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. That is the opinion of Jeroen Potma, Euro Credit Investment Director at Loomis Sayles.

By *our editorial team*

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 is said to have the potential to generate strong risk-adjusted returns. So how can active investors create portfolios of Euro-denominated corporate bonds that outperform over the cycle?

The simple answer is: with diligence, says Jeroen Potma, Investment Director for the Euro Credit team at Loomis Sayles, an affiliate of Natixis Investment Managers. 'We like to say we generate conservative alpha, which is to say we are prudent and very risk-oriented.' The risk-return profile in credit is asymmetric, Potma notes, with investors making regular small gains, but liable to lose considerable value in the event a company whose bonds they own gets into financial distress.

This idiosyncratic risk has convinced the euro credit team 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, on a sector level and on an issuer level. The overall beta of its portfolios can range between -30% to +30% relative to the benchmark, although it tends to be between -15% and +15%. On a sector level, portfolios deviate by no more than 5% relative to the benchmark, while at the issuer level, the deviation from the benchmark is no more than 3%.

Potma clarifies: 'Operating with structurally higher betas, as some of our competitors do, can create 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

'We are focused on capturing movements in credit spreads.'

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> ‘We see ESG as a key factor to analyse when judging a company’s credit quality.’

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 a top-down view on credit markets, which sets the level of risk that Potma’s team wants to manage its portfolios with, the team says it tends to generate the majority of its alpha by leveraging its bottom-up fundamental corporate and relative value analysis.

According to Potma, 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. ESG is fully integrated into the credit analysis conducted by the team.

‘We see ESG as a key factor to analyse when judging a company’s credit quality,’ says Potma. ‘Since we speak to companies about their strategy and financials, we are in an ideal position to assess ESG performance as well.’

If Potma’s 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. Our high information ratio is the result of alpha generation combined with a relatively limited tracking error.’

Market outlook

The so-called ‘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.’’

As a result of a renewed interest for fixed income investing that markets have seen over the past 1-2 years, substantial amounts of capital have been invested in the euro credit space. Nonetheless, there are still investors considering when to start to increase the duration of their portfolios. How does Potma view this?

‘Credit is still a relatively attractive asset class 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,’ Potma responds. ■

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SUMMARY

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.

Credit is still a relatively attractive asset class and should be considered a core building block of fixed income portfolios.

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