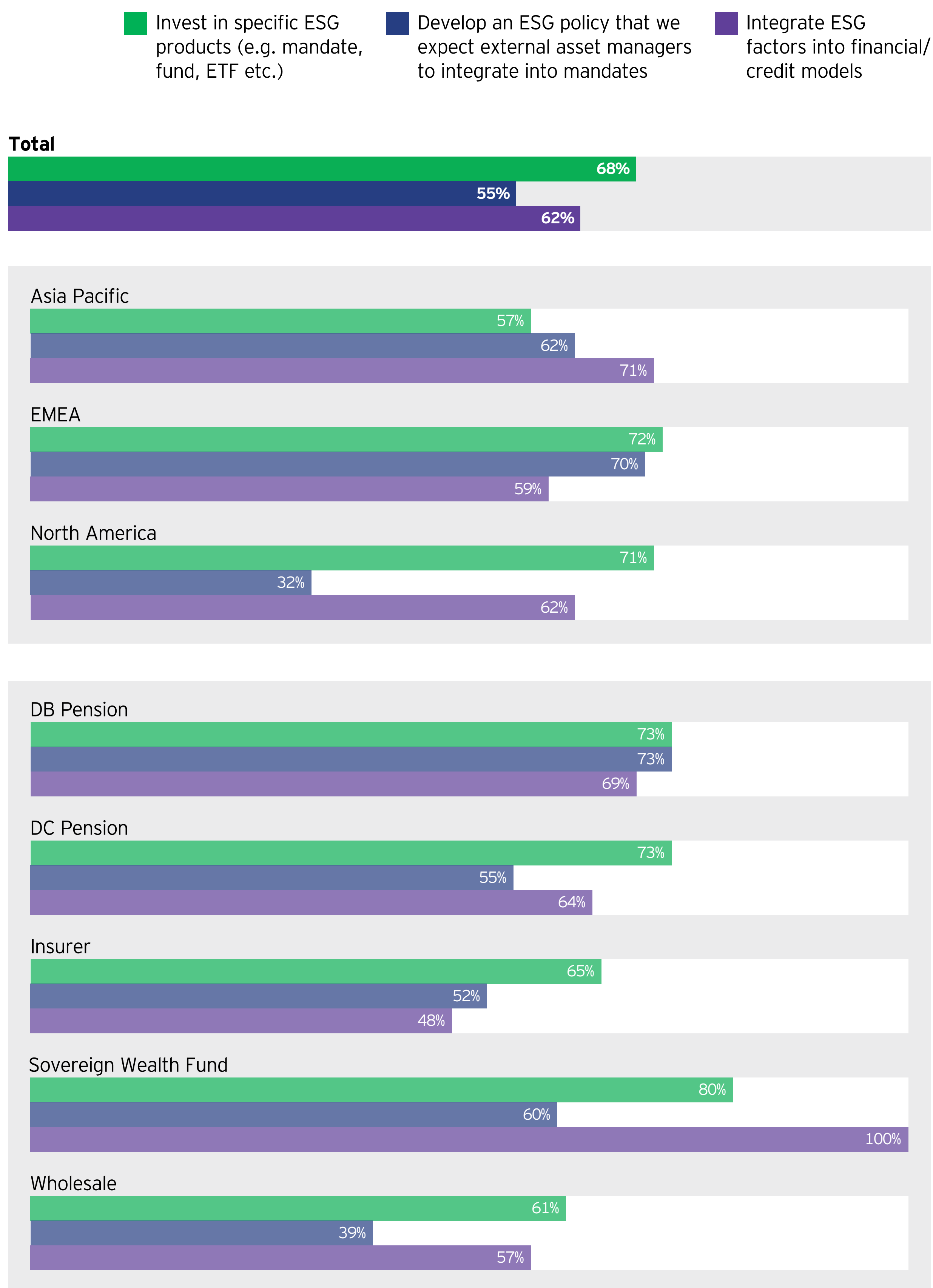
Figure 5.9
**Benchmark for ESG investments (% citations, ESG investors)**




How do you benchmark performance of your fixed income ESG investments?

Sample size: Total = 113, North America = 44 EMEA = 50, Asia Pacific = 19

Figure 5.10
**Approach to ESG integration to fixed income (% citations, ESG investors)**




How do you approach ESG integration in fixed income?

