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AEGON Asset Management

Opportunities in alternative fixed income

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Executive summary

- The alternative fixed income asset class is highly diverse, embracing private debt, consumer loans, mortgage investments, insured loans, loans to small and medium-sized enterprises (SMEs), infrastructure debt and asset-backed securities (ABS). These assets can offer enhanced yields compared to government and corporate bonds, along with relatively low correlations to traditional assets.
- An alternative fixed income allocation can offer investors practical exposure to a wide variety of return drivers, many of which also have an environmental, social and governance (ESG) focus.
- Alternative fixed income is particularly attractive for long-term investors, including pension funds and life insurance companies.
- An interesting feature of many alternative fixed income assets are the additional safety measures compared to traditional corporate loans, such as covenants and guarantees.
- Alternative fixed income strategies exhibit great variety in terms of spread, risk, capital charge, liquidity, duration matching and ESG impact. This enables investors to choose those assets which best fit their particular investment needs, by taking the different characteristics of these assets into account.

For more information about Aegon AM's capabilities in alternative fixed income, please contact your usual client representative or visit **www.aegonam.com/afi**.

Introduction

Alternative fixed income assets, such as mortgage loans, infrastructure financing or private debt, have become increasingly important for institutional investors. They provide opportunities to increase the overall portfolio yield when the (often lower) liquidity of these assets is less of a constraint. This is typically the case for long-term investors, such as pension funds or life insurance companies.

In practice, an alternative fixed income allocation can provide strong diversification benefits, with exposure to a variety of return drivers, often with a focus on ESG factors. These benefits include:

Consumer exposure	Many investors have a large exposure to sovereign and corporate risk. Alternative fixed income assets can offer exposure to consumer risk, for example through investments in residential mortgage loans, credit card loans, auto loans or student loans. This helps diversify their portfolios.
Sustainable financing	A huge capital flow is required to transform the current society into a more sustainable one. Impact investing in infrastructure is already a major trend. Opportunities in water, water treatment, communications and mobility are also available.

Real estate debt	Property investments are a long-term, stable asset class, with the potential for an ESG and/or impact investment focus. Investors who need their private debt investments to contribute to long-term liability hedges can also find real estate debt markets very attractive.
Trade finance and insured credit	Further diversification can be found in insured trade finance and insured credit. These strategies can be especially appealing for insurers due to their moderate capital charges under Solvency II.

Given the illiquid nature of most alternative fixed income categories, the practical allocation between sectors will not be particularly dynamic. However, the high income produced by many of these categories means there is a potential to reallocate income streams to new opportunities or increase allocations to favoured sectors. Regional diversification is also important, although there may be a preference for certain regions in some sectors, given the relative size of the markets and the expertise required for investing successfully in different parts of the market.

A high demand for impact investing - but still a limited supply of deals that conform to the strictest ESG definitions - makes building a diversified portfolio less easy, or at least a more time-consuming process. We believe, however, that the various existing opportunities and ongoing development of the alternative fixed income market make it a good choice for supporting long-term sustainable investing objectives. Of particular interest are direct lending opportunities, which we will discuss in more detail in this paper. However, given that direct lending is such a broad concept, we first provide some initial guidance in the exhibit below.

An introduction to direct lending

The defining characteristic of direct lending is that investors provide funding directly to the underlying business rather than, for example, buying a bond in the public market.

For certain transactions, banks may still be involved in the origination process, but they will usually look to (partly) pass on exposure to other investors. For other loans, for example those driven by private equity investors, they may approach known private debt managers to explore their options. In all cases, having an investment manager with experience and a strong network in the specific loan sector of interest will be important to access the best available deals.

Another important characteristic of direct lending, which you do not see in public markets, is the availability of covenants. These cover the rights of lenders to act against borrowers if they default on their loan obligations. When borrowers commit to a loan, they also agree to adhere to certain conditions, which can include providing collateral against a loan, maintaining certain financial measures within prescribed limits, and not paying dividends or taking on additional debt above prescribed limits.

Breaching such covenants can result in a technical default and the lender can then take certain actions against the borrower, such as asking for additional collateral or a higher interest rate on the loan. The private nature of the loans means the lender can negotiate such covenants directly with the borrower.

Some loans have all lenders in the same position in the capital structure, known as ‘unitranche’, while others will be split into first lien, second lien and mezzanine, with the first tranches having greater protection than later tranches, - such as through rights to assets or collateral.

