cio investment club

Roundtable #3 June 2024

Opportunities in credit: Risks, reward and the road ahead

In association with

M&G Investments

Muzinich & Co

Roundtable sponsor

Thank you to our sponsors for this edition of the Credit Opportunities Roundtable.

Muzinich & Co

M&G Investments

Contents

sean.thompson@cioinvestmentclub.com
www.cioinvestmentclub.com
cio-investment-club

Design by Go Vicinity Creative

Opportunities in credit: Risks, reward and the road ahead

Global credit markets are vast, varied and usually liquid. This asset class offers investors exposure to both public and private markets across almost every corner of the globe, with higher returns than play-it-safe debt and loans.

However, with higher returns typically comes higher risk. Credit markets are tied closely to the activities of central banks, with returns dictated in part by the broader interest rate environment. As central banks in most major economies hiked rates to curb recent inflationary pressures, credit markets have responded with higher yields but also tighter spreads.

While markets had priced in about half a dozen rate cuts by central banks in 2024, that scenario now looks overly ambitious, leaving the path for the rest of the year far less certain than had been anticipated.

In this context, investment grade corporate debt may look attractive, but when rates begin to fall, opportunities within other types of credit, from speculative grade bonds to asset backed securities and private debt, should emerge.

In this pivotal year for the cost of borrowing, the cio investment club hosted a roundtable with industry experts to determine where opportunities in credit may lie, as well as potential obstacles on the road ahead.

Market backdrop

The current credit market is influenced, perhaps most notably, by a rapidly shifting interest rate environment.

In response to recent high inflation, central banks in most major economies embarked on their most aggressive rate hiking initiatives in more than a decade – a dramatic turnaround compared to the near-zero rate environment of the post-Global Financial Crisis (GFC) era.

Higher interest rates typically mean higher credit yields. Yet while yields have risen in 2024, spreads, or the markup they make against government bonds, have tightened.

"In 2024, we expect to have to navigate the whole year in very tight spreads," said Erick Muller, Head of Asset Allocation Group at Muzinich & Co.

"Several key risks have been taken off the table – the US, UK and Europe appear to have evaded serious recessions, fallout from China's property sector looks contained and the risk of monetary policy mistakes, such as raising rates further or being too restrictive for too long, seems to have vanished as well. That means spreads have narrowed between risky and less-risky credit opportunities."

Tighter spreads cause investors to put credit quality under the microscope, conducting extensive due diligence to differentiate between issuers and identify promising opportunities. For many, this means restricting credit allocations to the safest high-yield options.

"Investors are asking, what is the risk here and am I being compensated for it?" said Colin Tipping, Chief Investment Officer at Compre Group.

"If you're being offered a yield of 5% with very little risk, and that suits your portfolio, why would you go for a riskier option?"

> *Investors are asking, what is the risk here and am I being compensated for it?*

It appears likely that the credit market will remain in this high-yield, narrow-spread environment for at least several more months, with interest rate expectations having shifted to a higher-for-longer scenario.

Investors came into the year predicting five cuts by the US Federal Reserve but, amid sticky inflation, that optimism has since been scaled back to just one or two cuts, according to Morningstar[1].

"I don't necessarily wake up in the morning worrying about inflation. That said, the market appears to have got ahead of itself at the start of the year, predicting more rate cuts than we've received," said Tipping.

"A lot of insurers are revisiting their risk appetites, realising that you have to work with what's in front of you, not what you'd like to have in front of you."

When interest rates do fall, this will likely give rise to a greater breadth of opportunities within credit markets. And as investors dig for these opportunities, markets have expanded to accommodate far greater choice.

"The opportunity set is much wider than it was 10 years ago and the ability to access those opportunities has improved," said Mark Parry, Head of Manager Research at Barnett Waddingham.

"There is far greater choice today in terms of the strategy you implement, how you allocate assets and your choice of manager. As the credit universe expands, investors need to be discerning in their choices to secure the right outcomes."

[1] Morningstar: https://www.morningstar.co.uk/uk/news/248135/4-charts-on-plunging-expectations-for-us-fed-rate-cuts.aspx#:~:text=Coming%20into%20the%20year%2C%20investors,in%20the%20offering%20in%202024

Role of credit

One of the primary roles of credit within an investment portfolio is to supply income. This characteristic is particularly useful for cashflow-driven investors such as insurers and pension schemes, which require consistent income streams to meet their obligations.

"In terms of defined contribution pensions, credit has a role to play in supplying sustainable income," said David Will, Fixed Income Investment Lead at Scottish Widows.

"That's particularly important since pension savers don't have to annuitise in the way they once did, meaning their pension may need to supply income right through retirement. In a higher yield environment, the income from credit can be quite significant."

In addition to supplying income, the role of private credit has grown to encompass alpha generation.

