Credit

Exploiting market inefficiencies

In conversation:
Patrick Zeenni | Joe Abrams | Martin Foden | Christine Farquhar | David Will | Sebastian Cheek

Exploiting credit market inefficiencies

The search for yield continues amid an ongoing environment of record low interest rates, all-time low gilt yields and experimental monetary policy by central banks.

Investors have come to accept lower-for-longer interest rates as a fact of life and as such, have had to broaden the search for yield in their fixed income portfolios across geographies and strategies.

With gilts not doing what they once were, the wider credit markets have become the hunting ground and exploiting inefficiencies in these markets as well as blending of credit types within multi-asset solutions, have become the weapon of choice for many investors.

Global market volatility has become a mainstay within portfolios, particularly given the political instability across Europe following the UK's decision to leave the European Union, China's slowdown and the fall in commodity prices. All of this has favoured a diversified and global approach to credit.

But as with all asset classes, investors need to understand exactly what they are investing in before making a commitment.

This roundtable sees a group of experts made up of asset managers and consultants debate the latest issues around investing in credit, including exploiting market inefficiencies and factors, researching managers and where credit sits in portfolios.

Sebastian Cheek
deputy editor, *portfolio institutional*

Sweating your assets

There's no getting away from it – gilts ain't what they used to be and investors are looking for alternatives for their fixed income portfolios, writes *Lynn Strongin-Dodds.*

There have been many false starts, particularly in the US, but the reality has finally set in – lower interest rates have become an interminable fact of life. Growth is spluttering and despite central banks' best efforts, inflation refuses to rise. The result is tried and tested government bonds have been losing their pride of place as institutional investors veer off the traditional fixed income path.

"We really are in a world where interest rates will stay lower for longer," says David Riley, head of credit strategy at BlueBay Asset Management. "There will be fewer hikes and it is difficult to predict when normalisation will return. The fact is that this reflects a structural decline in real interest rates that started 30 years ago and pre-dates the global financial crisis. The financial crisis has only deepened the trend which is why it will be hard to see the next peak of interest rates rising above 2% to 3% in the UK, Europe and US compared to 4% to 6% in the past."

The good news is that the current environment has spawned a plethora of fixed income alternatives that cater to the multitude of institutional investors' requirements and risk/return profile. The downside is that some of these strategies particularly those on the illiquid end are more resource intensive and timing entry points in today's volatile markets is not easy. Take the first quarter, where markets spent the first six weeks gyrating over global growth fears – particularly in China – and an almost 30% plunge in oil prices. Fears abated in the second half, triggering a strong US Treasury rally that drove high-quality bond yields lower – not just in the US, but globally.

As Jon Jonsson, managing director at Neuberger Berman put it: "The magnitude of the moves are in no relation to the underlying risks and outlooks. This has led to episodes of sell-offs, but pension funds need to be patient and tactical in order to take advantage of the dislocations in the market and lock in attractive valuations and better yields."

DEUTSCH THE WAY TO DO IT

One of his preferred trades is to sell 30-year German bunds in favour of buying its similarly long dated US government counterparts.

"If you look at the relationship over the past 20 years, it never exceeded 100 basis points (bps), but now with the European Central Bank's latest quantitative easing programme, the spread has blown out by 200bps," he says. "This dislocation is attractive because we believe the growth differential between Germany and the US implied by this spread is not sustainable over a long period of time."

High yield and investment grade bonds as well as leveraged loans also garner a strong recommendation although selectivity is key given the stage of the credit cycle.

"We are late in the cycle and corporates are more levered and spreads have come in," says Adam Smears, head of fixed income research at Russell Investments. "There is a potential that there could be a sell-off as we run into summer, but there are opportunities. We believe a good starting point is to buy shorter duration, high quality high yield or low quality investment grade bonds. I view this as the yield engine, but I would add alpha diversifying strategies such as trading currencies and rates to smooth the pathway."

In general though, European corporates, particularly in the high yield arena where returns are roughly 5.2% versus the roughly 1.1% in investment grade, are the favourites. Investors are more wary of the US, because although performance is slightly better at about 6%, the beleaguered energy and mining sectors are casting a pall. Analysts predict they could push the total percentage of defaults to a lofty 5-6%, up from roughly 2% last year and the long term average of 4.4%.

"High yield has seen a lot of stress but if you strip out energy, then there are companies that have strong fundamentals and balance sheets," says Sorca Kelly-Scholte, head of EMEA pensions solutions at JP Morgan Asset Management. "There are also opportunities in Europe, but the yields are lower because of the higher quality of the corporates and less exposure to the energy industry."

TRADING UP

The US-based fund manager has shifted its portfolio towards those sectors, however, sitting at the higher quality and more defensive end in both the US and European high yield markets.

