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# Flexibility and Fundamentals

When the yield on risk-free assets is close to or even below zero, investors tend to resort to old habits to maintain income. The first is to take more liquidity risk, earning a premium to own securities that seldom trade. The second is to deploy substantial leverage to boost their expected risk and return. And the third is simply to take more credit risk—chasing yield in the junkier parts of the market and hoping for the best.

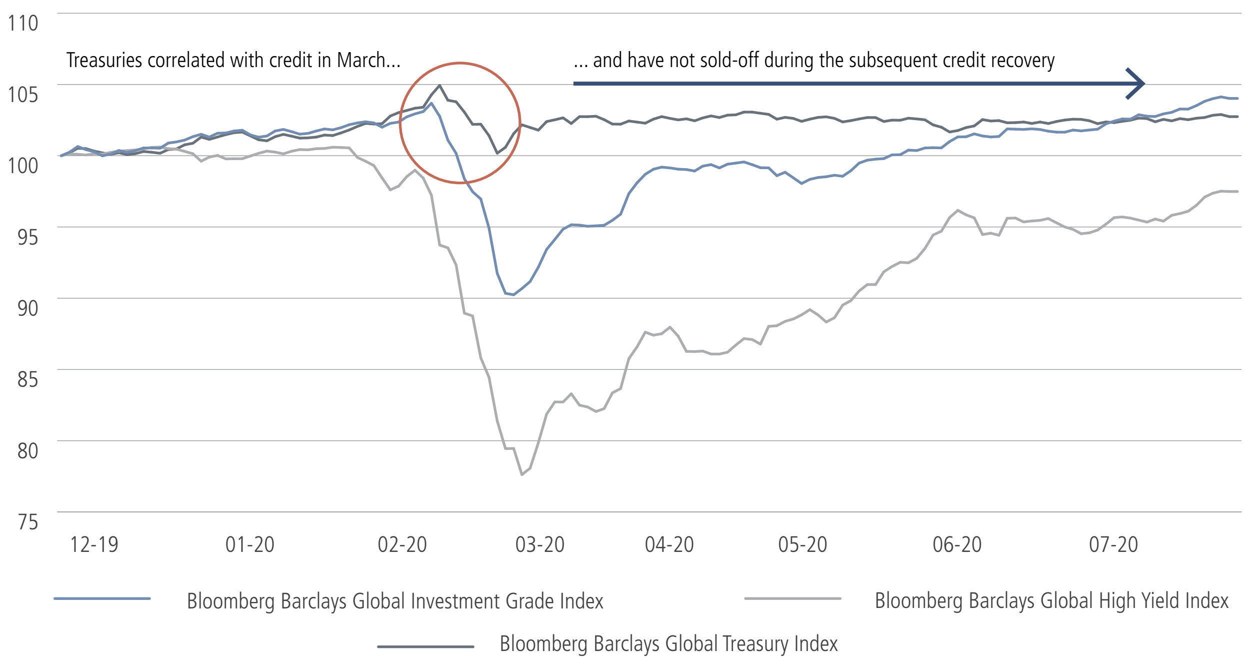
For a number of reasons, these three approaches are especially problematic in the current environment. Instead, we advocate a fourth approach to maintaining durable income: flexibility to go anywhere in the global credit markets, informed by a relative value assessment of the best risk-adjusted return potential, underpinned by high-conviction, fundamental credit selection.

Over the past 10 years, it has become increasingly difficult to rely solely or substantially on core government bonds for durable income. The onset of the COVID-19 crisis has only compounded the problem. Furthermore, even the argument for holding government bonds for diversification is now much harder to sustain: price upside has become limited as yields have approached zero, which has diminished the potential for risk-free assets to generate returns that are negatively correlated with credit returns during periods of risk aversion.

During March this year, a liquidity crunch in Treasury markets led to a yield spike that correlated with the downside in risky assets. Since then, however, risk-free yields have dropped back close to record lows and stayed there, despite a strong recovery in credit markets (figure 1). That means no cushion has been built back in to enable them to act as a diversifier during the next bout of risk aversion.

As a result, while Treasuries still have a role to play for most investors, many have been turning more decisively to credit for their return-seeking and income-generating bond portfolios.

**FIGURE 1. RISK-FREE ASSETS HAVE BEEN HIGHLY CORRELATED WITH CREDIT ASSETS THIS YEAR**




Source: FactSet. Indices rebased at 100 on December 31, 2019.