Sample size: Total = 101, Asia pacific = 21, EMEA = 46; North America = 34, DB Pension = 26, DC Pension = 222, Insurer = 23, SWF = 5, Wholesale = 23

## Are we there yet? Beyond negative screening

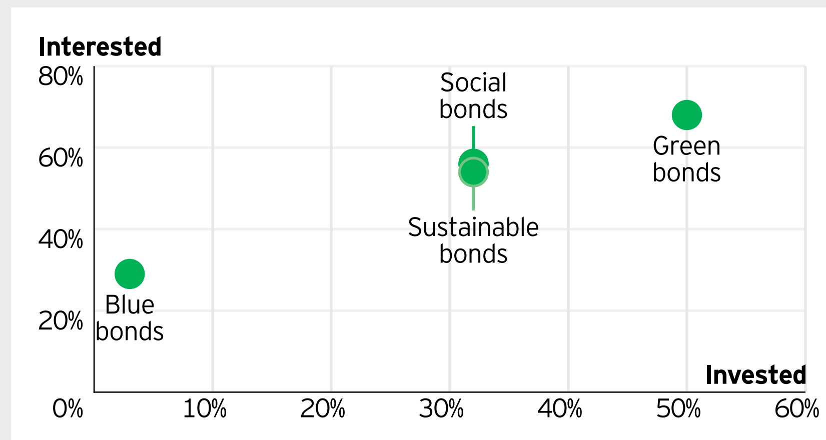
But while access to suitable product remains an obstacle, not only is the market broadening, it is becoming more sophisticated. Global implementation of ESG has expanded past the nascent stages of vague guidelines and generic goals. Almost 70% of those surveyed are purchasing specific product and another 60% are incorporating these factors into their financial/credit models (**Figure 5.10**).

Faced with a lack of supply of specialized ESG securities, investors are often looking to circumnavigate this obstacle by incorporating ESG in a structured way throughout their fixed income portfolios. This is achieved by developing ESG policies that managers are directed to integrate into mandates and via the integration of ESG factors into financial models. Given the range of drivers and priorities this is often being done on a fully bespoke basis, with the integration of ESG into the investment approach often requiring investors to work hand-in-hand with their asset managers to develop fully customized investment mandates that meet their objectives.

Each market exhibits its own unique integration approach. European investors continue to have the most conviction in ESG, with 80% having integrated it into their process. These asset owners require more, and 70% have developed a policy where they expect asset managers to comply with their ESG guidelines.

Global implementation of ESG has expanded past the nascent stages of vague guidelines and generic goals. Almost 70% of those surveyed are purchasing specific product and another 60% are incorporating these factors into their financial/credit models (Figure 5.10).

Figure 5.11
**Investment and interest in ESG bonds (% citations, global)**




Do you invest in any of the following types of ESG bonds? Which of these would you be interested in investing in the future (either additional or new investments)?

