

In defence of discipline

Global credit markets have shown remarkable resilience over the past year. However, with structural macro concerns still hanging over the market, fund managers need to avoid the well-worn path of taking on excessive credit risk at just the wrong time.



Ben Bennett is the Head of Credit Strategy, focusing on allocation within the fixed income funds and providing the credit input to macro strategies.

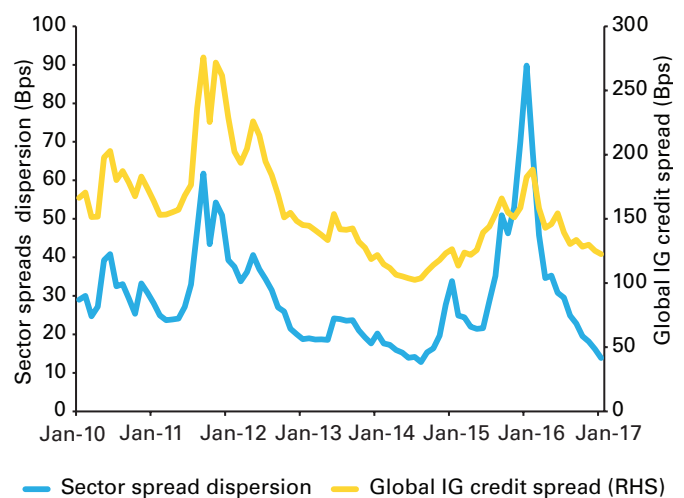


Tony Fan is the Head of Quantitative Strategies, focusing on multi-strategy and absolute return mandates.

Looking back over recent market history, there has been a strong positive correlation between credit spread dispersion and the absolute level of credit spreads (Figure 1). In other words, the amount of variation between the performance of different companies and industries in credit markets has moved closely in line with the extra yield that credit has offered compared to underlying government bonds.

When credit spreads are wide, the level of dispersion in markets also tends to be high. As a result, fund managers primarily tend to focus during those times on generating portfolio outperformance via a combination of good stock and sector selection. However, when credit spreads tighten and volatility drops, history shows that dispersion in credit markets also tends to fall, meaning that the potential pay-off from good stock and sector selections is reduced.

Figure 1: Global IG credit sector spread dispersion vs. credit spreads



Source: LGIM, Barclays

Notably, global investment grade credit sector spread dispersion has declined to the lowest levels seen in seven years (Figure 2), suggesting very little opportunity for profitable sector selection.

A combination of low spreads, low volatility and low market dispersion often encourages fund managers to add risk to portfolios in a bid to hit their alpha targets. For example, this can lead to investment grade credit managers looking up the risk spectrum towards high yield. The resulting portfolios are riskier at a time of tight credit spreads, while portfolio managers become involved in asset classes with which they are less familiar.

For as long as credit markets remain resilient, this drift can sit largely under the radar, and indeed can lead to even tighter credit spreads as the hunt for yield intensifies. However, once markets start to turn, the potential for aggressive moves is greater, as these so-called ‘yield tourists’ all run to the exits at once.

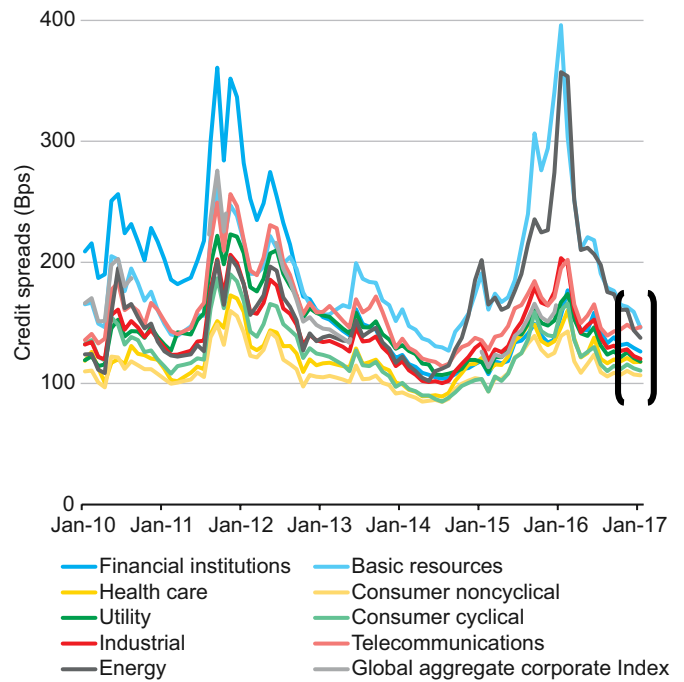
History suggests there is a well-worn path of fund managers taking on excessive risk at just the wrong time. In the past, when credit spreads have been at today’s levels, excess credit returns in the following 12 months have been modestly negative on average, with a material risk of a significant double-digit drawdown (Figure 3) as everyone tries to reduce risk at the same time.

THE BOTTOM LINE: IT’S IMPORTANT TO RETAIN INVESTMENT DISCIPLINE

While history suggests that many fund managers add risk as credit spreads narrow and sector diversification compresses, we strongly believe that it is paramount to retain investment discipline in today’s environment, particularly with one eye on structural macro problems that have yet to be resolved. A blinkered approach to short-term alpha targets can ultimately lead to excessive portfolio risk at very tight spread levels, leading to significant underperformance when long-term structural problems reassert themselves. Instead, by retaining liquidity in portfolios now, fund managers can take advantage of cheap valuations in the future when everyone else is trying to reduce risk.

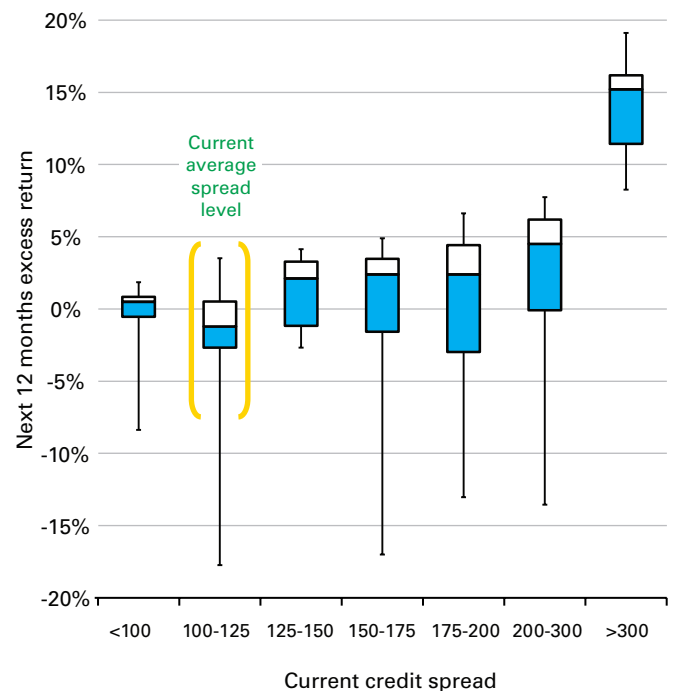
For more detail on the fixed income outlook, please read: Market Insights - [Taper Tantrum 2: The Fed and the Furious.](#)

Figure 2: Global IG credit sector spread performance



Source: LGIM, Barclays

Figure 3: Historical average prospective 12-month excess return vs. credit spreads



Source: LGIM, Barclays

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