April 2019

Credit where credit's due

There has been a barrage of negative rhetoric around credit markets for some time now. Bad news certainly sells, but it appears much balance has been lost in the often-blunt assessments market observers and participants offer up. In this paper we attempt to bring more context to the debate, while willingly acknowledging that we would certainly avoid some sub-sectors of global credit markets. But hasn't that always been the case, no different to equity and property investment? The skill of a good active manager is choosing which to be in and which to avoid over time.

What has driven the recent souring of sentiment?

In 2018, bonds rated BBB increased from ~30% of the US investment grade universe to almost 60%. A worrying trend, yes? Perhaps, but the drivers are clear and unless as an investor you are obliged to blindly track the investment grade index within your portfolio – which Kapstream is not – the trend is simple to circumvent. Cheap money (through low rates) made it a better environment to borrow to leverage, often for share buyback or M&A activity. So, a lot of US companies in particular took advantage of this - notably corporates in the commodities, healthcare, and telecoms sectors. However, for the risk budget Kapstream permits, we prefer to avoid these instances of financial engineering.

So, should I avoid the entire BBB space?

Absolutely not. While we don't discount the guide that credit ratings provide us, it pays to delve more deeply into the reasons some issues have such a rating. Areas long favoured by Kapstream where there are compelling BBB-rated investment opportunities are infrastructure, utilities and non-'big four' banks. Many issuers in the infrastructure sector are rated BBB, for example Sydney Airport. But these are stable entities with monopolistic features, which can tolerate more leverage in their structures. Other examples include toll roads and ports. And banks generally have come under greater regulation and rating methodology has become tougher. But we think they are certainly no riskier today than before.

Notably there continues to be appealing investment opportunities for our portfolios outside the Australian 'big four'. We think Bank of Queensland is an excellent example of a high-quality bank rated lower in part due to its size. Credit unions also, being typically smaller owing to their origins focusing on specific client segments, for example Teachers Mutual, maintain strong credit ratios. Kapstream continues to be very comfortable holding these typically more defensive names.

Shorten your horizon

A continuing theme across all Kapstream portfolios has been to shorten the average maturity of assets. Typically, Kapstream has favoured 4-7 year issues as they've been where the yield and risk/return intersection has been most appealing. However, in late 2017, with spreads nearing post GFC tights, we elected to replace some of those longer dated bonds (in the 4-7 year range) with bonds in the 2-3 year range. Why? Well, if a risk off event triggers further widening episodes, shorter dated bonds are less impacted. Further, if no 'snapback' rally occurs immediately after the widening episode, your 'pull to par' period is far shorter.

But… what if you're wrong?

There's always a chance and it certainly pays to keep a hedging card or two up your sleeve in the event the thesis breaks down. Today, there is good negative correlation between interest rates and credit risk. That is, if spreads widen, rates rally. Thus holding some positive duration exposure acts as a positive counterbalance to credit risk. And right now, with little chance of hikes in the near to medium term, a long outright duration position adds to your absolute return. It's rare to have periods where you are effectively getting paid carry to hold insurance.

So not all doom and gloom then?

No. While there are clear pockets of the credit market smorgasbord that should certainly be given a wide berth, Kapstream maintains the view that you still get well paid to take the risk inherent in a diversified portfolio of investment grade fixed income assets, where the real likelihood of credit default is materially unchanged and arguably more sustainable today with higher interest rates pushed even further back into the future. However, we are mindful of the following caveats:

- It pays to monitor and actively manage your maturity profile – shorter is sweeter in uncertain times
- Use duration exposure tactically and selectively
- Be more defensively positioned in low beta sectors and high-quality credits
- Focus on issuers in developed markets, including first tier Asian markets (Korea, Singapore, etc.).

Kapstream
—JANUS HENDERSON—