The lost art of credit analysis in buy and maintain management

M&G Investments

As we move into the later stages of the credit cycle, effective risk management within core fixed income portfolios is an increasingly pertinent issue for insurance companies. With corporate balance sheets under increasing pressure, traditional buy and maintain credit management strategies are being tested for the first time, placing increased focus on the benefits of a more active approach to long-term credit allocations.

The buy and maintain model typically serves insurers well, given that investments in corporate bonds provide regular payments and the return of capital at a known date, potentially offering predictable income streams. With specific cash flow requirements, insurers are therefore able to match future liabilities. The benefit of a portfolio approach provides active credit selection, alongside diversification.

Since buy and maintain investments typically provide exposure to investment grade credit market beta, bonds' stability is often prioritised over value. Portfolio management strategies that match durations and target problem avoidance have therefore proven adequate in stable bond markets over the last ten years.

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Shifting sands

The buy and maintain model evolved in relatively benign credit conditions post the Global Financial Crisis (GFC), which means investors have not needed to be hypervigilant to risk. Equally, the justification for credit analysis spend has been less apparent, set against increased pressure on asset management fees with the introduction of MIFID II. As a result, cost-efficient, quantitative driven strategies and reliance on external ratings agencies has taken precedence over rigorous fundamental credit analysis.

However, with geopolitical tensions and growing concerns around the credit market and economic environment, fixed income markets are facing increasingly uncertain conditions, and traditional buy and maintain strategies are being tested for the first time. It is also important to note that the average credit quality in the investment grade (IG) market has deteriorated markedly since the GFC, given the increase in corporates using bond markets for funding (rather than banks). With around 50% of corporates rated BBB, this in turn has increased the risk of rating downgrades from investment grade to high yield, along with the possibility of defaults.

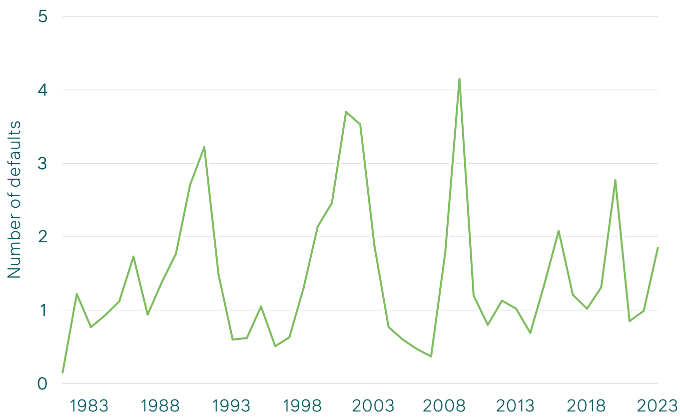
In this macroeconomic landscape, the role of active portfolio management and rigorous credit analysis cannot be underestimated, in our view – not only as part of the initial credit selection process, but on an ongoing basis as economic conditions change, given the potential impact on underlying issuer credit risks.

Corporate balance sheets are under increasing pressure

Following months of monetary policy tightening, the hallmarks of a late credit cycle look to be taking effect in the UK economy. GDP growth is slowing and corporate leverage is rising, meaning higher defaults and downgrades could manifest over the next 12-18 months.

Though defaults are rare within investment grade credit, they are certainly not unknown and history has shown that companies' fortunes can change quickly. Investment grade, defaults have spiked during past credit downturns; notably the dotcom bubble in the early 2000s and the GFC in 2008. Neither of these events were 'forecast' and, as a consequence, significant damage was done to less resilient credits and to those whose business models had been predicated on continuity of access to short term funding, for example.

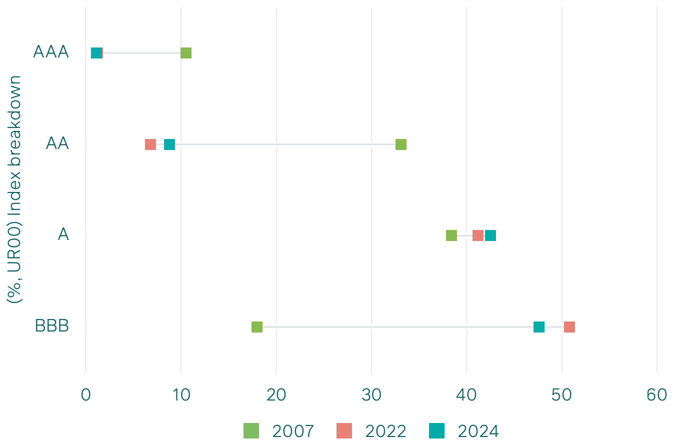
Investment grade defaults



Source: S&P Global Default and Rating Transition Study 2023.

However, credit downgrades are perhaps a more pertinent risk today. Just 8% of sterling IG bonds are rated AAA or AA, compared with around 44% in 2007. The implication of this lower baseline is greater potential for downgrades during the current credit cycle.

Credit quality in the sterling investment grade market



Source: M&G, ICE Bof AML Sterling Corporate Index (Ref. UR00) composite bond ratings and composition data, OAS spread as at March 2024. *Data as at March 2024.

For insurers particularly, downgrades can have significant repercussions. As well as the negative impact on their balance sheet and solvency position, downgrades can also lead to a significantly increased reporting burden and additional regulatory scrutiny.

The benefit of active management in a late cycle environment

With this backdrop, we believe it is imperative for investment managers to guard against credit risks by taking active decisions on what is and is not included in core credit portfolios; both identifying good value and looking to avoid or trade away from problematic credits where appropriate.

