FIXED INCOME

Fixed Income: Upending the Conventional Approach

BARINGS CONVERSATIONS

This piece was adapted from an interview with Michael Freno. The full audio podcast can be found ***here***.*

The search for yield trudges on amid trade and tariff clashes, and a credit cycle that continues to surprise in its longevity. In this Q&A, Michael Freno, Head of Global Markets, shares his views on where value can still be found and how investors can benefit from looking beyond traditional indexes in high yield, investment grade credit and emerging markets debt.

*Full podcast URL: https://www.barings.com/us/institutional/viewpoints/fixed-income-looking-beyond-the-index-for-late-cycle-value

In such an uncertain environment, how should investors be thinking about their fixed income allocation?

Whether you're looking at high yield, investment grade credit or emerging markets debt, we think there are benefits to staying invested through market cycles. In any asset class, it is very difficult to make top-down calls and effectively time the market. As an example, one year ago, some commentators were predicting that the 10-year U.S. Treasury was going to end 2018 at 4%, but here we are hovering close to 2%. For this reason, we avoid making sweeping rate and credit calls when we make investment decisions. Rather, our approach is to focus on analyzing what we feel we can confidently get our arms around, and that is pricing fundamental credit risk.

At the moment, we're slightly increasing our exposure to U.S. loans, primarily due to the run we've seen in bonds over the last several months. Because spreads between loans and bonds are currently comparable, we think it makes sense to look at the senior part of the capital structure from a risk premium standpoint.

We also see several benefits to taking an opportunistic or multi-credit approach to these asset classes. Unlike more traditional fixed income strategies, most multi-credit strategies are benchmark agnostic, giving a portfolio manager the flexibility to pursue the most attractive relative value opportunities across asset classes, sectors and geographies. The result is a more diversified approach to credit that can potentially deliver more attractive risk-adjusted returns relative to a single-sector strategy.

How have you implemented some of this thinking across the fixed income landscape, starting with high yield?

Back in 2011–2012, we spent a lot of time talking to investors around the world about how they were approaching high yield. One of the things we noticed was that many of them were thinking about high yield assets—whether loans or bonds in the U.S. or Europe—in a very siloed fashion, rather than looking at them in the aggregate. And we felt that investors were interested in moving toward a more global, holistic approach.

In response, we constructed portfolios that blend the various high yield sub asset classes together in what we think of as a global, high yield multi-credit strategy. At Barings, this means allocations to the "core four" high yield sub asset classes—U.S. high yield bonds, U.S. loans, European high yield bonds and European loans—with the ability to make opportunistic allocations to collateralized loan obligations (CLOs), stressed and distressed credits (special situations) and emerging markets corporate debt.

High yield asset classes do tend to track one another, and move in the same direction over long periods of time, but there are regional differences and technical differences in each market that can cause prices to become decoupled from fundamentals. We think the managers who are living and breathing this every day are well-positioned to recognize and capture those technical inefficiencies—which underscores the value of active management.

We don't see high yield as an asset class to trade in and out of, but rather we think the asset class lends itself to more of a strategic approach. It is extremely difficult—if not impossible—to consistently time exit and entry points well, and of course when you're out of the market, you're forgoing the income you would earn from clipping coupons. We think it may be more beneficial to take a strategic approach, but one that is flexible enough to allow a manager to allocate tactically based on where the best relative value is at any given period of time.

When you look across high yield today, are there any areas in particular where you're seeing attractive relative value?

High yield markets are very broad, and we believe value can be found in all of them. At the moment, we're slightly increasing our exposure to U.S. loans, primarily due to the run we've seen in bonds over the last several months. Because spreads between loans and bonds are currently comparable, we think it makes sense to look at the senior part of the capital structure from a risk premium standpoint.

Leading up to the first quarter of 2019, when the narrative was around rate hikes, loans saw a lot of inflows. But now that it has reversed, and the probability of a rate increase appears to be almost zero, we continue to look at it on a risk premium basis, and the better value appears to be in loans. As long as investors continue to make rate calls, it creates inefficiencies on the credit side, and we look to exploit that. We're also slightly reducing our exposure to Europe and increasing it to the U.S. We think the U.S. economic system is marginally better off than Europe's currently, and the spreads don't reflect that.

