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FOREWORD™ 2022
Celebrating 10 years

Enhancing returns from opportunities in global credit

Unlocking the full performance potential of different credit assets within a challenging environment

September 2022

By the Global Fixed Income Team

The global credit market offers multiple layers for investors to add credit exposure. Investment grade, sub investment grade and hybrid bonds as well as CLOs and loans are different ways to invest into credit. In addition, investors have different regional and currency options to build up exposure. The challenge on one hand is to analyse the different instruments from a bottom-up point of view but also on the other hand to optimise for the best asset allocation between the different asset classes, regions and currencies. The main investment regions are Europe, North America as well as Asia, but we believe it is also important to look for opportunities outside these areas. In terms of currencies, the main focus for credit investors is on "hard-currencies" which offer the highest liquidity. The main markets are euro as well as US dollar (USD) credit.

A sound investment approach to multi-sector credit investing will begin with the necessary in-depth research for all above mentioned asset classes but also the optimal asset allocation. A benchmark agnostic approach may allow the manager to deliver a stable income of 4-6% on an annual basis with lower volatility compared to the overall credit market.

An important cornerstone of a multi-sector credit fund is limited interest rate risk, ideally having a duration within a range of 1.5–3.5years. Performance of the fund will come from research-driven credit selection rather than interest rate risk. Over the last couple of years, a significant amount of fixed income performance came out of the constant push for lower rates, driven by central bank policies. As 2022 has shown, this push has come to an end. Central banks globally are raising rates to fend off the inflation threat. Therefore, it is important to consider alternative sources for performance and put more emphasis on the income component. While more credit risk could imply higher default risk, we would like to point out that portfolio construction offers ways to mitigate this risk. To achieve the latter, a multi-sector credit strategy is focused on secured assets to minimise credit losses. Secured bonds benefit from much higher recovery rates in case of a negative credit event. Typically, the portfolio management team aims to invest more than 50% in secured bonds while also more than 50% of investments fall into the sub-investment grade bucket. Having flexibility to move across the capital structure and geography allows the manager the ability to maximise value and minimise risk.

Another important consideration for the portfolio construction process of a good multi-sector credit fund is the asset allocation process. An example of this is how we at Nikko AM manage our multi-sector credit strategy. The process has two layers. Firstly, the portfolio management team establishes a strategic asset allocation (second number in the matrix) which is optimised to bring us on a mid-term basing into the performance corridor of 4–6%. However, the team also pursues a more active tactical asset allocation (first number in the matrix) taking advantage of short-term opportunities in the global credit market and deviations from the strategic asset allocation.

Fund/Neutral Position	US	EUR	Asia
CLO's	12.3/15.0	9.6/10.0	
HY Secured	7.4/15.0	12.7/10.0	1.5
HY Unsecured	17/10.0	2.2/10.0	0/5.0
IG	15.5/5.0	1.5/5.0	4.7/5.0
Hybrid Bonds	3.1/5.0	7.4/5.0	3
Cash	1.3	0.7	0.2

Source: Nikko AM Global Credit Research Team

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Nikko Asset Management

Tactical decisions are based on our fundamental research conducted by a global credit research team based in London, New York, Singapore and Tokyo. All research is stored on our global database and available 24/7 for the portfolio managers across the different time zones. In addition to our fundamental research efforts, a variety of proprietary quantitative models, developed over the last years, support the decision-making process. In addition to pure credit research, it is also important to us to invest our clients' money in a sustainable way. All research theses consider the environmental, social and corporate governance aspects of an investment. In addition to our own fundamental ESG analysis, we verify with the help of a quantitative ESG scoring model as well as third party research to ensure we haven't missed anything before we invest.

As important as investing is risk management. The portfolio management team receives daily a profit and loss matrix covering all holdings as well as a daily quantitative credit quality score and weekly ESG scores for our investments. This process ensures that credit quality deterioration is detected early and eliminated from the portfolio.

The current environment in fixed income is definitely challenging for investors as the rate cycle has turned. However, we believe that by unlocking the full performance potential of the different credit asset classes achieving positive absolute performance is still possible. This, of course, must be done utilising a structured investment process, combined with thoughtful risk management which is crucial to generating income. We are confident that we will be able to deliver this in the coming future.

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