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Fixed Income Insights

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Buy, Maintain and Sustain

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Our observation is that buy and maintain strategies have grown in popularity among long-term fixed income investors in recent years, especially pension funds in the United Kingdom. The core characteristics of a buy and maintain strategy are well-known by now: a focus on long-term investment horizons, low portfolio turnover, avoiding credit impairments and prudent diversification within a portfolio that is tailored to client-specific objectives. While buy and maintain is a well-established investment approach, it is evolving in the current environment through the integration of sustainability considerations.

Buy and maintain strategies have grown in popularity among long-term fixed income investors in recent years. Buy and maintain typically works well as an integrated component of a broader asset/liability risk management program. On this basis, a buy and maintain portfolio will be tailored through portfolio construction to meet the needs of the investor, typically a pension fund or insurance company, and can be calibrated to specific yield, cash flow or duration targets. The core characteristics of the buy and maintain strategy are low investment turnover, prudent diversification and a focus on avoiding credit impairments. We believe the emergence of investment portfolios aligned with sustainability objectives fits well within a buy and maintain framework, with a common characteristic being the need for long-term time horizons. However, in our view, the approach needs to be thoughtful, controlling and monitoring key investment risks such as potential negative credit migration and heightened exposure concentrations.

The need to integrate an evolving sustainability landscape

The growing urgency to address climate change and the transition to a low carbon economy is reshaping the investment landscape. What we have observed is that for UK pension and insurance asset owners especially, aligning investment strategies with net zero ambitions seems to have moved from being a mere consideration to being an imperative, mainly reflecting constraints and stakeholder pressures. Navigating this swiftly evolving sustainability landscape presents a formidable challenge for institutional investors. In response, a buy and maintain investment strategy can offer a solution that is benchmark agnostic, tailor-made to a client's specific goal such as fixed duration or maturity profile, cash flow distribution, or accumulation, incorporating the client's specific risk tolerance, ESG objectives and any other pertinent criteria, while maintaining stable credit quality, minimizing the risk of downgrade to sub-investment grade, avoiding principal impairments and keeping investment turnover to minimum.

A buy and maintain investment portfolio can help address systemic risks such as climate change by tracking the progress investee companies make towards their stated net zero goals, to shape and align the portfolio with a client's stated goals, while aiming to deliver consistent, long-term, risk-adjusted returns.

We believe that the extended investment horizon and low portfolio turnover of buy and maintain naturally aligns with sustainability imperatives such as decarbonization and the consideration of climate risks and opportunities, especially if coupled with active engagement with corporates. This alignment positions our buy and maintain capability as a potential contributor to investors' sustainability priorities.

At MFS, our objective is to create long-term value for our clients by allocating capital responsibly. In July 2021, we joined the Net Zero Asset Managers initiative (NZAM). As a signatory of NZAM, MFS supports the global effort to achieve net zero emissions. In our view, climate change is a systematic investment risk. Through our participation in NZAM, we have pledged to align our investment practices with the goal of reaching net zero carbon emissions by 2050 or sooner. This commitment includes an interim target of having our in-scope assets under management (our public equities and corporate fixed income assets, which make up approximately 90% of our total AUM) aligned or aligning with net zero goals by 2030. It is our belief that alignment can be achieved effectively and constructively by engaging with investee companies across relevant industries and sectors, fostering mutual understanding about their decarbonization efforts and our goal of reducing climate related investment risks within our portfolio, in the same way we convey our preferences for capital allocation and balance sheet management by investee companies.

Moreover, we actively collaborate with industry initiatives like ASCOR, participating in engagements and looking for ways to improve sustainability practices. Our buy and maintain approach is in alignment with these initiatives, emphasizing engagement as a tool for influencing sustainability outcomes. By targeting real-world emissions and focusing on issuer-level dynamics, we actively contribute to building a more sustainable future while seeking to deliver consistent, long-term investment returns.

