

The PODfolio Podcast Episode 18: Asset Class Mini-Series: Bonds

EUNICE HAN: You're really good at picking companies, that's a different skill set than understanding which emerging market countries should be invested with.

SPEAKER: Welcome to the PODfolio Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolio.

LOK MA: Hello, and welcome to episode 18 of the PODfolio podcast with me your host, Lok Ma. Now, before we start today's episode, just a quick little story for you if I may, so a few weeks ago we recorded episode 13 on inclusion and diversity in the investment industry with two guests, Nimisha Srivastava and Chris Redmond. Well, our listeners to our episode that day included somebody working at an asset manager who then put Nimisha in touch with the directors of the DIME program, that's D-I-M-E Diversity Investment Management Engagement, and their work is to give high performing students from minority backgrounds the tools and knowledge they need to pursue a career in the investment management industry.

Well, the upshot of all that is that Nimisha has just been invited to join the board of directors at DIME. So an unbelievable outcome, can hardly believe it. Goes without saying that our podcast team are very pleased to have played a tiny role in that development. And of course, big congratulations and best wishes to Nimisha in her new role alongside a day job by the way, she has just not left us for anything. So anyway, today is part two of our asset class mini series. Last time we covered equities, so this time we're going to talk about bonds. Two esteemed guests today, Kate Hollis, head of manager research for traditional credit. So welcome to the show, Kate.

KATE HOLLIS: Thanks a lot. Looking forward to it.

LOK MA: And also Eunice Han, our head of manager research for liquid alternative credit. And welcome to you too, Eunice.

EUNICE HAN: Hello. Hello to all our listeners as well.

LOK MA: So we know that as a whole, the bond markets fell very sharply in the first weeks of that COVID outbreak around March last year before recovering, I think, almost as quickly. Now, bond prices are still looking expensive today by historical standards at least. So first of all, what's the outlook from here? Are there any particular areas for example, where we're still finding good value in bonds?

KATE HOLLIS: You're late clock, particularly in investment grade credit it is looking expensive, but then all risk assets, liquid risk assets pretty much are looking expensive. We are having a big discussion internally about it at the moment about where it goes from here. Will spreads widen particularly at real interest rates continue to rise? Or will the market stabilize and spreads just continue to grind a bit tighter? Obviously the outlook for the global growth is key to that. And we are waiting for the Fed later this afternoon to tell us whether they're going to upgrade their growth rate to the seats or not. But we think there are still pockets of value, emerging market debt is something that springs to mind, but on the whole, we think in the liquid and in the investment grade sectors, it's looking reasonably expensive overall.

EUNICE HAN: Yeah, I'll just add. This been most extensive credit market for mainstream credit markets is also why you have to just look beyond those market in the first place across the credit spectrum. And we'll talk about this a little bit later as well. But use all the tools that you have at your disposal across credit rather than just fixating on one or two areas to get that return.

And as Kate mentioned, certain areas of emerging market debt look attractive. But there's also other areas such as private debt as well as secure tax credit that also look attractive as well. So this just goes back to getting rid of that narrow lens embodied in the lens across credit, all of that.

LOK MA: And when you talk about looking beyond maybe the mainstream markets and using all of the tools available, it's just reminds me that there are so many different types of bonds and lending in terms of who's lending to whom, how long you're lending it for, the level of riskiness in the loan, the contractual structure, the protection you get if the borrower doesn't pay you back and all that kind of stuff. We obviously can't go into all of that in our podcast. But I just want to focus on the broader categories of credit.

So I think we're talking about alternative credit versus I guess mainstream credit. So can you just tell us about what is the alternative credit an alternative to? And why might it be better than the more mainstream stuff as well?

EUNICE HAN: Yeah. That's sure. There's just so much different vernacular out there to define things like alternative credit, which really makes credit such a different asset class in something like equity if you think about it. And so how we define alternative credit is areas of credit that is meant to generate return. And broadly speaking this would include things like blow investment grade corporate credit i.e. high yield and syndicated bank loans. It would include securitized credit, emerging market debt, and the ever so growing world of private credit as well.

So these areas are meant to be an alternative to core fixed income markets as the yield is much higher. It's also meant to be an alternative or a complement to equities because these areas of credit generate return with lower risk. And this area of credit has actually grown exponentially post the financial crisis with banks no longer able to be that lender that they once were given increasing regulation. So this is why we think investors really owe it to themselves to explore this world of alternative credit and see what they can do by adding alternative credit to their portfolios.

