OPTIMISING YOUR CREDIT STRATEGY IN A LOW-YIELD WORLD

ALEX VEROUDE
Head of Credit,
Insight Investment

Investment grade credit markets provided investors with strong performance in 2014, much better than many commentators had anticipated. But with credit markets testing their highs, now is an opportune time for investors to reconsider how their credit portfolios might be affected as the world adapts to diverging US and eurozone monetary policy.

The first quarter of 2015 has seen another leg in the long-running rally in European investment grade credit. The European Central Bank (ECB) finally side-stepped German-led opposition to sovereign quantitative easing, outlining measures that exceeded most market participants' expectations. The ECB announced that it intends to expand its balance sheet by around 50% over the next 18 months, making purchases totalling around €1.1trn. Investors reacted by selling the euro and buying both stocks and bonds. Eurozone government bond yields fell to record lows, while European corporate bond spreads fell further.

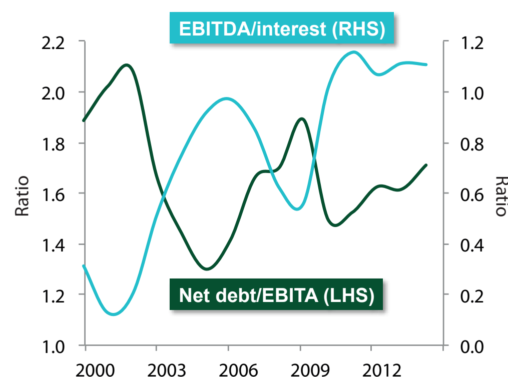
Together with an agreement among Greece's international creditors to extend the country's bailout programme, confidence in the eurozone has jumped[1]. Stock indices across Europe rallied to record highs, reflecting investors' exuberance, while also underscoring the degree of uncertainty that existed last year and how those concerns have abated.

DEFAULT RATES REMAIN LOW

From a credit investor's perspective, there are also reasons to be positive. Default rates remain very low, with the European 12-month rolling high yield default rate currently running at a mere 0.89%[2]. In addition, interest rate coverage ratios, which determine how easily a company can service interest on its outstanding debt, are arguably very strong compared to history as earnings have picked up and rates remain low. This has been reflected by the steady uptick in the number of credit rating upgrades versus downgrades in both the US and Europe (Charts 1 and 2).

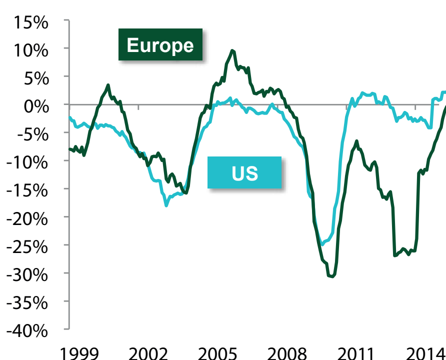
So how best to invest in an environment of low interest rates and consequently low investment yields, but in which corporate fundamentals remain sound? Investors looking to maintain a relatively high level of returns are faced with a stark choice. They can reduce credit quality or raise leverage and face a heightened risk of default, or explore more niche strategies where they may be paid for accepting lower levels of liquidity or increased levels of complexity. Our long-standing advice to clients is simple: maintain an uncompromising position on investment quality and avoid the headaches of owning assets that could easily become distressed.

Chart 1: European Investment Grade Leverage and Coverage Ratios



Source: Deutsche Bank, Bloomberg Finance LP as at 12 December 2014

Chart 2: Rating Drift: All Rated Issuers



Source: Deutsche Bank, Moody's as at 12 December 2014

Examining the credit universe, it is evident that there are a range of opportunities. Depending on the priorities of the investor, there are a number of avenues that can be followed, and here we explore a few of them. Situated at arguably the first rung of the risk ladder, but at the top of the 'liquidity ladder', is the tried-and-tested buy and maintain approach.

