BROADRIVER ASSET MANAGEMENT, L.P.
350 FIFTH AVENUE, SUITE 4215
NEW YORK, NEW YORK 10118
T: 212-486-0600 ¦ F: 877-323-7648

The Future of Fixed Income

The thing that hath been, it is that which shall be; and that which is done is that which shall be done: and there is no new thing under the sun. (Ecclesiastes 1:9)

As long as there are governments, commercial entities and individuals perceived to have the capacity and incentive to borrow and repay, others with cash will be willing lenders, subject to agreement on acceptable recourse, repayment terms and interest rates. Institutional investors still engage in these exchanges because it satisfies a demand for safety of principal, marketability, and cash flow. The investment grade variety of these agreements is also codified as acceptable and appropriate in investment policy statements around the world. It's an easy call.

So, what has changed for pensions, endowments, foundations and family offices?

The rate of interest for traditional fixed income no longer matches the cost of offsetting liabilities. For a while, as interest rates fell during the most recent crash, investors booked gains to offset falling yields. Then came the challenge of redeploying capital into a low rate environment, which brought out the old tool kit of moving down in credit quality or increasing leverage, both of which were constrained by many investment policy statements, not to mention the increased risk. Yet, even when these limitations were eased, rates on lower-quality instruments have also fallen below investors' income needs and are no longer sufficient to compensate for the increase in risk.

Today, managers have taken a hard look at the need for marketability/liquidity in their diversified pools. This examination – the reconsideration of the need for liquidity and where it should reside – has provided managers with the flexibility to seek strategies that can trade a reduction in asset marketability for higher returns via inefficiency and asset expertise, without increased risk. In accessing various “private debt" or "private credit" strategies, institutional fund managers have been able to look beyond the proxy of a debt rating for acceptable credit risk and capture yields closer to or even above the cost of their funds' obligations.

Another factor that tied managers to large allocations to traditional fixed income was the old refrain about the benefits of diversifying among stocks and bonds. The lesson of the financial crisis was that, when diversification is most needed, these asset classes are tightly correlated.

What may, to some, be a new development is the broader acceptance of formerly little known or poorly understood private credit strategies. In some cases, these specialized strategies have moved out of the "opportunistic credit" space into the space formerly occupied by investment grade fixed-income.

What are the common characteristics of the private credit strategies that have been awarded by various investment committees with the imprimatur of "fixed-income" (not alternative or opportunistic) and have gained wider acceptance due, in part, to persistently low interest rates in the bond market? High credit quality, reliable cash flow, low volatility, outsize yields reflective of inefficient asset pricing, and true diversification from the capital markets or general economy.

This is not to suggest that private credit is the future of fixed income. But, just as its analog – private equity – has been widely incorporated into the asset allocation of most institutional funds, so too will private credit strategies find their place among the allocations in large diversified investment pools.

Longevity risk is one such private credit strategy that, carefully considered and acquired, provides high credit quality, low volatility, and reliable cash flows at attention grabbing yields. From primitive beginnings two decades ago, institutional quality asset managers have professionalized the space to the point where sophisticated institutional managers are allocating significant capital to longevity risk from their fixed-income books. These strategies have been deployed by such well-known and respected entities as the Berkshire Hathaway, New Zealand Superannuation Fund, AIG and others.

The same dynamic that makes the performance of life insurance companies predictable animates the investment strategies in this asset class. While the specific application can be as diverse as any private equity play, the underlying longevity assets have common characteristics: they are highly diversified senior obligations of investment grade insurance carriers, required by statute to maintain reserves many times in excess of their outstanding claims, and their performance is uncorrelated to the financial markets and immune to behavioral economics.

Adding greater reliability to cash flows and targeted yields in longevity portfolios is the law of large numbers, which narrows the tails of potential outcomes both on the upside but more importantly, on the downside. This probabilistic phenomenon has an outsized subduing effect on volatility, which also tends to lower the volatility of any larger portfolio of diversified assets into which it is joined.

Similarly, assets such as municipal tax receivables exhibit the same characteristics: an over-collateralized senior position with low correlation to economic forces and, when sufficiently

diversified, low volatility in their returns.

The bulk of fixed income investing will remain with traditional instruments. But, the current interest rate environment has unearthed for managers a previously overlooked group of strategies under the "private credit" rubric that can deliver the needed returns without increased risk.