

IG private credit and solutions to LDI conundrums

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For pension plan sponsors, a liability-driven investment (LDI) approach can often involve a number of tradeoffs. How can plans invest in order for their assets to have strong correlation to corporate-linked liabilities, while still providing sufficient diversification to minimize the impact of downgrades and defaults? How much return potential should plans sacrifice to better hedge liabilities?

In this piece we discuss these challenges and how an asset class like investment grade (IG) private credit can help.



Correlation versus diversification?

One of the most paradoxical demands of an LDI program is its dual goals. The first is its goal of hedging liabilities, measured on a discount curve based on a narrow subset of corporate bonds. The second goal is ensuring that the portfolio contains sufficient diversification to avoid overconcentration across issuers or sectors that could negatively impact the portfolio through downgrades and defaults.

The need to answer this correlation versus diversification question has become more pressing for plan sponsors, as they have moved down their glidepaths and allocated more to fixed income assets. The goal of many multi-asset LDI solutions is to find the right mix of assets such that the benefits of a more diversified portfolio outweigh any adverse impact on the overall hedging strategy.

The introduction of a diversifying asset class often introduces additional tracking error versus the liabilities. For example, when plan sponsors use BBB-rated issues that fall outside the discount rate methodology used for most purposes, they are introducing an asset class into their portfolio that is not directly used in valuing their liabilities. However, because of the correlation to more highly rated bonds and the added diversification benefits, the potential upside of expanding the investible universe outweighs the downsides of introducing a slightly less-correlated asset for most plan sponsors. While this example is very straightforward, most other asset classes outside of public fixed income markets introduce a degree of tracking error relative to the liabilities that must be weighed relative to the benefits of a more diversified portfolio.

Hedging versus outperforming the liability

Plan sponsors face another tradeoff when thinking about balancing the risk and return goals of an LDI program. As plan sponsors look to lock in their funded status gains, they typically allocate away from growth assets such as equities to liability-hedging assets such as corporate bonds or Treasuries. This helps reduce the funded status volatility but also sacrifices some of the upside from the growth allocation.

Many plan sponsors are comfortable with this tradeoff – as they move down their glidepaths, the value of protecting their funded status outweighs the potential upside that comes from taking more risk. Other plan sponsors choose to achieve their hedging goals synthetically, utilizing Treasury futures or swaps to add duration while maintaining their growth allocations. However, these sponsors then face challenges in hedging the credit exposure inherent in their liabilities.

In general, the more we work to make the assets look and behave like the liabilities, the less potential upside we have to keep pace with some of the “unhedgeable” components inherent in pension plans. Such components include the fact that the discount curves used to value liabilities are immune to possible defaults and downgrades, and that liabilities themselves are impacted by factors such as increased longevity.

Does IG private credit “thread the needle?”

IG private credit might be positioned right in the middle of these tradeoffs. The asset class encompasses loans and debt securities issued by companies or entities outside of public capital markets. Issuance is primarily fixed rate, IG debt instruments, with tenors from 5–30 years but with structural

protections that surpass those typical for public bonds, including collateral and maintenance covenants. As IG private credit transactions are generally more customized and less liquid than public bonds, investors are paid a spread premium over comparable public bonds.

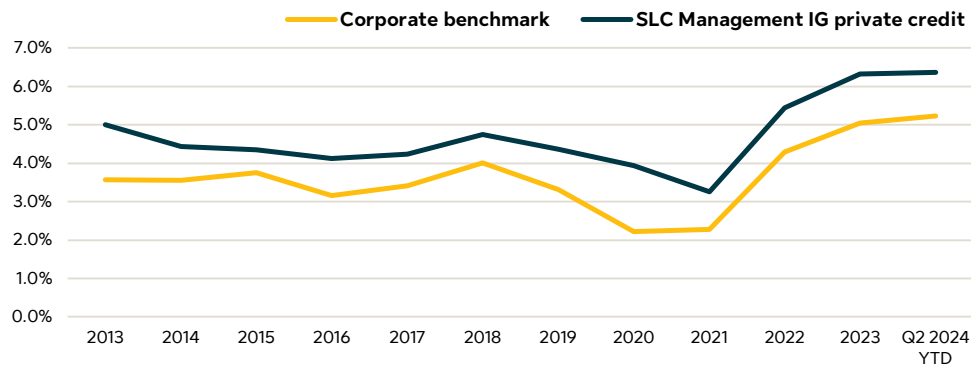
Correlation with diversification

IG private credit can be well positioned to provide both the potential benefits of correlation and diversification for plan sponsors. Firstly, and critically for LDI investors, IG private credit issues are typically priced relative to the interest rates and spreads underlying traditional IG public bonds. This gives them a direct connection to the discount curves used to value plan liabilities. This correlation makes the asset class a natural fit for a portfolio attempting to hedge liabilities on an accounting or funding basis.

Secondly, investing in IG private credit provides plans with access to a range of IG issuers and sectors outside public markets. Examples include major professional sports leagues, large accounting firms and asset managers. This breadth of opportunities can be critical for plan sponsors looking to reduce their concentration risk to names in the public markets.