The potential returns on direct loans vary considerably, depending on the riskiness of the loan, as well as other factors. Returns consist of interest payments, up-front fees where applicable, and for some loans the potential for equity warrants which provide exposure to the value of the underlying business.

Comparison

In Table 1 we compare different categories within the alternative fixed income spectrum. It is important to note, however, that the scores on the different dimensions can (and will) shift over time and that the assessment is sometimes based on qualitive instead of quantitative measures (the ESG assessment being an example). Capital charges are determined with the standard formula of the Solvency II regulations, see also the next section for more information.

Table 1: Comparing different alternative fixed income strategies

	Swap spread	Risk	Capital charge	Liquidity	Matching	ESG
Dutch mortgages	1.61%	Low **(AAA-AA)**	Low	Low	High	Sustainable
Danish mortgages	0.99%	Low **(AAA)**	Low	High	Low	Sustainable
ECA Loans	0.5%-1.5%	Low **(AAA-AA)**	Low	Low	High	Sustainable
ABS	1.55%	Low **(AAA-AA)**	High	High	Low	Sustainable
Insured credit	1.8%-2.0%	Low **(AA-A)**	Low	Low	Moderate	Responsible
Insured trade finance	2.0%-3.0%	Low **(AA-A)**	Low	Moderate	Low	Sustainable
Infrastructure debt (senior)	2.0%	Low **(BBB)**	Moderate	Low	High	Impact
SME loans	9.0%	Moderate **(BB)**	Moderate	Low	Low	Sustainable

Table 1: Characteristics of a variety of fixed income asset classes (for illustrative purposes only). Actual spreads are reported for strategies which are available via a well-diversified fund format. For more bespoke strategies a spread range is given. Rating indications in this table are either external ratings (when available) or internal ratings (for unrated instruments). We here consider the matching properties for an investor with long-term liabilities. More information about the ESG classification of the different strategies is given in the last column. We here use three labels (responsible, sustainable and impact), which are discussed in more detail below. Sources: Bloomberg, Aegon Asset Management, La Banque Postale Asset Management, Danske Bank, as of April 30, 2022 or latest available.

We now consider the characteristics of each of the alternative fixed income strategies in Table 1.

Dutch mortgages

Dutch mortgages are direct-to-consumer loans, which are accessible via funds, special purpose vehicles (SPVs) or segregated mandates. Investments are typically made via a pool of many thousands of mortgages. The total size of the Dutch mortgage market is around €765 billion.[1]

The credit risk associated with this asset class is very low. Part of this market is also guaranteed by the Dutch central government (with an own-risk clause of 10% for the issuer). The liquidity of these loans is very limited, however, so this asset class is most attractive for long-term investors.[2]

Spreads are substantial, typically between 1.25%-2.25%. Compared to Danish mortgage bonds, Dutch mortgage loans are less complex in terms of embedded options, particularly when considering the higher prepayment risk of Danish mortgages. As a result, Dutch mortgage loans are more suited as part of a matching portfolio.

[1] As of June 30, 2021. Source: Statistics Netherlands (CBS).

[2] Liquidity may be better for investors in mutual mortgage funds. Because the mortgage loans generate a substantial amount of income (due to regular mortgage payments and prepayments), enough cash may become available over time to facilitate the exit of fund participants.

Danish mortgage bonds

Danish mortgage bonds are a familiar category for European institutional investors, particularly in the Nordics. They are listed bond issues with a notional and coupon reflecting the notional and coupon of a pool of similar mortgages on a pass-through basis. They can be accessed directly via an investment in listed bonds or through fund structures. The market for Danish mortgage bonds is one of the largest covered bond markets in the world at around €419 billion.[3] These bonds are an attractive alternative to sovereign bonds, given their rating (AAA), relatively high liquidity and additional spread.[4]

A possible drawback is a less effective interest-rate hedge, due to prepayment being possible without penalty for callable Danish mortgage bonds. This can cause significant fluctuations of the duration of these bonds. For example, in case of decreasing interest rates, prepayment rates can increase rapidly. This in turn leads to a lower duration of the callable bonds and a lower hedge effectiveness, precisely when the interest rate hedge is most needed from a risk management perspective.[5]

Export Credit Agency loans

Export Credit Agency (ECA) loans invest in projects such as social housing, renewable energy and hospitals, with a full guarantee from a highly rated central government. Due to the central government guarantee, no capital charge for credit risk applies for these loans under Solvency II. ECA loans are facilitated by an export credit agency, which acts as an intermediary between national governments and parties who want to insure investments abroad.