LOK MA: And can I just possibly trouble you for a quick definitions guide on these things. I think I'm OK on emerging market debt, I think most people know what that is. Private credit as you say, direct lending out, kind of doing the stuff that the banks used to do. Securitized, could you just give us a quick definition of that, please?

EUNICE HAN: Sure. So what we mean by securitized credit is really debt that is secured, hence the word securitized credit by assets, and then that debt is basically sliced off into different risk and return tranches. A lot of what securing this debt tends to be consumer related loan. So think a house mortgage that we have, an auto loan, a student loan et cetera. So the packaging of those loans.

LOK MA: Fine. Thank you very much. Those are useful.

So I mean, a lot of these things that you're describing, I would say fall into more complex areas maybe compared to the traditional vanilla stuff. I think the reason we're doing that is because you're looking for that extra yield because other people might avoid it and therefore you can pick things up for a better price. So for me, I know we're talking about things where technical term, securitized, and what not. But I

think that complexity goes hand-in-hand with that better price as well. And this part of the reason why you're getting better value.

Now, let's part that thought for a bit now. I'd like to come back to that when we talk about governance and how do you know what you're doing with these complex instruments. In the meantime though, one of the main themes that run right through our podcast series really and also this mini series on the different asset classes is of course, sustainability and ESG.

So let's just talk about what sustainability means for bonds obviously in terms of managing the ESG risks and also finding ESG opportunities. But first of all, Kate I just want to get this out of the way and maybe provoke you a tiny bit. Is ESG a bigger thing for equities than it is for bonds?

KATE HOLLIS: No. It isn't. It's a much bigger thing for bonds than it is for equities. And the reason for this, ESG is, I prefer to use sustainability, ESG is too specific but sustainability, the ability to keep receiving cash flows is hugely important, it's what bonds is all about. Whereas equities are all focused on the upside and nobody ever expects to get their equity repaid and there are lots of equities that pay minimal to no dividends.

In bonds, you buy them for coupons and you buy them to get your money back. And so therefore, the part of sustainability that is to do with risk control is absolutely critical to credit investing, and it always has been. And this is in spite of the fact that people take different attitudes to ESG.

A while climate in particular is hugely important at the moment in Europe partly driven by regulation, in America social justice is as or if not more important at the moment. But when you're looking, for example, at investment grade credit, there are very, very, very few investment grade companies that go in one move to default. When they do, it's very often associated with fraud. And companies with poor governance are much more prone to fraud. So investment grade credit analysts have always looked at governance.

Now with investors particularly in the UK, but also in other parts of the world looking much more at long term cash flow driven investments, they are looking much more at the sustainability of those investments. And so one of the things, for example, in technology companies, the whole technology sector is really recent. Microsoft was only founded in 1975, less than 50 years ago. So lending money to technology companies for more than 100 years on the assumption they will still be around in 100 years time is perhaps something that you don't want to do if you are looking at a long term cash flow driven mandate. So you need to wrap that all into your worldview. And managers have got, although they've always done it, they've got much better at it. They've got much better at it and in particular, they are using data that was never available to them before.

And they are engaging with management in a way that they never did before not just to make sure that the management is doing all the right things for social reasons, but also just to make sure that managers for example, equity buybacks, great, if you're an equity investor, if you're a credit investor and it's increasing the leverage of the company, it's probably not something you want your company to do. So managers are engaging with companies all the time on these types of issues.

There are ESG opportunities out there because of this. You can buy a company or debt from a company that's perhaps not great ESG today because you know that they are or you expect them to get better at it. And it is well established that companies with better ESG tend to have lower costs of funding. And that's even after you compare credit ratings and you compare for maturities. And it's something that we're seeing increasingly managers do.

One of the other things that people are looking at is impact. Now, in an investment grade, that's really difficult. And the reason it's difficult is because when people buy investment grade mandates, they tend to want a very wide spread of sectors. They want a lot of diversification.

And green bonds, which is most of the investment grade impact stuff that's out there at the moment, at least in liquid markets, very concentrated in governments, agencies, financials, utilities and transport. And so if you buy a green bond mandate or even the green and social bond mandate, you're likely to materially reduce your diversification by sector. And we love diversification for all the reasons that you've heard over the years. So it is a bit of a struggle to find good impact mandates in investment grade liquid that don't compromise some of the investment reasons why you hold the mandate in the first place. In alternatives, it's much, much easier.

EUNICE HAN: And in alternatives, we've been able to find positive impact investments without compromising on returns. For example, one theme that we like with good tailwinds is playing that energy transformation theme. Now, we've been able to find opportunities in both the public and the private market to play this theme.