"Private credit didn't feature in defined contribution pensions historically, but now it's starting to provide an alternative avenue of growth for savers," Will said.

Tipping said private credit increasingly played a similar alpha-generating role in the portfolios of insurers.

"It wasn't too long ago that you would walk into an insurer's office and see 98 underwriters and two asset managers," he said.

"The role of an insurer's asset portfolio has changed. There's pressure on the portfolio to make a more significant contribution, rather than just throwing off liquidity."

"The role of an insurer's asset portfolio has changed"

While John Dockery, Outsourced Chief Investment Officer at Vesta Insurance Asset Management Solutions, agreed that "there may be a gradual movement towards private credit", he said this shift would require greater education around this riskier asset class.

"An age of conservativism, particularly among risk-averse investors like insurers, has made it difficult for private credit to gain traction," Dockery said.

"It is going to take an intensive education process and resources, both in terms of time and dollars, to shift that mindset."

Another benefit of credit is portfolio diversification, with opportunities that span the risk-reward spectrum, typically articulated by credit ratings. Credit also differs in terms of liquidity, from very liquid investment grade bonds to low-liquidity private debt.

"Credit, for us, is primarily diversification. We want to spread out our exposure to risk," said Denise O'Donoghue, Chief Investment Officer at Lancashire Group.

"That means we want different types of credit – structured product, investment grade, some bank loans and we added private credit a couple of years ago."

Many investment firms, including Muzinich & Co., offer a range of credit types to meet these diversification needs.

"We want to build long-term relationships with clients by offering all different flavours on the corporate credit spectrum – investment grade, crossover funds, multi-asset credit funds, private credit," Muller said.

"We seek to offer a continuity of corporate credit exposure in terms of not only quality but also across the liquid-illiquid spectrum."

While credit type is a key consideration during portfolio construction, it is also crucial to consider the duration of assets within this asset class.

According to Dockery, current tight spreads have caused investors to reassess their exposure to risk, pursuing higher risk opportunities only within shorter timeframes.

"Despite the allure of high yields, clients still hold concerns about credit spreads in the context of a high inflation environment," he said.

"Investors are keen to keep credit as an income source but want to do so within a tight risk management framework. Typically, the result is taking more credit risk where appropriate, but in short maturities."

While shorter maturities help to mitigate risk exposure, according to Richard Ryan, Senior Fund Manager at M&G Investments, market downturns may also present an opportunity to pursue longer-term investment opportunities.

"Asset owners have one key tool in their back pocket, which is their investment timeframe," Ryan said.

"If you're looking at a major market dislocation, like the onset of the pandemic in 2020, that may be an opportunity to deploy long-term capital and get hugely overcompensated for that risk."

Risk management

While credit plays an important role within an investment portfolio, it also presents challenges.

In 2024, one prominent risk is that of geopolitical uncertainty, with several significant elections slated throughout the year, including in the US in November. However, as noted by Morningstar DBRS[2], many of these geopolitical risks have already been factored into credit evaluations.

Given that known risks tend to be factored into market pricing, it's often unexpected developments that have the most significant impact.

Ryan reflected on his past risk assessment methods, which involved compiling a list of potential concerns each January for the year ahead.

“Inevitably, if there were 10 things on my list, the thing that went wrong that year was number 11. I realised that it’s never the thing everyone’s talking about that wreaks havoc, it’s the one thing that we can’t foresee,” he said.

“With that in mind, I now assess risk from a fundamentally different perspective. Instead of asking, what’s going to go wrong, I ask myself a very simple question – ‘Does this asset compensate me for the risk that I’m taking?’

“My team doesn’t claim it can see the future. We think about where we are today and the risks of owning a particular asset to determine whether it’s worthwhile.”

Todd Isaac, Chief Investment Officer at Hiscox, agreed, saying while he mightn’t foresee every specific risk, he can take steps to insulate his portfolio more broadly.

“If I spent all day trying to forecast the one thing that is going to happen and position the portfolio for it, I’d inevitably get it wrong,” he said.

“No actuary can tell me when exactly when a one-in-200-year event is going to happen or how bad it’s going to be. Thus, we plan and immunise the portfolio as best as we can and, as long as there are no defaults and we have a well-diversified portfolio, we should be able to weather the storm.”

While macroeconomic risk may be difficult to predict, there is one type of risk that ought to be considered above all others when investing in credit – the risk of default.

“The ultimate risk in credit is the risk that your asset doesn’t pay you back. I’m much less concerned by market volatility by comparison,” Ryan said.

“Additionally, the restructuring environment has become much more hostile. Gone are the days of consensual restructurings, gone are the days that creditors could walk into a defaulted business and take it over.

“New entrants in the restructuring market are deploying very aggressive legal moves that mean ...

“We think about where we are today and the risks of owning a particular asset to determine whether it’s worthwhile.”