Andreas Michalitsianos, executive director and portfolio manager in European investment grade corporate credit, says: "In both regions we have an up in quality bias within high yield. Sectors where we see value are autos along with cable, healthcare and utility companies because they tend to have a more transparent and stable cash flow profile. We are also allocating

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David Riley, BlueBay Asset Management

> There is a trade-off between local debt and hard currency, but what we saw last year is that you have to be fleet of foot and have a dynamic approach that can take advantage of market conditions.

Andy Tunningley, BlackRock

to European investment grade because although the yields are lower the technicals are strong primarily due to the stimulus from the ECB and Bank of Japan."

US investment grade credit has also taken a hit. Moody's downgraded more companies in the first three months of the year than in the whole of 2015. Overall, 51 corporates slipped into junk territory, up from eight in the fourth quarter and 45 in 2015. Almost half emanated from the oil and mining industries.

However, Pimco managing director and portfolio manager Mike Amey believes investors could still reap returns of 1% to 1.5% by focusing on strong credits that are more than capable of performing in a challenging or moderate growth environment. Illiquid credit strategies are also high on the list and over the past year institutions have been busy filling the gap left by cash strapped and regulatory laden banks.

Recent figures from Willis Towers Watson show that typically pension funds have globally allocated more than $7bn to these investments, which range from direct lending to real estate and infrastructure debt, over the past five years.

"These are opportunities for investors who have the capacity to lock up liquidity," says Riley. "It makes particular sense for pension funds and sovereign wealth funds that have long-term liabilities and limited near-term cash outflows. However, they also have to understand that in order to extract the illiquidity premium, there is an opportunity cost that rises during periods of market stress."

MORE POWER TO YOUR ELBOW

European leveraged loans have been popular as they were largely unaffected by global volatility at the end of 2015 and in the first few weeks of 2016, in stark contrast to US leveraged credit and European high yield bond markets.

"The loans had a difficult credit crisis but they were one of the best performing asset classes last year," says Annabel Gillard, director within fixed income at M&G Investments.

"There has been a lack of forced sellers and they have proven to be very defensive. We also believe that now is a good entry point for ABS and there is outstanding value after the sell-off in the beginning of the year."

Direct lending to mid-sized corporates has also gained momentum, although due diligence is required. "These strategies offer greater returns and although you forego liquidity, it does not always mean you take on additional risk," according to Gillard, who says these require closer monitoring and more secure contracts.

She adds: "We do our own in-depth credit research and lend to mid-sized companies where cashflows are stable and predictable."

Other fixed income investments have divided fund managers such as emerging market debt and contingent convertibles (Cocos). For the former, flexibility is key, according to Andy Tunningley, head of UK strategic clients at Blackrock.

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Annabel Gillard, M&G Investments

local debt and hard currency, but what we saw last year is that you have to be fleet of foot and have a dynamic approach that can take advantage of market conditions," he says. "For example, this year we have rotated into local currency and are picking up double digit returns by being in the right countries."

As for Cocos, these hybrid securities which are designed to bolster the capital of banks were all the rage until this year when concerns started to mount that the rules for these bonds were too complicated and could undermine a bank's financial position rather than strengthen it in a crisis.

As Amey says: "Cocos are for investors seeking high returns but who can tolerate volatility. Yields can be around 7-8%, but it is important to maintain exposure to solid institutions, particularly large US and UK banks."

BIG MONEY

Institutions lacking resources or the inclination to pursue individual or riskier strategies can use multi-asset credit funds combining many of these strategies under one umbrella.

They have the ability to generate alpha, diversify assets and mitigate risks. This is why globally these funds have doubled in size over the past three years from £48bn in 2012 to stand at £96bn as of June 30 2015, according to recent figures from Punter Southall.

The risks have also been highlighted. For example, in a credit-stressed environment, high yield, bank loans and ABS may suffer from poor liquidity, plus the defensive tilts and short positions that are taken may only offer partial protection in a sell-off.

However, over the long term, fund managers believe these funds should help cushion the blow from such events and produce better risk-adjusted returns for investors.

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Patrick Zeenni

“When you have an issuer going from a fallen angel or from investment grade to high yield, there are lots of inefficiencies thanks to index rebalancings.”
Patrick Zeenni

Is it possible to exploit credit market inefficiencies and, if so, how given the current environment?

Martin Foden: We operate in a market with established, structural characteristics which drive a misallocation of credit and, ultimately, mispricing. Rating agencies are clearly still the biggest driver of asset allocation, yet credit indices also contribute to these market inefficiencies. If we accept that there are inefficiencies, the last thing you want to do is internalise these within your own process. Also, given the potential severity of credit losses due to the asymmetry of risk and return, people hunker down to name recognition and the highest profile companies. You definitely can exploit those inefficiencies.

