Viewpoint

Crossover – Breaking the Ratings Barrier

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Tatjana joined Muzinich in 2007 and has 19 years' corporate credit experience. Tatjana came to Muzinich from Metlife Investments, where she served as an Associate Director of the Higher Return Unit. Prior to that she worked for Fortis Investments and Legal & General Investment Management. She has a Ph.D. from the London School of Economics, a Masters from the Kiel Institute of World Economics in Germany and an M.Sc/B.S. in Economics from the University of Vienna.

Seeking stable returns in most market conditions

We believe investors have been struggling with the low yields available from investment grade debt, both in the corporate and sovereign segments of the market (Fig. 1).

For those with a more flexible mandate looking for additional yield, investors may consider an allocation to a crossover strategy.

As the name suggests, crossover straddles the line between the defined ratings buckets of investment grade and high yield.

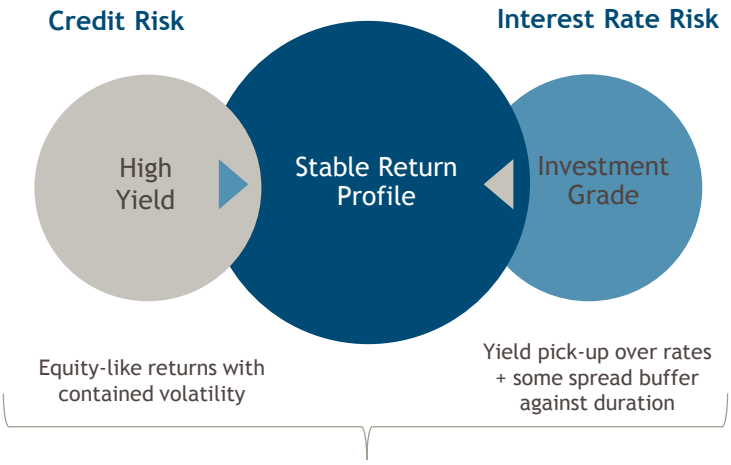

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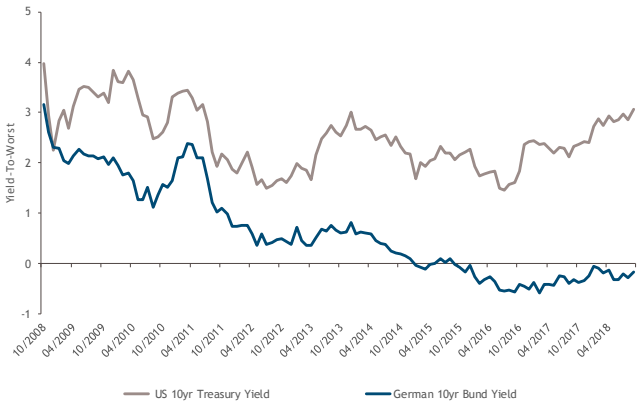
Fig. 1 – Yields on Core Government Fixed Income



Source: Bloomberg, as of 30th September 2018. US 10yr - ICE BofA ML Current 10-Year US Treasury Index, German 10yr - ICE BofA ML 1-10 Year German Government Index

We believe that combining high yield and investment grade rated credits into a single portfolio can enhance yield and may generate higher returns over the course of the credit cycle, while mitigating volatility (Fig. 2).

However, with the greater risk associated with high yield debt, we believe investors should carry out thorough credit analysis and maintain a deep focus on the cash-flow-generative nature of the issuer to ensure a company is able to honour its debt obligations and avoid default. We believe avoidance of speculative investments is paramount.

Within high yield, the length of time for which an investor holds a bond is an important factor in extracting additional yield. By holding a callable high yield bond until its call date, an investor can benefit from the running yield, which is much higher in value than the yield-to-worst, and provides a hidden source of return.

Within bullet bonds, an investor can also capture the 'roll down', which is another source of hidden return and is the price evolution of a bond as time passes.

The roll down contributes to the total return and is generated when a bond is purchased (in an upward sloping yield curve environment). As the bond rolls down the curve (for example when a three-year bond becomes a two-year bond), the roll down contributes to the bond's total return, which can make the contribution higher than the return implied by the annualised yield over the lifetime of a bond.

