Investment Managers

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Investor Thinking

Investing in credit: Building robust portfolios for the long term

- **Institutional investors have long been investing in credit. The current credit cycle fuelled by the inflation of Central Banks' balance sheets has however provided a relatively easy ride to credit investors, with little incentive to differentiate between issuers.**
- **With structural changes, such as increased transaction costs and the credit cycle nearing an end, some investors have started to question whether the asset class is offering sufficient value after transaction costs and credit events are accounted for. Rather than reducing their exposure to the asset class altogether, institutional investors concerned about these developments may be better off paying more attention to issuer and issuance selection, and avoiding some types of credit.**
- **In this paper, we highlight some of the structural changes the credit market has undergone recently and suggest ways in which investments based on fundamental analysis in an unconstrained framework could help generate sustainable, long-term return streams while managing the heightened risk in credit.**

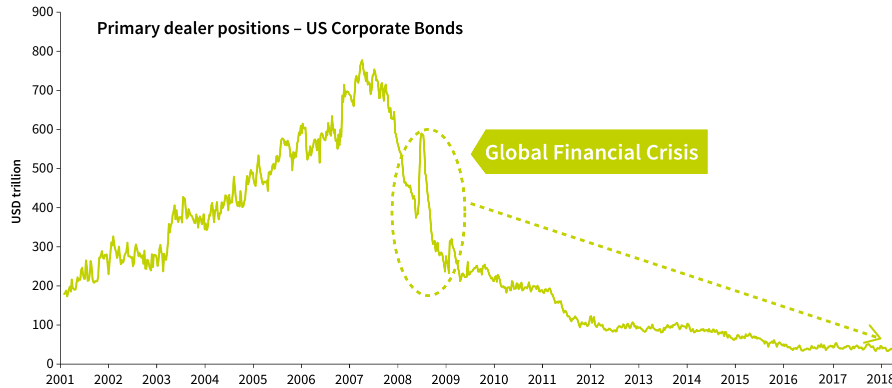
Structural changes within the credit markets today

Traditionally, fixed income markets have been structured as over-the-counter (OTC) markets with banks acting as market makers or dealers. As dealers, banks have been the ones providing liquidity by warehousing corporate bond inventory when buyers and sellers are not immediately available to settle a transaction. This has ensured the stable functioning of corporate bond markets.

After the Global Financial Crisis (GFC) however, regulatory reforms such as Basel III, the Dodd-Frank Act of 2010 and the Volcker Rules on proprietary trading, have resulted in greater capital and liquidity requirements for banks. As such banks are unable to maintain large inventories of corporate bonds (as illustrated using the US market in Figure 1) and market making in this sphere is no longer as lucrative for them. A majority of the corporate bond inventory therefore has shifted from bank balance sheets to investors. This means banks are unable to be efficient market makers – leading to lower liquidity in the system as a whole, which in turn increases the transaction costs of trading. As a relative measure too, transaction costs have become a larger proportion of the yields available as illustrated using the Sterling market in Figure 2. Hence minimising transaction costs has become a key consideration in managing a credit portfolio.

In addition to the regulatory reforms discussed above all major central banks (including the Fed, ECB, BoE, BoJ) have employed quantitative easing (QE) to help stabilise their economies in the wake of the GFC. While QE was critical in breaking the downward momentum of the crisis, it is now becoming clear that this benign credit environment is not going to be sustainable as the global economy approaches the peak of the long-term debt cycle.

