

**Capital at risk.** The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.

## Fixed Maturity Portfolios - Time to Lock in Income?

April 2023

### *How can investors seek to lock in potentially higher yields without taking undue credit risk?*

After over a decade of zero-to-negative interest rates, central banks globally have implemented rate rises to combat inflation. This interest rate normalisation has resulted in the return of the 'income' in fixed income.

However, how long these higher interest rates are likely to remain is uncertain and market participants are already predicting the peak of terminal rates. For fixed income investors seeking to capitalize on the higher interest rate environment, and stability and visibility of returns, an allocation to a fixed maturity portfolio could be an interesting option.

With credit markets finally offering what we believe to be an attractive yield that had disappeared for many years, investing in quality credit now offers a compelling risk/reward. Combining investment grade and high yield - a 'crossover strategy' - may enhance returns whilst reducing volatility. Therefore, we believe the current environment offers a good opportunity for carry and income without taking undue credit risk.

As the name suggests, fixed maturity funds have a finite life. Their key objective is to provide steady returns over a set timeframe with a focus on income generation while providing a sustainable distribution. Investors should be willing to commit for the life of a fund. The defined time horizon of the fund allows the return profile to smooth out over time, meaning the strategy can absorb short-term mark-to-market volatility.

Depending on the structure, investors may redeem before maturity, although there is a price adjustment mechanism whereby the transaction costs from outflows are paid for by those redeeming. This mechanism also protects the remaining investors in the fund.

As most investments are expected to be held until the fund's maturity date, they provide visibility into its potential return. Investments made during the initial investment period also offer protection against potential future falls in interest rates, as yields are locked in. Duration risk is meanwhile limited, given the short investment horizon of the strategy, and continues to decline as the fund nears maturity.

We believe a deep focus on bottom-up fundamental credit analysis is the key to success in managing a credit focused investment strategy. It is important to understand risk and minimize downside volatility. Thorough credit analysis helps identify attractive investment opportunities in both sub-investment and investment grade credits. It enables the identification of mispriced opportunities that are solid credits with upside potential. In our view diversification and strong risk management are key, and concentration limits around individual issuer/sector exposure should be applied.

As the fund is close-ended, the coupons and maturities that come due further down the fund's life - reinvestment risk - should be considered. The yield achieved on reinvested capital (following coupons and/or bond repayments) may have a potentially lower yield than that obtained during the fund's initial investment period. A manager can seek to mitigate this risk by investing in bonds with maturities commensurate to the lifetime of the fund. The utilisation of bullet bonds can also prevent the risk of early call dates (predominantly for investment grade issues). An active management approach can further seek to mitigate this risk with the manager choosing to sell outperforming credits prior to maturity and replacing them with bonds of a similar outstanding maturity that may offer additional return potential.

Experience in managing these types of strategies is key. In our view investors should consider an active investment manager with a long-term track record across multiple credit and economic cycles, combined with experience creating and managing fixed maturity portfolios in different market conditions.

Although the macroeconomic outlook may be uncertain, we believe fixed maturity portfolios have the potential of offering investors an appealing, steady income stream over a well-defined horizon.

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