Joe Abrams: How you go about exploiting them varies. The ability to trade investment grade credit has got more difficult. So perhaps you should look at a buy and maintain approach, moving away from a fixed income benchmark – trying to exploit the credit risk premium that is there but in a lower transaction cost, lower fees-type manner.

Christine Farquhar: If people are value driven, they can find the inefficiencies but then they have got to be patient to exploit them and you need patient clients.

Patrick Zeenni: What is key in exploiting the inefficiencies is a real global/helicopter view approach between different geographical regions and different products. Looking not only at fixed rate bonds but also vanilla credit derivatives, hybrid corporate debt, floating rate notes…

We see inefficiencies in the global high yield market, some of it due to the significant outflows in the oil sector. For example, you can catch cheap European issuers who issued in USD that were hammered by the outflows in the US. Looking at cross currency issuers is a great source of opportunities.

Foden: There is a real opportunity to exploit credit market inefficiencies as the market as a whole becomes more thematic and takes macro views, looking across different markets and asset types. The more that microscope gets pulled back and the more people are looking top down and macro, the more opportunities there are on the ground. The sterling credit market is a wonderful expression of that. It is so nuanced and specific. If you look at the index, it is two-thirds to three-quarters large global companies that can issue long dated capital. But that leads a wonderful tail of opportunity of mid cap/small cap, private companies and SPVs where real targeted, bespoke, bottom-up analysis discovers some fantastic returns for the fundamental credit risk that you are taking.

Zeenni: Take the example of the fallen angels and the rising stars. When an issuer goes from a fallen angel or from investment grade to high yield, there are a lot of inefficiencies thanks to index rebalancings. On the one hand, you need to be very diligent in your screening in order to catch those at a depressed price. On the other, you need to be able to sell your position if you have a rising star who has been much prized by the market.

Foden: In a real world sense and an intuitive sense there isn't a fundamental shift in the characteristics, if a company hasn't changed in any way apart from one notch of rating, one notch of opinion from the rating agencies. The client will understand what you are trying to do and you will have that mandate to take those opportunities.

Abrams: A number of fixed income managers over the years in this bull market have perhaps been consistently overweight beta in fixed income markets. They have used credit sometimes to do that. Active management will now or at some point come to the fore, because you will not be able to just be overweight in the market in order to derive your alpha. So the identification of effective active managers, who are not just grabbing the bull run, will come to the fore and become a lot more important.


Martin Foden and Joe Abrams

Farquhar: But opportunities come at the most difficult time when liquidity is not there; investment banks are not playing and they are not coming back. So active allocation is probably the starting point and how you allocate at the start of a mandate rather than relying on being able to sell bonds in order to take active positions or change those positions.

Foden: That big downshift in liquidity and banks just not being there in the way they were in 2007 in terms of warehousing and providing liquidity, has to frame your approach to delivering outperformance.

Farquhar: But with high yield bonds you have always been able to rely on a shorter maturity. You get your money back quicker on average than in investment grade.

Zeenni: There are a lot of opportunities in the short duration space for high yield managers. It is a win-win strategy since on the right issuers, you can earn performance with a limited risk as issuers redeem their bonds early by exercising their calls or making tender offers. We are seeing a continuing trend around refinancing. Basically issuers buy back old high coupon debts and issue longer debt with lower coupons. In the European Market, for example, about half of the redemptions over the last year were not original maturities but early calls or tenders.

What is key maybe more than ever is looking at governance. Many of the last troubled issuers clearly had a lack of strong governance.

How much do you incorporate agency ratings into your research?

Foden: Typically, a rating agency is telling you about the probability of default. But when you buy a bond and you get paid a credit spread, part of it is compensation for default, but it is also for the losses you actually suffer. If you build a model, whether it is a passive strategy or a smart beta strategy, that is solely reliant on ratings, you are investing on the basis of just half of the risk assessment. So, absolutely, use rating agencies as a good source of information. There will certainly be some names where they have better access to company management. Don't exclude them from the analysis, but absolutely don't believe that what they are telling you is a comprehensive assessment of credit risk.

Farquhar: Ratings, particularly investment grade ratings, are less indicators of a fundamental quality right now but lodestars for technical flows. So you have massive ECB buying if you are an investment grade corporate which falls away if you are BB+.

Zeenni: We take into account agency ratings but make our own full credit analysis and models. We look at different possible scenarios to assess the credit strength of issuers. As the ECB's corporate bond purchase programme is linked to agency ratings, we incorporate this factor in our investment decisions.

Foden: So we need to educate our clients. There are days when you do sit there and you think you are darkened by this big shadow, this purchasing machine.

Things like Solvency II, Capital Market Directives and a blanket purchaser of assets are creating distortions and inefficiencies. If you are an active manager that is the kind of asset class you want to be operating in, because you have to put the work in, but there are opportunities to add value through research.

