VIEWPOINT

Global Tactical Credit

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How can credit investors seek to have the right exposure at the right time to maximise their return potential, minimise risk and dampen volatility?

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Michael has managed the Muzinich Global Tactical Credit strategy since its launch in March 2013. Prior to joining Muzinich in 2012, Michael was president and Head of the High Yield Division at Seix Advisors, Inc. At Seix Advisors, he was the founding partner of the high yield strategy that grew to over $13 billion under his leadership. Previously, Michael served in various research and portfolio management capacities at American General Corp. and at Capital Holding Corporation. He earned a BA in Management Science from the University of California, San Diego and an MBA from Rice University.

As an asset class, corporate credit, viewed on a global basis, offers a range of risk/return profiles overlaid with myriad political and economic variations.

Here we explore the components of global corporate credit markets and explain how we believe a portfolio that can tactically allocate across a broad investment universe can enhance its risk profile, and in turn generate more attractive returns with less volatility, irrespective of where we are in the credit cycle.

A Broad and Diverse Universe

Each sub-asset class contains its own dynamics and variances. For investors with specific mandates that constrain them to an individual region or sub-asset class, investing in a single credit market has its benefits.

A drawback however is the lack of diversification which comes with investing in only one segment of the market. This ultimately results in a portfolio with a higher concentration of risk.

By looking at credit markets on a global basis, an investor has access to a much wider and more diverse pool of investments across geography, rating, maturity (or duration) and sector.

The ability to access multiple markets within a single portfolio may also prove more beneficial for investors than having to select individual managers for each sub-asset class.

Fig. 1 – The Global Corporate Credit Market

United States

	High Yield	Investment Grade	Loans
Total market value (USD billion)	$1,285	$6,359	$1,095
Number of issues	1,883	7,623	1,541
Credit Rating	B1	A3	BB
Average YTW (%)	6.12%	3.74%	5.37%
Average STW (bps)	355	100	352
Average DTW (yrs)	4.05	7.06	-
YTD Performance (%)	0.31%	-2.41%	1.25%

Europe

	High Yield	Investment Grade	Loans
Total market value (EUR billion)	€294	€2,130	€227
Number of issues	477	2,695	433
Credit Rating	BB3	A3	B2
Average YTW (%)	2.76%	0.84%	4.09%
Average STW (bps)	290	79	342
Average DTW (yrs)	3.67	5.20	-
YTD Performance (%)	-0.30%	-0.27%	1.95%

Emerging Markets

	High Yield	Investment Grade
Total market value (USD billion)	$502	$1,015
Number of issues	743	1,360
Credit Rating	BB3	A3
Average YTW (%)	5.85%	3.71%
Average STW (bps)	344	136
Average DTW (yrs)	3.94	5.33
YTD Performance (%)	-0.23%	-1.32%

Source: Data as of February 28, 2018. US High Yield "HY": U.S. High Yield Cash Pay Only Index (J0A0), US Investment Grade "IG": U.S. Corporate Plus Index (C0A0), US Loans: Credit Suisse "CS" Leveraged Loan Index (CSLLI), Europe High Yield: European High Yield Index (HE00), Europe Investment Grade: Euro Corporate Index (ER00), Europe Loans: CS Western European Leveraged Loan Index (CSWELLI), Emerging Markets "EM" High Yield: High Yield EM Corporate Plus Index (EMHB), EM Investment Grade: High Grade EM Corporate Plus Index (EMIB). Past performance is not indicative of future results. Average credit rating sourced from indices referenced; based on credit ratings available from Moody's, Standard and Poor's and/or Fitch. "YTW" Yield to Worst, "STW" Spread to Worst, "DTW" Duration to Worst, "YTD" Year to Date.

Regional Diversity

The US is the largest and most established credit market, primarily dominated by investment grade.

The European credit market is smaller, having only come into existence following the introduction of the euro. Yet it still offers diversification across country, sector and rating.

Since the financial crisis of 2007-2008 and the European sovereign debt crisis of 2011-2012, the region has recovered well economically and politically; it now boasts a stronger regulatory and institutional framework with more developed financial markets.

Today the emerging market (EM) corporate universe also makes up a large portion of global credit with a bias towards higher credit quality. The universe offers investors the ability to gain exposure to a number of countries at different stages of the economic cycle, as well as access to the long-term secular growth potential of emerging market countries.

As well as being one of the best coupon-clipping asset classes, in our view EM corporates also tend to have lower leverage and more cash on their balance sheets than their developed market peers.

Ratings Dynamics

Each ratings band and debt instrument has different characteristics.

Investment grade bonds form the largest segment of the market and as such tend to be the most liquid. While returns can be limited in this segment generally, we see value in the BBB ratings band.

