Global Credit – The Missing Asset Class – Re-Visited

Three years ago, I authored an article entitled, “Global Credit – the Missing Asset Class”. Set against a background of low and falling interest rates, the article highlighted the challenges facing income demanding NZ investors; and introduced a sometimes-overlooked asset class as part of a possible solution, Global Credit.

Three years on, this article examines how fixed income options have fared, we re-examine the case for global credit and look ahead to future challenges and opportunities for fixed income investors in New Zealand.

Interest rates in NZ, and globally remain stubbornly low. At 1.0%, the NZ Official Cash Rate[1] is at an all-time historical low and could even fall further. Investors in (six-month term deposits) are now hard pushed to get anything much above 3.0% per annum. With limited domestic supply, and a raft of older bonds and income yielding securities (issued when interest rates were higher) now maturing, income focussed investors in New Zealand continue to face challenging times. With nominal yields low and possibly falling further, inflation (in the form of the CPI) has crept up over the past 3 years and currently (as at the end of June 2019) sits at 1.7%[2], up from 0.4% in June 2016. This means that currently, investors in a 6-month term deposit after tax are now only just achieving a positive real return.

Globally interest rates likewise largely remain low. In the US, interest rates did start to rise but have more recently fallen, and are likely to do so further in the coming period (over the past 3 years, the US Fed rate has increased from 0.5-0.75% to 2.25-2.50% range and was cut recently to 2.0 to 2.25%)[3]. Interest rates remain low and in fact negative in some economies (0% in the Eurozone, -0.1% in Japan and -0.75% in Switzerland[4]). Likewise, longer term bond rates in most major economies have seen yields fall of late (most importantly in the US where the 10 year bond yield has fallen from a high of 3.2% in late 2018 to its current level of 1.74%, largely due to softer US and global economic data and a more dovish stance from the Federal Reserve, at least in the short term[5]). Current sentiment globally is for interest rates to stay low.

One option that remains popular for income orientated investors is the local stock market, and as at the time of writing the dividend yield from New Zealand’s largest 50 stocks remains high at 3.54%[6] (net) again noticeably above the current 10-year NZ government bond yield of 1.1% (three years ago the 10-year Government Bond Yield was 2.94%[7] by the way). Many individual stocks offer investors even higher yields.

As ever, this chase for yield comes with higher risk as we witnessed the 4th quarter of 2018 when the local stock market fell by 6%[8].

An alternative income generating asset which was discussed three years ago is Global Credit. This asset class typically generated a yield (return) higher than cash or government bonds, with a lower level of volatility (risk) than equities whilst bringing diversification benefits that can reduce overall portfolio risk. In this next section we briefly re-cap what Global Credit is and discuss some of its characteristics and benefits.

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 and emerging market credit. Credit instruments tend to be back and issued by a corporate entity (as opposed to a Government).

These credit sectors each have their own characteristics in terms of yield, credit risk and interest rate risk. Whilst 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$7.5 trillion[9] (compare that to the market capitalisation of the NZX of $NZ157.8 billion[10]). 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 typically 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 June 2019, US High Yield Bonds had a yield to maturity of 5.98%[11].

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 materials (about 48%[12] of ASX 200 market capitalisation is in those two sectors) and utilities (about 15.54%[6] 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. In the table below, we have highlighted the correlation of a sample of global credit sectors to other asset classes:

Table 1 - Correlation of returns between various asset classes – January 1992 to June 2019

	Global Government Bonds	NZ Fixed Income	Global Aggregate Index	US Leveraged Loans	US High Yield Bonds	World Equities (unhedged)	NZ Equities	Australian Listed Property
Global Government Bonds	1.00							
NZ Fixed Income	0.43	1.00						
Global Aggregate Index	0.96	0.43	1.00					
US Leveraged Loans	-0.25	-0.10	-0.06	1.00				
US High Yield Bonds	-0.06	-0.02	0.14	0.79	1.00			
World Equities (unhedged)	-0.14	-0.05	-0.07	0.22	0.30	1.00		
NZ Equities	-0.01	0.01	0.10	0.29	0.44	0.43	1.00	
Australian Listed Property	0.20	0.20	0.27	0.37	0.40	0.37	0.42	1.00

Source – Bentham Asset Management. All asset classes are either denominated in NZD and in the case of international assets, hedged back to the NZD unless otherwise stated.

As can be seen from the chart above, Credit sectors such as Leveraged Loans (a senior secured floating rate asset class) and US High Yields Bonds (for the period in question) are completely uncorrelated to traditional fixed income assets such as Global and NZ Government Bonds and have a relatively low correlation to global and NZ equities.

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.