What goes into the research?

Zeenni: The credit research in high yield is the essence of the portfolio. We need to be really comfortable with the company before investing. It is absolutely crucial. What is important is to find the catalyst that could change the credit profile of an issuer to be able to react very rapidly. We like niche players and best in class companies which have superior cash flows. We do not add issuers to our portfolio because they are part of our benchmark, but because we have a strong conviction around this issuer.

David WIll

Farquhar: My preference is for the analysts to be fundamental and then for the portfolio managers to make the call on valuation and choose which bonds or sectors to buy. But I want the credit analysts to be… How do I say this politely? Really obsessive and disciplined. I want them to be really focused on one thing – quality – and then it is up to the portfolio managers to make the money from it.

Zeenni: Our process is based around a traffic light system. First you need to have a strong credit and legal analysis, namely a strong view from our credit analysts. Then it has to be validated by our quantitative assessments. Finally, the green light is about market timing and catching the right trends and the right sectors.

We think the most important is a strong sell discipline: when a specific credit might deteriorate rapidly, or when issues become too expensive and we find better relative value opportunities.

Martin Foden

"If you are an active manager [credit] is the kind of asset class you want to be operating in, because you have to put the work in, but there are opportunities to add value through research." Martin Foden

Research wise, what is very important for a robust portfolio is to have a very close access to issuers as well. A very deep and thorough management assessment – to go on the ground and to speak with the management. It is important to be able to meet with the directors of a company, the CFOs, the CEOs to be able to assess credit, and go beyond the figures and facts in the balance sheet.

Do you meet every executive or top level person at every company that you own?

Zeenni: We participate in group and one-to-one roadshows with issuers. We can make face-to-face meetings or conference calls. Nowadays, you can easily have video conference calls as well.

Abrams: This type of access can be useful but of course the CEO is going to talk up their own book and say, "Look how great we are."

Foden: We are in a volatile world so meeting the executive team may give you all the comfort in the world, such as a soft commitment to a particular level of leverage or a particular strategy. But if you have bought solely on the basis of that, you come in the next day and that executive team has gone, you have got no rationale for your investment.

Fortunately within credit there is a subset of objective credit enhancements you can build in, which means if the management shifts or there is some big negative event like Brexit, you still have your leverage, security and certainty over your position in the capital structure. In an uncertain world these are very high

conviction characteristics, and should be weighted as such, within your evaluation of what you need to be paid when you lend your clients' money.

Then again, the worst thing from a credit analyst is ego. Believing you have more visibility than you actually ever can. In an equity market with equity analysis, you only have to get half the decisions right, you have got a nice symmetry to back you up. Actually, if things do get better you share in that upside.

The best thing that can happen in an IG space within a credit bond is you get the price right on day one for the risks that you identify. Then nothing changes until you come back and you get your money back. If things get better, you will have value taken away – that will go to equity. If things get worse, you will absolutely share in that pain.

Abrams: As we move into the private markets space of course it is a bit different because you can look at turnaround type opportunities. At some point of the cycle distressed debt becomes an interesting opportunity and the credit process there again is very different.

David, what is your approach to manager research in the credit space?

David Will: It is important to identify what sort of mandate type you are looking at. For example, if you are looking at a multi-asset or multi-sector credit product then you look for very different characteristics in terms of how the team is set up. No single person can be an absolute expert at everything and there are so many diverse credit instruments out there across the globe. Markets don't trade homogenously these days, although they can do when things go completely pear-shaped and everything correlates very

"It is important to be able to meet with the directors of a company, the CFOs, the CEOs to be able to assess credit, and go beyond the figures and facts in the balance sheet." *Patrick Zeenni*

quickly, but at other times they can trade very differently. For example, the dispersion in emerging market corporate debt returns recently, between the best performing and the worst countries, is vast.

How do investors get comfort with managers taking wider active remits?

Abrams: Trust is a really important element. The trust that clients have in active managers to deliver what they say they are going to deliver. If you are moving away from the benchmark, it can give you a very broad set of parameters and they could deliver something that looks completely different to what they said they were going to deliver you in the first place.

Foden: It is communication. The worst you can do is something different than the client thought you were going to do. That partnership approach, that interaction, is absolutely critical.

How is that trust built?

Farquhar: Managers should try to gently be honest and say, "Well you do know how much you will have to give up if I'm going to be a forced seller – over 10 years, in current market conditions…" That is another

Christine Farquhar

"The cost of selling things as they drop out of the index because they get downgraded not defaulted; probably over 10 years and longer, you are giving away 1% plus each year for this." Christine Farquhar

problem with the loss of liquidity. The actual cost of selling things as they drop out of the index because they get downgraded not defaulted; probably over 10 years and longer, you are giving away 1% plus each year for this.