We believe this portion can offer the best return potential given the greater chance for excess spread compression dependent on the economic cycle and the potential for upgrades.

While high yield bonds can be riskier, they are less sensitive to rising interest rates, they can benefit from economic growth (and can thus repay their debt more easily) and tend to have shorter duration profiles than investment grade bonds.

Consequently, they have a low correlation to government bonds and investment grade credit and we believe can provide further diversification benefits in a multi-asset credit portfolio.

Syndicated loans are a floating rate asset class and re-set their underlying interest rates on a frequent basis (i.e. every three-to-six months).

As a result, they can also provide investors with protection from rising base rates and tend to enjoy inflows during periods of rising rate expectations. They are also generally high yield in nature.

We would caveat that our definition of global credit incorporates the most liquid and transparent segments of the market. It excludes structured credit where the nature and opacity of the instrument prevents thorough credit analysis of the underlying fundamentals of each investment – something that we believe is paramount to the investment process.

Assessing Value

Given the above diversity across credit markets, how can investors seek to capture value?

Firstly, we believe it is key to have a thorough and in-depth understanding of each market at both a macro and micro level.

One must also remember markets are not perfectly correlated to each other and asset classes perform differently depending on the dynamics and variables in each market.

On a regional basis, markets are influenced by political and geopolitical events, as well as by macroeconomic trends such as the direction of monetary policy or inflationary pressures. This sets the scene for the relative value analysis.

These themes in turn feed into the sub-asset classes of credit and will have an impact on how each segment performs.

Fig. 2 – Performance of Credit Sub-Asset Classes Over Time

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Average
US HY	2.17	-26.21	56.28	15.24	4.50	15.44	7.38	2.45	-4.55	17.34	7.48	8.86
US IG	4.64	-6.82	19.76	9.52	7.51	10.37	-1.46	7.51	-0.63	5.96	6.48	5.71
Euro HY (Hdg USD)	-0.94	-33.11	74.89	15.40	-2.27	28.09	10.38	5.62	1.07	10.75	8.89	10.80
Euro IG (Hdg USD)	1.59	-3.73	14.84	4.79	1.59	13.35	2.54	8.25	-0.09	6.29	4.41	4.89
EM HY	2.32	-31.83	67.53	18.55	-0.14	23.31	1.44	-1.41	3.16	17.31	8.78	9.91
EM IG	3.84	-11.53	30.37	10.16	5.94	13.02	-1.76	5.35	0.02	5.82	5.89	6.10
US Loans	1.88	-28.75	44.87	9.97	1.82	9.43	6.15	2.06	-0.38	9.88	4.25	5.56
Euro Loans (Hdg USD)	2.31	-29.62	47.51	8.84	-0.83	10.80	8.97	2.06	3.64	8.04	5.32	6.09

Data as of December 31, 2017. Markets represented above include: US HY: U.S. High Yield Cash Pay Only Index (J0A0), US IG: U.S. Corporate Plus Index (C0A0), Euro HY: European High Yield Index (HE00), Euro IG: Euro Corporate Index (ER00), EM HY: High Yield EM Corporate Plus Index (EMHB), EM IG: High Grade EM Corporate Plus Index (EMIB), US Loans: CS Leveraged Loan Index (CSLLI), Euro Loans: CS Western European Leveraged Loan Index (CSWELLI). Past performance is not a guarantee of future results.

Dispersion – An Active Investor's Best Friend

The ability to tactically move in and out of markets at select moments means an investor may capture opportunities and avoid challenges within each sub-asset class.

Fig. 2 highlights how returns can vary significantly on a yearly basis, with each segment responding differently to headwinds and tailwinds.

While all markets were down during the financial crisis of 2008, there was a broad dispersion of returns; European investment grade bonds fell less than their high yield counterparts. However, that trend was reversed during the European sovereign debt crisis in 2009.

In 2013, the taper tantrum led to a sell off in EM and US investment grade while European investment grade was less impacted, being insulated by the European Central Bank's commitment to maintaining lower rates. High yield bonds and loans meanwhile performed better due to the characteristics which insulated them from interest rate risk.

Conversely, in 2015, US high yield was the weakest performer, impacted by the US energy segment of the market where defaults rose on the back of weaker oil prices, yet in 2016 it rebounded strongly as the weaker companies were weeded out, resulting in the strongest returns among the sub-asset classes.