Examples are loans via Atradius in the Netherlands, Euler-Hermes in Germany or Coface in France.[6] ECA loans are non-standard agreements with high entry barriers. The liquidity of these loans is much lower than the sovereign debt of the backing government, but this translates into significant spreads over the euro swap curve (0.5%-1.5%).

This asset class is very suitable for impact investing, for example by financing specific projects in developing countries. Due to the high credit quality and predictable cashflows, these instruments also typically fit well into a matching portfolio.

Asset-backed securities

Asset-backed securities (ABS) are securities backed by specific collateral. The largest ABS sectors are residential mortgages, consumer loans (credit card and auto loans), commercial mortgages and loans to corporations. Contrary to their reputation, default rates on European ABS during the financial crisis were significantly lower than on similarly rated corporate bonds.

We have seen strong ESG integration in the ABS space and liquidity via the secondary market is high. The drawback of this asset class is its punitive treatment under Solvency II, leading to a high capital charge (see also the next section for more information).

The attractive spread for this asset class is due to a lower level of asset purchases of ABS by the ECB (compared to sovereigns and credits) and less appetite from insurance companies (due to the harsh treatment under Solvency II). As a result, the ABS market is less crowded than other liquid fixed income markets.[7]

[3] As of December 31, 2019, see https://www.dfsa.dk/-/media/Nyhedscenter/2021/Transparency-in-Danish-mortgage-bonds.pdf.

[4] The spread for Danish mortgage bonds in Table 1 is representative for fixed rate, callable bonds. The yield in Danish Kroner is converted to an equivalent euro yield (assuming a currency hedged position). We here use the average spread, relative to the euro swap rate, for maturities of 10, 15, 20 and 30 years. Source: Danske bank.

[5] See van Bragt and Caplain (2018) for more information.

[6] These ECAs are fully guaranteed by their respective central governments.

[7] For investors who do not face high capital charges for ABS (e.g. retail investors or charities) the high yield segment of the ABS market may also be of interest. Typical spreads for high yield ABS are 3.95% over swap (at the end of October 2021) for a diversified mandate with an average rating of BB.

Insured credit 	Insured credit is backed up by an insurance company (with a rating of A- or higher). The insurance company explicitly and fully guarantees the contractually agreed principal and interest payments. This works like a financial guarantee and provides protection against the default of the underlying asset. The aim of the strategy is to create a higher-yielding and capital-friendly alternative to corporate bonds or corporate private placements. These loans have a typical maturity of five years and offer a significant spread (1.8%-2.0%). In terms of the underlying loans, this strategy uses BBB, BB or B rated assets. In general, there is a broad investment universe, including emerging markets, which are a good source for insured private debt assets. Other opportunities come from sports markets, project financing and infrastructure debt, as well as in collateralized debt obligations (CLOs). Capital requirements are expected to be low for this strategy, due to the additional insurance protection. ESG objectives can also be incorporated, since a tailored investment policy can be created that, for example, focuses on developing countries. Liquidity via a secondary market is limited, however, so this strategy is most interesting for long-term investors.
Insured trade finance 	Insured trade finance invests in notes shorter than 1 year which are secured with trade finance assets. These notes are financial instruments with additional protection from an insurance company. This removes risks, such as payments and supply, for the counterparties and thus facilitates global trade. In practice a special purpose vehicle (SPV) is used to bundle trade receivables (mainly unrated SME loans). Liquidity is limited, but this is mitigated by the short maturities of the underlying loans. Spreads are substantial (2.0%-3.0%) and the capital charge is limited due to the shorter maturities and additional insurance protection.
Infrastructure debt 	Infrastructure debt relates to the financing of equipment, facilities and networks that provide essential public services. These real assets typically generate predictable long-term contracted and/or regulated revenues. Infrastructure often offers some degree of inflation protection, depending on the specific investment. The rise of infrastructure as an asset class is supported by structural trends, such as the call by governments on private investors to undertake infrastructure projects. In particular, the EU and national governments have committed themselves to energy transition, in line with the Paris climate agreement. This is leading to a growing pipeline of renewable energy and clean tech projects. Investing in infrastructure therefore fundamentally contributes to the energy transition and responsible investment initiatives. An attractive feature of infrastructure debt is the moderate capital charge under Solvency II (compared to corporate bonds). For example, a BBB-rated corporate bond with a duration of 10 has a capital charge of 20%, compared to only 13.35% for an infrastructure loan with the same rating and duration. The insurance regulator (EIOPA) has argued that this is reasonable, given evidence that infrastructure investments exhibit superior recovery rates than corporate debt and are less sensitive to broader economic factors. Infrastructure investments, however, need to satisfy several criteria to qualify for a reduced capital charge. They also tend to be highly illiquid, so are most appropriate for long-term investors. The stable, long-term and predictable cashflows make (fixed rate) infrastructure loans a good candidate for a matching portfolio.
SME loans 	Loans to small and medium-sized enterprises (SMEs) in the Netherlands are most attractive to long-term investors, who are comfortable holding illiquid investments within their portfolios. A positive aspect of this strategy, compared to traditional fixed income assets, is the high lending rates (on average over 9%).

