BNY MELLON

Tomorrow's World

MARCH 2017

Insight INVESTMENT

A volatile investment environment characterized by divergent interest rate cycles and pockets of political instability increasingly calls for a global approach to credit investing, writes Insight credit portfolio manager Adam Whiteley.

Traditionally, many investors have accessed global credit through local currency or "regional" allocations, such as funds benchmarked against sterling, euro or U.S. dollar indices.

However, a growing number are expanding their investment horizon to a more global approach, hedged to and delivered in their domestic currency, in search of greater diversification, deeper liquidity and more scope to generate excess returns.

We believe many investors in sectors such as investment grade are overexposed to their domestic markets, which are starting to represent a smaller proportion of the global opportunity set.

As just two examples, sterling and euro credit are expected to make up only 3% and 14% of global credit markets respectively in 2019.[1] Today, global credit indices contain well over 11,000 bonds, with euro and sterling corporates collectively representing a relatively small proportion of this.

Sterling credit is, in relative terms, becoming a less liquid market which presents an additional concern. With the UK voting to leave the European Union last year, some commentators also fear "Brexit" related factors could lead to acceleration in the decline of sterling credit issuance.[2]

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[1] Standard & Poor's forecast. June 1, 2015
[2] FTAdviser.com. Brexit: A "nail in coffin" for sterling credit? July 6, 2016

SIZE MATTERS

The fact that global credit markets are so much larger than any constituent local region highlights a crucial benefit to investors—diversification. This is particularly important today because idiosyncratic risks (specific to individual credits) are on the rise. One of the most effective methods of combating specific risks is diversification.

At a sector level, the industrial composition of credit markets can vary significantly by region. For example, euro markets have traditionally held notably higher weightings in the banking sector. Similarly, U.S. markets generally have had greater exposure to healthcare and energy while sterling markets tend to be more skewed towards utilities and insurers. By adopting a global approach, sector weightings will more accurately reflect the true nature of global economic activity, ironing out the biases of particular markets.

Pricing is another important factor to consider. Global credit pricing in sectors such as investment grade is frequently inefficient across countries, sectors and currencies. For active managers, market inefficiencies present the best and most repeatable source of potential outperformance.

These inefficiencies are more pronounced because different regions are often at different stages of the credit cycle. In many instances, this means that credit will tend to behave differently across the globe over the long term, rising and falling in asynchronous patterns.

ACTIVE APPROACH

Active managers with the skill to view global markets from a top-down perspective will be most advantageously placed to tactically rotate between the most attractive markets when value presents itself. In turn, "bottom-up" investors will be able to look between global markets and find mispriced bonds, as local markets can behave like isolated "silos" with respect to each other.

A classic example is when a company issues two bonds in different currencies. Despite presenting identical credit risks, one bond will frequently trade at a higher credit spread than the other.

This is a well-understood characteristic of global markets. Companies often take advantage of the same discrepancies when issuing new bonds. For active managers, these inefficiencies are an opportunity to access higher returns for identical credit risks. They can occur by individual credit, between credits, by industry or even by region. Although these opportunities are available to regional credit funds as well, global credit managers, given their inherently wider opportunity set, are typically afforded the most latitude to take advantage of these pricing discrepancies.

HUNTING VALUE

Pinpointing value across such a large opportunity set requires a well-resourced investment team and it is crucial to combine top-down views with bottom-up credit coverage.

Top-down analysis allows managers to develop informed views as to how each credit market is progressing through its specific credit cycle. Without it, a potentially substantial source of returns will be neglected.

Equally important is thorough bottom-up credit research, covering multiple regions with a high degree of granularity. Without this, we do not believe a manager will be able to credibly access the full potential of relative value opportunities between countries, industries, individual issuers or bonds within the same issuer's capital structure or at least make a fully informed assessment of their true potential.

Credit indices tend to adopt a different form to their equity counterparts. While about 90% of the equity in the FTSE 100 by market value is issued by UK-based companies, in sterling investment grade credit, the equivalent figure is closer to 50%. Sterling credit indices are therefore already "global" in a sense, but skewed towards UK-based issuers. In other words it is "currency" rather than "country" that defines what investors tend to think of as a "regional" credit market investment.

For investors content with the yields on offer in their local currency markets not already overexposed to them or unable to access a global opportunity set, this may be acceptable.

But in a world where currency risk can be hedged, investing predominantly in local currency markets is arguably an arbitrarily-constrained asset allocation decision.

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