

Credit investing: Using long / short techniques to maximise opportunities

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Credit has become a core asset class for many institutional investors but little is known about the framework by which credit portfolios are best managed.

In this paper, we put forward the case for sector neutral credit investing, a long/short technique learned from the hedge fund industry but with applications in the traditional investment arena to maximise opportunities and aid in building a robust risk managed investment process.

The credit market pre and post-credit crunch

The past two and a half years, since the credit crunch began in the summer of 2007, have been arguably the most turbulent period in the history of financial markets, rivalled only by the Great Depression of the 1930s. Corporate bonds were caught in the eye of the storm as firstly the financial sector, then the wider economy went into meltdown. Credit spreads rapidly spiralled to unprecedented levels as fears of corporate bankruptcies gripped investors, fears that were confirmed when numerous large institutions failed, the most notorious of which was investment bank Lehman Brothers in September 2008. Write-downs from defaulted loans and structured products forced other investment banks to rapidly shrink their balance sheets to bring their finances under control, thus removing a huge source of liquidity from corporate bond markets, which consequently ground to a halt.

Fund returns suffered severely as bond prices plummeted, with even those able to hedge exposure to the falling market through credit default swaps (CDS) struggling as the relationship between cash bonds and CDS broke down. The complete lack of liquidity meant trading out of positions, other than at

a massively discounted “fire sale” price, was nigh on impossible. In order to meet fund redemptions, accepting these prices was often a necessity.

Intervention from governments around the globe through extraordinary policy measures, monetary, fiscal and beyond, finally halted the slide in March 2009 and subsequently sparked a rally in risk assets almost as rapid as the decline that had preceded it. The credit market was a huge beneficiary of this rally as credit spreads tightened dramatically from their peaks and moved to erase some of the losses from the previous period. This led to very strong returns for corporate bond mutual funds in 2009, the highest numbers on record, particularly for those focused on lower rated and high yield debt. Despite this, performance over the full period since the summer of 2007 as a whole remains weak, partly due to credit spreads remaining higher than pre-credit crunch levels, but also due to the decision making of portfolio managers who chose to reduce exposure once liquidity returned to the market.

Introducing the sector neutral approach

Movements in credit spreads before the credit crunch hit tended to be far less dramatic and volatility was considerably

lower than in the period since. Recent events have likely established a new normal for market movements – not to the extremes of 2008 and 2009, but volatility higher than the previous norm nonetheless. This all highlights the need for investment managers to ensure they have a focused and disciplined approach, with a rigorous process that combines efficient risk management with an ability to capture the opportunities to add alpha to portfolios.

The traditional, less structured approach to managing credit portfolios versus a benchmark often involves the merging of stock specific and sector positioning into one, resulting in a less than desired risk exposure. For example, if a credit analyst has a positive outlook on a particular company within their sector, establishing an overweight position to that company's bonds would give the desired exposure to the credit, but would also move the weighting to that particular company's sector to an overweight. Consequently, even if that company's credit was the best performing within the sector, much of the alpha related to the trade would come from the performance of the sector as a whole. The top-down and bottom-up decisions are indiscriminate from each other, leading to a lack of understanding as to where the true risk of the portfolio lies and thus a misinterpretation of the key drivers of returns. This, in turn, makes accountability difficult to establish – if the alpha added to a portfolio from an analyst recommendation cannot easily be measured, the performance of that particular analyst is difficult to ascertain.

The, so-called, sector neutral approach, however, has its roots in the hedge fund industry, where managers implement a total return approach that aims to produce positive returns regardless of the direction of markets as a whole. By establishing an equal number of long and short positions¹, a portfolio can be immune to fluctuations in the wider market and performance is driven solely by

the movement of the long and short positions relative to each other. Each long position must be funded by an equally sized short position to maintain portfolio neutrality.

The practicalities

Using this idea but applying it to each sector within the credit universe, the sector neutral approach results in every sector being considered to be a portfolio in itself. Each overweight position within the sector must be funded by an offsetting short position, leaving the overall sector weighting unchanged from the weighting in the benchmark. That's not to say that sector exposure cannot be varied from that of the benchmark, but the decision is made separately from a top down perspective and is not influenced by any stock specific trades within the sector. The key difference therefore between this and the traditional approach mentioned previously is the separation of decisions.

Applying the sector neutral approach in practice requires analysts to focus solely on their sector of expertise to generate trade ideas through the identification of relative value opportunities. This may be that they view one issuer as having greater potential for spread tightening (or less potential for spread widening) than another issuer, or it may be that they consider the prospects of two bonds from the same issuer but differentiated by features such as maturity, level of subordination or currency of denomination to vary materially.