This is where in-depth credit analysis comes into play, allowing managers to thoroughly assess the ongoing credit strength of an issuer, which in turn helps to accurately gauge and minimise at the outset the level of risk investors should take for the target income requirements.

> "...we advocate real-time monitoring of credit fundamentals and reassessment of the bonds within a portfolio..."

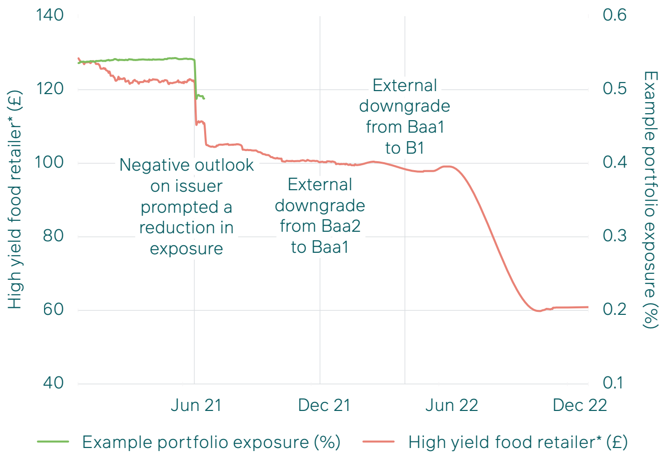
Fundamental credit analysis also plays a vital role in ensuring downside protection, helping managers to avoid problem credits ahead of potential downgrades or defaults. This does not mean selling assets just before they downgrade, therefore avoiding credit deterioration but realising a loss. Instead, we advocate real-time monitoring of credit fundamentals and reassessment of the bonds within a portfolio to proactively head off situations where the only choice might be to realise a loss or accept a downgrade.

Reviving the lost art of credit analysis

The benefit of robust research which overlays quantitative and qualitative analysis is pivotal in an environment of economic contraction and potential credit market deterioration. This can help to reduce volatility by broadening a managers' understanding of a company, including its culture, management and reputation. Bonds must be thoroughly assessed through a fundamental, value and ESG lens to ensure suitability, factoring in specific ESG and climate risk metrics to manage physical and Net Zero transition risks.

Tooling and expertise that facilitates rigorous credit analysis and active decision making around risk, value, and buying and selling decisions is fundamental to M&G's buy and maintain approach. In the example below, this capability provided the option to make an active decision about the direction of travel for a BBB-rated sterling bond investment, ahead of a steep decline in credit quality.

Example investment in which an active approach helped to avoid negative impact from credit deterioration



*4.75% 2029 price. Senior unsecured, BBB at time of issue.
Source: M&G Investments.

Staying alive to value

An active management approach can also provide opportunity, allowing managers to capture mispriced issues which can often present themselves during periods of market volatility.

Credit downturns can be associated with market dislocation and increased spread dispersion, yet credit spreads are typically more volatile than underlying credit fundamentals, as a consequence of risk aversion and forced selling. With the right understanding of credit risks, therefore, it is possible to find issues where credit spreads appear too wide relative to their fundamentals.

Credit quality in the sterling investment grade market

Source: M&G, ICE Bof AML Euro Corporate Index (Ref. ER00) and Non-Financial High Yield Constrained Index (Ref HEAD), composite credit rating derived from average of S&P/Moody's/Fitch as at March 2024.

We believe it is important for buy and maintain strategies to maintain a degree of flexibility in order to capture these type of value opportunities, while also providing the ability to selectively sell positions that may become disproportionately expensive, or where a deterioration in a credit profile has been identified.

Given the current disconnect between spreads and credit market fundamentals in significant sections of the credit markets, an intricate understanding of market dynamics is fundamental to capturing potential opportunities and managing portfolios effectively.

Balancing risk in portfolio construction

When it comes to portfolio construction, a key challenge is striking the right balance between taking on too much risk, and following an excessively cautious approach. Just as credit events can harm insurers' balance sheets, portfolio construction risks can also negatively impact investment returns.

On one hand, there is the risk of running an 'over optimised' portfolio, where managers seek to maximise return on capital by buying issues with the highest spreads without regard for credit quality. Such an approach can face significant headwinds during a credit downturn, resulting in broken asset allocation, a de-graded capital provision, and potential losses due to the forced sale of bonds.

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However, we think there are also risks with taking an overly conservative, index-based investment approach, whereby managers only invest in the most highly-rated issues. Besides concentration risk, we believe the 'managing risk by not taking risk' approach leaves value on the table and can ultimately lead to sub-optimal returns, and risks owning bonds that do not compensate for taking credit risk.

Again, getting this balance right relies on a bottom-up approach based on an in-depth understanding of the risks faced by individual companies. This in turn helps to identify mispriced securities which can be a source of future alpha generation.

Designing an optimal buy and maintain strategy

It is critical that insurers' mandates are managed and cultivated to the highest potential, particularly in the late cycle environment. Given the deterioration in credit quality in the IG universe, the need for active management is more relevant than ever for insurers, in our opinion.

Our experience in managing core fixed income allocations has shown that an optimal Buy and Maintain strategy incorporates bottom-up active management based on rigorous credit analysis; a focus on diversification; and overall return profile monitoring. Critically, insurers should expect solutions to be tailored to their specific objectives, constraints and risk appetite, prioritising capital efficiency and considered management of trading costs. One size does not fit all.

Having access to high quality credit analysis and proprietary ESG tools is therefore one of the single most important differentiators in managers' ability to capture upside potential and mitigate downside impact through Buy and Maintain strategies. ◻

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