Fixed income: how to generate "conservative alpha"

The Euro credit market offers opportunities for active managers with a proven process and extensive data analysis capabilities

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Key takeaways:

- Active investors can take advantage of multiple inefficiencies in the Euro credit market to create portfolios that outperform over the cycle;
- A "conservative alpha" approach combining a top-down market view with bottom-up corporate fundamental analysis and underpinned by a beta-driven risk orientation can result in superior risk-adjusted returns;
- The Loomis Sayles Euro Credit team combines this "conservative alpha" approach with state-of-the art data analysis capabilities to generate consistent alpha.

Despite its relative maturity, credit remains a relatively inefficient asset class, providing active investors with no shortage of opportunities to outperform benchmark indices.

The question is how to seize those opportunities. Active management allied to a conservative investment philosophy has the potential to generate strong risk-adjusted returns.

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How credit value is left on the table

Let's consider inefficiencies in credit markets that make them a potentially happy hunting ground for active investors.

First, credit remains predominantly an over-the-counter market, offering less transparency than for instance equities. Although innovation in fixed income trading continues apace, it is likely still some years away before the majority of fixed income transactions are conducted on exchanges .

Second, the credit market's biggest buyers by volume – insurance companies – have long investment horizons, often buying bonds to match their liability cash flows and holding them to maturity. Selling a bond can impact this matching process and realizing gains and losses prior to a bond's maturity being reached may have tax implications for insurers. The inflexibility in the portfolios of insurers and similar buy-and-hold investors represents opportunity for active investors to respond in a more agile fashion to changes in valuations and corporate fundamentals.

Equally, some investors have internal or client-generated guidelines that force them to sell bonds in response to changes in their rating profile. For instance, if a bond is downgraded from, say, BBB to BB, certain investors are forced to sell at what later might prove to be the trough for a company's credit quality and a peak in spread levels.

Then there is the direct and indirect influence of central banks. In the wake of the financial crisis, central banks around the world have been actively buying large amounts of bonds, frequently without regard to price. This plays to the strengths of active investors who are more discerning when judging the relative value of underlying bonds. Whilst central banks have tightened monetary policy, and have, in some cases halted their bond buying programs, unfavourable economic conditions in the future may see the central banks again ramp up their involvement in bond markets.

Finally, there is the trend towards passive fixed income investing. Passive investors aim to replicate exposure to underlying benchmarks at minimum cost. But in doing so, they can build up relative exposure to selected companies not on the basis of underlying fundamental credit quality, but frequently based on the amount of bonds these companies have issued. This also leads to bonds being mispriced from a fundamental perspective, thereby offering active investors additional opportunities to uncover relative value.

Generating "conservative alpha"

So how can active investors create portfolios of Euro-denominated corporate bonds that outperform over the cycle?

The simple answer is: with diligence.

"We like to say we generate conservative alpha," says Jeroen Potma, investment director for the Euro Credit team at Loomis Sayles, an affiliate of Natixis Investment Managers, "which is to say we are prudent and very risk-oriented."

This idiosyncratic risk has convinced Loomis to emphasise high levels of diversification in the portfolios it manages. In practice, this is achieved by limiting the extent to which these portfolios deviate – in Beta terms - from their benchmarks on an overall portfolio level, a sector level and an issuer level. The overall beta of its portfolios can range between 70% and 130% compared to the benchmark, although typically we tend to be between 85% and 115%. On a sector level, portfolios deviate by no more than 5% relative to the benchmark and at the issuer level, the deviation from the benchmark is no more than 3%.

Potma says: "Operating with structurally higher Betas, as some of our competitors do, cancreate substantial volatility in the return profiles of a portfolio and the extent to which these portfolios outperform their respective benchmarks. We are, in contrast, looking to limit volatility and deliver a more consistent and more predictable outperformance. Importantly we do not try to generate alpha through duration positioning. We are instead focused on capturing movements in credit spreads and, therefore, manage the duration of our portfolios very closely with the duration of their respective benchmarks."

Through the use of derivatives, the team ensures that the portfolios have the same duration as their respective benchmarks.

Potma continues: "We have also done a fair bit of analysis in looking at the diversifying nature of our approach when our strategy is combined with other Euro Credit managers. What we typically observe is that we are a true diversifier in a Euro Credit portfolio context. Adding us to a portfolio that has an allocation to other Euro Credit managers, tends to result in an improving risk-return metric on a portfolio level."