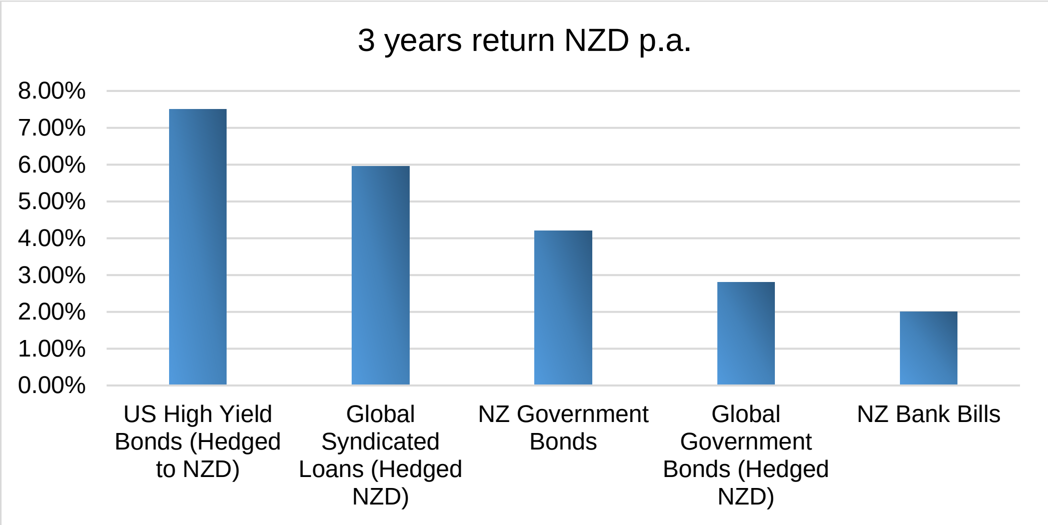
Changes in credit risk can impact at both an individual security, and at a sector and overall market level. For example, when credit risk increases (due for example to a slowdown in economic activity or tight liquidity conditions), this will typically lead to a fall in the value of credit securities (as seen during the Global Financial Crisis). This also occurred in the 4th Quarter of 2018 where credit spreads widened across most credit sectors. For example, High Yield bonds fell by 4.84%[13] in the 2018 December quarter.

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.

How has Global Credit Fared over the past 3 years?

For the most part, the past 3 years has been supportive of riskier assets such as equities. Against a backdrop of (up until recently at least) improving economic conditions, most credit sectors have performed well. In particular, they have benefitted from relatively low corporate defaults and a narrowing of credit spreads (i.e. the cost of debt has fallen). The chart below provides a summary of the performance of various credit sub-sectors and other asset classes like government bonds over the 3 years to end June 2019.

Table 2 – Fixed income performance for the 3 years to 30 June 2019.

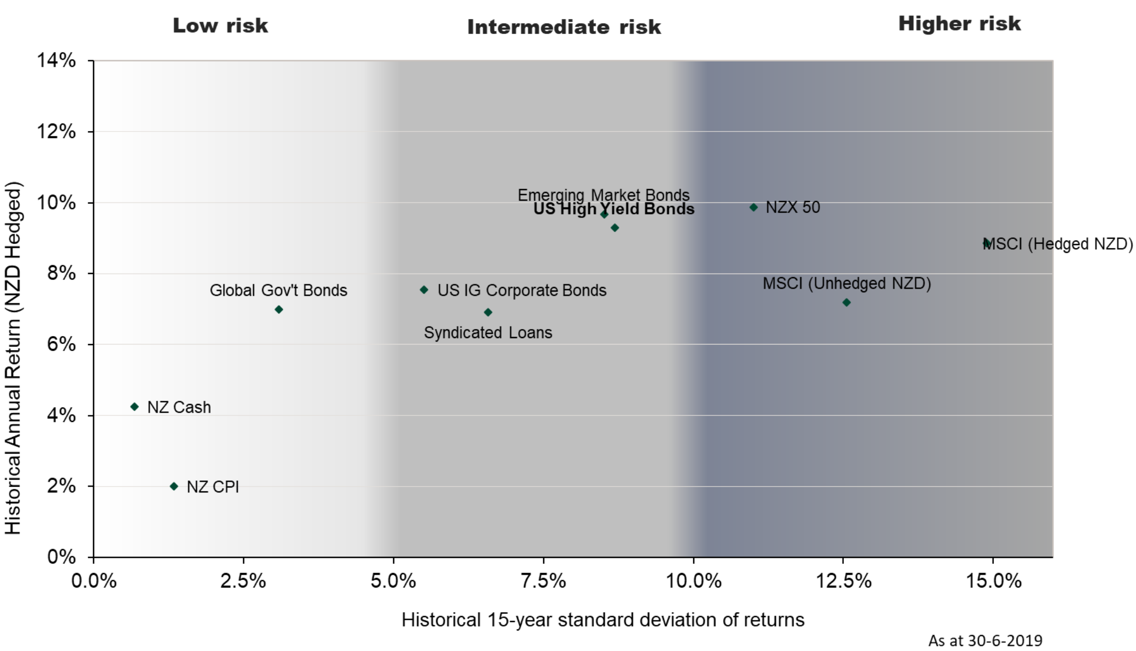


Sources: Bentham Asset management, Bloomberg, Challenger and JP Morgan. Past performance is no indication of future performance.