These rates exist across different direct lending strategies, but this specific strategy is supported by relatively low Dutch SME default rates and partial guarantees of an AAA-rated European entity, the European Investment Fund (EIF).

Guarantees are either provided through the EIF InnovFin program (50% guarantee) or through the EGF Guarantee Facility (70% guarantee). The expected recovery from an EIF guarantee is much greater than from enforcement of collateral assets in, for example, a senior secured lending arrangement. These benefits should be weighed against the possible drawbacks of the loans. They are highly illiquid and (currently) concentrated on Dutch SMEs. The returns also depend on the ability of the manager to invest in the most attractive loans under the right set of covenants. A benefit is that a specialised manager can focus on the Dutch market and use established contacts with market participants such as banks and private equity investors.

Capital requirements

While most alternative fixed income strategies in Table 1 score well in terms of risk and return, their liquidity is typically lower than for traditional assets. We now examine the capital requirements of these strategies in more detail. In Figure 1 we compare the capital requirements for the different strategies introduced above. We use the Solvency II capital requirement (SCR) for spread risk, except for Dutch mortgages, where we show the SCR for counterparty default risk.

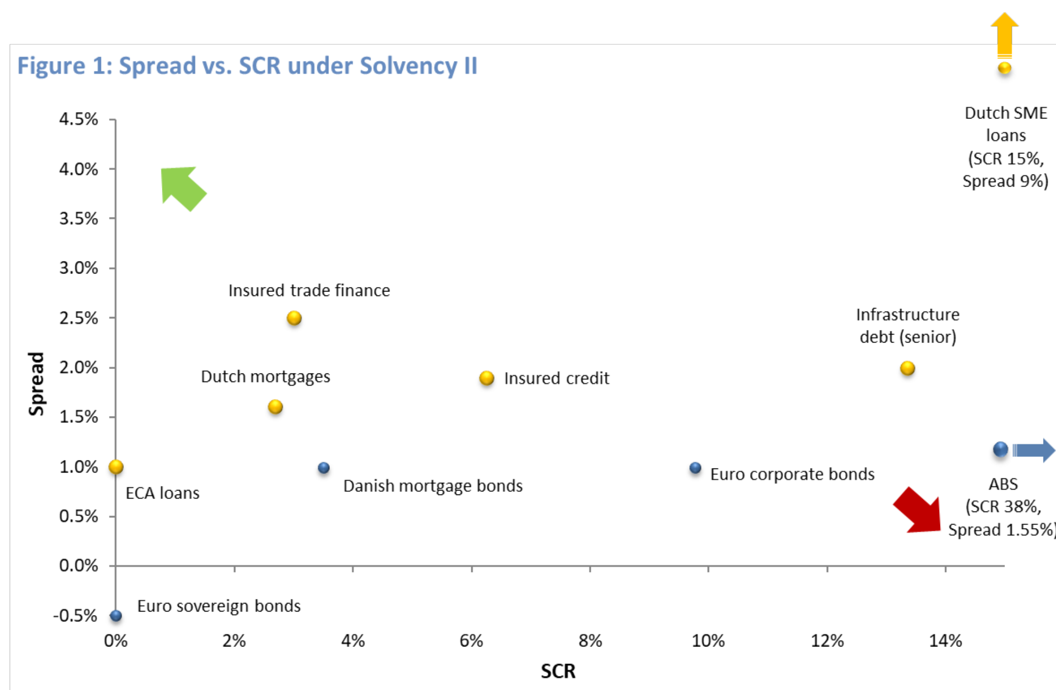

Figure 1: Solvency II capital requirement (SCR) vs. spread for a variety of fixed income asset classes (for illustrative purposes only). Spread levels are shown at the midpoint of the ranges given in Table 1. Sources: Bloomberg, Aegon Asset Management, La Banque Postale Asset Management, Danske Bank, as of as of April 30, 2022 or latest available.

