30 Years Managing Corporate Credit

Viewpoint

October 2020

It has been 30 years since Muzinich & Co first allocated to the then nascent US high yield market. Since then, the Firm has expanded to cover almost every asset class across the corporate credit spectrum. We continue to develop our investment capabilities to meet the needs of investors, and to help preserve and grow their assets. Risk-adjusted returns remain a key focus, as credit markets experience renewed volatility and dislocation. We have asked six of our portfolio managers to comment on past and current challenges, and to share their thoughts on what to expect next.

Michael McEachern

Co-Head of Public Markets,
Global Tactical Credit Portfolio Manager

What Market Risks Concern You the Most and How Do You Manage to Them?

The quantitative easing policies pursued by central banks have reduced average market volatility. However, unprecedented liquidity in this current crisis has also led to brutal shocks of volatility, potentially erasing in a few days or weeks the income generated over several years. Our strategies have been designed to be flexible and nimble.

We manage our strategies with the aim of preserving capital and containing volatility. The Muzinich product offering and reputation were built on these two essential objectives.

What Can Asset Owners Expect Over the Next 12 Months?

We believe our strategies will remain effective in the current and upcoming market environment. Managing through the Covid-19 crisis was challenging, and unfortunately this healthcare crisis will not go away easily or quickly. Rebuilding the economy is a several years task, and we believe the corporate credit market can provide essential financing for the reconstruction. This can create opportunities but also risks, as the unprecedented amount of debt accumulated may create further instability in the financial systems.

Massive liquidity infusions from central banks are difficult to control and will almost certainly lead to large market valuation changes in coming credit cycles. We believe that thanks to a robust investment process and experienced credit research, our multi-asset credit strategies have fared well even in the most extreme market conditions.

These strategies seek to provide long-term annual positive returns with an overall volatility below the market average. Our multi-asset credit strategies have solid foundations of experience, research, market knowledge, and teamwork. We use these strategies to help create value, income, and protect capital.

Tatjana Greil-Castro

Co-Head of Public Markets,
Crossover Strategies Portfolio Manager

What Do Muzinich's Credit Strategies Offer Investors?

Our strategies are constructed to offer a steady stream of enhanced potential income, even in the current environment of low or negative interest rates. When generating income we believe passive investing is no longer effective. Bank deposits offer little refuge since they provide either little or no income.

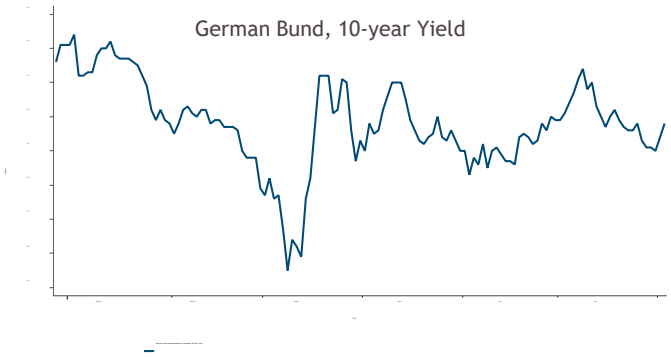
Our crossover strategies seek to capture yield by limiting volatility without sacrificing liquidity. They can provide a liquidity solution on both sides of the equation – sourcing opportunities and liquidating them at what we believe is the best price in most market conditions. As Muzinich is an established corporate credit manager, we have a strong relationships in the global corporate bond market, which we believe is essential to accessing liquidity in turbulent times.

Where Does Risk Lie in Today's Markets – and What Are You Doing to Address It?

The impact of low and negative interest rates over the long run cannot be overstated. We have seen government bonds spike rapidly, with associated volatility (see Fig.1).

The risks of brutal spikes in yields may become more asymmetric in the future. The strategies use fundamental credit research to help create solutions, which are naturally short duration. The income they generate is therefore not reliant on yield sensitivity, leaving it less exposed to interest rate shocks. This also means the income should be regular and repeatable.

Fig. 1 - Volatile German and US Sovereigns



Source: Macrobond from December 27th, 2019 to July 2nd, 2020.

