

# Credit Without the Constraints

## Building more resilient credit allocations with synthetic credit

Three years after the crisis in liability-driven investing (LDI) reshaped UK pension governance, trustees face a new challenge. The Pensions Regulator's funding code (effective September 2024) mandates that schemes demonstrate clear paths to low dependency, encouraging high allocations to matching assets, which are predominantly investment-grade credit. At the same time, many schemes are actively planning for their endgame. For some, this means preparing portfolios for an eventual insurance transaction; for others, it involves "running on" (at least for a period) whilst questions around surplus extraction and emerging policy reforms are resolved.

In both cases, investment strategy is converging around a similar outcome: greater sensitivity to credit spreads and return targets in the region of gilts +1.0–1.5%, rather than the gilts +0.5% implied by a pure low-dependency framework. Yet, precisely as regulatory, strategic and endgame considerations push schemes towards credit-oriented portfolios, sterling credit spreads sit at historically tight levels and the physical market in general presents mounting constraints around valuation, concentration and liquidity. Therefore, the challenge for trustees is no longer whether to increase credit exposure but how to do so whilst preserving flexibility, resilience and optionality as endgame decisions evolve.

### The old credit playbook is breaking down

Since our 2024 analysis<sup>1</sup>, sterling investment-grade spreads have compressed to historic levels. Meanwhile, the supply-demand imbalance persists; with pension liabilities totalling £1.12 trillion<sup>2</sup> against a sterling corporate bond market of just £373 billion<sup>3</sup>, mathematical

reality suggests not every scheme can achieve its matching portfolio credit targets through traditional implementation.

This convergence of strategic considerations, regulatory mandates, market constraints and post-crisis liquidity requirements demands fresh thinking. The question isn't whether to allocate to credit (that decision has effectively been made) but how to access credit exposure efficiently whilst maintaining the operational resilience that 2022 showed must not be compromised. The answer is to build a resilient and robust matching portfolio whilst not sacrificing basic investment tenets of credit risk diversification, adequate compensation for credit risk and sufficient liquidity. Because we view sterling corporate bonds alone as unsatisfactory for this task, we collaborated with consultants and clients who shared our concerns and developed the Global Credit Alternative (GCA) strategy as a complement to sterling and global credit.

### A new credit checklist for trustees: three questions

Before September 2022, trustees' primary considerations were return over discount rates, risk relative to liabilities and cost. Today, three additional questions dominate boardroom discussions:

- 01 "Can we access capital allocated when we need to?"** The crisis revealed how quickly liquid markets can become illiquid. Bid-ask spreads on sterling corporate bonds more than doubled within days. Schemes that needed to raise collateral became forced sellers in a dysfunctional market. Any credit strategy must now demonstrate genuine, stress-tested liquidity.



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**02 “Are we concentrated in ways we don’t intend to be?”** The UK corporate bond market’s structure creates unavoidable concentration. It’s all about large issuers in that market. With financials representing 49% and utilities 17% of the sterling corporate index<sup>4</sup>, schemes cannot achieve true diversification within sterling markets alone. Going global can really help, but foreign exchange (FX) and rate (i.e., duration) hedges can cause large, unexpected collateral calls, disrupting a precise cash flow matching strategy.

**03 “Can we size exposure efficiently within our risk budget?”** Post-crisis collateral buffers have more than doubled to 300–400 basis points<sup>5</sup>. Physical credit requires full capital deployment; in a world of enhanced collateral management, capital efficiency has become more important.

