Credit where credit is due – making the most of unconstrained credit

The search for a sustainable return has led many pension schemes to allocating more investment to a credit solution. Jeff Boswell and Garland Hansmann of Investec Asset Management outline how unconstrained credit strategies could help address the challenges.

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Global growth remains lacklustre and the outlook for inflation highly uncertain. As a result, central banks are continuously looking at the effectiveness of their monetary policy and how to sustain the economic recovery. This has resulted in government bonds losing their income-generating qualities, with investors having no choice but to look elsewhere. Unconstrained credit strategies typically offer a higher yield, while furnishing defensive qualities via risk management using several different credit asset classes. The strategy seeks to provide a strong income element on a consistent basis that few other assets can provide. An investor must also consider the security of that income. If, for example, income generation relies on equity dividends, there is a risk that these could be deferred in the case of a bad year or poor outlook for the firm. The coupon of debt securities is, on the other hand, predetermined.

CORE CREDIT

A substantial allocation to credit is increasingly being recognised as part of the solution to solving the yield conundrum. We are seeing investors opt for this solution to de-risk core equity holdings and revamp vanilla credit portfolios. Adding to credit should also help defined benefit schemes that are facing the threat of becoming cash-flow negative and struggling to pay pensions without selling down assets. The capture of this credit risk premium is, however, difficult to execute in practice, with the relative attractiveness of individual credit markets changing daily. Unconstrained credit strategies seek to find the best risk-adjusted return within the credit markets, while also allowing the fund manager increased flexibility in managing portfolio risks.

CHALLENGING RATES AND BOND MARKETS

The US Federal Reserve embarking on its rate hiking cycle and the European Central Bank slowing the pace of quantitative easing has raised concerns for fixed income investors about the impact of higher rates. In our view, while the likelihood of a normalisation of rates to long-run averages (e.g. 6% for 5-year US Treasury) from today's levels seems low, any movement in that direction will have a significant impact on bond markets and other rate-sensitive instruments. Unconstrained credit strategies, which have the flexibility to derive returns from a broad opportunity set, have typically delivered robust performance through recent interest rate volatility. The short duration profile of our unconstrained credit strategy means there should be no need to predict interest rate moves in the same way as for a typical credit strategy. A key element of this performance is a focus on generating returns principally from credit spreads, rather than any significant duration views. This versatility, coupled with appealing income generation, will prove helpful in negotiating the yield-challenged environment facing many investors.

In many cases an unconstrained credit strategy can also include a selection of loans in the portfolio to help take advantage of a rising rate environment. Loans are floating rate in nature and therefore have very low duration. Secured loans usually sit at the top of the capital structure above senior unsecured bonds and equities and therefore can provide a higher level of protection than high yield bonds although care needs to be taken to understand each loan's covenant structure. Assessing the loans universe also improves diversification.

VOLATILITY ON THE RISE

Volatility spikes have become more common in recent years. In our view, such volatility is likely to continue. Macroeconomics (low growth), monetary factors (low central bank rates, low dealer liquidity) and politics (anti-globalisation, terrorism, and divisive campaigning) are all contributing to the increasing spikes in volatility. In this environment, we believe a flexible and reactive investment strategy will be far better placed to navigate this array of risks with the potential to perform well in both up and down markets.

THE FUTURE OF UNCONSTRAINED CREDIT

The current yield challenges facing many investors undoubtedly requires a new way of thinking in terms of asset allocation. While credit has long been a core income-generating component of many traditional asset allocation models, the evolution of financial markets, coupled with the complexities of investing in the current environment, has cultivated a different way of credit investing. While a siloed credit investing approach may capture the beta of a variety of markets, capturing the right asset mix – and getting the timing right from an asset allocation perspective – is exceptionally difficult.

This is one of the key drivers that sparked the evolution of unconstrained credit strategies. Rather than attempting to thread the needle in terms of top-down timing, these funds principally construct their portfolio through bottom-up credit selection, looking for the best value across the credit markets for a given level of risk. This approach ensures that rather than relying upon market timing, the manager would typically look for opportunities that are attractively valued within one market over the other.

Although a robust top-down process is still critical in terms of establishing a broader portfolio risk bias, as well as any preference for a region or sector, unconstrained credit portfolios are typically driven by the aggregation of the bottom-up driven best ideas across the credit spectrum. It is worth noting that certain unconstrained credit strategies do apply a more top-down approach, whereby an allocation is made to internal credit class capabilities or external funds, effectively creating a portfolio of sub-portfolios. We believe this approach meaningfully waters down the key benefits. Not only does it re-introduce the importance of asset allocation timing, but instead of constructing a best ideas portfolio, designed to outperform the individual credit markets, the main driver of portfolio returns will be beta selection.

Another important consideration in the context of bottom-up portfolio construction is that the unconstrained credit manager should have the right team structure to assimilate those best ideas, and then make an investment decision on their inclusion or exclusion without undue bias exerted from local teams or asset class specialists. We believe a structure of disparate regional teams, siloed into different asset classes, has the potential to result in the very same structural biases we discussed earlier, which goes against the grain of what unconstrained credit strategies are trying to accomplish. As such, a robust decision-making structure, with strong alignment of interest from stakeholders, is essential in efficiently executing a best ideas bottom-up driven strategy.

We believe the breadth of opportunity and flexibility afforded to the unconstrained credit manager in seeking its target return should not only result in a better investment outcome, but also one that is better than the sum of the underlying constituent parts.

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