We believe in the power of integration and engagement over blanket exclusions. As such, we integrate ESG factors into our fundamental investment decisions, with a particular focus on engagement as a method of influence. By constructively engaging with the companies in which we invest, we believe that we can assess and try to manage the overall financial risks within our buy and maintain portfolios, including those related to climate which may impact the risk/return profile of any issuer. Importantly, the avoidance of blanket exclusions contributes to the objective of achieving appropriate levels of portfolio diversification and seeking to achieve defined performance objectives. (Box 1) ESG considerations significantly impact our research analysts' recommendations for inclusion within portfolios and, importantly, the investment time horizons to be considered. Hence, while our bias would be to avoid ex-ante exclusions, we are aware of the long-term risks associated with certain industries. For example, we are unlikely to maintain long-duration positions in issuers with significant exposure to transition risk. We also accommodate investors' special investment guideline requirements within customized mandates.

Our global research platform, with over 300 investors in regions across the major markets in which we invest, affords us the benefits of scale, allowing us to conduct thorough research into the companies we own using the diverse expertise of our platform to better help investees manage ESG risks and opportunities. Our approach ensures that the inclusion of ESG factors is not an isolated process but is woven into the broader portfolio surveillance. We hold periodic risk reviews to assess the materiality of identified ESG factors, including social and governance considerations, thereby ensuring a holistic approach to sustainable investing.

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Box 1: MFS's Buy and Maintain Engagement With a Leading Automotive Manufacturer – A Case Study

To illustrate how we think about the materiality of ESG factors and engagement in fixed income, we present a short case study highlighting our engagements with a globally recognized automotive maker. This case study outlines our engagement efforts with this company, particularly in relation to the issues of climate change and governance.

Engagement Overview

In January 2024, we engaged the automotive manufacturer's investor relations, debt capital markets, and sustainability departments in a series of meetings. Our discussions focused on the manufacturer's corporate governance, sustainability strategy and efforts to address environmental, social and governance issues.

Sustainability

The automotive manufacturer continues to make strides in sustainability and electrification, having introduced a new ESG strategy in early 2024 which reflects the company's ongoing commitment to environmental improvements. These include fleet decarbonization, vertically integrated investments and the development of six new battery production sites. The company's Battery Electric Vehicle (BEV) share of the total fleet stands at 8.3%, with a target of 10% for 2024.

Governance

The manufacturer's unique corporate governance, made up of family members, a state entity and a sovereign wealth fund, was a significant drag on the company's broader ESG profile. Despite no immediate plans for changes, the company indicated plans for greater transparency and new initiatives in its upcoming sustainability strategy. These efforts aim to increase investor confidence and align the company's management with current ESG considerations.

Climate Change

The manufacturer's commitment to reducing its environmental impact is evident in its response to the European Union’s Green New Deal. The company is accelerating its need for EV model outlay, which strengthens its position and promotes EV adoption by consumers. Despite some challenges, the manufacturer remains confident in achieving its emission targets for 2025.

Engagement Outcomes

Our engagement efforts with the manufacturer enabled us to impress upon them the importance we assign to an improving ESG profile, and at the same time, we took comfort from the efforts and resources the manufacturer allocated to improving its ESG ratings and improve its environmental credentials.

Conclusion

Our buy and maintain strategy aligns with our clients' considerations for long-term investments, such as climate change and governance. Our engagement with this leading automotive manufacturer demonstrates our commitment to these considerations as we continue to work with the company to improve its ESG performance. This engagement underscores the value of our buy and maintain strategy as a lever for driving positive change in the companies we invest in.

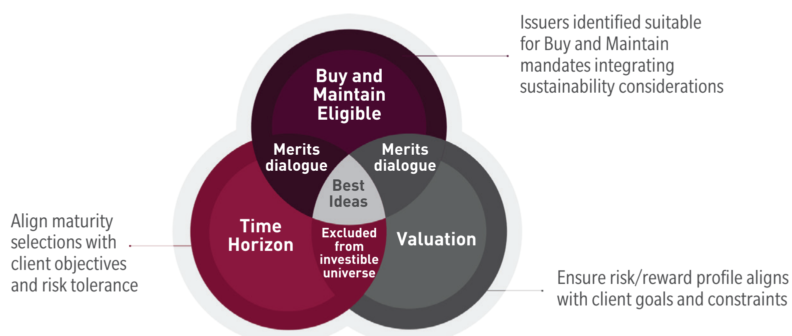
The importance of portfolio diversification

