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The evolution of credit portfolios – managing through cycles

Investors are looking for opportunities further along the credit risk/return spectrum as sovereign bonds lose their shine.

The recent evolution of Australian institutional and sophisticated investors' credit portfolios has been anything but straightforward. The story generally goes like this: once investors have become more secure about the likelihood of a systemic recovery following the global financial crisis, they allocate capital towards investment-grade and then non-investment-grade credit. Fast forward a few years and the low interest rate environment and low-yielding/high-duration features of sovereign bonds - which are usually considered a safe haven - have compelled investors to seek more opportunities further along the credit risk/return spectrum.

Accordingly, many investors have progressively allocated capital to ever more idiosyncratic non-investment-grade credit sectors – initially, as stated above, high-yield bonds and senior secured loans, but more recently convertible bonds, emerging market sovereign and semi-sovereign debt, municipal bonds, agency and non-agency mortgage backed securities, mezzanine debt, CLOs and even direct lending.

In comparison to common equity, these credit sectors not only differ in regards to the operating and financial characteristics of the issuing company or sovereign (just like equities), but also due to the structure of the securities. Whereas common equity is the same everywhere, credit securities differ markedly. Consequently, non-investment grade credit allocations have significantly increased in size and complexity.

Given these developments, some investors have been outsourcing credit sector allocation decisions to specialist managers by arranging more flexible mandates or investing directly into multi-strategy credit products. Specialist multi-strategy credit managers actively allocate across several credit sectors and sub-sectors, and in turn industry sectors, issuers, credit quality, duration - bound by the limitations imposed by market liquidity, issuance levels and so on. Active allocation decisions are made in anticipation of, and in response to, market opportunities to exploit inefficiencies and capture relative value to maximise risk/return outcomes. Typically, these managers have deep credit research skills and analytical capabilities across the capital structure.

Despite criticism from some quarters that multi-strategy credit managers are simply raising capital for higher fee products, investors are finding the potential to improve risk-adjusted returns, over and above single sector non-investment grade credit strategies, quite convincing. This is because many sectors often perform differently during various types of interest rate, credit and equity market regimes. For example, the coupons of senior secured loans adjust according to levels of LIBOR, sometimes after exceeding a LIBOR floor, making them generally less sensitive to changes in interest rates. By contrast, high-yield bonds are more sensitive to changes in interest rates as coupons remain steady until maturity.

However, they offer more attractive coupon income compared to senior secured loans. Senior secured loans offer call protection to the issuer - in a bullish market the upside is capped - whereas high yield bonds do not. Further, the returns of convertible bonds are more closely correlated to the movement of equity prices as those prices rise and conversion becomes more likely or as they trade in-the-money - however, they offer even lower coupons than senior secured loans and are typically of lower credit quality.

Within multi-asset portfolios, multi-strategy credit approaches are potentially serving as a complement or partial substitute to a core sovereign bond and investment-grade credit exposure for investors seeking to enhance yield by adding incremental credit risk with proportionally lower volatility. It is also permitting investors to better manage duration. These approaches may also act as a complement or substitute to an equity portfolio, potentially reducing volatility without a significant diminution in total returns.

However, investors realise that multi-strategy credit is not without risks and potentially unintended consequences. Despite the attraction of higher yields and the flexibility to manage duration, security/issuer selection and credit quality, there is an overarching concern that investors are essentially swapping duration for credit risk at a time when the reward for credit risk is lower due to recent spread compression. Some investors are aware that default rates are historically low, and cautious credit selection - predicated on deep research by seasoned professionals - can deliver credit risk premium while also avoiding defaults.

The quote

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Further, they realise that traditional credit skills should not be sacrificed by increasing the scope to a greater number of credit sectors and aggressive tactical trading. Arguably, managing non-investment-grade credit requires specialised skills, and adding more and more sub-sectors or implementing active tactical trading outside a manager's core expertise may introduce significant risks and nullify their ability to really exploit market dislocations in a timely and efficient manner.

Multi-strategy credit investing not only requires an ability to manage risks of the underlying sectors, but also to monitor and manage those risks aggregating across the credit and entire portfolio. Additionally, although adding credit risk may reduce duration and correlation to sovereign bonds, it may also increase correlation to equities. Without thoughtful consideration of the various risk factors across a multi-asset class portfolio, the addition of multi-strategy credit may actually reduce portfolio diversification. Additionally, allocating to some sectors may amplify liquidity risk in a part of a multi-asset portfolio occasionally relied upon to provide liquidity during market dislocations.

Moreover, track records are not always a reliable yardstick of the managers' capabilities, given the short life of many of these strategies. Consequently, many investors are evaluating managers based on their performance in the underlying sectors such as high-yield bonds or senior secured loans. Although there is valuable information to be gleaned from single sector performance, the allocation across sectors requires acute insight into how the returns and risk of the sectors interact in different interest rate, credit and equity environments, which may not be readily apparent when focused on managing the underlying sectors. It also requires organisational and management structures that foster appropriate communication in order to exploit the information garnered from the sector teams. FS