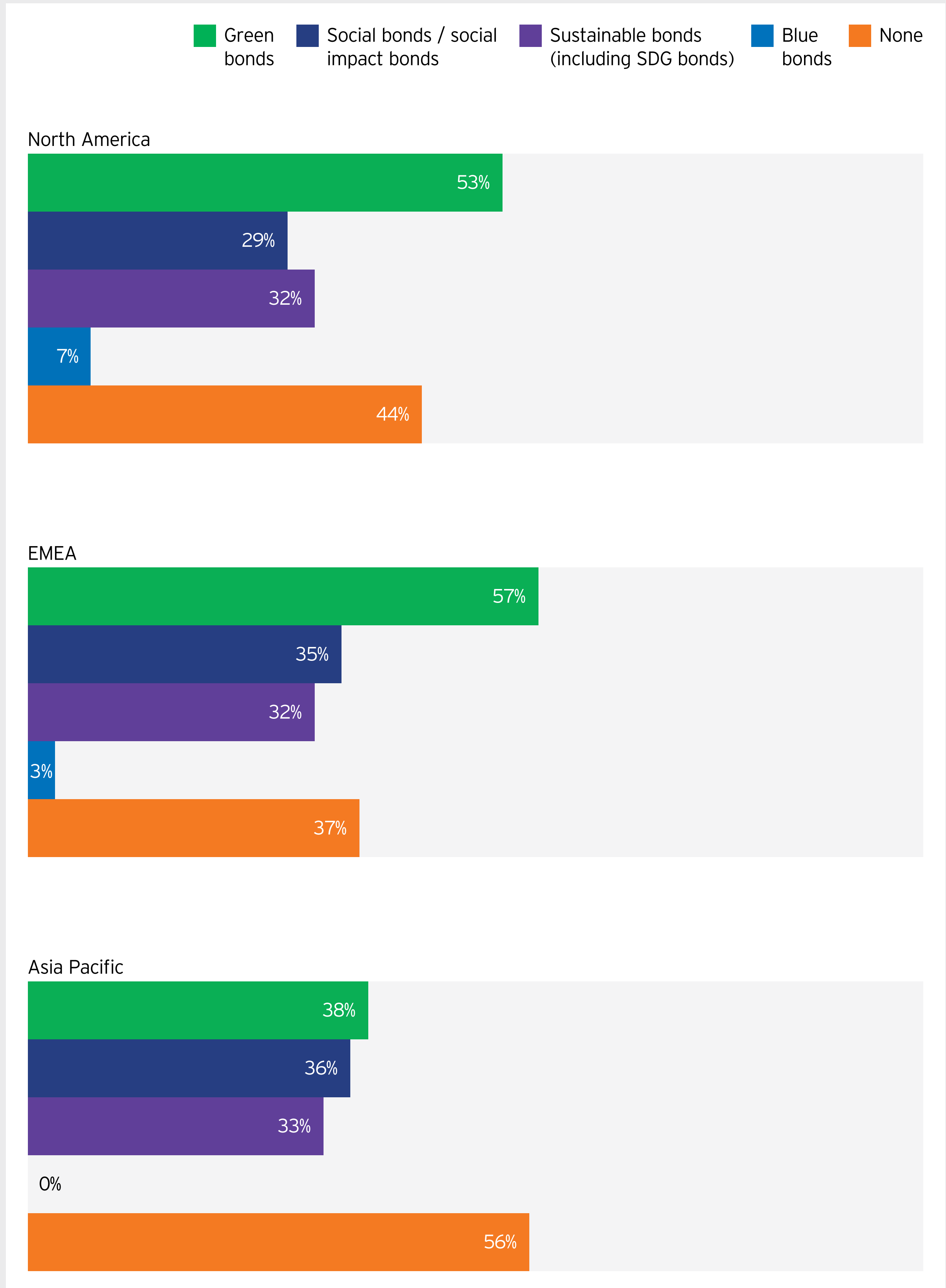
Sample size: 159

In addition to the increasing proportion of investors making money managers comply with their ESG policy, it's possible to gauge ESG progress by looking at the development of green bond uptake and related interest in other sustainable bonds (**Figure 5.11**).

In 2019, our Study found most investors chose not to purchase ESG-specific products, whereas today half own them and 80% are anticipating making new/additional investments in the future. While green bonds are the most common instrument globally, interest has also expanded across the full range of offerings, with a third of investors having bought social and sustainable bonds and more than half expressing an interest. Blue bonds, designed to finance ocean conservation initiatives such as sustainable fishing, remain a more niche proposition, with only 4% of respondents investing. However, even in this nascent category some 30% of investors expressed interest in investing in the future (**Figure 5.12**).

Taken as a whole, this indicates an increased appreciation of the different strategies and products with which investors can define and realize their ESG goals.

Figure 5.12
**Current investment in ESG bonds (% citations, global)**




Do you invest in any of the following types of ESG bonds?

Sample size: Asia pacific = 39, EMEA = 60, North America = 59

# Appendix

## Sample and methodology

The fieldwork for this Study was conducted by an independent, full service advisory firm integrating consulting, insights and analytics exclusively in asset management, wealth management and protection. Invesco chose to engage a specialist independent firm to ensure high quality objective results. Key components of the methodology include:

- A focus on the key fixed income decision makers within institutional investors and wholesale investors (including private banks, diversified fund managers, multi-managers and model builders), conducting interviews using experienced consultants and offering market insights rather than financial incentives
- In-depth, face-to-face interviews (typically 1 hour) using a structured questionnaire to ensure quantitative as well as qualitative analytics were collected
- Analysis capturing investment preferences as well as actual investment allocations, with a bias towards actual allocations over stated preferences
- Results interpreted by NMG's strategy team with relevant consulting experience in the global asset management sector

In 2019, we conducted interviews with 159 different insurers, defined benefit and contribution pension funds, sovereign investors and private banks across APAC, EMEA and North America. The breakdown of the 2019 interview sample by investor segment and geographic region is displayed in Figures 6.1 and 6.2.