TAILORED PORTFOLIOS

This approach involves buying bonds from companies on which you have formed a fundamentally long-term positive view and then keeping those bonds until maturity. It can be an excellent, low-cost way of creating a personalised portfolio of holdings that suit specific needs for yield and/or income while investment decisions can be focused on long-term return potential and ignore short-term market volatility.

One of the main advantages of this approach is that it frees investors from the constraints of investing according to a specific benchmark. The benchmark approach, although very widespread, does come with a number of downsides, namely exposure to potentially the most indebted issuers, leading to unintended portfolio concentration.

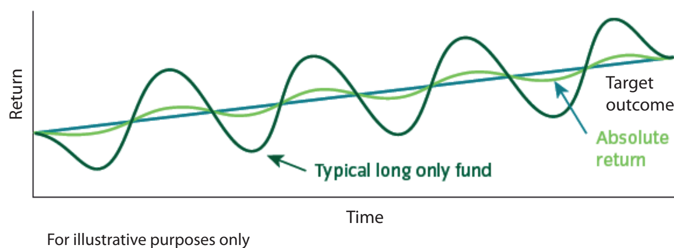
Ignoring benchmark references to build your own portfolio sidesteps these issues; portfolios can instead be constructed with strict, pre-agreed geographic, sector and issuer concentrations limits. Such a strategy could, for instance, have zero exposure to deeply subordinated perpetual financial debt where coupons are optional.

Taking this strategy one step further and implementing a hold-to-maturity policy, means that turnover should be modest: transaction costs are minimised while index rebalancing costs are avoided altogether. Naturally, this type of portfolio must be carefully monitored to avoid a significant deterioration in issuer credit quality loss or default, but in theory this risk should have been minimised at the outset if thorough credit analysis has been carried out.

IDIOSYNCRATIC OPPORTUNITIES

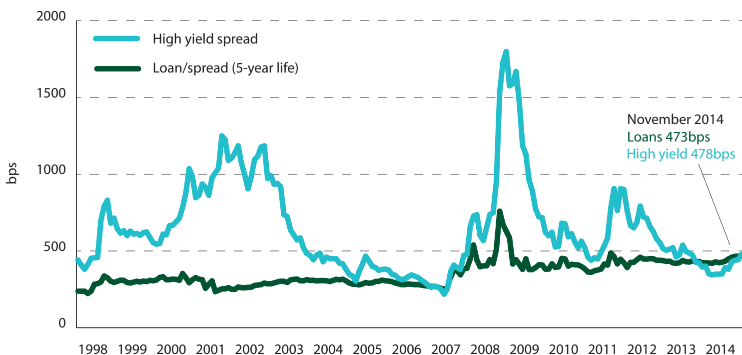
Stepping up the risk spectrum, is the long/short approach to credit. Similar to buy-and-maintain, benchmark constraints are also ignored. But that is where the similarities end. Here, portfolios are actively managed, targeting a large proportion of returns from alpha, rather than being reliant on market returns. Given that a long/short approach is normally offered with an absolute return objective in mind (Chart 3), this adds the flexibility of using derivatives to exploit idiosyncratic credit opportunities and pric-

Chart 3: The Long/Short Approach to Credit



For illustrative purposes only

Chart 4: Spreads – Loans vs High Yield



Source: Credit Suisse Western Europe Institutional Leveraged Loan Index and Credit Suisse Western European High Yield Index as at November 2014

ing anomalies in the market. The range of strategies which might be used by the portfolio managers include carry, momentum (long or short credit), special situations (distressed), capital and market structure arbitrage, tactical macro and basis trades, as well as risk hedging techniques.

With this type of approach, views are taken based on much shorter time periods, offering the ability to anticipate or respond to market volatility. The range of investments that can be considered can also be much broader: not just investment grade credit, but high yield, secured corporate loans, and emerging market debt.