Let's shift gears and talk about investment grade credit—which is sometimes considered more of a safe haven or sleep-at-night asset class. Do you see value in a multi-credit approach?

When it comes to investment grade credit, we do see potential benefits to a more opportunistic strategy. The risk profile of an investment grade portfolio is different than high yield—whereas volatility and risk of loss tend to be lower, sensitivity to interest rates can be much higher.

If managed appropriately, multi-credit or opportunistic strategies can give managers the flexibility to help investors navigate some of this interest rate-induced volatility—in both rising and declining markets. A rules-based approach to duration management based on the slope of the short end of the yield curve is something Barings has done successfully for more than 25 years. With this type of strategy, a manager can seek to mitigate interest rate risk by, for example, adjusting the portfolio's target duration and/or favoring less rate sensitive sectors of the market. While there may be short periods when performance is more challenged, we believe, based on our experience, that significant value can be added over the long-term. With this type of approach to duration management, and in our case, this allows us to do what we're built to do, which is generate alpha by analyzing and pricing credit risk.

From a portfolio construction standpoint, we also think there are benefits to exploring opportunities outside of more traditional corporate and government bonds. With respect to the opportunity set, we currently prefer securitizations where investors can earn incremental yield relative to investment grade-rated corporates or government securities, while still owning an investment grade-rated asset with seniority in the capital structure—such as certain parts of the asset-backed securities universe and investment grade CLOs.

In addition to diversifying risk exposure and lowering the correlation of the asset classes in the portfolio, this type of strategy can help mitigate duration risk as it includes a mix of fixed and floating rate assets.

Shifting the focus slightly, can you share your view on emerging markets debt?

Emerging markets debt is over $5 trillion in size, and includes local currency, which makes up about $3 trillion; sovereign hard currency, which makes up less than $1 trillion; and corporate debt, which makes up about $2 trillion. While these markets move in tandem to varying degrees, they don't always move exactly together—and they have somewhat different risk profiles.

In our view, approaching these three markets together in a blended strategy can be an attractive way to gain exposure to emerging markets debt as an asset class. There tends to be more volatility on the local side, and more duration risk on the sovereign side—so, similar to other fixed income asset classes, a blended strategy can help diversify that risk.

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Additionally, in emerging markets, fundamentals are arguably driving performance even more than in developed markets—where central bank actions have distorted markets significantly—and other technical factors are playing a bigger role as well. As such, we think emerging markets debt is more appropriately priced from a fundamental level—and that's how our team approaches investing. We use models to assess the fundamentals within each country, and based on that, seek to identify the areas we think offer the best relative value at any given time.

Similar to the investment grade and high yield space, we're seeing some of the most attractive opportunities beyond traditional indexes. For example, when it comes to sovereign debt, we are finding opportunities in countries like Albania and Macedonia, even though you won't find those in the index today. We're also comfortable taking zero exposure in countries, even if they're part of the index. For instance, we made a tactical move out of Venezuela almost three years ago, when the country was far from default and information was scarce. In recent years, we kept our exposure at zero—a sizable view to take versus the index—given the high probability of default. At the end of the day, we don't attempt to make sweeping macro calls; rather, we make our investment decisions based on deep fundamental analysis.

Lastly, if you take a step back and evaluate the landscape as a whole, what final takeaways might you offer to investors?

This may be a contrarian call, but I think the economy is doing better than headlines would suggest, and interest rates could actually move higher over time. That said, looking ahead over the next several months, there are a handful of issues—interest rates, tensions with China and Iran, ongoing Brexit negotiations, sector-specific risks in the U.S., and more—that we can point to as potential volatility triggers. As you think about investing in fixed income in this environment, we think a multi-credit approach can be particularly beneficial, as it gives managers the flexibility to pivot to those regions or sub asset classes that offer the most attractive opportunities at any given point in time—while also avoiding unwanted risks.

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