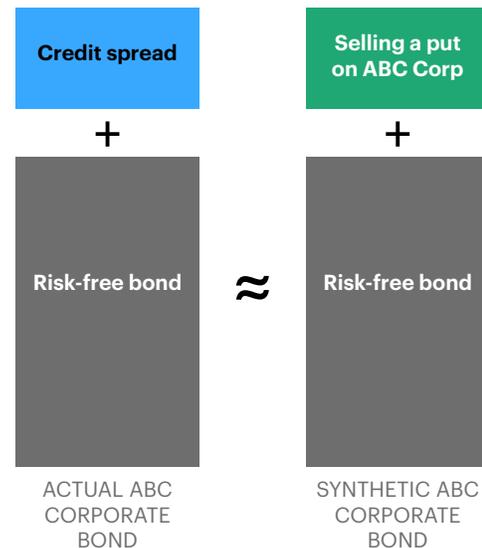
## Understanding GCA: a trustee’s guide

GCA is built on a simple principle: holding corporate bonds is similar to selling suitable equity puts in that they both expose the investor to downside protection in exchange for income in normal to good markets. Nobel laureate Robert Merton’s seminal work many years ago formalised this relationship: a corporate bond can be modelled as a risk-free bond plus a short put on the issuer’s assets (Figure 1). If the issuer’s asset value falls below its balance sheet liabilities, the “put” is exercised (default occurs). In other words, credit investors earn a spread for bearing downside risk, just as put sellers earn a premium for taking on equity downside risk. The two are synonymous.

GCA applies this same logic systematically across global equity indices rather than just individual issuers (Figure 2). The structure is straightforward:

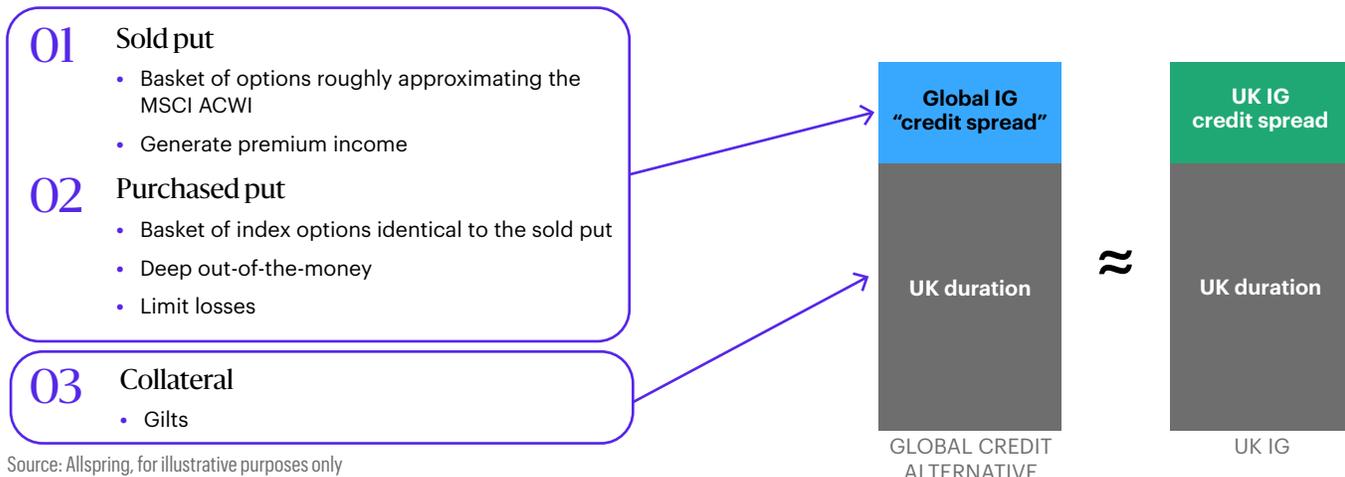
- **Sold put:** a basket of equity index options (approximating MSCI ACWI) is sold below current market levels to generate premium income (analogous to earning a credit spread).
- **Purchased put:** deep out-of-the-money options are bought on the same basket to limit losses (creating a maximum downside, similar to the limited default risk of investment-grade bonds due to recovery value).
- **Collateral:** UK gilts provide duration exposure and margin support, akin to that of a physical corporate bond and aligning with LDI frameworks.

