A Relative Value Framework for Unbiased Credit Asset Allocation

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The dislocation that we have seen in credit markets since the emergence of the COVID-19 pandemic has been rapid and extensive, creating compelling opportunities in the process. A key challenge facing investors is how to navigate the global credit opportunity set and build a portfolio that is appropriate for them. Insight's credit allocation framework is designed to provide investors with a practicable approach to evaluating the opportunity set and constructing a portfolio designed to meet their specific objectives.

Credit opportunities abound but where to begin?

AN EXTRAORDINARY PERIOD OF DISLOCATION AND OPPORTUNITY

Global credit markets have experienced an extraordinary number of months. The COVID-19 pandemic triggered a rapid repricing of assets right across the credit spectrum as investors grappled with the prospect of severe economic disruption amid a backdrop of structural market illiquidity. Global central banks and fiscal authorities have responded forcefully. Their interventions have succeeded in shoring up corporate liquidity and ensuring the smooth function of financial markets. They should also shield corporates from the worst of this external shock.

Despite the considerable market turmoil and ongoing uncertainty, our strategic outlook for credit is positive. This is largely a function of two factors. First, from a valuations perspective, most credit sectors are now flashing 'cheap' both on a historical and risk-adjusted basis. Second, we believe that the extraordinary and unprecedented fiscal and monetary measures implemented by the authorities should be enough to cushion any potential future liquidity and default stresses.

THE OPPORTUNITY SET IS VAST AND POTENTIALLY OVERWHELMING

While the existence of opportunities is clear, getting to grips with the sheer breadth and diversity of global credit markets can be overwhelming. Investors are often left perplexed by the question of where to begin. The global credit universe is segmented across many dimensions. At the overarching level, there are publicly traded securities as well as private assets. Drill deeper, and the universe is crisscrossed by ratings, geographies, sub-asset classes, maturities and liquidity profiles.

Having access to such a vast opportunity set, with effectively trillions of dollars of instruments to consider, creates a risk of paralyzing the top-down asset allocation process: instead of benefiting from the sheer breadth and diversity of the opportunity set, investors are instead led to inaction.

Insight's credit allocation framework

A FRAMEWORK FOR MAKING SENSE OF THE GLOBAL CREDIT UNIVERSE

In order to avoid such a state of paralysis, and to instead enable investors to actively capitalize on the best opportunities in global credit as and when they arise, we have developed the Credit Allocation Framework. This enables investors to think logically and holistically about the global credit universe in a way that is dispassionate, risk-minded and valuations-focused. It distills down the investment universe in a way that is digestible and consistent with the unique objectives of individual investors, while cutting through the inherent biases often found in traditional asset allocation approaches.

By comparing credit sectors on a like-for-like valuations basis, we can narrow down and focus on the most compelling risk-adjusted valuation opportunities.

CREDIT ALLOCATION FRAMEWORK: HOW WE DO IT

We work with our clients to arrive at a credit allocation that generates a risk-adjusted income as well as provides an element of diversification to a portfolio's growth assets. Should client guidelines permit, the portfolio can be overlaid with derivatives to guard against drawdown risks.

The Framework involves several steps, which we describe in the sections below and illustrate by presenting our current views.

1 Determine whether credit exposure makes sense today

Before delving into the global credit universe, the initial question to address from a top-down perspective is whether it makes sense to own credit at all at this moment. Answering this fundamental question requires an assessment of the current credit cycle and overall credit valuations.

We maintain a positive structural view on credit.

Currently, our monetary cycle analysis is supportive of credit and despite clear uncertainties on the growth cycle, we believe these are offset by the outright level of credit valuations. We generally prefer investment grade (IG) over high yield (HY) given expectations of a pickup in the default cycle. While we suspect that the peak in defaults will be lower than might otherwise be expected thanks to the amount of forbearance and policy intervention, this may just push the problems out to the future which means defaults will remain elevated for some time.

Notwithstanding the elevated default risk and despite some recent spread retracement, we retain a positive strategic outlook for credit.

2 Establish client investment parameters

Every individual client's circumstances are unique. We work with our clients to establish the investment parameters specific to their objectives and we frame this via six key decisions:

Key objectives: Prioritize key objectives — liquidity, hedging, income.

Sizing: What size should the credit allocation be within the client's broader investment portfolio?

Default considerations: Determine default risk tolerance, and willingness to extend down the credit rating spectrum.

Geographical diversification: Is the remit global or is geographical exposure targeted?

Public versus private: Is there a willingness to add private debt exposure?

Market diversification: Are there any credit asset class limitations?

3 Assessing current valuations

Finding strategic value: there is always a cheaper asset.