[2] Morningstar DBRS: https://dbrs.morningstar.com/research/432451/consider-credit-fundamental-ratings-monthly-briefing-may-2024

outcomes for creditors are deteriorating. Should you be unfortunate enough to hit a default, the outcome is significantly worse today than it was even 12 years ago."

As noted by Isaac, these potential scenarios make it essential for private credit deals to have strong covenant protection in place, with managers that are not afraid to take action.

"Strong covenants don't turn a bad loan into a good loan, but they do allow a lender to interact with the distressed company and take corrective actions," he said.

"If covenants are working properly, it gives the creditor the ability to restructure on the fly, potentially reducing the risk of default. That doesn't mean investors shouldn't be discerning about the kinds of loans they take on. If I relied on just covenant protection and nothing else, I would find it very difficult to sleep at night."

While the risk of default looms, several panellists noted technological advancements had made it easier for investors to identify high-quality opportunities.

"We've seen an explosion in terms of access to financial market information in recent years. Artificial intelligence could be hugely useful in helping to filter and manage that information," Parry said.

"Ultimately, though, investors still need a great portfolio manager to sense-check those technology-driven insights and leverage them effectively."

O'Donoghue agreed, saying: "It's important to be extremely, extremely selective when evaluating these opportunities. Have your models checked and re-checked to make sure no stone is left unturned."

Muller added that technology has dramatically reduced trading costs, making it easier to adapt one's portfolio to a changing market.

"Tech has reduced the cost and increased the speed of trading, which, combined with greater use of vanilla derivatives alongside cash, make it more cost effective to change a portfolio and bring more flexibility. That's very helpful in terms of a manager's ability to shape the portfolio's exposure to risk," he said.

When it comes to selecting the right opportunity, Muller recommended collaboration with an effective active manager.

"Passive investing is great for quickly locking in an entry-level market position as an opportunity arises. However, many of our institutional clients do not wait too long before switching to an active fund when market volatility strikes," he said.

"While passive investing has its place, especially as a foundational element within a portfolio, it's crucial to employ active management to select high-quality opportunities with trustworthy borrowers."

Looking ahead

Looking ahead at credit markets, a cautious eye remains trained on the trajectory of interest rates.

A decade of record-low rates provided fertile ground for start-ups and other companies reliant on cheap borrowing – including some with underlying financials that may not have been robust enough to weather a higher rate environment.

However, credit markets have remained impressively resilient even as interest rates have risen in recent years. In the first quarter of 2024, global defaults remained elevated but steady, dominated by sectors that are large users of very low-rated, floating-rate debt, according to S&P.

Default rates may continue to climb, with S&P[3] predicting a peak in the third quarter of 2024. While this is a concern for credit investors, several panellists noted that the current rate environment mirrors historic norms.

“Interest rates will fall, but they’re not going back to zero,” Parry said.

“The post-GFC world was defined by 0% interest rates, free availability of leverage and incredibly tight spreads. I would argue that we’re moving back towards a pre-GFC world, where the availability of leverage is more moderate and interest rates are more normal.

“Over the long-term, I expect to see a default rate that’s higher than the one from which we’ve benefitted for the last 10 years, but it’s still a historically normal, healthy credit environment.”

Though the current higher rate environment has resulted in greater uncertainty within many asset classes, including credit, it has also revealed new pockets of opportunity.

“Higher interest rates and particularly higher yields should be viewed as an opportunity to be managed,” Isaac said.

“As investors, we always need to consider what the market looks like today and where opportunities lie. If we play our cards right, those opportunistic investments should deliver tomorrow.”

“*As investors, we always need to consider what the market looks like today and where opportunities lie.*”

[3] S&P: https://www.spglobal.com/_assets/documents/ratings/research/101595511.pdf

Participants

John Dockery

OCIO, Vesta Insurance Asset Management Solutions

25 years fixed income investment management experience in London and Dublin with New England Asset Management (NEAM) and Barclays Capital. Client base was insurance enterprises. Secondary exposure to multi asset classes.

Keen interest in financial markets and their impact on both strategic and tactical portfolio allocation and construction. Managed bond portfolios to benchmarks through many economic and credit cycles.

Recently established Vesta to support London-based insurance enterprises with the twin challenges of economic and governance uncertainty in their investment portfolios – namely through Outsourced Chief Investment Officer (OCIO) services for their investment committees.

ACA (KPMG) and Masters in Finance (Imperial College London) qualifications.

Todd Isaac

Chief Investment & Treasury Officer

Todd is an investment, treasury, and accounting professional with over 30 years' experience in the Insurance industry. He has worked in a range of markets including North America, Europe, the UK, and Bermuda and is currently the CITO of Hiscox. His experience covers investing in public and private markets, financial systems debt capital markets and has joined Hiscox from Monument Re, where he was Deputy Chief Investment Officer for Europe and oversaw portfolio construction, manager selection and Committee and Board contributions for the reinsurer's European subsidiaries. Prior to Monument Re, Todd spent time at Blackrock, where he focused on business development for the Bermuda and UK P&C sector; Hyperion, where he served as Global Treasurer; Endurance, where he was Treasurer and VP Investments, Zurich as VP of Investments and Ernst and Young.