FIGURE 1: HOLDING CORPORATE BONDS IS SIMILAR TO SELLING EQUITY PUTS



Source: Allspring, for illustrative purposes only

FIGURE 2: APPLYING THE CONCEPT TO GLOBAL INDICES



Source: Allspring, for illustrative purposes only



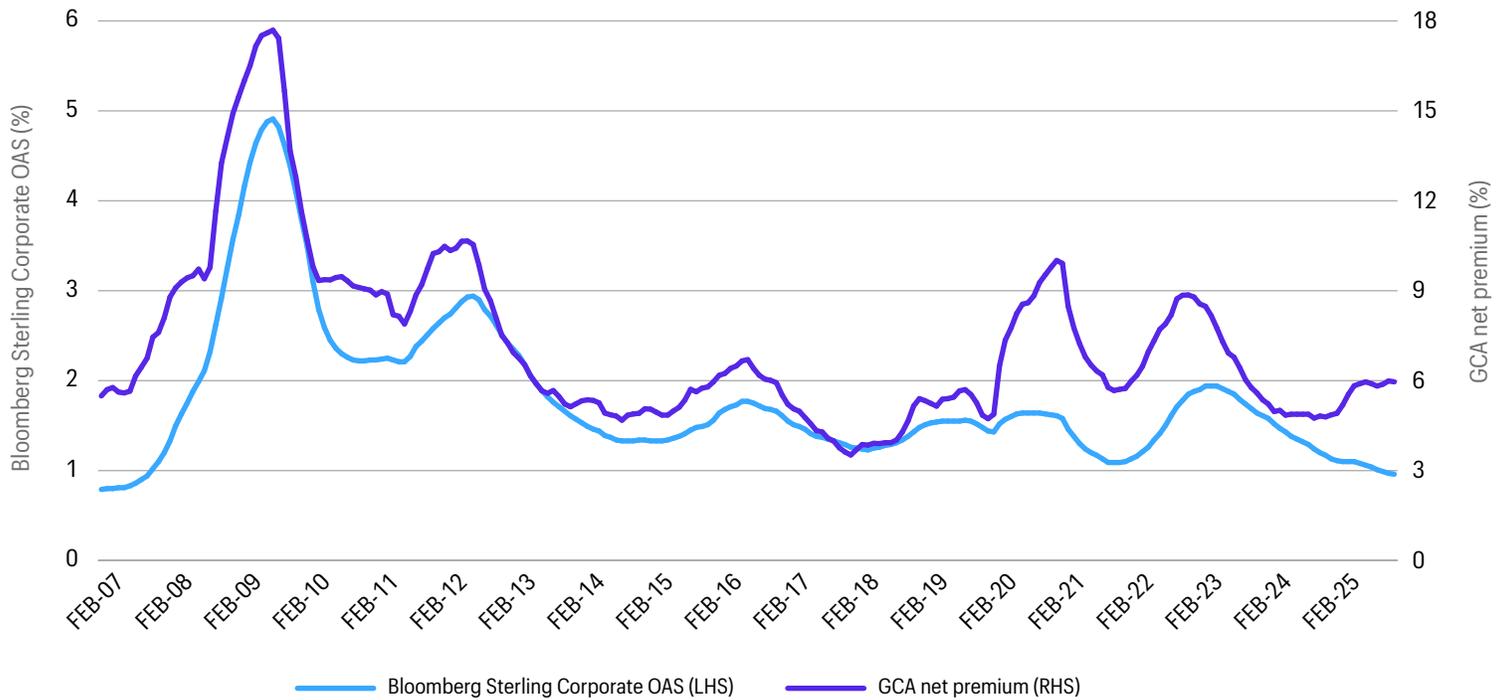
This creates three defining characteristics:

- 01 Coupon-like income:** regular cash flows from option premia, conceptually similar to bond coupons
- 02 Defined risk:** protective puts cap losses, ensuring risk is quantified and collateralised
- 03 Corporate bond-like economics:** duration exposure plus spread-like return, grounded in the same structural logic that underpins corporate bond pricing

The crucial insight here is that both credit investors and equity put sellers are in the business of earning steady income for bearing adverse-event risk. In benign markets, both collect their premia; in stressed markets, both face losses, albeit GCA's losses are contractually capped by design.

Does this theory work in practice? Evidence suggests that it does. Figure 3 shows the similarity between the level of credit spreads and the GCA net option premium (structured as outlined above).

FIGURE 3: CREDIT SPREADS AND THE GCA NET PREMIUM HAVE BEHAVED SIMILARLY



Sources: Allspring, Bloomberg Finance L.P. and FactSet, as at 31-Dec-25

### Three structural advantages vs. other credit diversifiers

Figure 4 highlights key advantages of GCA relative to physical credit. The table in Appendix 1 compares GCA with similar investment approaches across other dimensions.