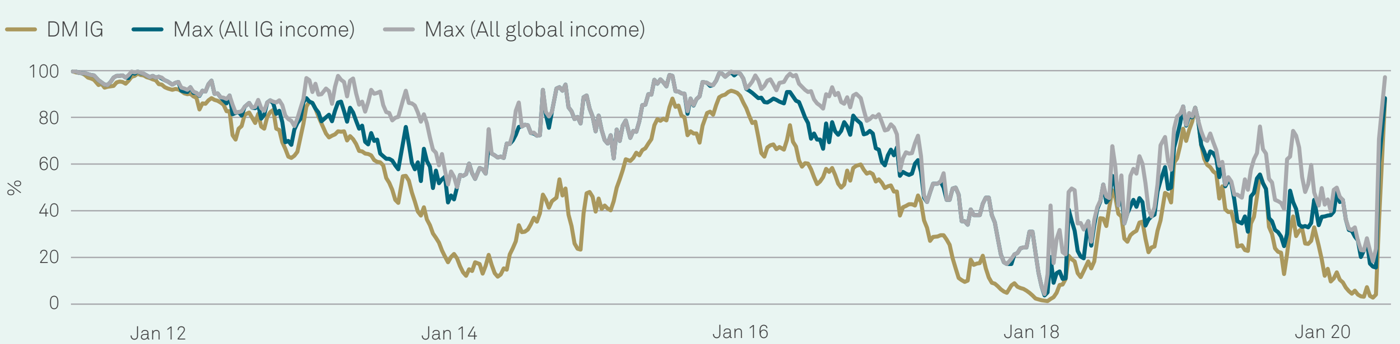
Having determined that it makes sense to own credit and having established the client's investment parameters, the next step involves undertaking an unbiased assessment of global credit sector valuations.

Figure 1 underscores why this is worth the effort. It shows historical valuation percentiles for a) Developed Market (DM) IG (gold line) b) the cheapest asset class across all key IG asset classes (dark blue line), and c) the cheapest asset class across all key global credit asset classes now including HY (gray line). Percentiles are useful since they allow us to understand how 'cheap' or 'expensive' a given asset class' spreads are relative to history. As an example, the 90th percentile indicates the level at which spreads have only been cheaper 10% of the time, and more expensive 90% of the time.

This chart shows that, if we extend the universe beyond just DM IG by introducing additional IG-rated credit asset classes, we can consistently find a cheaper asset class at a higher percentile as illustrated by the dark blue line being persistently above the gold line. Furthermore, if we extend the universe again to include some high yield (HY) credit asset classes, we tend to find even cheaper opportunities.

This chart essentially conveys the value that can be unlocked by extending the investable universe and undertaking an element of dynamic asset allocation within your credit portfolio as there often tends to be an asset class that is cheaper than DM IG.

Figure 1: Finding strategic value: historical spread percentiles[1]



[1] Source: Insight, Bloomberg, JP Morgan, Credit Suisse and Bank of America Merrill Lynch as of June 2, 2020. For illustrative purposes only.

Table 1: Finding strategic value: absolute value[2]

	Developed Market IG	Developed Market HY	Global Loans	Global ABS	Emerging Market Corp IG	Emerging Market Corp HY	Emerging Market Sov IG	Emerging Market Sov HY	Global IG CDS	Global HY CDS
Spread (bp)	160	537	540	350	290	662	228	686	78	517
Percentile (full history)	64%	68%	72%	93%	76%	67%	83%	85%	57%	80%
Percentile (10 year)	75%	82%	82%	93%	88%	75%	85%	98%	56%	83%
Data start date	May 00	Feb 00	Nov 08	Jan 11	Jan 02	Jan 02	Jan 00	Jan 00	Sep 04	Jan 06

Undertaking an unbiased relative value assessment.

In order to provide a dispassionate assessment of which credit asset classes currently look attractive, we examine the current valuations against their historical context. As an illustration of this, **Table 1** details where spreads currently stand for 10 key credit asset classes relative to the preceding 10 years. Shining this light on credit, we can gauge just how cheap valuations have become. Every asset class is highlighted, with several valuations in excess of the 80th percentile — implying valuations have only been cheaper 20% of the time through their respective histories.

While this 'absolute' approach to valuation is informative, it fails to give a complete picture. **Table 2** extends the analysis by examining the current valuations of the credit asset classes relative to DM IG. To do this, we take the ratio of the respective asset class spread to the DM IG spread and once again calculate the percentile. By normalizing each individual credit asset class valuation relative to DM IG, we effectively remove market beta allowing for a more dispassionate comparison of valuations across asset classes.

From Table 2, we see that there are several asset classes that now appear expensive. These are instances where current spread ratios are low relative to history. In fact, according to this relative value analysis, several asset classes including Global Loans, Emerging Market (EM) Sovereign IG and Global IG credit default swaps (CDS), are close to their most expensive relative to DM IG over the past 5 years. Contrast this with Table 1's absolute valuations analysis which shows that each of these asset classes are flagging as being historically cheap.