The following exhibit illustrates this balance of correlation and name diversification, utilizing SLC Management’s combined IG private credit pool¹ as a proxy for IG private credit:

Historical yields



~10-year monthly spread correlation of IG private credit vs. corporate benchmark:

0.80

Less than 10% name overlap between IG private credit and the corporate benchmark

Sources: Bloomberg, SLC Management, 2024. Data include U.S. currency and fixed rate transactions. Data for IG private credit represent the weighted average of SLC Management’s combined investment grade private credit pool.¹ Data for the corporate benchmark represents the weighted average benchmark of investment grade public bonds that are equivalent in rating, maturity and sector. Past performance is not indicative of future results. The ~10-year monthly spread correlation was determined using data from Bloomberg and StoneCastle.

A hedging asset that outyields the liability

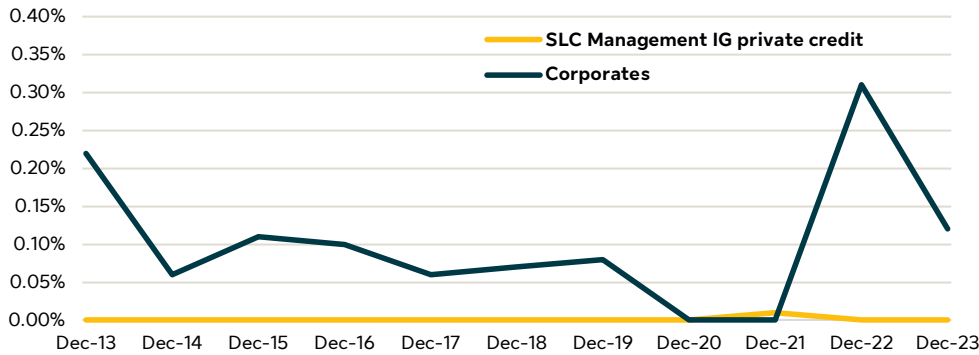
Similarly, IG private credit can allow plan sponsors to both closely hedge pension liabilities and add excess return to keep pace with some of the previously referenced unhedgeable components of pension plans.

As illustrated previously, IG private credit maintains a close correlation to pension discount curves. However, the asset class may also provide additional compensation in return for investing outside public markets. This yield premium typically ranges from 30–300 basis points depending on the nature and complexity of the deal. Unlike public markets, where higher yields are typically seen as compensation for taking additional

credit risk, investors in IG private credit are instead being compensated for the lower liquidity of the asset class and the additional complexity involved in sourcing, underwriting and maintaining these private deals. This additional yield and lower loss experience can be critical for plan sponsors as they look to keep pace with downgrade-immune liability discount curves.

The following chart illustrates the lower default and loss experience of IG private credit relative to IG public markets alongside historical spread premiums. The yield premiums and maintenance covenants associated with IG private credit result in these attractive risk–return characteristics.

Historical losses (realized)



IG private credit's 10-year average spread over corporate benchmark:

1.02%

Sources: Bloomberg, SLC Management, Moody's, 2024. Shown for illustrative purposes only. Data for IG private credit represent the weighted average of SLC Management's combined investment grade private credit pool.¹ Data for the corporate benchmark represents the weighted average benchmark of investment grade public bonds that are equivalent in rating, maturity and sector. Past performance is not indicative of future results.

Many pension plans are in a favorable position when it comes to managing liquidity. Heavy allocations to fixed income assets typically generate more than enough income to meet benefit payments. Meanwhile, major liquidity events such as pension risk transfer activities normally have a significant lead time providing plan sponsors a sufficient window to liquidate assets. **It is also worth noting that IG private credit can provide some liquidity through fund vehicles.** Such solutions often have enhanced liquidity characteristics compared to the IG private credit market overall, and do not have the lock-up periods associated with non-IG private credit.

An old solution for a new challenge

IG private credit has been around for decades as a hedging asset. However, the largest life insurers have traditionally monopolized the space, utilizing their scale and depth of expertise to originate transactions. This has been a large driver of the annuity buyout market, as life insurers are able to price transactions under the assumption that they will benefit from the attractive yields and downside protection available in IG private credit.

Barriers to entry in this market have historically ruled out many participants, as the private and specialized nature of the asset class meant investors needed a deep bench of credit analysts, underwriters and originators to build the necessary relationships with issuers and other market participants. However, more recently we have seen vehicles specifically designed to provide improved liquidity, market pricing and access for plan sponsors. This makes IG private credit now available more broadly to both large and smaller plan sponsors looking to use these solutions in LDI programs.

While no asset class provides a silver bullet for plan sponsors facing tradeoffs in their LDI program, we believe IG private credit might be well positioned to help address those tradeoffs.

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¹ SLC Management's IG private credit pool comprises all U.S.-dollar investment grade private credit commitments made by SLC Management for use by all clients, including Sun Life Financial's general account, other insurance pension and separate account clients and SLC Management's private credit funds.

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