Source: Macrobond from July 1st, 2020 to September 15th, 2020.

How Does Muzinich's Investment Approach Set You Up For the Future?

Many of our strategies can benefit from global investing opportunities. We believe incorporating global macro considerations in the allocation process allows the strategies to capture extra potential income, but also to protect income when necessary by shifting the regional allocation. Muzinich benefits from a Global Credit Research Platform, where opportunities can be compared, and well-informed investment solutions can be chosen.

We also follow an ESG approach, where holdings are evaluated through several filters measuring opportunities and risks. ESG is fully part of the credit research and risk management process. There is a wealth of evidence supporting the ESG investment approach in potential income generation. We engage with market participants to help improve standards and influence the ESG adoption across credit markets. We consider this holistic approach, combined with our distinctive investment style and attributes, leads us to be well-positioned for the years ahead.

Bryan Petermann

US High Yield, Portfolio Manager

Markets Have Changed Dramatically Over the Last Three Decades. What Are the Standout Moments and Themes?

The US High Yield market has evolved dramatically from 1998 to the present day, as illustrated in Fig. 2.

In the 1990s, when the market was in its early stages, high yield was associated with high risk. Technology, media, and telecoms sector issuers were speculative, developmental companies – more closely aligned with the equity growth profiles of today. This coincided with the dotcom market bubble and collapse. Investors had to learn to navigate this environment quickly.

Further meltdown plagued the market in the early 2000s, before it transformed into a formative decade for US high yield. Insurance companies started managing fallen angels instead of disposing of them, resulting in fewer forced sales. The high yield market also expanded to absorb larger issuers, so we started to see a stabilizing effect.

The 2010s were the decade where the high yield market matured, and credit quality improved across the board. Now in the 2020s, events which would previously have been a crisis are now more like blips in our view; defaults in the Covid-19 pandemic era have been, so far, materially lower than in previous market crunches.

In the aftermath of the financial crisis, with banks in retreat, there was an opportunity for fund managers to provide new lending avenues. This has allowed companies to expand and to be less reliant on bank funding. This has resulted in the high yield market becoming an exceedingly important part of the overall financial market.

How Do You Choose Investments?

What is common across all of our investment desks is the belief that research, and diversification are crucial. In US High Yield investing we consistently focus on fundamentals, such as cash flow and stress testing.

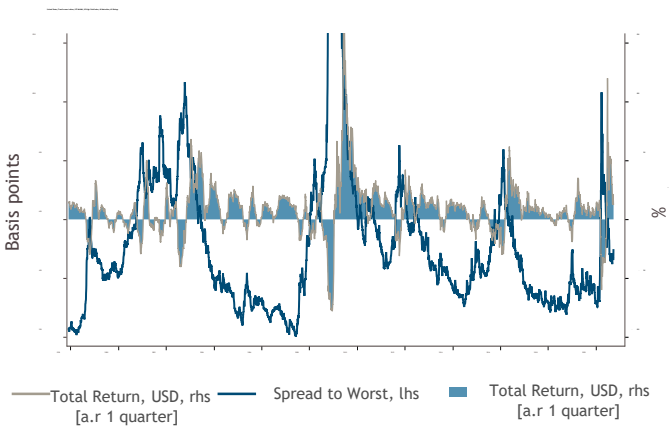
Our in-depth research capabilities helps us to spot once-in-a-decade potential opportunities, while seeking to take advantage of fallen angels and secured debt.

This means we need to be nimble enough to react quickly to changing circumstances. The last 30 years have given us plenty of practice.

What Can Asset Owners Expect Over the Next 12 Months?