Abrams: Even passive managers, as things drop out of the index under the one year maturity level, you will see them try to offset transaction costs by holding that credit longer to maturity.

Farquhar: Yes. So don't sell things just because they have gone outside the rules. Maybe, even if you are really quality constrained and this is the opposite end of high yield, hold on to it.

Zeenni: Sometimes a downgrade can be an opportunity to buy. Sometimes it can be a catalyst to sell and avoid defaults. It is a case-by-case study.

Foden: If you have invested on a more objective basis with security and a set position in the capital structure and it gets downgraded, possibly just for a default risk, financially your loss conditions haven't changed at all. The last thing you want to have to do is sell those kind of positions because you know the valuation would have changed, because it is no longer in that bucket that certain people can invest in. But the fundamental conviction of the investment case hasn't changed, so to have that flexibility to pick up those opportunities when they happen is really important.

Zeenni: What is key on top of that when you are managing credit is to avoid defaults and accumulate superior performance over time. We have not suffered any default in our management since inception.

How are UK institutional investors using credit in their portfolios at the moment?

Abrams: The beauty of moving away from a benchmark is that you can tailor credit portfolios to deliver what you want them to deliver. So if you need a certain level of cash flow or if you need a certain level of duration, you can separate those decisions a bit more.

Will: Credit is being used in different ways. It really isn't just about the characteristics of the underlying asset class but what function, or what part it plays in the client's overall strategy. This can vary, quite considerably, from client to client depending on where they are in their journey plan and whether or not they need the income to help meet benefit payments.

What is your view on securitised vehicles?

Farquhar: What you need are credit analysts who can actually read. What they need to do is go down into the structure and the documents and actually work out what those clauses mean. Who has got the right of substitution on the collateral? Who has got the right to change the balance of control against you?

Foden: There is a day one complexity to understand in those documents but you do that work and you embed it on day one for the life of the investment.

If you are lending on a pure cash flow basis, it may seem simpler, but acknowledging that I can't predict the future, to me seems much more complex. Where is McDonald's going to be in two years', five years' time? It is a much more complex decision than with a securitised vehicle.

Farquhar: What never ceases to amaze me is that time after time the industry will delusionally decide to believe that something is okay. So with financial perpetual bonds – they decided to believe that all the issuers were going to exercise the call options. They were really 10 year bonds. For asset backed securities they decided "It is fine, it is AAA, it has got monoline insurance on it… no, the insurers haven't got any reserves but hey…it is okay."

Foden: It all comes down to there being no replacement for that stock-by-stock individual analysis and understanding the assets and the structure you are in when you buy an asset. You can't outsource that. You can't delegate that access route.

All those structures make some sense in theory and then capitalism finds a way of over extending them and so misapplying them. It doesn't mean that the nub of the idea is bad.

Farquhar: As long as you are disciplined and you say, "Actually, some of this yield is a liquidity premium and whether that's part of a complexity – whatever." The premium is justified.

What are your thoughts on the development or the use of smart beta in the credit space?

Abrams: If you try and build a systematic approach which periodically says, "Based on these factors you should have a portfolio that looks like this", you might take this to your trading team and they're likely to say, "Are you joking?" There is more of a disconnect in the credit market between what is achievable theoretically and what is achievable practically. I have seen a lot of different back tests which show me how these factors are adding value over the time of the period tested. But I haven't seen anything on a systematic basis which convinces me that it is practically implementable.

Farquhar: Don't just do it blind. Credit indices are potentially buckets of failure. You don't want to be rules based and selling out at the wrong price. Be prepared for a nice long grandfathering list, where the bonds fall out of the rules but you do the credit analysis and you still want to hold them.

The academics struggled to actually prove the existence of a credit premium for years. But once they got round to duration adjusting the models they said, "Yes, actually there is a credit premium that is probably more attractive in high yield. On a risk adjusted basis, it is even more attractive if you capture the short dated high yield premium." So, to the extent that it is about capturing yield I am quite enthusiastic. Less keen on expensive rules based rebalancing. You won't get your transaction back.

Zeenni: The credit market is so diverse; there are so many multiple layers of risk. I am not a specialist of smart beta products but I strongly believe that to outperform in credit in the long run, an active and flexible management centred around alpha generation is needed. We are in such an idiosyncratic risk driven market.

Foden: I am personally very sceptical about the application of a smart beta rules based type of approach to credit. I fail to see how any kind of screening for whatever factors will result in a more diversified portfolio. The cost differential between active and passive management in equity spaces is vast whereas in credit spaces, it is not that great.

Will: Also, the difference between active and passive credit management fees is much smaller than the differences between active and passive equity management fees, so there is a greater argument for simply using active management for credit in order to address the shortcomings of market cap benchmarks than smart beta products attempt to do.

Do factors such as momentum exist in credit that can be systematically exploited?