FIGURE 4: GCA HISTORICALLY OFFERED BENEFITS COMPARED WITH OTHER CREDIT DIVERSIFIERS

FEATURE	PHYSICAL CREDIT (STERLING INVESTMENT GRADE)	GLOBAL CREDIT AND CREDIT DIVERSIFIERS*	GLOBAL CREDIT ALTERNATIVE
Liquidity	Adequate but constrained at long maturities and during times of market stress	Variable but generally more liquid than sterling credit	Deep, exchange-traded/cleared derivatives; scalable
Diversification	Fewer bonds, heavier sector concentration	Variable but generally more diversified than sterling credit (especially global credit)	Global, broad indices; diversified sector/geography without currency and interest rate complexity
Capital efficiency	Fully funded positions	Fully funded positions	Easy to leverage the (synthetic) credit exposure

\*For example, emerging market debt, asset-backed securities and commercial mortgage-backed securities.



**01 Deeper liquidity pool**

Globally, exchange-traded equity index options trade more than US\$4 trillion daily, dwarfing the sterling corporate bond market. Crucially, this liquidity is supported by a broad and diverse buyer base, including asset managers, insurers, hedge funds, systematic strategies and market makers with different objectives and behavioural triggers. For example, during the September 2022 crisis, gilt and sterling credit markets became highly one-sided, as a concentrated investor base was forced to act in the same direction. By contrast, equity index options continued to trade normally, benefitting from participants both seeking and providing protection, allowing liquidity to remain robust under stress.

**02 Global diversification without currency and interest rate complexity**

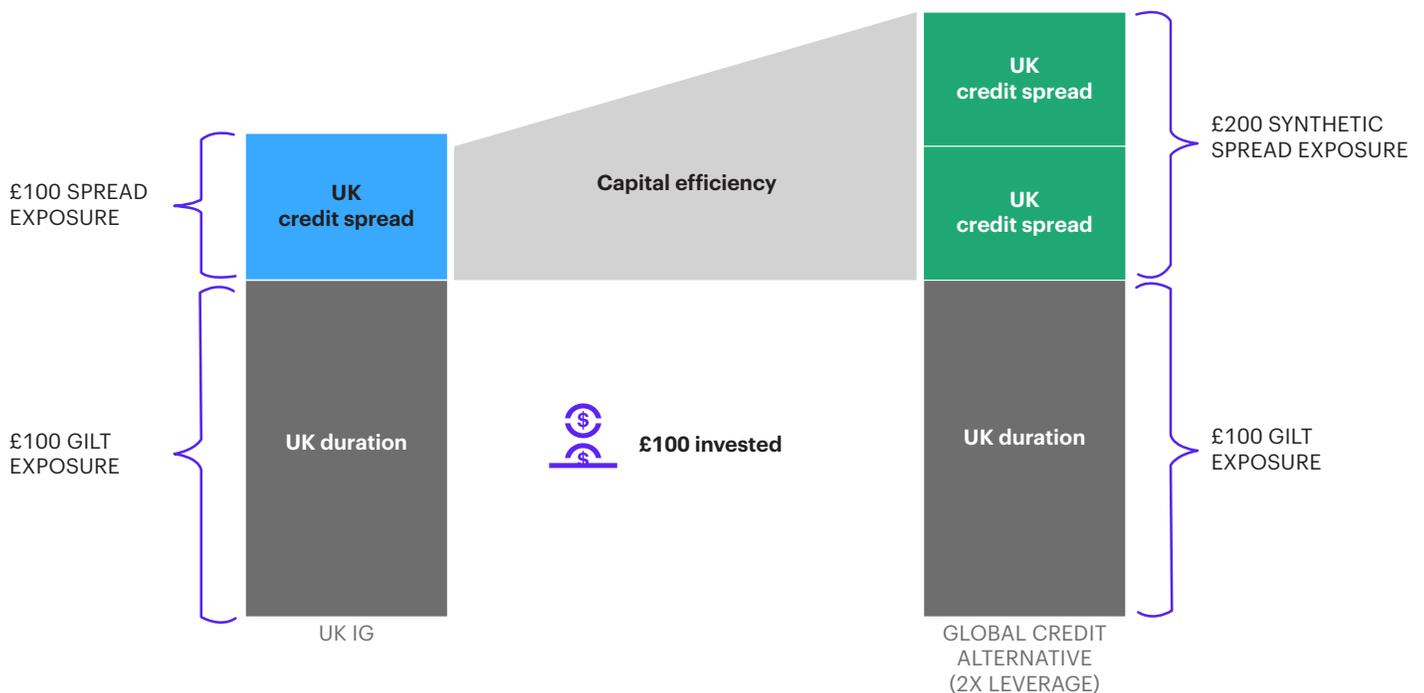
Rather than wrestling with the concentrated sterling market, GCA accesses global equity markets that naturally reflect worldwide economic exposure. The implicit sector allocation spans technology, health care and consumer sectors—dramatically different from sterling credit’s financials/utilities concentration. Crucially, GCA avoids the foreign exchange and interest rate hedging complexity associated with global bonds. Capital is not invested overseas; instead, gilts are used as collateral and option premia are systematically converted into sterling, simplifying collateral management and preserving the efficiency of the liability hedge<sup>6</sup>.