So such as solar panel securitized credit, so bank get backed by if someone wants to install a solar panel in their home as well as in private debt lending to projects financing the construction of some of these renewable energy projects. So solar panels, wind farm, bio, diesel, fuel et cetera. So we think it's possible to actually find these investments in the alternative space that will make positive impact. It definitely seen out there.

LOK MA: So let's move on to talk about putting some of this theory I guess into practice. So credit as I said, lots of different flavors. We've just heard about traditional versus alternative, public, private, liquid, illiquid, securitized, not securitized. Just to name a few examples. So potentially lots of different flavors, that long list of technical investment terms.

I think there's always some tension in investing between only doing what you understand well versus looking for better value outside of the obvious places. And I think that's especially true for credit actually. So let's say I'm an institutional investor, so in a broad sense not a specialist in this area, what are the key details that I need to personally understand about investing in credit? And what do you think are the more peripheral details that I can actually let my manager or my advisor get on with?

KATE HOLLIS: The first thing you've got to decide is why you're doing this. It's easy in alternative credit. As Eunice said, it's all about return seeking, so you know why you've got the alternative credit mandate. In traditional, you could be doing it for a return seeking or you could be doing it for liability matching. And as you know it's something that WTW believes in very strongly that a mandate should do one thing well and not three things not very well. And so therefore we feel really strongly that if you've got a liability matching mandate, you don't want to model it with at the same time trying to do an excessive amount of return seeking. You should just manage, design your mandate to match your liabilities and picking up as much return as you can without compromising that important objective.

The other thing you've got to decide is how much diversification you want. Not just by corporate sectors, but as Eunice said, in a securitized involves a lot of consumer lending, private debt involves lending to all sorts of types of borrowers that are not consumer and not corporate either. Emerging market debt is as diversified as well because you're lending to countries and not only countries but countries in a completely different part of the world from where a lot of the other types of credit are based.

So the other thing you need to think about is whether you are only going to invest with what you understand, which as a broad principle is of one we very much recommend or whether you are going to delegate to a manager, you understand the broad frames of the asset class like securitized which is hugely complex when you get down to the technical details. But you're going to delegate that to a manager. But the things you should always delegate to a manager, security selection, credit research, day to day implementation and trading.

I mean, they're not things that investors generally have any expertise in. And there's not things that we at WTW claim we've got any particular expertise in what we are good at is picking managers and understanding the areas in which they work and then advising our clients what we think makes sense.

LOK MA: And Eunice over to you as well. To you, what does good investing look like for bonds? In other words, how do you go about trying to do better than the broad traditional mainstream market in terms of finding better yields than the mainstream, avoiding the defaults, and also as Kate said, diversifying across all of these different specialist areas.

EUNICE HAN: Because credit is such an asymmetric asset class, you need to be conscious of the downside risk which we've already talked about. So because the world of credit is not homogeneous, it includes different sectors, different borrower types, different regions, all of which we've highlighted today, to minimize the downside risk, quote unquote "good investing" means you need to look across the credit spectrum and utilize all the tools to decide where you want to invest and use that diversification that is offered in this asset class to your benefit.

The other thing you should be conscious about is that you want to invest with people who are good at each of these subsectors. And the skill required to be successful in one of these subsectors is quite a different skill set than it is to be successful on another. That makes us intuitively, if you're really good at picking companies, that's a different skill set than understanding which emerging market countries should be investing with.

And so this is why we talk to clients about investing in credit but using specialist to invest in the different areas of credit. And then the last thing I'll add is, I don't think this is a set it and forget it type of asset class. There is an aspect of wanting to understand where the opportunities are and being able to tilt your portfolio to one area of credit versus another not market timing by any means. None of us have a crystal ball, but just over certain quarters or on the medium term, understanding where some of those opportunities could be or where they could arise.

LOK MA: Well, I very much appreciate you both for taking this time to give us that overview of the bond market. So to summarize, I think there's value in looking beyond the obvious places but also needing to take care to diversify across these different alternative areas and using specialist managers who know what they're doing in those areas. Also, thinking properly about sustainability and ESG as well. So thank you very much for coming onto this show Kate.

KATE HOLLIS: Thank you very much, Lok and thank you to everybody for listening.

LOK MA: And thank you to you too, Eunice.

EUNICE HAN: Thank you for having me. And it's been a pleasure. Thanks to all our listeners.

LOK MA: Yes. And we hope our listeners also got something else of our discussion as well. So please do tune back into the next episode of our asset class mini series. And in the meantime do take care.

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