# Illiquid credit, QE and the growing risk of rising rates

**Adrian Jones** of Allianz Global Investors discusses how schemes can achieve their investment objectives, the pros and cons of illiquidity premium and key themes for 2017

**Q To what extent must schemes look beyond traditional investment strategies to achieve their objectives?**

For many schemes the combined forces of increased longevity and general financial repression present a genuine existential risk. Faced with such pressures all schemes must continually reassess investment strategies, including considering whether asset classes that have traditionally not featured in their portfolios should be re-considered. This is particularly pertinent if their historic exclusion was caused by lack of availability or market access rather than a conscious decision of the scheme.

What may be less obvious is the fact that certain assets may be less directly affected by some of the mechanisms of financial repression than others and that it may be the more traditional assets i.e. exchange traded equities and fixed income which are most susceptible to price distortion by the latest manifestation of quantitative easing (QE): the direct acquisition of non-government securities by central banks.

Clearly all assets are affected by a general reduction in rates and spreads but many non-traditional assets are not (yet) accessible to central bank bond buying programmes and not all of the private money displaced by such programmes is able (yet) to access non-traditional assets. Some pricing has been stickier to date, for example illiquid credit vs liquid credit.

**Q What do you believe are the key asset classes and strategies schemes should be investigating at the current time? How can these strategies help them achieve their goals?**

Illiquid credit, especially highly secured credit such as project finance, presents features that can enhance many portfolios. No single asset class or strategy offers a panacea. The strategic allocation between matching and return-seeking assets must reflect the situation of the individual scheme, the scheme's maturity and near-term cash-flow requirement, as well as the covenant strength and risk appetite of its sponsor. However, having made the strategic allocation, the next question is the optimal composition of those matching assets. This selection is often thought of as a zero sum trade-off between absolute return, credit-quality and liquidity.

Analysis of illiquid credit opportunities in the current rate environment challenges some of this paradigm. What if an issuer, favouring a known and stable long-term investor-base grants better covenants and a slightly higher margin in return for the comfort of knowing that his debt cannot fall into the hands of vulture-funds? What if the resulting illiquid debt is structured as an amortising liability rather than a bullet redemption thereby further reducing a key credit risk (re-financing risk) while reducing the relevance of early disposal of the asset as a route to liquidity for the investor in any event?

We believe that closed-ended funds of transparent well-structured illiquid credit offer such possibilities of simultaneously improved credit, improved pricing and only marginally worse relative liquidity.

**Q Can schemes take advantage of the illiquidity premium to boost investment returns? If so, how should they look to access these sorts of investments and what are the key issues to consider?**

While illiquidity premiums are available for private debt, investors should take full advantage. However, it would be detrimental to the development of the private debt market if investors' advisers made current differences between listed and unlisted spreads a permanent hurdle to private debt investment. We believe the apparent illiquidity premium offered by private credit is less a reflection of the opportunity cost of holding such investments relative to listed bonds and more a reflection of distortion of public markets by QE.

As rates rise the resulting correction in listed debt prices could erode spread differences between public and private debt. At the same time differential credit quality could become more important to ultimate realised returns. **Private secured debt with robust covenants and active creditor management is likely to outperform senior unsecured passive listed debt both in terms of cumulative probability of default and recovery post default.** Credit performance over the last 30 years has benefited from falling interest rates, making lower cost re-financing a regular way out of distressed situations and elevating asset residual values. We believe a rising rate environment credit quality will be more valuable to investors than relative liquidity.

**Q What will be the key investment themes of 2017 and how will this affect fund investment strategies?**

Heighted awareness of the risk of rising rates will probably be a theme of 2017. Given so few investors predicted the levels to which interest rates would fall, nor for how long low rates would persist, many will probably fail to predict the timing and speed of any eventual rebound. If that is the case any debt acquired today for greater future liquidity relative to illiquid assets available on better credit terms could be at risk of being mispriced, especially if refinancing risk is being underestimated as a source of future credit losses in less structured debt programmes. For example, much long-term amortising illiquid debt is less exposed to refinancing event risk.

We would suggest pension funds approaching decumulation should consider stress scenarios in which all assets are illiquid and assess to what extent the cash-flows of their assets match the cash-flows of their liabilities and how much re-financing risk is being borne in those liquid investments which they expect to be able to easily liquidate. In particular de-cumulating funds used to focusing on long-term performance may need to become as sensitive to the path of value growth as well as ultimate long-term growth. A 20% loss followed by a 25% gain is only neutral if you are not cash-flow negative.

Allianz Global Investors

**Adrian Jones, director of infrastructure debt, Allianz Global Investors**

Before joining Allianz Global Investors, Jones was a managing director within MBIA UK Insurance. He was primarily responsible for infrastructure debt, project finance, and public finance origination and execution. Prior to joining MBIA, Jones worked for Schroders/Citigroup, Deloitte and ANZ Bank in advisory and debt arranging capacities.