Investments in Fixed Income Spreads, Spread Your Investments

Fixed income spread products can be an attractive addition to an investor's portfolio, providing additional yield and risk diversification. However, various credit asset classes respond differently in different scenarios. Understanding and actively managing risks of credit spread investing is essential to fully take advantage of its potential.

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Spread investing
Fixed income spread products have become an important asset class over time. The value of any fixed income investment is a function of the future expected cash flows, the timing and the probability of effective payment. Investing in credits comes with the risk that the contractual cash flows will not be paid or not be paid in time. To compensate for that risk, credits offer higher yields (credit spread) than 'safer' bonds with similar cash flow patterns (e.g. German government bonds). There are various factors that can have a substantial influence on the total return of credit investments, the most important ones being credit spread volatility, downgrades and defaults. Therefore, managing credits implies managing risks and finding opportunities.

Investment grade versus non-investment grade
Within credits, a distinction is made between investment grade credits and non-investment grade credits. Investment grade bonds are bonds that have a sufficiently high probability to timely deliver the promised cash flows. A high yield bond or a non-investment grade bond is issued by an issuer that is rated below investment grade (rated BB or lower by Standard and Poor's). Those bonds typically offer higher spreads than investment grade corporate or government bonds and the potential for capital appreciation in the event of a rating upgrade, an economic upswing or improved performance at the issuing company or sector. Returns on high yield bonds typically show a low correlation with government bonds and investment grade bonds and a larger correlation with equities and emerging market bonds. While the U.S. high yield bond market is by far the largest in size, euro high yield bonds have also gained in importance in recent years (market capitalization exceeding € 300 billion).

Emerging versus developed market debt
Another distinction often made is the origin of the debt issue: developed markets versus emerging markets, the latter being a bond issued by either emerging markets sovereigns or emerging markets corporates. Both these sub-asset classes can offer diversification potential with over 40 countries represented in the EM benchmarks. The asset class also has a substantial size with a combined market capitalization close to US$ 1,300 billion. The EM corporate bonds typically offer slightly higher spreads than the sovereign bonds of similar origin and structure. The sovereign bonds typically have longer maturity than corporate bonds. For both these sub-asset classes, it is noteworthy that about two-thirds of the investable universe is rated as investment grade; and yet it can offer attractive yields compared with developed markets bonds.

Next to the above mentioned categories, there are other credit asset classes with distinguishing features. Senior bank loans and asset backed securities usually have floating rate coupons, which can be attractive in a rising rate environment. Covered bonds and ABS are collateralized and therefore have a relatively safe risk profile.

Recent developments
Over the last years, total returns on certain types of credit investments have been attractive. This is mainly on the back of declining interest rates and

Return on the major credit asset classes 2004–2013 (based on index returns in US$)

Sources: Barclays, J.P. Morgan, Bloomberg

Asset class	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Global investment grade Corporate credits	9.48	-3.56	7.23	6.73	-8.65	19.18	5.83	4.32	11.21	0.35
Global high yield	13.17	3.59	13.69	3.16	-26.88	59.40	14.82	3.12	19.60	7.33
Asset backed securities	7.04	-0.68	7.00	8.23	4.12	7.97	4.20	5.06	5.11	0.36
Emerging markets debt Local currency, sovereign	22.97	6.27	15.22	18.11	-5.22	21.98	15.68	-1.75	16.76	-8.98
Emerging markets debt Hard currency, sovereign	11.62	10.25	9.86	6.16	-12.03	29.82	12.24	7.35	17.44	-5.25
Emerging markets debt Hard currency, corporate	9.89	6.84	6.65	3.45	-15.36	38.61	13.50	3.24	16.95	-1.73
Emerging markets debt Local currency, money market	14.79	3.21	12.30	16.04	-3.85	11.69	5.68	-5.19	7.45	-2.04

credit spread compression. However, the diversity in total returns over time and across different types of credit investments has also been significant. The table shows the returns on the major credit asset classes 2004 to 2013.

Ever since the great financial crisis and with central banks in developed markets pursuing an expansionary monetary policy in response hereto, high yield has been one of the best performing asset categories. Since 2009 the performance of global high yield actually outnumbered the performance in world equity markets. Note that this holds for both global and euro high yield as well as for U.S. high yield (till the end of 2012) versus their respective equity markets. Ever lower core government bond yields induced investors to search for yield that favored the asset class. While this search for yield initially uniformly favored different spread products, high yield appeared to be one of the few spread categories where investor flows continued to stand firm until today. High yield credit spreads and yields fell substantially from their crisis peaks and high yield corporate default rates simultaneously declined as refinancing and balance sheet restructuring took place.

With defaults low and not expected to increase soon, ING Investment Management International (ING IM) currently (April 2014) believes that spreads have the possibility to further tighten as investors continue to buy credit sensitive strategies in favor of interest rate sensitive strategies. Credit conditions remain favorable, and it is expected that fixed income investors will continue their focus on spread related products. Although spreads tightened solidly in 2013, they are still removed from the historic hights reached in prior cycles. Also, with disinflationary trends in developed markets still present, monetary policies are expected to remain supportive. As a consequence, the "search for yield"-theme may have further to run, favoring spread products.

Flexible and active multi-asset credit investing

It is clear that investing in credits can offer attractive returns over time. At the same time, it is clear that different type of credit investments can perform quite differently for (longer) periods of time. So despite the belief that there is a long-term investment case for the various credit investments, being invested at the right time and "knowing when to get out" can significantly contribute to the longer term total returns from diversified spread investments.

An active, multi-asset credit approach takes away the need for an investor to pick the right asset class at the right times. These multi-asset credit strategies are typically well diversified across markets and issuers and are often managed in a flexible, benchmark-unaware way aiming for an appropriated return over cash in multiple market circumstances. These multi-asset credit strategies often have the possibility to decrease the overall interest rate sensitivity (duration) of the portfolio in order to limit the impact of rising rates. Since trading in and out of certain credits can be very costly, derivatives can also be used to efficiently and effectively steer the portfolio to the areas where risks are expected to be most rewarded.

Summary

Adding fixed income credits to a portfolio can improve the overall risk/return profile of an investor's portfolio. In order to benefit from the potential of credit investing, a diversified, risk-controlled investment process is key. Only the understanding of both, credit market fundamentals and behavior of market participants, as well as the flexibility to dynamically tilt the investments in an efficient and effective way to the most rewarding areas allows actively managing risks, mitigating liquidity traps and achieving investment targets.

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