**03 Capital efficiency through intelligent leverage**

The strategy employs a scalable options overlay that can be implemented at 1x to 4x notional exposure, depending on a scheme’s return objectives and risk appetite. At its core, the structure transforms gilts into gilts plus a multiple of the credit-like spread, rather than the gilts plus 1x spread profile delivered by traditional physical credit. This flexibility allows trustees to calibrate exposure precisely (Figure 5):

- 1x for a low-risk, credit-substitute profile
- 2x for a balanced enhancement
- 3–4x for clients seeking more meaningful return amplification within a controlled, defined-risk framework

FIGURE 5: COMPARING GCA AT 2X LEVERED EXPOSURE WITH STERLING INVESTMENT GRADE



Source: Allspring, for illustrative purposes only



Because the strategy is implemented as an overlay on gilts held elsewhere within the LDI portfolio, it does not require full capital funding. Only margin is posted (typically 10–25% of notional), with the remainder staying invested in gilts that continue to support liability-hedging requirements. This creates a powerful form of capital efficiency: schemes can seek yield enhancement without compromising liquidity and without reallocating away from the high-quality assets (gilts) that underpin their hedging and collateral frameworks.

## Complementing physical credit—not replacing it

We believe GCA works best as part of a diversified credit strategy, with natural complementarity to physical credit holdings:

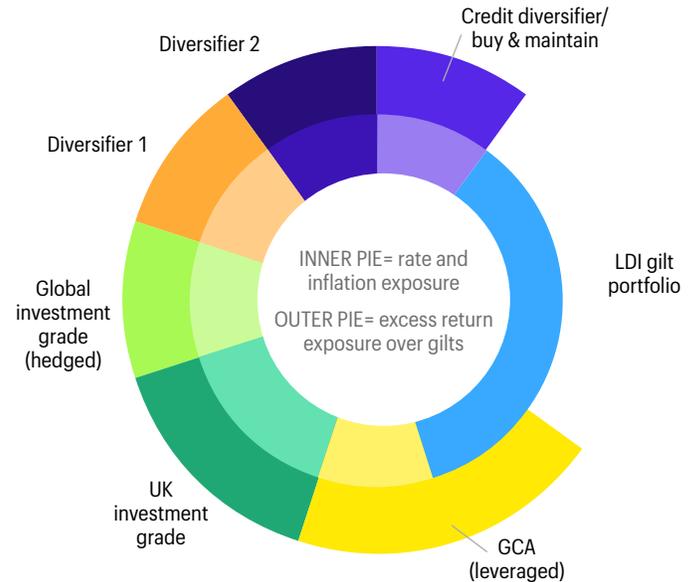
- **When spreads are tight:** physical credit offers limited risk premium. GCA's option premia, driven by factors other than credit spreads, can maintain attractive income even when traditional credit yields disappoint.
- **When spreads widen:** physical credit becomes attractive for long-term holders. GCA provides liquidity to rotate into physical bonds opportunistically.
- **Throughout the cycle:** combining physical credit and GCA creates multiple levers for managing risk and return—physical for issuer selection, with potential spread tightening and cash flow matching, and GCA for liquidity, diversification, systematic premium collection and operational flexibility.

## Practical implementation for trustees

GCA was designed to provide trustees with a transparent and self-contained way to access the equity put-spread return stream within a liability-aware portfolio. At its core, the structure delivers gilts plus a chosen multiple of the put-spread premium, targeting a more flexible and capital-efficient alternative to the traditional gilts plus 1x spread profile of physical corporate bonds.