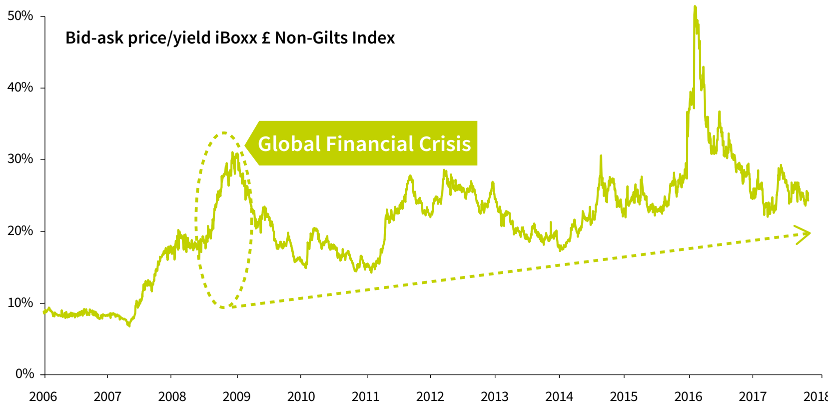
Figure 1: Diminishing dealer inventory



Source: AXA IM and Bloomberg LP as at 31/05/2018. For illustrative purposes only.
Adjusted for the size of the bond market as measured by the BofA Merrill Lynch US Corporate Index (C0A0). US Corporate Bond inventory is measured by the sum of Primary Dealer Positions Net Outright Total Corp Securities (PDPPCRP2), Primary Dealer Positions Net Outright Non-Agency Residential MBS (PDPPGCMB), Primary Dealer Positions Net Outright Other asset-backed securities (PDPPOABS) and Primary Dealer Positions Net Outright Other CMBS (PDPPOCMB).

> "Corporate bond inventory has shifted from bank balance sheets to investors - leading to lower liquidity in the system as a whole and increased trading costs."

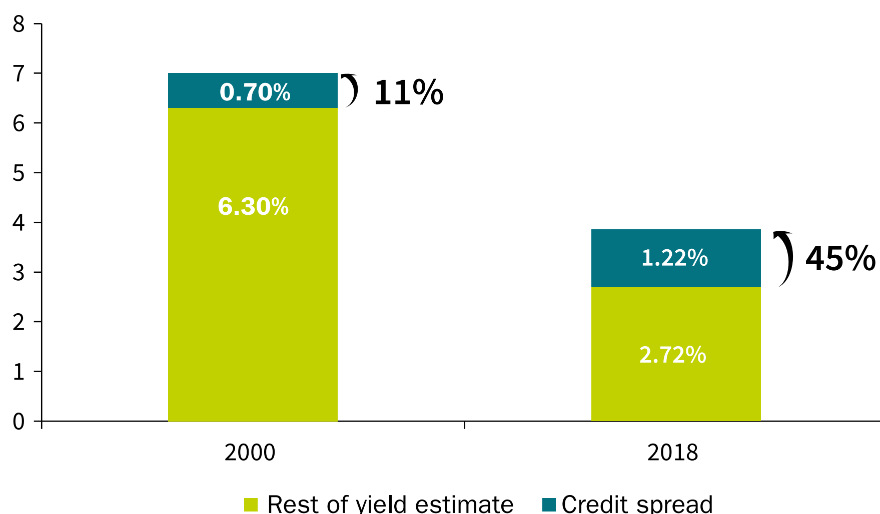
Figure 2: Increasing transaction costs relative to yield



Source: UBS Delta, iBoxx Sterling Non-Gilts Index, 01/01/2006 - 31/05/2018. For illustrative purposes only.

Just as transaction costs are a larger proportion of available yields in today's environment, credit spread makes up a significant part of the total return an investor can hope to receive as illustrated using the US market in Figure 3 (11% at the end of 2000 versus 45% in May 2018). With a reduced buffer to compensate for potential defaults, the quality of credit analysis and risk assessment has become even more important for investors, particularly in the anticipated less-benign credit environment.

Figure 3: Increasing share of credit spread in total credit yield



Source: AXA IM and Bloomberg LP as at 31/05/2018. Data shown for the BofA Merrill Lynch US Corporate Index (C0A0). For illustrative purposes only.