Abrams: Managers are, in reality, likely already aware of factors which drive markets but have not explicitly labelled them, and already manage their portfolio cognisant that a bond is good "value" for example. "Momentum" is a funny one in the credit space, especially in the IG credit space as bonds move more in a homogenous manner. For "size", small issuers within an index might have a liquidity premium attached to them. But why would you make the selection process systematic and naive?

Foden: It almost feels like a bit of a misnomer because again you go back to how the credit markets develop. It is ultimately an income product. It is not a capital gain product. So in some ways even the concept of beta versus alpha is a bit of a challenge.

Patrick Zeenni

As investors look for yield are they moving into ever riskier assets?

Foden: Policy is forcing people into riskier assets. It is all based on encouraging leverage and encouraging investment and that theoretically feeds back into the economy. So, we have to be vigilant about how corporates are reacting to that in terms of how they are levering up.

In a way the industry is really pro-cyclical on this. So things like buy and maintain, fixed spread targets or fixed yield targets. What will the average manager do based on that fixed reference points when yields fall? You have to push the envelope in terms of risk to deliver to those set targets.

Abrams: The nature of the benchmark is that as demand for a certain part of the market rises, the market value of the weight in the index rises. But it just speaks to the fact – why would you want to follow the benchmark approach when you are probably systematically embedding a lot of the future risk naively by

"Why would you want to follow the benchmark approach when you are probably systematically embedding a lot of the future risk naively?" Joe Abrams

being part of that build up in demand.

Zeenni: With one third of government debt in negative rate territory, investors are looking at alternatives and yield with good risk adjusted figures. One key feature of the high yield market is that it can withstand a Goldilocks type macro environment. Today, we are in this scenario with low overall world growth. One of the major risks for the high yield market is a deep recession which is not today our main scenario. So the high yield market offers a good carry opportunity for an investor that can withstand some volatility. Today, we have these extra liquidity conditions given by the central banks which drive defaults at low levels because liquidity is there and issuers are able to extend their maturity wall.

Will: Yes, investors are being forced to invest in riskier assets – be it lower credit ratings or less liquid assets – and non-sterling denominated assets in order to achieve the yields they require. For a lot of small or medium sized pension funds, who won't have the governance budgets to make discreet allocations to some of the more esoteric credit types out there or change allocation when opportunities present themselves, a multi-asset credit strategy where the manager has discretion to allocate across various credit types and markets in a risk controlled manner makes sense.

Abrams: Yes, we shouldn't be investing in anything at any price. The ability to be opportunistic, and allow the experts to do that for you in a controlled manner, is the right thing to do.

Navigating bond market volatility

By Martin Foden, head of credit research, Royal London Asset Management

Markets have been affected by intermittent bouts of volatility during 2016, beginning with Asian stock market turbulence in January, and more recently the sharp reactions to the UK's decision to leave the European Union. In fact, it is becoming increasingly plain that exogenous shocks, liquidity challenges and volatility are the new normal for investment markets and against such a backdrop the cornerstones of our long established credit approach have never felt more relevant: (1) effective portfolio diversification to dampen idiosyncratic risk (2) acute targeting of market inefficiencies to embed undervalued bonds (3) high quality credit analysis undertaken by an experienced credit team within an environment that encourages interaction and efficient decision making.

Whilst the general merits of forecasting may quite reasonably be called into question at times like these, it does feel prudent to assume low yields continue to be a feature of the investment landscape. Having persisted since the financial crisis, yields have been further anchored by policy makers' responses to impending Brexit. In our funds, we focus on stable, long-term income generation, which we think should be a valuable component of achieving attractive returns in an environment where a growing number of core government bonds are currently yielding negative returns.

Investment universe

We place a high level of importance upon searching for investment opportunities in under-researched areas of the market. We believe that although credit ratings can be a useful part of risk assessment, they do not provide the full picture; bonds with very attractive fundamental credit characteristics and structures can often be under-rated because of rigid rating agency methodologies and the limitations in the scope of their research. The fundamental question for us is whether the price of a bond is an accurate reflection of its overall risk and return potential, and we operate a stock-specific approach across sectors to constructing our portfolios. As a consequence, our portfolios tend to differ in composition from those of more benchmark-driven competitors and from market indices, as they reflect our conviction in specific issues, entities and areas of the market.