Erick Muller

Director of Market and Product Strategy

Erick joined Muzinich in 2015. His responsibilities cover macro and fixed income markets strategy and product management as well as client relationships across institutions, global distribution platforms and global private banks. Erick has an MBA in Finance – Marketing from the ESLSCA Business School and a degree in Economics from the Universite Pantheon-Assas.

Muzinich & Co

Denise O'Donoghue

Chief Investment Officer

Denise is currently the Chief Investment Officer and has been with Lancashire Holdings Limited for over 15 years, with a portfolio of just under $3billion. Denise previously held roles at Everen (previously Oil Insurance Limited) and Zurich Investment Services. Denise holds both a CFA and a CA designation.

Lancashire Holdings Limited

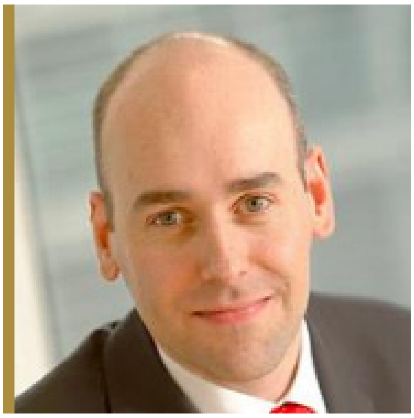
Mark Parry

Head of Manager Research

Mark leads our Manager Research Team. Working closely with our consultants, Mark's team provides independent and well-researched views on investment opportunities, tailored to the specific needs of the client.

A senior investment professional with over 20 years' experience as a multi asset and fixed interest fund manager, Mark has the knowledge and expertise to assist clients with the information and support they need.

Mark also sits on our investment research priorities group, so has visibility of research across different areas. This enables him to identify and develop research opportunities that are likely to benefit our clients.



Richard Ryan

Senior Fund Manager

Richard joined M&G Investments in 2001 and is a senior credit fund manager looking after Pan European credit strategies, absolute return strategies and fixed income asset allocation.

Prior to joining M&G, Richard worked for Nomura Asset Management as an institutional fixed income fund manager. Before this, he worked for Dresdner Kleinwort Benson in the Credit Products Group trading corporate bonds.

Richard graduated from Southampton University with a degree in Economics.

Colin Tipping

Chief Investment Officer

Highly experienced investment professional having held senior roles across across asset management and insurance. Technically proficient and commercially astute with a keen understanding of board level interaction, external stakeholder engagement, decision making processes, governance and oversight.

Committed to adding value through thought leadership with a collegiate approach based on empathy, coaching and relationship building.

David Will

Senior Manager, Portfolio Management

David is a Senior Manager in the Investment Office at Scottish Widows. His responsibilities include investment governance, fund manager oversight, search and selection as well as acting as the fixed income investment lead. Prior to joining Lloyds Banking Group, he worked as an investment consultant where he had responsibility for advising clients on asset allocation, manager selection, liability hedging, strategy implementation and investment governance. David has over 30 years' industry experience and extensive knowledge of fund manager research across a variety of asset classes. One of his previous roles was that of Head of Manager Research at JLT, now part of Mercer. In addition to his role at Scottish Widows, David is a regular speaker at industry events.

Elizabeth Pfeuti (Moderator)

Director

Former Dow Jones staffer Elizabeth Pfeuti is a member of the Rhotic Media executive leadership team. A highly decorated journalist, Elizabeth has been in financial journalism for almost 20 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes. She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

In attendance

Andrew Douglas

Head of Institutional Sales, UK and Ireland

Andrew joined Muzinich in 2021 from AXA Investment Managers where he was director of the institutional business. Prior to that, Andrew worked for two other asset managers in similar positions after starting his career as a fixed income analyst. Andrew has a BA (Hons) in Industrial Economics and is an IMC and ESG CFA holder.

Muzinich & Co

Christian Thompson

Director, Insurance Solutions

Christian joined M&G investments in 2014, as part of the Institutional client team. His primary focus is working with insurance clients globally on their specific investment needs, delivering M&G's investment capabilities across public and private markets.

Christian is part of M&G's Insurance Solutions Team who are responsible for working closely with our insurance clients globally, assisting across multiple parts of their businesses including the asset/investment side, supporting on regulatory developments, working with internal risk and capital teams and helping to ensure effective and optimised portfolios based on our clients' specific liabilities and needs.

M&G Investments

Sean Thompson

Founder & Director, cio investment club

Sean has 38 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.