The importance of a holistic analysis of fundamentals

In the credit market, return outcomes are asymmetric, meaning that the penalty from not holding a bond that does better than its peers is small whereas the penalty from holding a bond which defaults can be severe. This asymmetry means that an investment approach that aims to pick the best performers may be at greater risk of including some of the worst performers and result in an outsized negative impact on an investor's portfolio. Conversely, long-term investors should achieve greater benefit from a focus on excluding the worst performers as the impact from missing some of the best performers should be relatively less material.

In light of the importance of minimising transaction costs, assessing credit risk effectively and avoiding defaults, we explore below some examples of the role of fundamental analysis in identifying risks that a purely quantitative assessment would likely miss.

When assessing credit, it is important for long-term investors to evaluate a company's business model to judge whether dramatic or repeated change will be required for the company to navigate the next 20 or 30 years successfully. Addressing such questions cannot be performed through purely quantitative analysis of historical data and shorter-term projections. The issues that a long-term investor needs to consider are numerous and cover many dimensions, some of which are 'top-down' in nature such as sector, geography, regulation, etc as shown in the following examples:

- How is the emergence of renewable energy impacting traditional utility companies?
- Are incumbent long haul airline operators being impacted by low cost carriers on short haul routes?
- Are electric, driverless or low-emission vehicle manufacturers challenging the traditional automotive manufacturers?
- Is the tobacco industry a sunset sector? Is it only declining in developed markets and not emerging markets?
- Has the retail sector grown too fast while trying to compete with the likes of Amazon? Has it been too aggressive and taken on too much debt over a short period?

> "The quality of credit analysis and risk management has become even more important to investors."

'Bottom-up' assessment of credit quality is equally crucial. Bottom-up analysis of a bond includes, for example, an in-depth assessment of the callable features of the bond and its liquidity, as well as its covenant package, senior versus subordinate status, operating company vs holding company status, and subsidiary guarantees. Thorough analysis of such fundamentals helps identify signs of weakness, anticipate changes in credit quality, and mitigate issuer-specific downside risk.

In addition, the durability of an investment over the long term is dependent on how sustainable the company's business model is from an environmental, social and governance (ESG) perspective. Academic research[1] suggests ESG criteria may reflect the quality of a firm's management or act as a leading indicator of slow-burning problems which could later impact creditworthiness. As such, introducing ESG criteria into the credit selection process creates a more holistic decision-making process which includes information on certain risks that cannot be readily identified through traditional credit analysis or publicly available credit ratings.

"In assessing a credit, it is important for long-term investors to evaluate a company's business model and what will be required to navigate successfully the next 20 to 30 years."

The examples below show how an investor may unintentionally take on uncompensated risk by not considering such ESG factors when investing in corporate credit[2]:

Looking beyond financial metrics

An analysis based only on key financial metrics would indicate that a certain pharmaceutical company has a strong credit profile. However, when we analyse the social and governance factors, in our view, the company has performed quite negatively. This is most visible in their business ethics incidents and bribery and corruption scandals. This company is currently facing investigations in multiple countries that could potentially result in litigation cost, fines and pressure on the company's top line. These factors can be a real risk to performance and the future credit quality of the company which is not reflected in the current credit metrics.

A closer look at Governance

Our credit analysis goes well beyond an assessment of financial indicators. We believe non-financial factors such as governance impact financial performance over time, although short-term effects are typically less pronounced. Moreover, we prefer to invest in companies with solid governance standards even in cases where the benefit is challenging to quantify.
In December 2017, the Australian Government launched an inquiry ('The Royal Commission') into misconduct in the financial services industry. Over the months that followed, we gradually adopted the view that management at one financial company had, over many years, failed to act appropriately towards its clients and its regulator. Given question marks around its governance, we are fundamentally cautious on this company, although the financial implications are still uncertain.