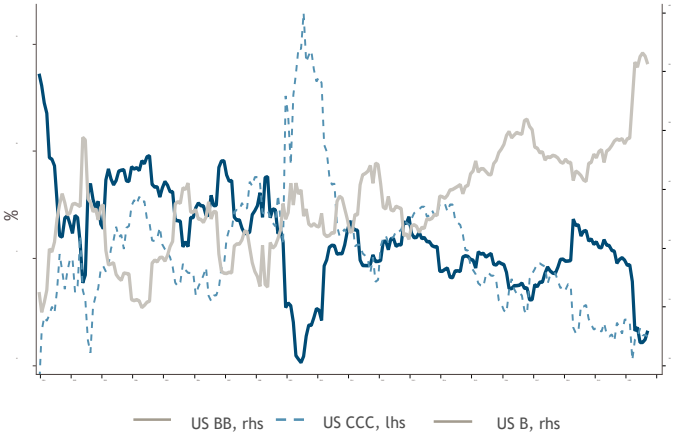
I believe it is reasonable to expect the US economy to improve and high yield spreads to compress from their current lows in the next 6-18 months. The speed will depend on the pace of recovery from the Covid-19 pandemic.

Fig. 2 - A Growing and Evolving US High Yield Market Has Long Provided Ample Opportunities for Active Management



Source: Macrobond from December 8th,1997 to September 22nd, 2020 for ICE BofAML US High Yield Index (H0A0). Returns calculated on quarterly basis and annualised. Past performance is not indicative of future results.

Fig. 3 – US Relative Market Weight by Rating Bucket



Source: Macrobond. Monthly data from January 2000 to September 2020 for ICE BofAML BB US High Yield Index (H0A1), ICE BofAML B US High Yield Index (H0A2), and ICE BofAML CCC US High Yield Index (H0A3).

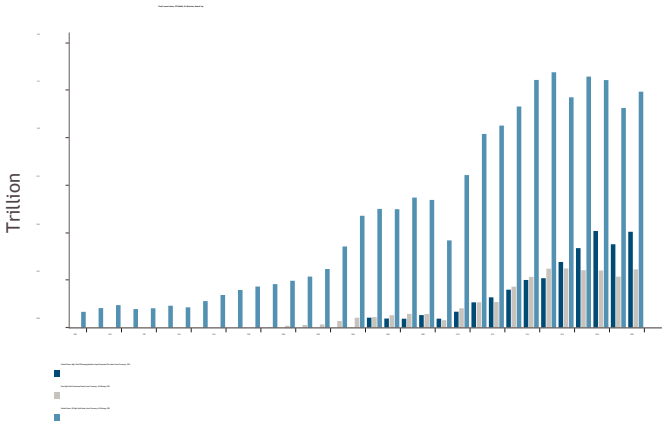
Thomas Samson

European High Yield, Portfolio Manager

What Has Stood Out in the Asset Class Over the Last Two Decades?

As with many other credit asset classes, we started to invest in European high yield early. However, back in 2000 it was a market available to few issuers, with some highly risky balance sheets coupled with low liquidity. Structural growth happened in the middle of this period, with corporates looking to diversify sources of funding and move away from banks. Quantitative easing programs in the wake of the 2008 financial crisis led to a new demand for yield and income. The high yield market was there to help provide the sought-after steadier returns. This supported the growth of this market as an essential source of financing. We now have a mature market that is many times larger than its original size, as referenced in Fig. 4.

Fig. 4 - Consistent Growth in High Yield and Emerging Markets Credit



Source: Macrobond as of December 31st, 2019 for ICE BofA High Yield US Emerging Markets Liquid Corporate Plus Index (ECHY), ICE BofA Euro High Yield Constrained Index (HEC0), and ICE BofA US High Yield Index (H0A0). Most recent data available used. Updated annually.

How Are You Navigating Market Uncertainties?

We are very comfortable with the type of idiosyncratic risks that are present in the market. We use stress testing of financial models in difficult sectors, and we take different approaches to risk depending on credit quality. This allows us to maximize efficiency in our credit research.

There are considerable regulatory constraints for many institutional investors in high yield bonds. This results in a large differential between companies rated BBB or BB. Regulators should take note that many investors may be pushed to take ratings at face value to make capital allocation decisions.

And Your Thoughts on What the Market Might Offer in the Near Future?

Over a 12-month horizon it seems likely low yields are here to stay. We believe this should allow high yield the ability to offer compelling potential returns versus other fixed income markets. I would expect this carry to be the main driver of total returns.