## The Usual Solutions: Giving Up Liquidity, Adding Leverage or Chasing Yield

But even in credit markets, for some years now tightening spreads have led to a stretch for illiquid assets, leveraged exposure and more and more credit risk.

Of the three, we at Neuberger Berman generally have most sympathy with adding illiquidity risk. We do not think that investors should hold illiquid securities in a simple race for yield, but we do think there are attractive opportunities in private debt and the less liquid parts of loan and structured credit markets. This can only be part of the answer to low market yields, however—and it is not an answer at all for investors that are allowed to invest only in liquid credit markets.

Adding leverage via credit derivatives, particularly in investment grade, has been another way to counter low yields and tight spreads. We think leverage is a useful tool for making marginal adjustments to risk exposures, with a view to maintaining balanced portfolios. We are skeptical about leaning heavily on it to boost returns or income, however, particularly now that yields have come so low. It is not uncommon to see diversified credit portfolios applying leverage of 400 – 600% in the current environment. That implies a lot of risk—and we would also argue that it is quite an inefficient way to get credit exposure. Leveraging credit default swap indices can work well when the market is not differentiating much between one credit and another, but now that the COVID-19 crisis has turned the cycle over, investors have become more discerning.

What about taking more credit risk? Can investors maintain income by holding lower-rated high yield bonds?

Back in March, at the height of the COVID-19 panic, high yield markets were pricing in a cumulative projected default rate in excess of 30%. Since then, the willingness of capital markets to provide businesses with liquidity to get them through the crisis, and unprecedented monetary and fiscal policy support, have warranted the lowering of our cumulative default outlooks for 2020 – 21.

Nonetheless, it's clear we are no longer in the pre-crisis environment in which central banks supported a slow-but-steady economic expansion where the high yield default never seemed to climb above 2%. Not everyone is going to get to the other side of COVID-19 unscathed, companies are taking on more debt, and while central banks have stepped in, they are primarily focused on higher-quality credits.

## An Alternative: Flexibility, Relative Value and Dynamic Allocations

We think that a reasonable alternative approach might have the following three objectives:

1. Maintaining a target yield commensurate with a current, conservative high yield allocation
2. Maintaining portfolio volatility commensurate with an investment grade allocation
3. Investing within cheap sectors of the market when the opportunity arises, while managing the potential downside risk of individual market sectors

To achieve these three objectives, we believe it is important to have the flexibility to "go anywhere" in credit markets. Given market events and the general turn of the credit cycle, the best risk-adjusted yields can be available in any sector, and the best portfolio-level, risk-adjusted yield can be available in any blend of sectors.

To take the most obvious recent example, in April and May this year, a high single-digit income and total return profile was possible even in an investment grade-only portfolio. At that time, AA rated issuers were coming to market to shore up their balance sheets with long-dated borrowing: 30-year bonds with 15 years' credit duration that would normally trade with a 100-basis-point spread were selling at 200 basis points over Treasuries—from that starting point, a gradual return to normal spreads would generate a double-digit return even before coupons were factored in.

For us, that means a flexible credit portfolio for durable income would have wide ranges of potential allocations to the five main credit sectors: between 10% and 80% in global investment grade credit; between 10% and 80% in global high yield bonds or loans; up to 30% in emerging markets, mainly investment grade hard-currency sovereign and corporate bonds; up to 30% in securitized credit, such as asset-backed securities (ABS), credit risk transfers (CRTs) and collateralized loan obligations (CLOs). The flexibility can also extend to geography (with perhaps up to 50% in non-U.S. markets), as well as duration and curve positioning.

In our view, taking advantage of this flexibility requires two things:

The first is a genuinely "apples-to-apples" framework for comparing credit risk pricing across different sectors, regions and rating bands. As an asset manager with many years of multi-sector credit experience, Neuberger Berman has developed a tried-and-tested methodology for doing just that.

The second, particularly now that macroeconomic uncertainty is exceptionally high and credit market liquidity is fragmented following banking-system reforms, is a dynamic approach to allocation.

In April 2020, a flexible strategy such as the one described above would likely have been meaningfully tilted to investment grade credit, with perhaps 60% in this sector, 40% of which could have been concentrated in high-rated, long-duration bonds—delivering spread duration as long as eight years or more. The remainder might have been shared 30% in high yield bonds and 5% each in emerging markets and securitized credit.

By July 2020, following rapid spread-tightening, it would likely have rotated meaningfully into BB rated high yield bonds and started adding ABS, particularly those eligible for the Federal Reserve's new Term Asset Backed Securities Loan Facility (TALF).