In terms of credit sectors, we tend to limit investment in supranational and government agency debt, as we find that credit bonds offer a better balance between risk and return for long-term investors. We continue to operate a bias towards under-valued secured debt within our credit portfolios and remain keen to look beyond more superficial credit characteristics which continue to be over-valued by the market. This has been further perpetuated by the recent mushrooming of high-level, rules-based bond selection in the market, whether due to the transplanting of Smart Beta processes from the equity market or the influence of regulation and central bank purchase programmes. This demands that investors become more focused on the specific risks of bonds, using these distortions to identify and embed under-priced and over-looked bonds of the highest quality without compromising return.
Examples of areas where mispriced credit enhancements can be extracted include asset-backed securities, residential and commercial mortgage-backed securities, investment trusts, social housing and real estate. The yield advantage from bonds in these sectors, despite their low risk characteristics, renders them attractive, and through our specialist credit analysis we identify opportunities in individual bonds where 'overall' credit risk (probability of default and loss of capital) is significantly mispriced.

We will happily include allocations to 'higher risk' assets, including high-yield bonds, subordinated financial debt and corporate 'hybrid' assets but only where we understand the risk dynamics over the life of our investment and, most crucially, are adequately compensated for the additional risk. Indeed, what is anathema to us is buying supposedly high quality bonds on thin credit spreads due to the market's over-appreciation of more transitory features, such as name recognition. Against the current market backdrop of lower yields, when the temptation may be to keep up returns by pushing the risk boundaries, there really is no substitute for 'through the cycle', investment experience and a long-established and disciplined investment approach. It is vital that any increase in risk is thought through and coupled with an assessment of whether the additional return available is commensurate and in line with clients' requirements and expectations.

Our credit research capabilities enable us to analyse these specialist areas with the extra focus they deserve, in order to identify appropriate investment opportunities.

Investment outlook

Following the UK's vote to leave the European Union, we have amended our outlook and growth forecasts across asset classes to take account of the likely impact of an extended period of political and economic uncertainty upon growth and activity, both in the UK and in other regions.

We expect the effect of the Brexit result to be focussed on the UK and the eurozone, and we do not anticipate that it will lead to a systemic global financial event. UK inflation now looks set to rise during 2017. We expect the positive effect of lower sterling on import costs to be tempered by a slowdown in growth. We anticipate further policy easing from the Bank of England in the third quarter, and we think that the government will change its fiscal strategy. We do not think it is likely that former targets for deficit reduction will be maintained, and we think that austerity policies will be watered down in order to encourage growth.

UK yields have fallen significantly following the referendum, and remain at extremely low levels. Yields on German bunds have fallen into negative territory, and other core government bond yields have also declined. While we think the extreme drop in UK government bond yields was an overreaction to the event, we expect that yields will continue to stay low, as statements from the Bank of England have indicated a clear support for further monetary policy easing, to be enacted through interest rate cuts, along with other forms of quantitative easing programmes, including a corporate bond purchase programme.

We still believe investment-grade and high-yield credit offer better relative value than government bonds in the current low-yield environment. Credit valuations are being underpinned by strong company balance sheets and extended central bank liquidity, which is forcing investors to broaden their search for yield. We expect returns from investment-grade corporate bonds to exceed those from government bonds over the next three years. While the full implications of the Brexit decision are not yet clear, we believe that market shifts will provide opportunities for investors to reassess portfolio risk and return, and to take advantage of price movements to adjust positioning. We think that portfolio diversification becomes even more important during bouts of volatility, and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.

Whichever way short-term market volatility plays out, what remains clear is that credit markets, with their over-reliance on credit ratings and fixation with benchmarks, will provide mispriced opportunities that an active investor with the right approach and team can continue to exploit.

ROYAL LONDON

Navigating credit opportunities in a low-rate environment

By Patrick Zeenni (deputy head of high yield and credit arbitrage), Fawzy Salarbux (global head of consultant relations), Candriam Investors Group


When it comes to formulating a fixed income strategy, investors face a real Hobson's choice. The current investment landscape has left investors arguably bereft of the traditionally 'safe haven' fixed income asset class and at the mercy of economic and political shocks of divergent US Fed and major central bank policies. This has forced investors down the risk curve.

With nearly one-third of government debt already in negative rate territory, the China slowdown, commodities drop and political uncertainties across Europe have all contributed to an uncertain macro-economic outlook and created significant disparities across regions and sectors.

The investment challenge lies in navigating within increasingly complex dimensions of risks whilst delivering returns. At Candriam, we believe that well thought-out credit strategies which are actively managed and flexible in approach, whilst anchored in a robust risk framework, will have an increasingly influential role to play in investors' portfolios.

Credit is for high conviction active management

Aside from this uncertain macro environment, we view the high yield market as a good carry opportunity for long-term investors who are searching for yield and can withstand some volatility.

In a low-growth environment, issuers with high leverage are sometimes unable to meet their debt repayments, and smaller companies struggle to maintain their pricing power. Well-honed bond selection skills are required to identify, capture and benefit from these opportunities.

Our active management style has a proven track record of generating alpha whilst managing the key sources of risk which a typical passive approach would be vulnerable to.