The SCR is determined with the standard formula under the first pillar of Solvency II. Possible capital add-ons under the second pillar are not shown here. Under the standard formula, the SCR for spread risk depends on the rating and (spread) duration of the assets. From an SCR point of view, this naturally favors assets with a high rating and a short duration. In Figure 1 infrastructure debt, insured trade finance and Dutch SME loans are all treated as unrated instruments. For the other categories we assume that an external rating is available. For comparison, results for two traditional, liquid categories (euro sovereign bonds and euro corporate bonds) are also shown in Figure 1.

It is clear from Figure 1 that most alternative fixed income strategies are relatively capital-efficient (a higher spread at a similar SCR, or a lower SCR at a similar spread). Adding these strategies will, however, typically lead to less liquid portfolios, so investors should have sufficiently large illiquidity budgets to accommodate this.

Both ABS and the Dutch SME loans strategies are off the scale of this graph, due to a very high SCR for ABS and a very high spread for Dutch SME loans. Insured trade finance scores relatively well, due to a high spread coupled with a low SCR (due to the short duration).

ESG considerations

Alternative fixed income strategies are well-suited for sustainable investing. They often finance projects that do not have easy access to capital markets and would otherwise receive less financing. Furthermore, many ESG solutions are driven by smaller, innovative, privately-owned companies, which are commonly involved in direct lending transactions.

Investors can be selective and specific when it comes to ESG. Investors, individually or in small groups, can negotiate terms to stipulate adequate reporting on ESG, or set interest rates contingent on general ESG performance or specific ESG factors. They can also have more direct controls and ways to engage with borrowers.

Integrating ESG is part of our investment process for each category of alternative fixed income. In Table 1 we classified each strategy in one of three ways:

Responsible	Our ESG process begins with a thorough due diligence and consists of integrating financially material ESG factors in our traditional financial analysis framework, to help inform our decision making. In Table 1, we classified this as *responsible*.
Sustainable	With certain strategies investors can also explicitly focus on addressing certain sustainability themes. In Table 1 we classified this as *sustainable*.
Impact	Investors may also find opportunities to make a more direct link between investment decisions and the impact on the real world, compared to traditional public debt. Some debt investments allow for the specific allocation of loans to ESG-led projects, creating real-world positive outcomes. In Table 1 we classified this as *impact*. Infrastructure debt is a good example of a strategy with a high potential for impact investing. An important point here is that choosing to invest for impact does not mean sacrificing yield. Across our investment universe we see only minimal differences in yield pick-up between positive impact investments and those which do not have a specific impact angle. This is something we also see across a broader group of alternative fixed income strategies.

Conclusions

- In recent years alternative fixed income assets such as mortgage loans, infrastructure financing and private debt have become much more important categories for institutional investors. They can provide opportunities to increase portfolio yield when the (often lower) liquidity of these assets is not a constraint. This is typically the case for long-term investors, such as pension funds and life insurance companies.
- Many insurance investors will already be aware of the benefits of Dutch mortgages and Danish mortgage bonds, which can provide an attractive return on capital. Other types of alternative fixed income can add diversification alongside mortgages, but also alongside public market investments. Substantially higher yields are possible (even with well-collateralized senior loans), particularly in private corporate debt markets.

- In practice, an alternative fixed income allocation can offer exposure to a wide variety of return drivers, many of which also have an ESG focus. Examples discussed in this article include insured loans (either private loans or trade finance), SME loans and infrastructure debt. An interesting feature of these categories is that greater safety measures can exist compared to traditional corporate loans, for example in the form of additional covenants or guarantees. Dutch SME loans can, for example, benefit from additional protection by the European Investment Fund, while private debt and trade finance can benefit from additional protection by an insurance company.
- Alternative fixed income strategies demonstrate great variety, both in terms of spread, risk, capital charge, liquidity, duration matching and ESG factors. Investors have an opportunity to select those assets which best fit their particular investment needs, by taking the different characteristics of these assets into account.

References

Van Bragt, D. and N. Caplain (2018), “A look across the border: Danish mortgages bonds versus Dutch mortgage loans”, Alternative View, Aegon Asset Management. Available at https://www.aegonam.com/en/aegon-insights/research/a-look-across-the-border-danish-mortgage-bonds-versus-dutch-mortgage-loans/.

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