When conditions call for a more aggressive asset allocation, we could see this flexible strategy investing 40% or more in B rated credit as part of its full 70 – 80% allocation to non-investment grade, and the full 25 – 30% in emerging markets. This would still allow it to hold 20 – 25% of its assets in investment grade, diversified across corporate bonds, emerging markets, hybrids, structured credit and loans.

## Managing the Risks: Diversification and Fundamental Credit Analysis

With this kind of flexibility, we think it is important to stay in control of portfolio exposures.

What do we mean by that? When we believe that the big opportunity or the safest place to be is investment grade, that doesn't mean that we think it's a good idea to be structurally and heavily biased to investment grade market risk. That stricture applies even more when we believe that the big opportunity is in riskier sectors such as high yield or emerging markets.

In other words, flexibility should not imply "big bets" on or against credit "beta" or some individual credit sector. This implies three things:

The first is the importance of maintaining diversification even when the portfolio expresses a high-conviction top-down view. One can have a very positive view on credit risk, with a 70 – 80% allocation to high yield, for example, but diversify within that by allocating to different rating bands, regions, countries, points on the curve, liquidity profiles and asset classes, from bonds to loans to structured products.

The second implication is that one should focus on markets where one has special insight and expertise. When you have an "edge," you are more likely to be able to identify, with some confidence, opportunities that marry quality and a relatively low probability of default or impairment with a relatively high yield or credit spread.

Different investors and asset managers will have their "edges" in different markets, and these are likely to lend different flavors to the flexible credit strategies they offer. At Neuberger Berman, we are fortunate to have an unusually broad and deep fixed income capability. This includes long experience structuring securitized products as well as investing in them; one of the world's largest emerging markets debt teams, including a dedicated China onshore bonds team; one of the industry's few dedicated non-financial corporate hybrids strategies; high yield bond and loan capabilities informed by deep experience in private equity, private debt and residential mortgage markets from elsewhere in the firm; and a genuinely global credit research presence.

The third implication is the importance of privileging conviction on individual securities' credit fundamentals over conviction on credit risk itself. In our view, managing a flexible credit strategy does not involve diversifying idiosyncratic credit risk away, but embracing it as a way to identify attractively valued quality in all credit sectors at all times. We think a portfolio should be well diversified in terms of its exposures to credit sectors, rating bands, regions and curve positioning, but not over-diversified in terms of issuers or securities. Over-diversification can imply a lack of fundamental knowledge and conviction.

As such, we think there is real advantage in allowing sector specialists to select their "best-in-class" securities, based on risk-adjusted income potential, before applying our "apples-to-apples" relative value methodology to choose between them. In other words, we believe that effective asset allocation begins as a bottom-up analytical process. A strategy that makes a relative value assessment from the top down and then attempts to fill the implied asset allocation buckets runs the risk of selecting securities only for the sake of filling the buckets—which then necessitates diversifying away unwanted idiosyncratic credit risk.

We think this has the potential to make the biggest difference in down markets, when a credit-only portfolio has nowhere to hide. Having confidence in the fundamental quality and value of a credit not only tends to lower its potential downside, it also makes it easier to hold onto a position through periods of volatility and uncertainty.

Moreover, confidence in a particular issuer can underpin an investor's decision to add incremental exposure as the market goes down, by adding to an existing position, or perhaps by extending credit duration by allocating to the issuer's longer-dated securities or hybrid securities. Combined, these kinds of tactical decisions, based on fundamental credit analysis, can help to limit exposure to the market downside while maintaining exposure to the recovery.

## Conclusion: A New Approach to Durable Income Investing

In summary, we believe the transition from low rates, tight spreads and low volatility to an environment of even lower rates but much higher credit market volatility calls for a new approach to durable income investing. This new approach focuses on credit, and prioritizes both flexibility and bottom-up fundamentals.

The focus on credit is necessary to generate the total returns that income investors are used to and require. The flexibility to "go anywhere" in credit markets enables investors to seek out the most attractive risk-adjusted income and yield, through the cycle and during the periods of market stress and dislocation that can be unusually rich in opportunity. And the emphasis on fundamental analysis can help to prevent flexibility from turning into uncontrolled "bets" on the outlook for credit, strike a balance between quality and yield in the portfolio, and provide the basis upon which "apples-to-apples" relative value assessments can be made.

With these guidelines, we believe it is possible to generate through-cycle returns comparable to those of high yield or emerging markets debt, but with investment grade levels of volatility.



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