Once a relative value opportunity has been identified, there are two ways that long and short positions can be established. The portfolio manager can reduce the holding in the unfavoured bond below the benchmark weight, down to a minimum holding of zero². The weighting to the preferred bond is then increased above the benchmark weight to an equal but opposite degree. Alternatively, if portfolio restrictions and

1. Quantifying what constitutes an equal number of long and short positions is open to interpretation by the individual portfolio manager. This may involve purely numerically balancing long and short positions, or may involve equalling the sums of particular risk measures such as beta, value at risk (VaR) or weighted spread duration.
2. In the less regulated hedge fund industry it is possible to "short-sell" bonds to create outright negative positions. In the long only space, legal constraints prevent this practice meaning the most a manager can do to underweight a particular bond in the benchmark is to not own it.

capabilities allow, the portfolio manager can establish positions using CDS contracts. By selling protection on the favoured bond and buying protection on the less favoured bond, the portfolio will benefit should the favoured bond outperform as expected.

Sizing of positions is extremely important to establishing sector neutrality, as different bonds will have different levels of price volatility. A long dated bond will have a higher level of credit spread duration than one with a shorter maturity, meaning the longer dated bond will experience a larger price move for a similar change in credit spread. When building offsetting long and short positions therefore, the size of each side of the trade must be determined by matching not the percentage holding but the contribution to the credit spread duration of the portfolio. Further to this, credits with higher spreads are likely to experience larger changes in absolute spread than those with lower spreads i.e. their beta to the market is higher. Consequently, the absolute spread levels must be combined with the weighted credit spread duration in order to determine the size of offsetting positions necessary to maintain sector neutrality.

Implementation

There are a number of factors necessary to allow the implementation of the sector neutral approach to be successful, or at least to extract the maximum possible value from it. Information is key because of the requirement for an analyst to not only decide which bond or issuer they consider to have good prospects, but also which bond or issuer they consider to have relatively worse prospects. For the best results, a large analyst team is required to allow a focus level down to individual sectors, where each analyst can gain the best possible insight into every issuer and bond within their sector. The better the access the analyst has to information about the companies within their sector, the higher the chances of them

picking winning relative value trades, so contact with numerous research sources as well as company management is vital.

The successful implementation of a sector neutral approach brings with it a number of benefits. The core of the portfolio is designed to deliver the beta of the market, with an overlay of risk positions designed to add alpha. Focussing on relative value means alpha can be added to a portfolio regardless of the overall market direction.

Sector neutral is a pure team-based approach, where responsibilities are divided up between analysts and portfolio managers and each member is held accountable for their actions. The traditional approach, where analysts feed ideas into a lead portfolio manager who makes the ultimate decision is susceptible to the "star" portfolio manager syndrome, when the entire process is centred on the skill of that one manager. Were that manager to leave the company, the process breaks down as the rationale behind the structure of portfolios leaves with the manager. Through trade ownership and an ability to measure their contributions, analysts are empowered to make a significant contribution to the performance of portfolios, allowing management to judge them more effectively and reward them based on the success of their trades, thus fostering an entrepreneurial spirit and motivating analysts to generate only high conviction ideas.

The separation of top-down and bottom-up positions makes risk management a simpler and more effective process because unintended risk positions should not appear in portfolios, and all intentional risk positions are easily quantifiable. This aids transparency when it comes to reporting the drivers of performance, which are more distinct. The approach also allows trades to be implemented consistently across different portfolios whilst still maintaining control in a central point.

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The challenges

Of course, there are some downsides to the approach, many of which stem from the requirements alluded to previously. A sufficiently large analyst team is required in order that each sector can be covered with the necessary focus. In instances of the largest sectors, such as financials, this may require more than one analyst per sector. In the long only space, the use of derivatives is often restricted by client constraints, meaning the only way to short unfavoured bonds is to not own them. If the bond represents a very small portion of the index, the relative short position is also very small and may not introduce enough risk into the portfolio to make the trade worthwhile. Certain assumptions are made when it comes to the sizing of trades, making accurate sector neutrality somewhat difficult to truly establish. Finally, there is a risk that a portfolio can become over-engineered, making the marginal gain of further decisions too small to warrant the marginal effort of making them.

Conclusion

During the market falls of 2008, the challenge for investment managers was to manage the beta of the falling market and avoid the major blow ups. Much of 2009 involved obtaining beta exposure as the market recovered aggressively. These beta trades now appear to be over, and the focus of credit investors needs to switch to the identification of high conviction alpha opportunities in order to deliver credible performance through what is likely to continue to be a challenging time for financial markets. The sector neutral approach sets up a framework for capturing alpha whilst building a coherent and rigorous investment process that will insulate portfolios against future turbulence.

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KEY POINTS:

- Credit markets have experienced unprecedented turbulence since the credit crunch began.
- Fund returns have been weak and events have highlighted the need for a robust investment process.
- The traditional approach does not extract maximum value from analyst research and may introduce unwanted risk exposures.
- The sector neutral approach introduces a strict discipline that empowers analysts to generate high conviction trade ideas.
- Advantages in alpha capture and ease of risk management make the approach particularly prevalent to the current environment.