Our active positions are founded on a solid base of both fundamental and quantitative analyses, as well as a thorough legal review of covenants. We overlay this with a global big-picture view to ensure that the key drivers of performance and risk are captured.

We invest in companies with strong liquidity profiles, robust governance, potential upgrade stories, deleveraging issuers, special situations (e.g. M&A, refinancings) and specific capital structure positioning (e.g. senior secured, hybrid corporates). We focus on finding niche and "best in class" players, such as value-adding issuers with high barriers to entry. A key element of our process is our management assessment, through several contacts and our ability to be an "on the ground" investment team.

Today, we focus on resilient sectors such as commercial services, TMT and real estate as they are less tied to overall growth than commodity-linked sectors such as energy, metals and mining.

The right tools for the credit mission

In order to achieve the twin objective of delivering returns whilst managing risks, we use several proprietary tools across our portfolios.

We manage our portfolios with complementary performance drivers, whilst applying a strong sell discipline, triggered by both quantitative and qualitative filters.

Our macro filter allows us to closely monitor the sovereign risk embedded in each issuer and informs our view on the € and $ exposures and sector allocations.

We also apply a level of 'legal review' in our investment process, through the use of legal experts. This enables us to remain very discerning about the covenant strengths and manage credit risk efficiently.

This approach has served us well across our range of strategies to deliver a resilient pattern of returns whilst managing downside risks and building a strong track record in mitigating default risks.

We have successfully avoided all defaults since the inception of our credit strategies.

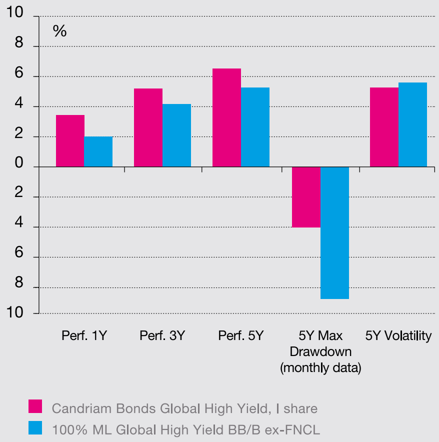
Our credit strategies – where do they fit?

We recognise that different clients have different needs from their fixed income portfolios. Aside from liability-hedging purposes, investors are looking for ever elusive ‘equity-type’ returns to support the growth component of their portfolios. Our strategies should appeal to return-seeking investors looking to achieve alpha within a strong risk framework.

Candriam Bonds Global High Yield - A high conviction, ‘pure corporate’ strategy, excluding Financials with a demonstrable track record of delivering alpha with strong Sharpe ratios and a high active share. The investment process is based on a bottom-up selection with a macro filter.

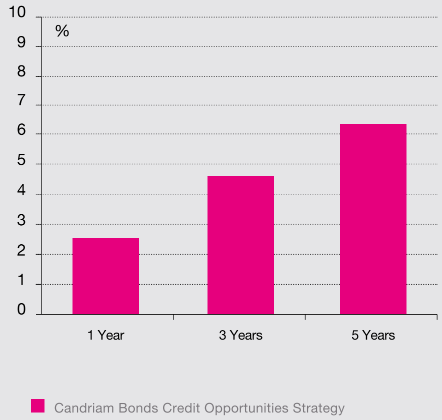
Candriam Bonds Credit Opportunities – An absolute return approach, global long/short credit strategy with a long bias combining two complementary performance engines: a short duration bucket exhibiting low beta and an opportunistic long/short bucket which seeks to capture alpha, coupled with dynamic tail risk hedging policies and drawdown management.

Chart 1: Candriam Bonds Global High Yield



Monthly Data as of 30 June 2016.
Fund performance calculated net of fees / Past performance is no guarantee of future results and is not constant over time.

Chart 2: Candriam Bonds Credit Opportunities



Monthly Data as of 30 June 2016.
Fund performance calculated net of fees / Past performance is no guarantee of future results and is not constant over time.

The credit challenge

To manage credit successfully, we believe that an active and flexible style that enables analysis from a number of angles - fundamental, quantitative, legal - is appropriate to navigate the volatile and uncertain credit landscape.

Our portfolio management team are pioneers in the high yield space. Our stable, integrated and experienced team of portfolio managers have worked together for over a decade and refined a philosophy and investment process over time that has successfully navigated a broad spectrum of challenging market environments.

CANDRIAM INVESTORS GROUP
A NEW YORK LIFE COMPANY

portfolio institutional

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Are you interested in participating in future roundtable discussions?

Investors and investment consultants are invited to share their opinion and can be offered a complimentary place in future roundtable events. Asset managers interested in joining the panel can secure one of the limited sponsorship packages.

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The next roundtable is on impact investing and will be held on Friday 14 October.

Topics for upcoming roundtable discussions include:

DC investment
Managing volatility
Fixed income

portfolio
institutional