With growing secular demand for fixed income from buy and maintain–oriented asset owners, investors may increasingly face an investible universe size problem, especially when trying to preserve a strong home bias. Some individual-country markets, including the UK, may lack the depth of eligible issuers. On this basis, some global diversification appears necessary to expand the buy and maintain investible universe, with the particular focus on the United States and pan-European markets. There are many benefits to a globally oriented approach, including the opportunity to take advantage of divergence and dislocations across different markets. Large corporate credit issuers often issue bonds in multiple currencies and geographies, so there may sometimes be an opportunity to find better value for the same issuer elsewhere than in its country of origin. When carrying out a currency hedging strategy, this approach can be implemented without additional rate and currency risk exposure. With that in mind, we believe that a global credit research platform is a desirable attribute for a buy and maintain manager.

Beyond the geographical and sector diversification, there may also be an opportunity to broaden the range of investible securities outside the global investment–grade corporate credit universe. Depending on investor preference, we view US taxable municipal credit as a potential candidate for inclusion in global buy and maintain portfolios given its quality and duration characteristics. Other options can include allocations to high yield or emerging markets bonds. Ultimately, customization and alignment to client-specific needs is a major pillar of buy and maintain strategies.

A buy and maintain strategy may afford investors the opportunity to be truly diversified, as portfolios tend to be benchmark agnostic. Sector allocation is designed to take account of sector returns as well as risks, and sector exposure can be determined accordingly, rather than as an over/underweight versus a benchmark. Buy and maintain strategies also require a specific security selection framework. At the issuer level, we place more emphasis on the credit research factors that we believe will promote a low portfolio turnover, including: longer-term visibility of the issuer's fundamental assessment; low secular risk; low external event risks; diversified product or service offerings; cashflow generation through the cycle; stable and responsible management; sustainable capital structure; strong competitive position with natural barriers to entry; manageable ESG-related risks; debt structure and covenant protections; and a favorable long-term valuation assessment. With that in mind, we have introduced a specific buy and maintain designation as part of our broader global research process, which means that an issuer can be deemed eligible for buy and maintain if it meets specific long-term holding criteria (Exhibit 1).

Exhibit 1: Our Buy and Maintain Security Selection Process



Sources: MFS. For illustrative purposes only.

The need for active long-termism

There is value in a long-term approach to investing in global credit, in our view, as long as it is based on active security selection. Indeed, we believe that the longer the holding period, the more active the asset manager needs to be. It may at first glance look paradoxical, but a low-turnover portfolio can only be effective in meeting long-term investment objectives if the investment process is supported by strong portfolio construction, a rigorous credit research process and active market surveillance. This is because buy and maintain managers need to be able to preemptively identify potential credit events. The buy and maintain investment approach aims at capturing the credit risk premium through a low-turnover portfolio. That credit risk premium is sizeable over the long term, roughly averaging 90 basis points annually since 1997.[1]

Typically, we would maintain positions through periods of price volatility or negative credit rating migration if the risk of impairment is low. However, we would implement a proactive sell discipline and exit positions if there were material fundamental deterioration and increased default risk. Given the low-turnover investment style, a thorough security selection process becomes critical, with strong emphasis placed on fundamental analysis. The main advantage of an unconstrained approach, *i.e.*, the absence of a formal benchmark, is it tends to favor portfolio stability, including lower turnover and a longer holding period, minimizing transaction costs and capturing more of the credit premium.

Overall, we expect buy and maintain strategies to play an increasingly prominent role in the strategic asset allocation of long-term institutional investors going forward. This is because, in large part, we believe buy and maintain is well suited to serve investor needs in terms of sustainability credentials.

Endnotes

[1] Source:Bloomberg, ICE BofA. Global Corporate Credit index. Monthly data from December 1997 to September 2024. Excess return = difference between total return and rate return, YoY change, basis points.

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