Looking at 'key man' risk[3]

The CEO and Vice Chairman of Walgreen Boots Alliance led the leveraged buyout of Boots and its merger with the Alliance Unichem. An understanding of what drove the CEO, his willingness to raise debt burdens and his desire to control a larger slice of the healthcare sector globally was critical to analysing the credit risk of Walgreen Boots Alliance. At the time, our research and analysis led us to believe that from a 'governance' perspective, this company was at risk of being excessively leveraged for further acquisitions, forcing its credit quality into sub-investment grade territory. Such an understanding could only be reached through direct interaction with the CEO and not, we believe, solely through an assessment of credit metrics.

As illustrated by these examples, a robust credit analysis process requires portfolio managers to undertake their own fundamental research and actively draw out all available information. As such, evaluating both top-down influences (including industry trends, challenges, potential external shocks and regulation), and issuer-specific and ESG risks from a bottom-up perspective, provides a more holistic analysis of credit bonds than quantitative analysis alone, and, can help reduce the risk of investing in the worst performers.

Furthermore, quantitative models tend to use historic financial data to derive key metrics, with no account of forward looking aspects. Such forecasted financial metrics are in themselves insufficient to derive a credit opinion as they lack context. Conversely, an approach based on thorough fundamental research, as described above, can take into account an assessment of the reasons for the metrics - the strategies and the risks behind what the numbers are saying, providing an additional dimension beyond basic credit risk assessment.

> **"An investor may unintentionally take on uncompensated risk by not considering ESG factors when investing in corporate credit."**

[1] Kane, G. Velury, U. and Ruf, B. June 2005. 'Employee Relations and the Likelihood of Occurrence of Corporate. Financial Distress.' Journal of Business Finance & Accounting. Volume 32, Issue 5-6, pages 1083–1105. Ashbaugh-Skaife, H. Collins, D. and LaFond, R. January 2006. 'The Effects of Corporate Governance on Firms Credit Ratings'. Journal of Accounting and Economics 42. Bauer, R. and Hann, D. 2011. 'Corporate Environmental Management and Credit Risk', Working Paper, Maastricht University.
[2] The following examples are for illustration only and do not constitute a recommendation to buy or sell.
[3] For illustrative purposes only. This information does not constitute an offer, solicitation or recommendation for the purchase or sale of any securities nor does it constitute advice, a personal recommendation or our view as to whether a particular security or financial instrument is suitable or appropriate for a recipient and meets their financial or any other objectives.

A global, long-term and unconstrained approach

Institutional investors seeking to achieve incremental returns through credit cycles while managing potential downside risk may derive additional benefits by adopting a global, long-term and unconstrained approach in addition to a holistic, fundamentally-driven research process:

- 'Going global' offers a larger pool of assets from which to identify more attractive credit opportunities, to select the most rewarding bond when a company issues debt in several currencies; to better diversify the portfolio across sectors; and to better manage the duration risk from rising sovereign yields in certain countries.
- A holistic, fundamental approach with a long-term view diminishes portfolio turnover and thus reduces value leakage through transaction fees.
- An unconstrained approach focusses on the intrinsic qualities and risk of the securities. It helps avoid the pitfalls of a benchmarked approach where the largest allocations are made to the most indebted and potentially risky sectors and issuers.
- Adopting an unconstrained approach can also help better manage the liquidity profile of the portfolio and align it with an institutional investor's specific requirements.

> "Institutional investors may derive additional benefits by adopting a global, long-term and unconstrained approach to credit investing."

Conclusion

The rapid expansion of central banks' balance sheets over the last decade has meant that bond markets have benefitted, primarily, from technically-driven performance. This looks set to change with the end of quantitative easing – and fundamentals will begin to matter more. Moreover, the end of quantitative easing, coupled with the structural changes to the credit markets, have made credit spread a significant part of the total yield available to investors – and therefore credit assessment also matters more than previously. In this context we believe that a forward-looking, fundamental approach to credit investing – that takes advantage of multiple themes whilst managing risk effectively and lowering transaction costs - is indispensable to building robust corporate bond portfolios for the long term.

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