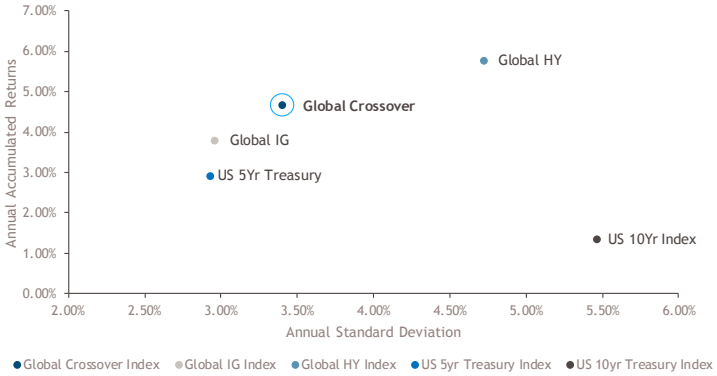
As the global interest rate environment becomes more hawkish, a crossover strategy may also provide protection from duration risk; high yield credits are less sensitive to interest rate rises and thus have a very low correlation to both government bonds and investment grade credit.

Therefore, we believe incorporating high yield into an investment grade portfolio can act as a great diversifier in a rising rate environment.

The crossover universe has grown considerably over the last 10 years (Fig. 4). B and BB rated corporates numbered 2364 in 2007, yet today there are around 3000. The story is more pronounced in the BBB space which has risen from 2265 issues to nearly 7000.* This offers investors a large, well-diversified opportunity set in terms of sector, region and rating.

However, in such a large universe how does an asset manager select the best credits in order to generate attractive risk-adjusted returns?

Fig. 2 - Historical 7-year Risk and Return in Crossover Bonds



Source: Bloomberg & BofA Merrill Lynch. Data as of September 30th, 2018. Crossover Index includes 70% of the ER40 - ICE BofA ML BBB Euro Corporate Index, 15% of the HE10 - ICE BofA ML BB Euro High Yield Index and 15% of the HE20 - ICE BofA ML Single-B Euro High Yield Index. Global IG Index - ICE BofA ML Global Corporate Index (G0BC), Global HY Index - ICE BofA ML Global High Yield Constrained Index (HW0C), US 5yr Treasury - ICE BofA ML Current 5-Year US Treasury Index (G0A5). Duration to Worst of all the indices average around 4.3%. Past performance is not indicative of future returns.

Fig. 3 – A Lower Correlation to Government Debt

	Crossover Index	Global HY	Global IG	German Government 1-10 Year	10-Year US Treasury
Crossover Index	1.00				
Global HY	0.97	1.00			
Global IG	0.67	0.58	1.00		
German Government 1-10 Year	-0.12	-0.21	0.48	1.00	
10-Year US Treasury	-0.06	-0.19	0.59	0.75	1.00

Source: BofA Merrill Lynch. Bloomberg. Global HY – ICE BofA ML Global High Yield Constrained Index (HW0C), Global IG – ICE BofA ML Global Corporate Index (G0BC), German Government – G5D0 (hedged to USD), US Treasury – ICE BofA ML Current 10-Year US Treasury Index (GA10). Note: Crossover Index is a representative account comprised 50% ICE BofA ML BBB US Corporate Index (C0A4) & 50% ICE BofA ML BB US High Yield Index (H0A1). As of 31 August 2018.

We believe there are two key elements to managing a successful crossover strategy: credit selection and asset allocation.

*Source: ICE BofA ML Global Corporate & High Yield Index Index, as of 31 December 2017

In our view, credit selection is paramount to ensuring successful performance generation; an investor needs to understand the characteristics of the investment instruments in order to extract the most value.

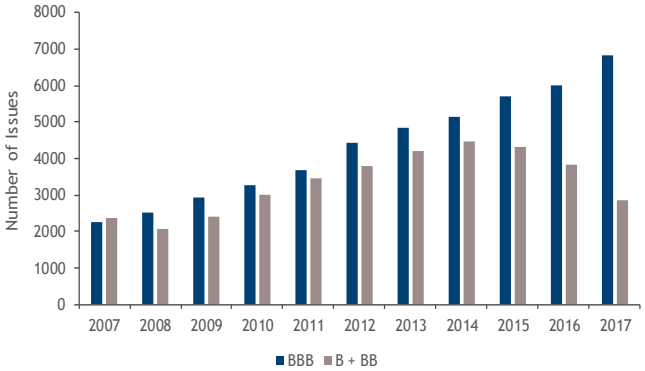
While fundamental analysis and bottom-up research is an obvious requirement in high yield, we believe it is equally important in investment grade.