In practice, GCA blends naturally with other UK and global bond exposures. Figure 6 illustrates how the strategy can sit alongside both corporate credit and credit diversifiers (e.g., private credit, emerging market debt, asset-backed securities and commercial mortgage-backed securities) to enhance resilience whilst preserving the scheme's overall hedging and liquidity profile.

FIGURE 6: GCA IS DESIGNED TO COMPLEMENT CORPORATE CREDIT AND CREDIT DIVERSIFIERS



Source: Allspring, for illustrative purposes only

## Building for the next decade

The UK's regulatory framework and stronger funding positions have created lasting demand for matching assets. Physical sterling credit remains a cornerstone, but its limitations (rich valuations, sector concentration and episodic illiquidity) are increasingly evident. By itself, therefore, sterling credit is only a partial answer to matching portfolio needs. Global credit broadens the opportunity set yet introduces its own challenges around foreign exchange and duration risk management. Other, more exotic credit diversifiers, whilst valuable, have their own issues. All may be useful, but we believe it's best to seek other solutions that can improve a blended matching portfolio.

We believe GCA is one such solution, offering something extra and a practical way forward. It complements physical credit allocations by delivering credit-like returns with a deeper liquidity pool, capital efficiency and diversified exposure. GCA is not a silver bullet, but it is a valuable tool to add to the toolbox and represents a targeted solution for today's market and structural issues.



**Appendix 1: comparing GCA with other credit diversifiers along other dimensions**

GCA offers an attractive range of characteristics and benefits, making it a worthy complement to sterling credit and other credit diversifiers

	STERLING CREDIT	GLOBAL CREDIT AND CREDIT DIVERSIFIERS	GLOBAL CREDIT ALTERNATIVE	BLEND: 50% sterling credit + 25% credit diversifiers + 25% GCA
Diversified return	●	●	●	●
Limited downside risk	●	●	●	●
Avoid limited supply and crowded trades	●	●	●	●
Avoid concentration	●	●	●	●
No FX issues	●	●/●	●	●
Capital efficient	●	●	●	●
Maintain liquidity	●	●	●	●
Cost and complexity	●	●	●	●

KEY ● = Good ● = OK ● = Poor

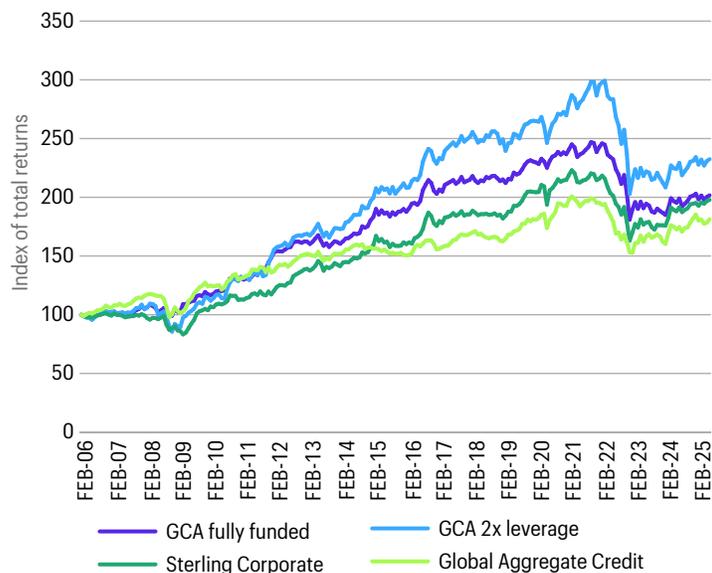
Source: Allspring

Credit diversifiers include asset classes such as emerging market debt, trade finance, asset-backed securities and commercial mortgage-backed securities. Sterling credit includes direct lending, infrastructure debt and private mortgage loans.

**Appendix 2: hypothetical back-test results**

HYPOTHETICAL BACK-TEST

28 February 2006–31 December 2025 back-test



HYPOTHETICAL ANNUAL PERFORMANCE (%)

As at 31 December 2025

	2025	2024	2023	2022	2021	2020
GCA (%)	7.74	-0.67	4.76	-22.32	-0.12	7.32
GCA 2x leverage	9.97	-0.04	4.94	-27.67	4.23	8.61
Sterling Corporate	7.14	1.71	9.79	-19.28	-3.26	9.09
Global Aggregate Credit	10.45	0.71	9.24	-16.96	-3.21	10.03

GCA is not a live strategy; it demonstrates our investment capabilities. Hypothetical past performance is not a reliable indicator of future performance.



