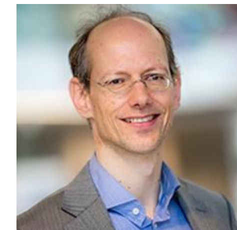
Aegon Asset Management

Solutions
June, 2023

AEGON INSIGHTS

Opportunities in alternative fixed income

Alternative fixed income assets, 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.



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Executive summary

- The alternative fixed income asset class is highly diverse, embracing many asset classes such as 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 opportunities. 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**.

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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.

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.
Insured credit	Further diversification can be found in insured credit. This strategy can be especially appealing for insurers due to its relatively attractive return on capital 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.

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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 factors
Dutch mortgages	1.5%-2.0%	Low **(AAA-AA)**	Low	Low	Moderate	✓
ECA Loans	0.5%-1.5%	Low **(AAA-AA)**	Low	Low	High	✓
ABS	~ 2.75%	Low **(AAA-BBB)**	High	High	Low	✓
AAA STS ABS	~ 0.7%	Low **(AAA)**	Low	High	Low	✓
Insured credit	2.0%-2.5%	Low **(AA-A)**	Low	Low	Moderate	✓
Infrastructure debt (senior)	2.0%	Low **(BBB)**	Moderate	Low	High	✓
SME loans	7.0%-8.0%	Moderate **(BB)**	Moderate	Low	Low	✓

Table 1: Characteristics of a variety of fixed income asset classes (for illustrative purposes only). Indicative spreads in EUR. 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. For details on how the strategies can have an ESG angle, get in touch with us. Sources: Bloomberg, Aegon Asset Management, La Banque Postale Asset Management, as at June 30, 2023 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 €799 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 1.5%-2.0%. As a result, Dutch mortgage loans are well suited as part of an institutional investor's longer-term portfolio.

2023 Aegon – a.s.r. deal enhances Aegon AM's Alternative Fixed Income platform

Under the transfer of portfolios with a.s.r., approximately GBP 14 billion will be added to our illiquid fixed income asset base, which currently amounts to circa GBP 52 billion (per 31 Dec 2022). This will further strengthen our already strong position in these specific areas. As far as our future product offerings are concerned, our alternative fixed income suite will broaden with the transition of a.s.r.'s mortgage funds, private debt and renewable energy funds to Aegon AM.

[1] As of December 31, 2022. Source: De Nederlansche Bank (DNB).
[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.

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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.[3] 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.

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.

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. A sub-category of ABS are the simple, transparent and standardised (STS) ABS.

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). As a result, the ABS market is less crowded than other liquid fixed income markets.[4] We have also seen strong ESG integration in the ABS space and liquidity via the secondary market is high.

Simple, transparent and standardised (STS) ABS need to meet a more stringent set of requirements from regulators involving a multi-step process to satisfy the STS eligibility criteria set out in the Securitisation Regulation. However, the resulting capital treatment for the STS sub-category is more favourable for European insurance companies.

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 (2.0%-2.5%). 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.

Given its spread pickup, insured credit offers an efficient return on capital, particularly under Solvency II, where the capital requirements can be reduced 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.

[3] These ECAs are fully guaranteed by their respective central governments.
[4] 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.

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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 c13% 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 (7-8% above swaps).

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 under Solvency II

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.

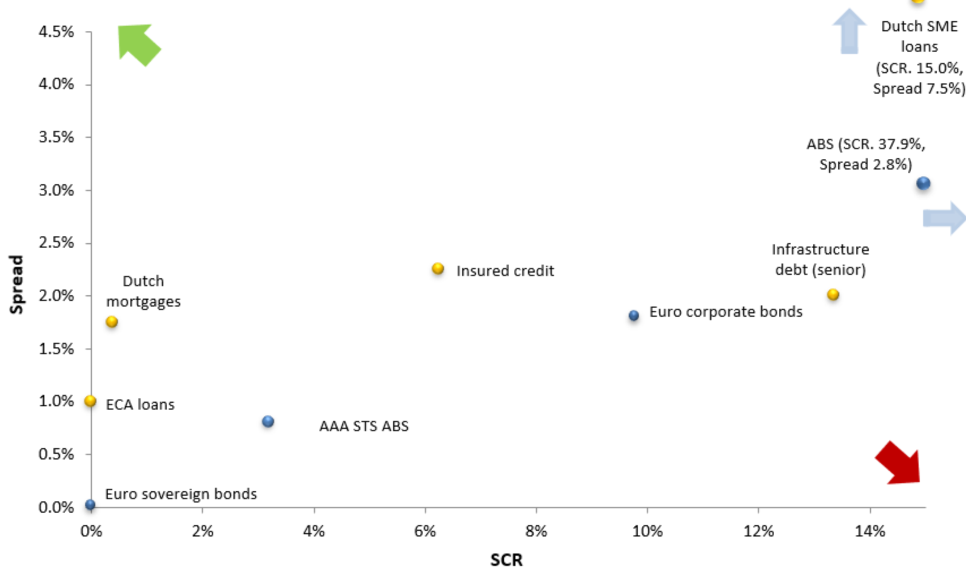

Figure 1: Solvency II capital requirement (SCR) vs. spread above swaps for a variety of fixed income asset classes (for illustrative purposes only). Spread levels are in EUR and indicative only. Sources: Bloomberg, Aegon Asset Management, La Banque Postale Asset Management, as of as of June 30, 2023 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 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 non-STS ABS and the Dutch SME loans strategies are off the scale of this graph, due to a very high SCR for non-STS ABS and a very high spread for Dutch SME loans. Insured credit scores relatively well, due to a A-AA credit rating and yield pick-up over corporate bonds.

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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. This is different for each strategy and opportunities for responsible, sustainable and impact investing can be found.

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, 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. 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, 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 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.

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