BROADSTONE

BUY AND MAINTAIN BOND FUNDS

Offering both protection against falls in interest rates and the opportunity to generate a return above the liabilities, corporate bonds are an important element of many pension scheme investment portfolios. Buy and Maintain Bond Funds are one of the newest additions to the fixed income offering for pension schemes and may offer a more stable investment over the longer term.

What are Buy and Maintain Bond Funds?

These funds aim to generate a return by investing in global bonds, predominantly these are of investment grade quality. To preserve value over the course of a bond cycle they avoid defaults and securities experiencing a significant downgrade in quality.

Why use them?

Buy and maintain strategies are increasingly being used by investors looking beyond traditional credit exposure, whether as part of a liability-driven investment strategy or simply as a different approach to credit management.

These funds can provide investors with diversified, global investment grade bond exposure. They also reduce the drawbacks of being constrained to benchmarks reflecting the market capitalisation.

How do they work?

Buy and maintain differs from a traditional approach as bonds are bought with the intention of holding them for the medium to long term, preferably until maturity. Therefore they only take a long term strategic view on particular securities.

The investment process has two distinct parts. The ‘buy’ process which determines initial portfolio construction and the ‘maintain’ process that covers portfolio monitoring. The ‘maintain’ process includes decisions on when to sell securities and when to hold them, as well as how to replace bonds that have been sold and thereby preserve value.

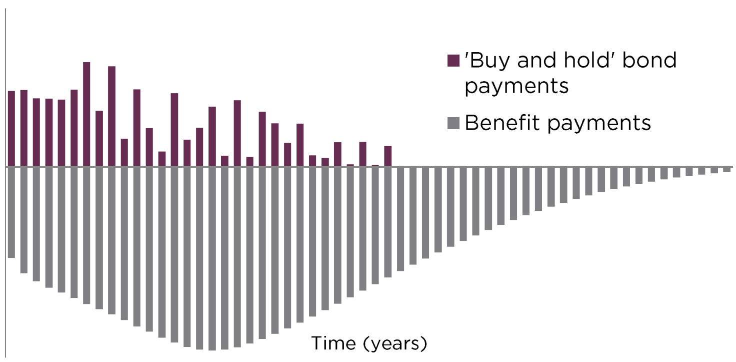
Maintaining the quality of the portfolio is just as important as building it. Bond holdings are screened on a continuous basis. This ensures the managers remain confident that the expected return will be met, while using the cashflows from maturing bonds to reflect new ideas and opportunities.

Buy and Maintain as part of a de-risking solution

By choosing fixed income assets with more predictable cashflows, a Buy and Maintain strategy is suited for providing the core allocation of matching assets as a pension scheme de-risks.

Buy and Maintain Credit can be used to fully or partially match pensioner cashflows. It also delivers additional returns over and above a UK gilt based approach. This mirrors the way in which insurers invest.

Where buy-out is a long term objective, Buy and Maintain Credit can provide a more comparable asset profile. One used by insurance companies with which they might execute a buy-out. This would provide a better hedge against the changing drivers of buy-out pricing. It may also ultimately reduce the costs of buy-out, by having a higher proportion of assets that the insurer is willing to take directly.



What are the key features?

Benchmark agnostic – During the portfolio construction process, exposures are capped on an absolute basis rather than positioned relative to an index. As such Buy and Maintain portfolios usually have lower concentrations in large issuers and sectors and may exclude issuers, sectors or geographies entirely where the portfolio manager has significant concerns. Where permitted, Buy and Maintain portfolios take a global approach to security selection. This improves diversification and allows a focus on favoured issuers. This gives some flexibility to invest where there is most value, either on a market or issuer basis whilst unwanted currency and interest rate exposures are hedged.

Liability aware – Buy and Maintain Credit portfolios emphasise securities which are a good match for long-term liabilities. As a result, sectors and issuers are favoured where there is long-term visibility on fundamentals and a higher degree of asset backing. Portfolios also seek to minimise exposure to bonds where structural features reduce the certainty of cashflows, for example subordinated bonds from financial issuers which have embedded call options and deferrable coupons.

Low turnover – Buy and Maintain Credit portfolios are not concerned with rebalancing to an index and generally have a long-term investment horizon. As such, turnover in Buy and Maintain portfolios is typically low, at around 10% p.a.

How do they compare to traditional funds?

Strategy	Traditional active fund	Buy and Maintain Fund
Return target	Index + target	Based on initial yield
Time horizon	Rolling 3 years	To maturity / 5 years +
Risk profile	Risk limits relative to benchmark	Risk viewed on an absolute basis
Turnover	Medium to high (25% pa)	Low (10% pa)
Costs	Standard active fees	Between active and passive fees

Interested in finding out more? Our experienced investment team can discuss buy and maintain bonds funds now or as part of your next investment strategy review.

If you would like to discuss this please contact your usual Broadstone consultant or:

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