Global Credit – the missing asset class

Matthew Mimms | May 2016

Income focussed investors in New Zealand are facing challenging times. Bonds that were issued a few years ago at high interest rates are now maturing. A quick look at a comparison of term deposit rates shows that you're unlikely to get much over 3% gross from a 6 month term deposit. A recent syndication for an April 2033 NZ Government stock set a coupon of 3.5%[1].

Whilst this level of income may seem low by historic standards, New Zealand investors in domestic cash and fixed income assets should consider themselves lucky. With inflation (as represented by the Consumer Price Index or CPI) currently sitting at 0.4%[2], at least we are getting a positive real rate of return (above CPI/inflation). Globally, inflation is largely benign and interest rates are very low (for example, the "official cash rate" equivalent in the UK is 0.5%, in the US 0.5%, in the EU 0.00%, and in Switzerland -0.75%, that's right, you have to pay them to look after your money[3]).

International comparison may however prove cold comfort for many investors used to more attractive income levels. One possible option for those seeking income is to invest in high yielding equities. Historically, both New Zealand and Australia have offered attractive dividend yields. For example, the current cash dividend yield on the NZX 50 is 4.56%[4] noticeably above the current 10 year government bond yield of 2.62%[5] (many individual stocks offer investors even higher yields). But this chase for yield does come with higher risk; equities, even higher yielding ones are still equities. When the sharemarket falls, higher yielding stocks will also almost certainly fall.

Unbeknown to many local investors, there is also another asset type that offers attractive yields, typically above that offered by cash or government bonds, with a lower level of volatility (risk) than equities whilst bringing diversification benefits that can reduce overall portfolio risk; Global Credit.

What is Global Credit?

There are many types of global credit and fixed income instruments, including:

- Investment grade corporate bonds
- Convertible corporate bonds
- Secured corporate loans
- Asset backed debt securities
- Non-investment-grade corporate (high yield) bonds
- Bank capital securities
- Emerging market credit.

The above credit sectors each have their own characteristics in terms of yield, credit risk and interest rate risk. The majority of global credit sectors are not directly accessible to retail investors. Global credit markets are large and deep. For example, the US corporate bond market alone is worth US$8 trillion[6] (compare that to the market capitalisation of the NZX of $NZ119 billion[7]). The size of the market, the number and size of issuers and investors and the wide variety of credit securities and products can help to support liquidity, even in difficult times.

What benefits and characteristics does Global Credit bring to portfolios?

Income generation

Corporate bonds, loans and high-yield securities tend to pay investors regular coupons, with a higher yield than cash or fixed interest. A diversified portfolio of such coupon-paying instruments allows for the smoothing out of all those cash-flows, which can be paid out as regular, high-yielding income. For New Zealand investors, credit securities, when hedged back to the New Zealand dollar offer higher income than cash and most traditional fixed income assets. For example, as at 31 March 2016, US Investment Grade Corporate Bonds had a NZD hedged yield to maturity of 4.5%, and US High Yield Bonds, 9.7%[8].

Capital resilience – seniority and security

Credit investors may benefit from having priority of payment above equity investors for payment of coupons and repayment of principal. Senior credit investors rank ahead of hybrid and subordinated debt investors. A credit investor's ranking in the company's capital structure is a key determinant of their recovery of investment if a company gets into trouble, and their certainty of receiving ongoing distributions.

In addition to seniority, some credit investments also provide investors with the benefit of security over specific assets of the borrower, providing further protection to the investor. This normally takes the form of a mortgage over property and other realisable assets.

A liquid and resilient asset class

Global credit is a large and deep market and significantly larger than global sharemarkets. It has many different investor types, including asset managers, banks, insurance companies, pension funds and sovereign wealth funds. This diversity of investors means credit investments are traded between buyers and sellers even in difficult times.

Global credit has been a more resilient asset class than equities, recovering far faster than equities after the GFC. Global credit is regarded as intermediate risk with an investment horizon of three to five years.