Liquidity needs can be taken to account, so that a highly liquid, dynamically-managed portfolio can be created. In addition, medium- or longer-term return targets can be more aggressive, offering the possibility of opportunistic and tactical holdings in a range of higher-yielding assets.

With a long/short strategy, given that it is much closer to a hedge fund-type management style than a traditional long-only portfolio, it is important to pick a manager that can offer a high level of transparency, with a clear investment process monitored by an independent risk team.

In contrast to a credit multi-strategy approach, investors may want to look at the individual credit sub-asset classes. Some of these sub-asset classes can be relatively illiquid and often do not carry public credit ratings. This is the case for much of the secured corporate loan market. This is a well-established part of the credit market and a good example of an asset where investors are well rewarded for giving up some liquidity.

COLLATERAL PROTECTION

Senior secured loans are tradeable loans that are traditionally made by banks to a wide range of large businesses. The investable universe of syndicated senior secured loans for well-established corporates includes those which are used to fund acquisitions, undertake refinancing to improve balance sheet efficiency and for leveraged buy-out transactions.

Here, the opportunity lies in the yield potentially available. Yields on senior secured loans are currently higher than those offered by high yield corporate bonds, even though they are higher-ranking in the capital structure (Chart 4). This means investors benefit from enhanced levels of collateral protection and stronger covenants and are ultimately given a higher priority claim on a borrower's assets than a bondholder in the event of a default.

Because of the secured nature of the asset class, recovery rates are generally higher after a default than is the case for corporate bonds. Another interesting characteristic of loans is that they typically pay a floating rate coupon that is reset in line with market interest rates, which provides a natural interest rate hedge.

But loans do require the expertise of a specialist asset manager. The investor base of the asset class can be highly sophisticated, requiring specific skills to originate, manage and settle the loans. Managers have to be able to make an in-depth credit assessment themselves and understand the structure and documentation.

FOOTNOTES

1 European Commission Economic Sentiment Indicator, a measure of business and consumer confidence, rose to 103.9 in March 2015 from 102.3 in February 2015, reaching its highest level since June 2011.

2 Source: Credit Suisse, as at end December 2014

3 Source: CS High Yield and Leveraged Loan Default Review January 2012. Defaulted loans defined as those which have missed coupon, filed for bankruptcy, entered administration, undertaken a distressed exchange, or cross-defaulted. Institutional includes TL-b, TL-c, TL-d, delayed draw and other tranches generally held by institutional investors.

Loans - key characteristics

SENIORITY: loans are the most senior obligation that a company can have on the liability side of its balance sheet. They supersede corporate bonds, with only tax receivables and salaries ranking higher. The seniority of secured credit loans is undoubtedly one of the strengths of the asset class. It can be an excellent investment strategy for investors with a more conservative risk-reward outlook.

SECURITY: loans are secured against assets and shares and therefore typically benefit from better recovery rates in the event of a default.

VOLATILITY: Loans are generally less volatile than high yield bonds which sit lower on the capital structure, and exhibit a higher sharpe ratio than high yield through an economic cycle.

COVENANTS: secured loans often come with covenants, or restrictions, which provide further security to the lender. For example, business activities that might harm the interests of the lender are restricted by covenants within the legal structure of the loans. These are designed to stop the company from wilfully reducing its creditworthiness.

FLOATING INTEREST RATE: the interest rate on loans is floating, typically indexed to three-month Libor in the appropriate currency. Consequently, there is minimal interest rate and duration risk.

CREDIT RATING: secured loans are typically sub-investment grade instruments.

PRE-PAYMENT: secured loans generally have maturities of between seven to nine years, but the issuer has the right to repay the loan at par at any time.

RECOVERY RATES: senior secured loans have historically displayed a lower rate of default relative to lower-ranking high yield bonds. In the event of a default, loans often have a higher recovery rate, typically averaging around 62% versus an average 29% recovery rate for high yield bond holders[3].