Long-term investing in bonds

Fi credit: in it for the long run

In this very low yield environment, investment grade corporate bonds can be an attractive prospect for investors. When considering the overall yield available from a typical corporate bond, it becomes clear that the proportion which comes from credit spread (as opposed to the underlying government yield) has been increasing in recent years, and is now significant[1]. This market development can help mitigate the effect of a rise in interest rates on a credit investor's total return.

Looking to the immediate future, the low interest rate trend shows no sign of abating, with central banks across the world continuing to implement their Quantitative Easing programmes. This means investing in corporate bonds can still provide clear scope for increasing the yield of an investment portfolio. Additionally, the growing importance of spreads as a percentage of yield makes intelligent risk-taking an easy way to add value.

Dealing with a difficult backdrop

The credit cycle is approaching its end and transaction costs are currently very high – this, taken at face value, sheds a negative light on fixed income. But by turning their backs on the asset class, investors could be missing out on an opportunity. If you drill down to specific issuers and take a long-term approach, you can still capture interesting returns in corporate bonds, under the condition that risks are properly managed by professional investors with strong capabilities in picking names (Credit Research) and constructing portfolios (for diversification and limitation of risks linked to benchmark indexing). Diversification in particular is extremely important and we caution investors against the pitfalls of following market-cap weighted benchmark strategies too closely.

The prevailing combination of pressure imposed by central banks on rates and the related search for yield, mixed with relatively good fundamentals

[1] Source: AXA IM, As at 30 June 20107, more than 40% of the overall yield of the broad Global Credit universe (as represented by the BofA Merrill Lynch Global Corporate Index) came from credit spread.

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for large companies, creates an ideal environment for investing in corporate bonds. But how to appropriately take risk and capture returns is where the picture becomes more complex, as we grapple with structural changes. One way around this is to place greater emphasis on the risk/return proposition and the implementation of diversification. A prudent, long-term, fundamentally driven approach, which limits risk taking, is how we see value being added to investor portfolios.

Tackling high transaction costs

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.

The Global Financial Crisis (GFC) unleashed a range of regulatory reforms on banks, including Basel III, the Dodd - Frank Act of 2010 and the Volcker Rules on proprietary trading.

Traditionally, fixed income markets have been structured as over-the-counter (OTC) markets with banks acting as market makers or dealers. As dealers, they 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.

But the recent regulations mean banks face a requirement for greater capital and liquidity, so they are unable to maintain large inventories of corporate bonds, and market making in this sphere is no longer as lucrative for them. A majority of the corporate bond inventory has therefore 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, transaction costs have also become a larger proportion of the yields available.

From investors' point of view, minimising transaction costs has become a key consideration in managing credit portfolios.

Credit cycle concerns

In the wake of the GFC, QE measures adopted by the Fed, ECB, BoE and other major central banks were necessary to break the downward momentum of the crisis and provide stability to the world economy. But it is becoming clear that this benign credit environment is unsustainable as the global economy approaches the peak of its long-term debt cycle.

Just as transaction costs are a larger proportion of available yields in today's environment, credit spreads make up a significant part of the total return an investor can hope to receive (10% in 2000 versus 56% in 2016[2]). 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 with a less benign outlook for the credit environment.

[2] Source: AXA IM as at 30.06.2017

Time to focus on fundamentals

In the credit market, return outcomes are asymmetric, meaning 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 an investment approach based solely on picking the best performers, with less consideration of the downside, may be at significant risk of including some of the worst performers and could suffer as a result.

Not only are investors vulnerable to asymmetry – we also appear to be at the bottom of the default cycle[3], which means companies are likely to struggle to refinance if interest rates go up. As Warren Buffet astutely pointed out: "It's only when the tide goes out that we'll see who has been swimming naked."[4]

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An approach focusing on excluding the worst performers should be better placed to navigate the current situation, as the impact of missing some of the best performers should be relatively less material. After all, when spread dispersion is very low, you are not compensated to add additional risks.

To achieve this, "bottom-up" assessment of credit quality is crucial. This kind of analysis 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. By gaining such a thorough understanding of fundamentals, it becomes easier to identify signs of weakness, anticipate changes in credit quality, and mitigate issuer-specific downside risk.

A further benefit of fundamental research over purely qualitative analysis is its ability to identify environmental, social and governance issues (ESG), which can spill over onto a company's balance sheet and impact its creditworthiness if they are not spotted and factored into investment decisions.

Integrating Responsible Investment (RI) into your credit strategy is therefore important when attempting to avoid uncompensated risks. In practice, a long-term corporate credit investing approach that incorporates ESG can add significant value.

We explore below some examples of the role of fundamental analysis in identifying risks that a purely quantitative assessment would likely miss.

Example 1: Looking beyond key metrics

An analysis based only on key financial metrics for a certain pharmaceutical company would indicate a strong company with an improving credit profile. However, when we analysed the drivers of this improvement we linked it with the company's ambition to make a large acquisition. Indeed, in 2016 the company tried and failed (twice) to acquire suitable takeover targets.

This company's management team has come under a lot of pressure to perform an acquisition in 2017 – which has been flagged by our qualitative analysis as a real risk to the credit quality of the firm.

[3] Source: Moody's 'pessimistic' default outlook as at 30 June 2017.
[4] Source: Warren Buffet Speaks, by Warren Buffet

Example 2: looking at ownership structures

In the large cap retail space it is unusual to have concerns about ownership structures. However, in the case of one retailer, the ownership structure is what is driving the credit profile of the firm and may well result in the company losing its investment grade status. Key financial metrics would point to a weak but improving credit profile for the company, however such pure quantitative analysis misses the fact that this retailer is controlled by its executive chairman, who also controls the leveraged holding company which owns a majority stake in this retailer. Financial difficulties at the holding company level may well force a more aggressive dividend policy for this retailer, directly impacting its credit quality.

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 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.

Conclusion: looking forward with fundamentals

The rapid expansion of central banks' balance sheets over the last decade has meant bond markets have benefitted, primarily, from technically-driven performance. This looks set to change with the end of QE, however, and fundamentals will begin to matter more. At the same time, changes in the credit environment have made spreads a more significant part of the total yield available to investors, resulting in the need for a greater focus on credit assessment.

In this context we believe a forward-looking, fundamental approach to credit investing, which takes advantage of multiple themes while managing risk effectively and lowering transaction costs, is indispensable when it comes to building robust corporate bond portfolios for the long-term.

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