Diversification

Global credit allows New Zealand investors to diversify away from the local sharemarket and achieve a broader spread of exposures across issuers and economic/geographic areas. Industry diversification is particularly important, because corporate failures may occur in clusters - the technology crash in the early 2000s, or financial institutions during the GFC, for example.

Industry diversification is difficult to achieve in the New Zealand and Australian market. Our markets have a heavy concentration to financials and miners (about 60%[9] of ASX 200 market capitalisation is in those two sectors) and utilities (about 15.8%[10] of the NZX50). Far greater diversification is available by investing in global asset classes.

Credit sectors also tend to have a relatively low correlation (which is good for portfolio diversification) to traditional asset classes. For example, for the 10 year period ending 30 June 2015, Syndicated Loans (a sub-sector of credit) had a correlation of 0.31 to unhedged global equities, 0.54 to Australian equities, and -0.29 to global government bonds (i.e. negatively correlated)[11].

No free lunch

Like all investments, there are of course risks to consider when investing in global credit. The key one is credit risk, where a company fails to repay coupons or principal in full and on time, or where a company experiences a credit downgrade which in turn can have implications for their yield and the capital value of their bonds. Many credit sectors will comprise on average lower credit rated securities than traditional government bonds. Credit worthiness will vary across sectors, ranging from AAA to BBB rating categories for example in investment grade credit to BB and below for High Yield Bonds.

Changes in credit risk can impact at both an individual security, and at a sector and overall market level. For example, when credit risk increases (due for example to a slowdown in economic activity or tight liquidity conditions), this will typically lead to a fall in the value of credit securities (as seen during the Global Financial Crisis).

Credit risk can be better managed and mitigated through careful investment analysis and security selection, thorough review of creditor protections in any security (i.e. seniority, security), a focus on rated, liquid investments, and significant diversification.

Institutional grade assets

For retail investors, it is very difficult to effectively access global credit investments directly. Local Australian and New Zealand credit markets are relatively small in size, with lending (and capital markets issuance) dominated by banks. In addition, global credit securities are typically only sold to wholesale investors and/or have large minimum investment sizes ($500,000 plus). The small number of individual credit securities made available directly to the retail market in Australia and New Zealand are often of "non-institutional quality", being subordinated, unrated and without a liquid, traded market. Finally, Credit investing requires considerably more diversity than equity portfolios. Diversity is more important in credit portfolios than in equity portfolios but less recognised. A credit portfolio with 20 to 50 securities is not diversified enough to reap the full benefits of diversification. The diversity required to create a robust credit portfolio is simply not possible to replicate with a small portfolio.

This is why global credit has historically been a more institutional market. Even the larger institutional investors, such as superannuation funds, will typically invest in global credit via managed portfolios, not through selecting a small number of individual bonds.

In conclusion, global credit is a large, and globally diversified asset class that has historically generated higher levels of income than cash and traditional fixed income assets but with a lower level of volatility than equities. It provides global diversification benefits to New Zealand investors. Credit is an intermediate risk asset class (over the longer term, more risky than cash and government bonds, but less risky than equities). The institutional nature and unique characteristics of the asset class means that for most retail investors, access is easier and best achieved via a professional active fund manager with expertise in the sector.

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Notes and sources:

[1]New Zealand Debt Management Office, 15 October 2015
[2]Statistics New Zealand. Annual change in CPI index for quarter ending March 2016
[3]www.globalrates.com
[4]As at 27/516; source Factset and Devon Funds Management.
[5]Bloomberg, as at 25/5/16
[6]Fitch ratings, May 2013
[7]Market capitalisation of NZX Main Board was $119,452,193; source NZX, 26/5/16
[8]Bentham Asset Management, as at 31/3/16. Yield to maturity is the internal rate of return of an investment in a bond if the investor holds the bond until maturity and if all payments are made as scheduled. It is not the current cash or running yield.
[9]Bentham Asset Management
[10]S&P Dow Jones Indices. Fact sheet NZX 50, 30 June 2015.
[11]Bentham Asset Management. 10 year correlation figures to end June 2015. Australian dollar returns.