Survey participants' experiences may not be representative of others, nor does it guarantee the future performance or success of any product. The opinions expressed are those of NMG and are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

There may be material differences in the investment goals, liquidity needs and investment horizons of individual and institutional investors. Invesco is not affiliated with NMG, an independent full-service market research provider, specialising in wealth management and financial services market research and consulting.

Figure 6.1
**159 respondents across three regions covering US$20 trillion in assets**

# 159
**Total Sample**

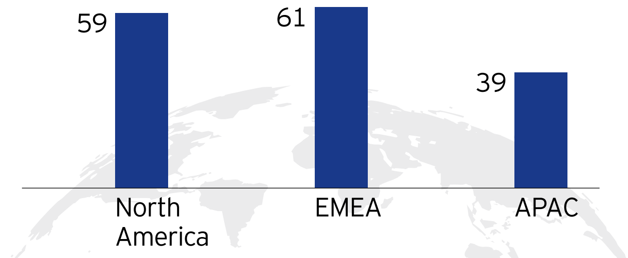



Figure 6.2
**Segment Splits**

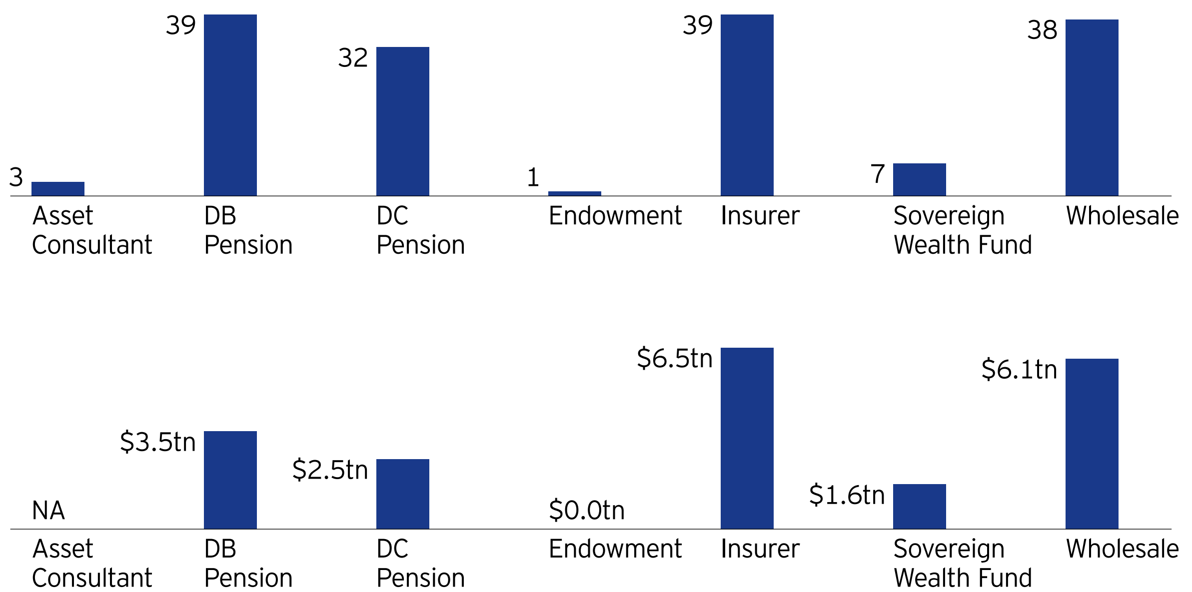
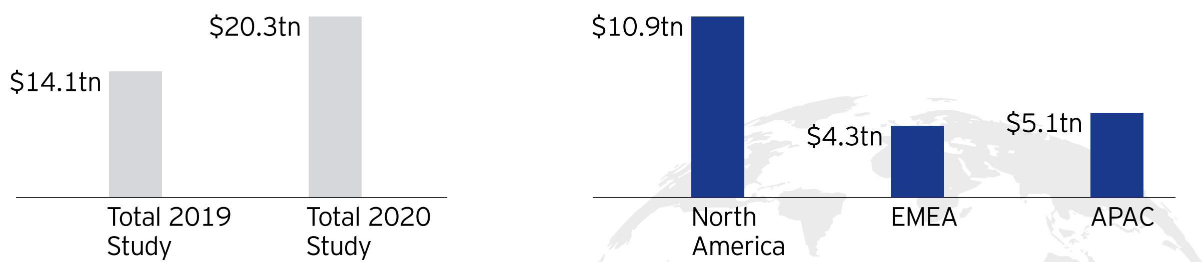



Figure 6.4
**Sample AUM**



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