	ANNUALISED RETURN (%)	ANNUALISED VOLATILITY (%)	CORRELATION TO STERLING CORP (%)	WORST MONTH (%)	MAXIMUM DRAWDOWN (%)
● Global Credit Alternative (GCA)	3.89	6.93	0.77	-10.9	-26.7
○ Global Credit Alternative 2x leverage	4.72	9.44	0.72	-14.2	-32.2
● Sterling Corporate	3.77	7.37	—	-8.9	-26.9
● Global Aggregate Credit	3.45	6.75	0.72	-7.8	-23.9

Sources: Allspring and Bloomberg Finance L.P. Index source: FactSet. 28-Feb-06 to 31-Dec-25. For illustrative purposes only. Performance shown is gross and does not include fees or other expenses, which will reduce returns. All returns for periods greater than one year are annualised. All returns in USD. The hypothetical model is not maintained as a live composite or portfolio at Allspring Global Investments. It is for illustrative purposes only. Hypothetical data does not represent actual performance and should not be interpreted as an indication of such. This data is based on knowledge that was available after the fact and thus with the benefit of hindsight. Hypothetical past performance has inherent limitations and is shown for illustrative purposes only for the period 28-Feb-06 to 31-Dec-25, as no actual performance exists. There is no guarantee hypothetical past performance will be similar to any actual performance. Any forecast, projection or target is indicative only and not guaranteed in any way.

### Back-test data and methodology

STRATEGY	GLOBAL CREDIT ALTERNATIVE	
TIME PERIOD	28-Feb-06 to 30-Dec-25	
UNDERLYING	60% S&P 500, 30% MSCI EAFE ETF (EFA), 10% MSCI Emerging Markets ETF (EEM)	
OPTIONS	Sold put	Purchased put
STRIKES	30 delta	15 delta
EXPIRIES	One month*	One month*
ROLL FREQUENCY	Weekly S&P 500   Monthly EFA and EEM	Weekly S&P 500   Monthly EFA and EEM
OPTION NOTIONAL	1.0x	
TRADING	Thursday close for weekly rolls   Third Friday close for monthly	
FEE ASSUMPTION	Gross of management fee	

Source: Allspring

\*S&P 500 Index options were first listed on a regular weekly expiry cycle in 2012. Back-test data assumes monthly roll on Thursday close through June 2012, with weekly overlapping four-week positions since July 2012 for the S&P 500 portion.

Options back-test using OptionMetrics-supplied price data. We assume 30-delta sold puts on 60% S&P 500/30% EFA ETF/10% EEM ETF and 15-delta purchased puts on the same instruments. 50% of the PUT or of the PUTY as a proxy could be used.



## For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains.

Click or scan the QR code to check out Allspring's insights:

1. "The Pension Scheme Paradox and How to Solve It," Allspring, July 2024.
2. Total UK Scheme liabilities on a full buy-out basis. *The Purple Book*, 2025.
3. ICE BofA Sterling Corporate Index, UR00, 27 January 2026.
4. Allspring, Bloomberg Finance L.P. and FactSet, as at 30-Sep-25.
5. The Pensions Regulator's (TPR's) response to the Financial Policy Committee's (FPC's) Recommendations on Liability-Driven Investments (LDI), January 2024.
6. For UK pension schemes, investing in global bonds typically introduces FX risk and exposure to non-sterling yield curves. Whilst these risks can be hedged, doing so requires FX forwards and interest rate derivatives, increasing daily collateral movements, transaction costs and operational complexity. GCA avoids these issues because capital remains invested in sterling assets (gilts) and only realised option premia are converted into GBP on a regular basis.

Hypothetical past performance is not a reliable indicator of future actual results. The results are theoretical, reflect performance of a strategy not currently offered to investors and do not represent returns that any investor actually attained. Hypothetical performance results have many inherent limitations. No representation is being made that any account will or is likely to achieve results similar to those shown. There are frequently sharp differences between hypothetical performance results and the actual performance results subsequently achieved by any particular trading strategy.

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