Outperformance through relative value

In addition to the top-down view on credit markets, which sets the level of risk that the team wants to manage its portfolios with, the Euro Credit team also seeks to generate alpha by leveraging its bottom-up fundamental corporate- and relative value-analysis.

The structure of the Loomis Sayles Euro Credit team, Potma believes, is a big factor behind its ability to generate alpha. First, it conducts all credit analysis in-house. Second, contrary to traditional investment team structures, it combines the roles of portfolio manager and sector analyst/specialist.

"By combining these roles, you get a level of attachment to decisions that is not always seen in the traditional portfolio manager-analyst set-up, where analysts throw ideas at portfolio managers in the hope that some of them stick," says Potma. In the Loomis Sayles Euro Credit team, all portfolio managers take responsibility for the creation, implementation and monitoring of their trade ideas.

Credit research encompasses amongst others an analysis of a company's business model and strategy, the quality of its management team, its liquidity profile, balance sheet strength, competitive positioning versus industry peers and the extent to which the company is positioning itself to remain relevant and thrive in societies that are placing greater emphasis on sustainability. The ESG analysis are carried out by the respective sector specialists within the Euro Credit team.

"We see ESG as a key factor to analyse when judging a company's credit quality," says Potma. "Since our sector specialists talk to companies about their strategy and financials, they are in the ideal position to talk meaningfully about ESG performance too."

If the Loomis Sayles Euro Credit team is comfortable with the fundamental credit quality of an issuer, the subsequent step in the investment process is to determine which of that issuer's bonds or debt instruments offers the best risk-adjusted returns. Questions being raised include, for example, whether investors are getting sufficiently rewarded, in terms of additional spread, for extending maturities or from moving from a senior bond to a more subordinated instrument.

"The Information Ratio is our prime indicator of whether our "conservative alpha" investment process is working," says Potma. "If we make the right investment choices, our Information Ratio can be impressive." The high information ratio is the result of alpha generation combined with a relatively limited tracking error.

Credit is all about the data

At Loomis Sayles, there is a strong belief that data management and analysis forms an essential building block in the organization's goal of delivering strong risk adjusted performance for is clients. This ultimately led to the development of a proprietary, real-time data and analytics platform called In2!. The In2! platform provides investment teams with customized tools that are required to effectively and actively manage client portfolios.

The In2! platform is of significant value to the Euro Credit team as it has allowed for the creation of several proprietary applications that support the team's investment process and ability to generate alpha in a segment of the capital markets that encompasses a huge amount of data.

These applications allow the team, for example, to view their portfolios from numerous angles, whilst also supporting the generation of trade ideas and providing new tools for risk management purposes. Furthermore, the In2! platform facilitates the storage of information and research produced by the team.

"We are focused on risk-adjusted performance and we have invested substantial amounts of money in our IT systems/data infrastructure to give our portfolio managers the best possible chance of generating alpha," says Potma.

Importantly, the technology platform also supports the team's ESG analyses and enables the team to provide its clients with customised ESG reporting.

Return expectations and market outlook

The Loomis Sayles Euro Credit team sets an outperformance target over the cycle of between 75bps and 125bps a year, depending on the underlying benchmark (e.g. investment grade or high-yield) and ESG related restrictions. Potma adds: "As the team now has celebrated its first 3 year track records for the Loomis Sayles Euro Credit strategy and the Loomis Sayles Euro High Yield strategy, we can clearly observe that over this period, the team has been able to outperform those targets."

The conservative alpha approach should be considered as a core part of any credit allocation, Potma believes. "If you're keen to avoid excessive risk in the credit asset class, then the conservative alpha approach makes sense. No-one is going to blame you because you outperform a little less than a high-risk manager in a bullish market environment, whilst in a bear market, your downside is much better protected." For those, however, bullish on the asset class, it may make sense to add a higher-beta manager in tandem with an allocation to "conservative alpha".

Indeed, the ranks of bulls may continue to be rising. As a result of a renewed interest for fixed income investing that we have seen over the past 1-2 years, we have witnessed substantial amounts of capital being invested in the Euro Credit space. Nonetheless, the fact remains that there are still investors considering when to start to increase the duration of their portfolios. Euro corporate bonds now have considerably higher yields than we have seen over the past few years.

"Credit is still an attractive asset class given favorable technicals and reasonable valuations and should be considered a core building block of fixed income portfolios. Investors that are still underweight duration might want to close that position by increasing their allocation to Credit in a couple of steps, as the 'perfect' timing of an entry point may prove very difficult given rates and spread volatility," adds Potma.

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