Previously Investec Asset Management

The increasing role of credit in fixed income portfolios

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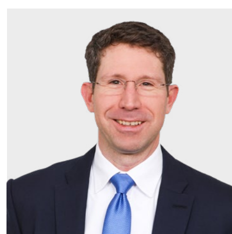

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Despite significant growth and massive inflows, historically, credit markets have suffered from being considered dull, yet the recovery from the liquidity meltdown (interestingly led by investment grade) earlier this year was anything but. Assistance provided by the US Fed and the ECB was extremely rapid, and more recently news about potential COVID vaccines have proved supportive, with the result that credit has produced some truly astounding performance and we are now seeing the resumption of significant credit issuance and investor inflows.

- Many government bonds are at the zero interest rate lower bound and unable to generate returns. If one imagines rising interest rates at some point, they could almost be considered a risky component in a portfolio; it contrasts sharply with the ability of many corporate bonds to supply yield and generate returns. The potential alpha from credit selection beyond that is extensive, so the aim is delivering that incremental return, while minimising risk.
- Used as a substitute for equity, high yield credit often may be more volatile than investment grade but more attractive in returns, too. This middle ground between equity and IG bonds should be researched in an unconstrained manner. Remember that spreads for Nestlé and Unilever, for example, will be driven by government bonds and ultimately central banks. But to really access the opportunities available, one should be studying corporate decision making and analysing companies' earnings profiles and balance sheets, particularly in lower rated companies where a larger proportion of the return depends on the company rather than the overall rate environment.

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- Traditional peak credit default rates at the depths of a downturn used to range between 10-14%, and many would have thought that reverting to the higher end might likely during March 2020. Yet it did not happen; the responsiveness of recent central bank support has helped default rates stay significantly below that peak, around 4-6%. Conditions would have to weaken substantially from here for default rates to reach that historic peak once again, in our view.
- In credit, it is always possible to make a purchase or sale, but sometimes there are liquidity gaps, when it might be difficult to sell (but conversely a good time to buy) and vice-versa. Scouring the market, to see what is in demand or on offer is an important part of credit management.

- A crucial part of the investment process is analysing covenants, or more precisely, the need to be aware of one's rights as a lender. Covenants, like pricing, are cyclical and loosen as liquidity increases and tighten as borrowers become more desperate to access the market. Investors need to understand the strengths and weaknesses of security packages and the accompanying collateral.
- ESG is now integrated within the investment process. Often severe ESG risks in the context of credit can jump to default risks. Using the 'E' component as an example, imagine a chemicals producer which has an accident and then faces a class action suit. The damages awarded could easily be so large that it takes the company out of business, in the same way that the 'S' recently has been a challenge for several pharma companies in the opioid crisis. Some of these companies have had to file for bankruptcy.

- Inflation bad for credit? Admittedly, inflation for an asset with a fixed income is not great, but a little bit can be positive. It will be easier for a company to issue fixed interest payments as an inflationary environment allows it to increase its selling prices and generate more revenue. This may help credit investors by leading to quicker deleveraging of the company. At the same time though, a large part of the low interest rate environment has to do with low inflation. If that were to change significantly, it could lead to a meaningful amount of volatility.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results.
Specific risks. Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss.

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