Screening out the lowest-yielding segment of the market – the sizable, over-bought, well-known names and those under the European Central Bank's (ECB) asset purchase programme – can lead to a higher average yield on the rest of the universe. We believe the less well-recognised credits can offer a more attractive risk/return perspective.

In addition, for investors who have greater flexibility in their mandates and the available resources, there is the opportunity to further expand their opportunity set by looking at mis-rated or unrated credits.

In some instances, smaller companies may not have a rating because they may be unable to pay the costs associated with obtaining a credit rating, while also being too small for index inclusion.

Fig. 4 – Sizeable Opportunity Set



Source: BofA Merrill Lynch, Bloomberg, as of December 31st 2017. GI00 - BofA Merrill Lynch Global Corporate Broad Corporate & High Yield Index.

Others may feel that the cost of a rating is not justified given their issue size is too small to be included in an index, or they believe they can obtain sufficient investor interest without having a rating.

These opportunities may fall under the radar of investors who lack the dedicated resources to make their own assessments of individual company fundamentals.

An asset allocation component is also an essential part of a successful crossover strategy in our view. In a global universe, investors should look across the US, emerging and European markets in both the investment grade and high yield space (including loans if permitted) to help determine the most optimal allocation by region and sub-asset class.

The ability to change the size of an investment grade or high yield allocation can help ensure the portfolio is well positioned in a rising or falling interest rate environment.

A declining economic backdrop or poor sentiment benefits investment grade as rates rally. The reverse is true in high yield where an allocation in an environment of improving economic fundamentals helps offset higher rates.

Conclusion

Global central bank rhetoric is turning increasingly hawkish. Tighter monetary policy and higher rates are likely to have an impact on all fixed income assets, sovereign and corporate, and the outlook appears uncertain.

Following a benign and bullish period for credit that has proven a boon to passive investors, we are entering a new era that we believe should play to the strengths of an active manager.

In our view, an investor who has the resources and expertise to carry out in-depth credit analysis on all the bonds in their portfolio, and who are unconstrained by ratings allocations, is likely to be able to provide better risk-adjusted returns as well as protection to the downside, in all market conditions.

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ER40 – The ICE BofA ML BBB Euro Corporate Index is a subset of the ICE BofA ML Euro Corporate Index (ER00) including all securities rated BBB1 through BBB3, inclusive.

HE10 – The ICE BofA ML BB Euro High Yield Index is a subset of the ICE BofA ML Euro High Yield Index (HE00) including all securities rated BB1 through BB3, inclusive.

HE20 – The ICE BofA ML Single-B Euro High Yield Index is a subset of the ICE BofA ML Euro High Yield Index (HE00) including all securities rated B1 through B3, inclusive.

Important Information

HW0C – The ICE BofA ML Global High Yield Constrained Index contains all securities in The ICE BofA ML Global High Yield Index (HW00) but caps issuer exposure at 2%.

G0BC – The ICE BofA ML Global Corporate Index tracks the performance of investment grade corporate debt publicly issued in the major domestic and eurobond markets. Qualifying securities must have an investment grade rating (based on average of Moody's, S&P and Fitch), have at least one year remaining term to final maturity as of the rebalancing date, at least 18 months to maturity at point of issuance and a fixed coupon schedule.

GA10 - The ICE BofA ML Current 10-Year US Treasury Index is a one-security index comprised of the most recently issued 10-year US Treasury note.

C0A4 - The ICE BofA ML BBB US Corporate Index is a subset of the ICE BofA ML US Corporate Index (C0A0) including all securities rated BBB1 through BBB3, inclusive.

GI00 – The ICE BofA ML Global Corporate & High Yield Index tracks the performance of investment grade and below investment grade corporate debt publicly issued in the major domestic and eurobond markets. Qualifying securities must be rated by either Moody's, S&P or Fitch, have at least one year remaining term to final maturity, at least 18 months to maturity at point of issuance and a fixed coupon schedule.

G5D0 - ICE BofAML 1-10 Year German Government Index (G5D0) ICE BofAML 1-10 Year German Government Index is a subset of ICE BofAML German Government Index including all securities with a remaining term to final maturity less than 10 years.

GA05- ICE BofAML Current 5-Year US Treasury Index (GA05) ICE BofAML Current 5-Year US Treasury Index is a one-security index comprised of the most recently issued 5-year US Treasury note. The index is rebalanced monthly. In order to qualify for inclusion, a 5-year note must be auctioned on or before the third business day before the last business day of the month.