And longer term?

The chart below illustrates the risk and return of credit and other asset classes over the past 15 years in New Zealand Dollars. Over this period, it can be seen that credit asset classes (in the form of Us Investment Grade Bonds, Global Syndicated Loans and Global High Yield Bonds) have generated returns better than cash and government bonds and have done so with a much lower level of volatility than equities.

Table 3 – Past Volatility, Past Returns.

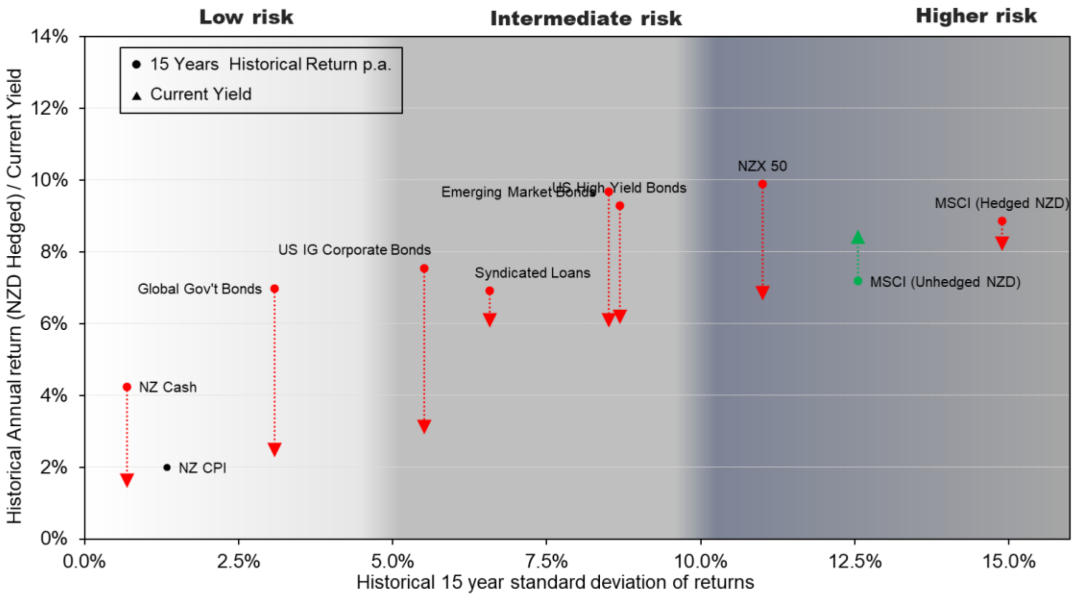


^ Overseas yields are hedged into NZD using the one-month interest rate differentials. The historical standard deviation shown for these equity asset classes is based on the total return for the relevant index. The total return on equities will generally be comprised of both dividend income and share price movement and as a result could vary substantially from those shown above. The outcomes shown above may be affected by known or unknown risks and uncertainties that cannot presently be identified. Accordingly actual outcomes may differ from those shown above.
Source: Barclays Capital, Bentham, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley and UBS,

What about the future?

Fixed income assets have benefited from significant falls in interest rates over the past few decades. All things being equal, as interest rates have fallen, bond capital values have appreciated. To illustrate this point, in 1980, the 10-year US Bond yield was 15%, currently, it is just 1.74%[14]. Whilst it is of course impossible to predict the future, it seems unlikely that we will witness interest rate falls of such magnitude in the coming period. For fixed income investors this means that they are not likely to benefit from the performance tailwinds of the last few decades, that yields are much, much lower, and the risk of eventual interest rate rises are higher (which would be a headwind for investment returns). This is illustrated in the chart below which is an extension of the previous chart and highlights current yields for various asset classes including credit.

Table 4 – Past Volatility, Past Returns, Current Yields



Sources: Barclay's Capital, Bentham, BoA Merrill Lynch, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley & UBS
Past performance is not a reliable indicator of future performance.
For equities Bentham inverted the forward PE and add 2.5% growth.
Investors should vary their estimate of growth to the equity earning yields to compare returns.

As at 30-6-2019

Accessing global credit

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]Reserve Bank of New Zealand
[2]Statistics New Zealand. Annual change in CPI index for quarter ending June 2019.
[3]www.federalreserve.gov
[4]www.globalrates.com
[5]Bloomberg
[6]Factset and Devon Funds Management.
[7]Bloomberg, 10 NZ Government Bond Yield on 1/4/2016 and 07/08/19.
[8]Yahoo Finance, S&P/NZX50 Gross Index
[9]Barclays, Bloomberg, Credit Suisse and Bentham – as at 31/12/17
[10]Market capitalisation of NZX Main Board was $157.8bn - source NZX, 08/08/19
[11]Barclays Capital, Bentham Asset Management, Bloomberg, Credit Suisse and UBS.
[12]www.marketindex.com.au, April 2019
[13]Bentham Asset Management
[14]Macrotrend.com and Bloomberg