Conversely, global asset backed securities (ABS) look even more compelling here, with valuations relative to DM IG flagging at the 99th percentile. EM Sovereign HY also flags as cheap whereas Global HY CDS, EM Corporate HY, EM Corporate IG and DM HY do not show a strong signal.

Pulling it all together.

The above analysis shows Global ABS and EM Sovereign HY as being amongst the key asset classes to consider adding exposure to. This allocation is contingent on these asset classes satisfying the individual client's investment objectives.

Assuming this is the case, there are two additional key questions to address:

i) What are the other factors driving these valuations that would need to be taken into consideration?

ii) How should allocations be sized in the portfolio?

4 Is there anything else that could be driving these valuations that needs to be taken into consideration?

There may of course be other factors to consider that a valuations assessment alone can never convey. Episodes of fundamental deterioration specific to a given asset class could be driving valuations to historically cheap levels, and with good reason.

This is where Insight can leverage its extensive expertise in actively managing fixed income portfolios, with dedicated asset class specialists covering a broad spectrum of both public and private credit asset classes. By working with the asset class specialists, we can determine if the cheap valuations are driven by a fundamental deterioration in the respective asset class.

Distilling down to our asset allocation recommendations.

While the absolute value analysis shows that all asset classes are strategically cheap on a historical basis, with a full global credit opportunity set, our current preference is to own asset classes that exhibit the following characteristics:

- More default remote, i.e. IG and not HY
- Assets that have become central bank policy tools
- Assets that are in jurisdictions where government fiscal plans are least reliant on foreign flows

Given these considerations, we still recommend allocating to Global ABS while not increasing EM Sovereign HY exposures, despite historically cheap valuations.

Table 2: Finding strategic value: relative value versus DM IG[2]

	Developed Market HY	Global Loans	Global ABS	Emerging Market Corp IG	Emerging Market Corp HY	Emerging Market Sov IG	Emerging Market Sov HY	Global IG CDS	Global HY CDS
Spread ratio	3.3	3.4	2.2	1.8	4.1	1.4	4.3	0.5	3.2
Ratio percentile (5 year)	63%	17%	99%	35%	26%	9%	86%	4%	68%

[2] Source: Insight, Bloomberg, JP Morgan, Credit Suisse and Bank of America Merrill Lynch as of June 2, 2020.

5 Calibrating position sizing using our Units of Risk methodology

Critical to effectively managing multi sector portfolios is an ability to both consistently communicate investment views but also manage investment risk. At Insight, we have developed a proprietary Units of Risk framework that allows us to do just that by:

1 | Speaking a common language across all areas of credit

2 | Expressing strength of conviction on a +/-3 scale

3 | Recognizing that different asset classes have different levels of volatility

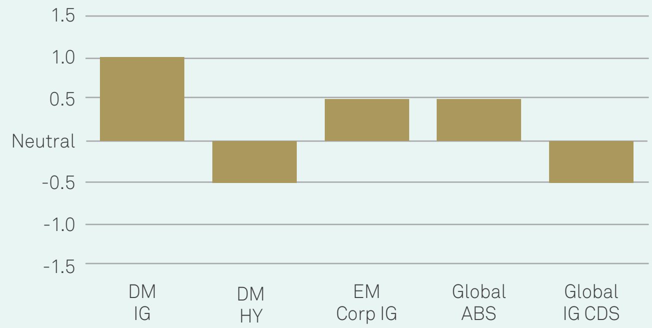
4 | Calibrating the exposure to each asset class such that for each unit allocation, they contribute an equal amount of risk (tracking error)

5 | Scale allocations for different client performance targets and risk budgets

Sizing our asset allocation recommendations.

Using Units of Risk to size positions, our current asset allocations are shown in **Figure 2.** Starting from a neutral credit allocation position,we recommend adding risk to DM IG, Global ABS and EM Corporate IG, while trimming allocations in DM HY and Global IG CDS. We remain neutrally positioned across the remaining credit asset classes.

Figure 2: Sizing asset allocations by Units of Risk away from their neutral position[3]



A relative value framework for unbiased credit asset allocation

The economic toll inflicted by the COVID-19 pandemic has been unprecedented in its severity. The impact on credit markets has been equally severe and its reverberations are likely to be felt for some considerable time. Price dislocations caused by the ongoing uncertainty and forced liquidations are expected to continue to inhibit asset price discovery.

Shrouded behind all this volatility and noise lies an opportunity for credit investors. The challenge however remains in being able to make sense of the vast global credit universe to access it. Insight's Credit Allocation Framework has been developed to provide investors with a practicable, structured and unbiased approach to uncovering the most compelling global credit opportunities on a relative value basis.

[3] Source: Insight Investment, as of June 2, 2020.

Risk disclosures

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

Associated investment risks

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

Learn more

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