Warren Hyland

Emerging Markets, Portfolio Manager

Which Themes Have Had the Greatest Impact?

The most profound change is the rise of Asia and its middle class. Between 1998 and today the proportion of Asian securities in the Bank of America's corporate Emerging Markets index has risen massively, especially after China joined the World Trade Organization in 2001.

However, despite the shift in the market, the fundamentals the investment process relies upon are unchanging. In fact, the first investment decision I made in 2013 when I joined Muzinich is still held in that portfolio today.

What Should Investors Expect in the Coming Year?

Significant levels of uncertainty will continue to be a factor, and concomitant volatility. Our willingness and ability to dive deeply into credit research has allowed us to invest with conviction in companies we like. This is something we have successfully done for 30 years – as a portfolio manager it enables you to invest with confidence.

Both consumer and corporate confidence will hopefully rise, which would drive a pent-up demand cycle for consumption and investment. In an environment of excessive liquidity, driven by central bank buying programs, our strategies will aim to offer a compelling balance between risk and reward for investors searching for access to the global recovery.

Mark O'Keefe

Senior Managing Director, Private Markets

How Has the Private Debt Market Evolved?

Capital markets' direct lending to small and medium sized companies (SMEs) has had a relatively long history in the US, but a much more recent one in Europe and Asia. The aftermath of the 2008 financial crisis saw banks pulling back from providing finance to these SMEs.

This created a significant opportunity, given SMEs typically account for a large percentage of the GDP of many economies. We developed our private debt offering to meet this demand for long-term institutional finance. Private debt traditionally requires investors to make a long-term commitment without having the advantage of liquidity. This lack of liquidity is compensated by private debt investors receiving what can be a significant premium to what is available in public markets.

What Market Themes Cause You Concern, And How Are You Addressing Them?

It is the best of times for the financial markets, it is the worst of times for the economy. Vast levels of indebtedness – and unprecedented government and central bank intervention – place us in new territory. Predictive guidelines that previously helped us understand markets are no longer valid.

Potential returns available from SMEs are well suited to institutional investors who are willing to make a long-term commitment. Private debt complements bank lending. The latter normally has a relatively short-term tenor to match a bank's liabilities and risk appetite. Just as the bond market works hand-in-hand with the banking system, so should private lending work hand-in-hand with banks for SMEs.

What Is Your Market Outlook?

Private debt can offer valuable diversification opportunities to institutional investors. It allows them to access companies who do not participate in the public debt markets.

In this exceptional period of rebuilding domestic corporate sectors, we believe savings will be reallocated to this growing segment, leveraging the experience of institutional investors.

We consider this asset class to be flexible and diverse. This asset class will increasingly become an important part of any country's financial landscape in our view.

Private debt helps stimulate the growth potential of SMEs. We believe it is vital that we provide this financial flexibility to SMEs to help them meet the growing challenges of an ever more complex world.

Market Index Descriptions

ICE BofAML US High Yield Index (H0A0) - tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

ICE BofAML BB US High Yield Index (H0A1) - is a subset of the ICE BofA ML US High Yield Index (H0A0) including all securities rated BB1 through BB3, inclusive.

ICE BofAML B US High Yield Index (H0A2) - is a subset of the ICE BofA ML US High Yield Index (H0A0) including all securities rated B1 through B3, inclusive.

ICE BofAML CCC US High Yield Index (H0A3) - is a subset of the ICE BofA ML US High Yield Index (H0A0) including all securities rated CCC1 or lower.

The ICE BofA ML High Yield US Emerging Markets Liquid Corporate Plus Constrained Index contains all securities in the ICE BofA ML US Emerging Markets Liquid Corporate Plus Index (EMCL) rated BB1 and lower, based on an average of Moody’s, S&P and Fitch but caps issuer exposure at 2%.

The ICE BofA ML Euro High Yield Constrained Index contains all securities in the ICE BofA ML Euro High Yield Index (HE00) but caps issuance exposure at 3%.