Fig. 3 – Global Volatility – Creating the Right Balance

	1 year		3 years		5 years	
	Return (%)	Volatility (%)	Return (%)	Volatility (%)	Return (%)	Volatility (%)
US Loans	4.39	1.23	4.36	2.63	4.28	2.33
Euro Loans	4.74	0.96	5.53	2.08	5.47	1.91
US High Yield	4.10	2.23	5.19	5.61	5.33	5.25
Euro High Yield	4.65	2.03	4.27	4.68	6.14	4.27
EM High Yield	4.79	2.26	9.07	6.30	5.24	6.63
US Investment Grade	2.33	2.82	2.41	3.63	3.00	3.96
Euro Investment Grade	1.55	1.76	1.62	2.76	3.35	2.61
EM Investment Grade	2.67	1.74	2.97	3.24	2.86	3.90
S&P 500	17.08	7.58	11.13	10.16	14.73	9.80
German Federal Govt 7-10yr	-2.91	3.31	0.32	4.17	2.76	4.19
Euro Stoxx	6.93	11.27	2.02	14.88	9.35	14.26

Data as of February 28, 2018. Markets represented above include – US Loan: Credit Suisse Leveraged Loans Index (CSLLI), Euro Loan: Credit Suisse Western European Leveraged Loans Index (CSWELLI), US High Yield: ICE BofA ML US Cash Pay High Yield Index (J0A0), Euro High Yield: ICE BofA ML Euro High Yield Index (HE00), EM HY: ICE BofA Emerging Markets Corporate Plus Index (EMHB), US IG: ICE BofA ML US Corporate Index (C0A0), Euro IG: ICE BofA ML Euro Corporate Index (ER00), EM IG: ICE BofA Emerging Markets Corporate Plus Index (EMIB), S&P 500 Index, German Govt.: ICE BofA ML 7-10 Yrs. German Govt. Index (G4D0), Euro Stoxx Index (SX5E). Past performance does not guarantee future results.

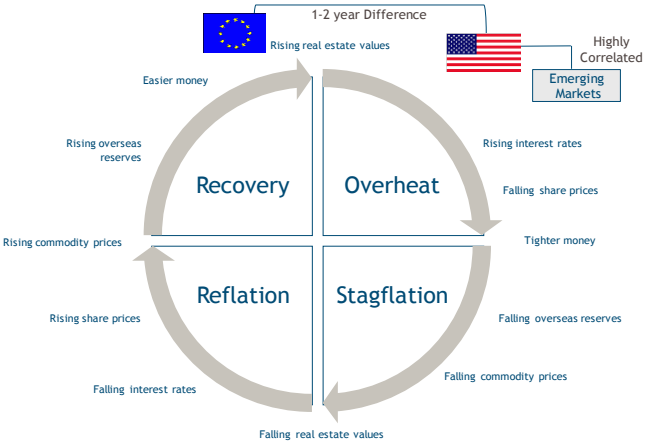
In addition, different sub-asset classes experience varying levels of volatility (Fig. 3), which should be taken into consideration when deciding an allocation.

We believe it is also important to fully assess each market by individual region i.e. EM high yield, European high yield and US high yield, as well as doing a deeper dive into sectors within each segment.

In our view this ensures the ability to move dynamically across and within each sub-asset class in order to extract the best value as well as avoid sectors or regions facing challenges.

For example, the gradual misalignment of US and European monetary policy (Fig. 4) is creating opportunities and challenges within each region, specific sectors and across ratings bands. A global credit strategy can therefore assess the macroeconomic policies of each area and tailor an investment approach accordingly.

Fig. 4 – The Credit Cycle



Source: Muzinich & Co. analysis. As of 28 February 2018.

Ultimately therefore it is the breadth of the investment universe that provides the multiple investment levers a global credit strategy can actively take advantage of, and tactically manage, in order to seek to generate returns.

The flexibility of an active, global approach may lead to the generation of a better risk-adjusted return than the constraints of a single sub-asset class.

Effective Implementation

However, we believe it is how a global approach is implemented that is the key to the generation of those returns.

Macro Overview

This should start with a thorough, top-down, macro analysis to determine global trends and regional variations. This assessment can help identify the best relative value trades (i.e. EM versus US or investment grade versus high yield), views on certain macro themes (i.e. the outlook for oil/commodities) and highlight potential risks which could result in higher volatility.

These themes influence how a portfolio is constructed and where the values and risks lie. The portfolio may also be repositioned ahead of any expected volatility, thus providing protection from large drawdowns and in turn preserving capital.

Fundamental Analysis

Nevertheless, we believe bottom-up, active credit selection should ultimately shape how a portfolio is constructed. We would emphasise that it is the idiosyncrasies of each bond that drives the credit selection process and ultimately generates alpha.

Consequently we believe the most emphasis should be placed on fundamental corporate credit analysis, which requires a deep understanding of credit markets at the individual company level.

A thorough knowledge of multiple jurisdictions is also important in helping to identify and capture additional features in the market.

