GENERALI INVESTMENTS

Where next for credit markets?

Simon Thorp, co-manager of the Aperture Investors SICAV - Credit Opportunities Fund, and UK Chief Investment Officer of Aperture Investors Ltd, explains why actively managing credit exposure is crucial at a time when markets are priced for perfection.

September 2021

Simon Thorp

Simon Thorp is the Chief Investment Officer, UK, based in Aperture's London office. Simon is a career credit investor, with over 30 years experience in fixed income markets as well as an investing track record spanning over 15 years, most recently serving as the CIO of KKR Credit. His experience includes broking, investment banking and fund management. Simon received his B.Sc in economics and politics from the University of Keele. He has received and been nominated for numerous honors throughout his career, including Hedge Fund of the Year in 2009, the 2005 Eurohedge runner-up for Credit Fund of the Year, and nominations for Credit Fund of the Year in both 2008 and 2009.

Caution required for the next phase of the credit cycle

Credit markets right now are priced for perfection, with very low yields and very tight spreads. Central bank intervention is still the main force driving buoyant credit markets. The US Federal Reserve alone are buying around $120bn of fixed income instruments out of the market every day and have been for the last 18 months. But we've got to be cognisant of the fact that we're probably mid-to-late credit cycle here and a bit of caution is required as the best of the beta trade is likely over.

Because of where we think we are in the cycle, we believe that risks are on the rise. These risks include too much growth and inflation leading to higher yields around the world, which would be negative for credit markets. But the opposite – too little growth and inflation – would lead to higher default rates and that threat would mean wider credit spreads. In my view it's a good time to begin reducing long-only credit exposure which has performed very well so far, which is what we're doing in the fund. Instead we're focused on finding bonds where the returns are more uncorrelated to overall markets.

Eyes on the prize...

Our aim over a five-to-seven-year cycle is to generate market-type returns by taking less risk than if you were 100% exposed through an ETF or a pure long-only fund.

We do that by trying to ensure the bulk of our returns are alpha-driven, rather than beta. We're not market neutral; we will go long or short of a market if we think there's a defined trend, but our focus is longs and shorts, with positive and negative convexity, trying to find mispriced opportunities in the market and relative value trades that mirror the market trend. In my view, if you actively hedge your credit portfolio during periods of potentially higher volatility and weaker markets, then over time you can generate a high Sharpe ratio and what we believe are high risk-adjusted returns and an attractive risk-reward profile.

Don't fight the Fed

"Don't fight the Fed" has been the key doctrine since the Global Financial Crisis. The good news is that compared to, for example, 2013's taper tantrum, central banks are much more skilled at communicating their intentions and giving the market time to adjust. So there shouldn't be too many surprises from central banks on a very short-term basis. Our job as credit investors is to understand whether credit markets are overestimating or underestimating central bank actions. Then we can either increase portfolio hedging or add to risk, depending on where we see the opportunities. These next few months are going to be crucial because it feels

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like the Fed is trying to talk itself into a taper and yet macroeconomic data has clearly been weakening over the last three or four months, which will make tightening monetary conditions much more difficult.

Don’t underestimate inflation risk

I suspect the Fed currently is a bit too sanguine on inflation. It’s something we’ve been monitoring for over a year now, as a direct result of the stimulus. There is no question that prices are rising everywhere. Every single company we engage with talks about rising inflation. It’s the single biggest threat to credit market valuations, in my opinion. If we do see a big selloff why would you hold a US high yield bond at 3.5% if 10-year US Treasuries get to 2% or more? So much is correlated to the US 10-year.

In my view, it’s not clear that inflation is wholly transitory. It may be we see a slowing economy and sticky inflation, particularly around wages. That would mean stagflation, which would probably be the worst of all worlds for markets, but as active credit managers we would view that as an opportunity, as we would in many other scenarios. Some businesses would do very well if prices continue to rise, for example those companies that produce raw materials and pass on higher prices as long as demand remains robust. These would be good long opportunities. Good short opportunities might come from businesses that unfortunately would suffer from higher leverage, higher prices and weaker demand. As always, there will be winners and losers and it’s our job as active managers to discern which is which and find those opportunities for our investors.

Active, all-weather credit exposure

We have been increasing long exposure into high yield over the last year, which hasn’t yet got to a point of being eye-wateringly expensive versus investment grade. Equity markets have been on fire, so there have been lot of short-term tactical opportunities through refinancing, IPOs, and M&A. We’ve also been focusing on the laggards in the market that we feel are undervalued, such as the “reopeners”, particularly in the travel and leisure sector where deep credit analysis is critical but rewarding. The last six months has been less of a time for finding short credit opportunities mainly because of the liquidity in the market.

To hedge risk, we hold put options on equity and credit markets. In terms of interest rate risk, we hedge each investment grade position. In high yield, we look at the aggregate interest rate risk we’re running and then work out exactly how much we should hedge of that risk so that we don’t under- or over-hedge; it’s something we continuously monitor. If we felt central banks were losing the battle and that yields were on a prolonged move higher, then we would run the portfolio outright short of interest rate risk.

As we enter the next phase of the credit cycle, we feel confident that the fund has access to the fullest spectrum of fixed income instruments, across longs and shorts, to deliver attractive risk-adjusted returns for our investors, regardless of the market environment.

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Aperture Investors is part of Generali Investments

Aperture Investors, based in New York, is a global asset manager founded in 2018 by a partnership between Generali Group and Mr Peter Kraus, former Chairman and CEO of AllianceBernstein. Aperture operates with an unconstrained investment approach and a unique fee model that aligns the company’s profitability with that of its clients. The company charges low, ETF-like fees when performance is at or below stated benchmarks. When and only when returns are generated in excess of a strategy’s benchmark, Aperture Investors charges a performance-linked fee, and as such, investment teams are compensated primarily on outperformance.

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Key features

ISIN	LU1958553239 (I EUR-H Acc.) LU1958553072(I USD Acc.)
Inception date*	05/08/2019
Benchmark	Secured Overnight Financing Rate (SOFR) +2%
Fund Currency	USD
Domicile	Luxembourg
Management fees	0.39%
Performance fees	30% > benchmark
Ongoing charge	1.06%
Entry fee	5%
Exit fee	3%
Management Company	Generali Investments Luxembourg S.A.
Investment Manager	Aperture Investors UK, Ltd

Performance analysis

	MTD	YTD	1Y	3Y	5Y	SI*
USD I Acc.	0.20%	3.20%	5.34%	n/a	n/a	12.44%
Benchmark	*0.18%*	*1.35%*	*2.05%*	-	-	*5.28%*

Source: Generali Investments Partners S.p.A. Società di gestione del risparmio as of 31.08.2021. Past performance provides no guarantee for the future. No express or implied liability or guarantee is assumed that the future performance will correspond to the performance described above. The value of and income from fund units or sub-fund units ("Units") may rise or fall. No guarantee can be assumed that the investment objectives of the fund will be achieved. The performance of and income from the Units have to be reduced by costs and taxes.

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The views expressed are those of the Simon Thorp but may not be the views of Aperture Investors UK, Ltd and its parent company Aperture Investors, LLC (“Aperture”).
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