For example, there may be an opportunity to gain additional upside from a single tranche of a multi-currency issue, which is trading wide due to a technical factor. Yet it is only by having the right experiences and resources that such nuances can be identified and implemented.

While it is important to have the flexibility within investment guidelines to implement such an approach, appropriate risk controls should also be in place to ensure a strong focus on risk management.

We believe a diverse toolkit – i.e. the use of CDX or futures - is also vital in managing risk and being able to stay invested, whatever the weather.

Three Key Benefits of a Global, Tactical Approach to Credit

In our view, multi-asset, global credit portfolios can provide a number of benefits for investors looking to diversify their credit exposure, including:

1. Improved Risk-Adjusted Returns

An allocation into a portfolio that accesses multiple areas of credit may provide better risk-adjusted returns than an investment into a single asset class, as well as protection against drawdown and a better Sharpe ratio.

A diversified credit strategy can act as a proxy for other strategies which may have riskier profiles or sit outside an investor's mandate, such as absolute return hedge funds, which many investors may be unable to access due to high fees and investment restrictions.

It may also act as a compliment to other asset classes due to the differentiated return drivers.

2. Lower Volatility

As each credit segment and region has different characteristics, the ability to reallocate depending on market conditions can reduce volatility. Less volatility may in turn also result in a more stable return profile over time.

3. A Strategy for All Seasons

We believe investing in a multi-asset (or tactical) credit strategy offers investors a way to generate attractive returns across the credit cycle. Even during challenging credit markets it is a way to stay prudently invested; it may provide moderate levels of return yet has the flexibility to position or re-position for a variety of potential risks.

When to Invest?

Whatever stage of the credit or economic cycle, we believe corporate credit maintains its relevance due to the long-term strategic needs of its investor base.

As multi-asset global credit strategies are not confined to any one segment of the market. in our view they are well positioned to take advantage of dispersion and idiosyncrasies across markets.

While index benchmarked investment strategies have been successful at producing solid returns over the past few years, as we move into a more differentiated return environment for credit, we believe a global, unconstrained and dynamic approach to credit investing can deliver optimal risk-adjusted returns for investors.

Important Information

This document has been produced for information purposes only and is not intended to constitute an offering, advice or recommendation to purchase any securities or other financial instruments. The investment strategies and themes discussed herein may not be suitable for investors depending on their specific investment objectives and financial situation. Investors should conduct their own analysis and consult with their own legal, accounting, tax and other advisers in order to independently assess the merits of an investment.

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Market Index Descriptions

The ICE BofA ML US Cash Pay High Yield Index (J0A0) tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period, that is 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.

The ICE BofA ML US Corporate Index (C0A0) tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an 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.

The CS Leveraged Loan Index (CSLLI) is designed to mirror the investable universe of US dollar denominated leveraged loan market. The index is rebalanced monthly on the last business day of the month instead of daily. Qualifying loans must have a minimum outstanding balance of $100 million for all facilities except TL A facilities (TL A facilities need a minimum outstanding balance of $1 billion), issuers domiciled in developed countries, at least one year long tenor, be rated "5B" or lower, fully funded and priced by a third party vendor at month-end.

The ICE BofA ML Euro High Yield Index (HE00) tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. 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, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

The ICE BofA ML Euro Corporate Index (ER00) tracks the performance of EUR dominated investment grade corporate debt publicly issued in the Eurobond or Euro member domestic markets. Qualifying securities must have an 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, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

The CS Western European Leveraged Loan Index (European Loans) (CSWELLI) is designed to mirror the investable universe of the Western European leveraged loan market. Loans denominated in US dollar or Western European Currencies are eligible for inclusion. The index is rebalanced monthly on the last business day of the month instead of daily. Qualifying loans must have minimum outstanding balance of $100 million (in local currency), issuers with assets located in or revenues derived from Western Europe, at least one year long tenor, be rated "5B" or lower, fully funded and priced by a third party vendor at month-end.

The ICE BofA ML High Yield Emerging Markets Corporate Plus index (EMHB) is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated BB1 or lower.

The ICE BofA ML High Grade Emerging Markets Corporate Plus index (EMIB) is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

The ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) tracks the performance of the US dollar and euro denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying issuers must have risk exposure to countries other than members of the FX G10, all Western European countries, and territories of the US and Western European countries.

The ICE BofA ML 7-10 Year German Government Index (G4D0) is a subset of the ICE BofA ML German Government Index (G0D0) including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks seen as a leading indicator of US equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.

The EURO STOXX 50 Index (SX5E) is derived from the 19 EURO STOXX regional Supersector indices and represents the largest super-sector leaders in the Eurozone in terms of free-float market capitalization.

You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility performance of an investment.