FUNDS ON FRIDAY

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Corporate bonds – offering value or not

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Corporate Bonds are a key contributor in generating income

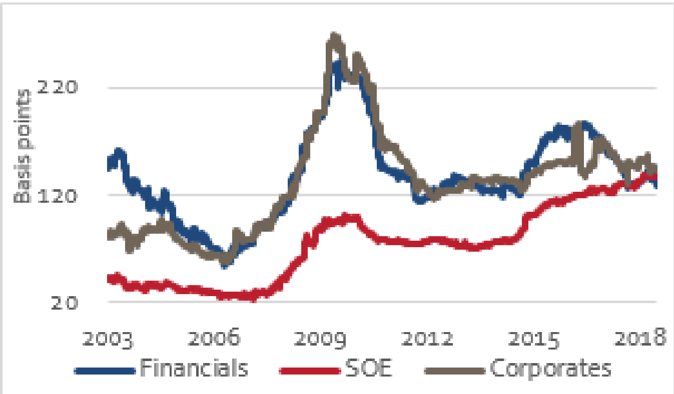
Granate Asset Management uses corporate bonds in its funds as a source of alternative income, as they have consistently provided a level of income greater than that of government bonds or bank deposits. Corporate bonds are also a low volatility asset and provide consistent positive returns, so suit the type of investor that is in the retirement stage of his or her life and looking for a moderate risk profile. The corporate bond market has grown to almost R900 billion. This is off the back of demand for alternative sources of funding from Corporates, as well as growing institutional investor appetite. However, for the first time in many years, we are questioning whether corporate bonds are offering value at their current prices.

Credit Spreads have been narrowing

The term ‘credit spread’ means the extent of the yield pick-up above the risk-free rate that investors receive as compensation for the risk they are taking. It is essentially the difference in yield between corporate and government bonds. The higher the credit risk, the wider the spread. In the past 2 years, we have experienced strong performance from the corporate bond market. This period can be characterized as one with very subdued economic growth, leading to depressed consumer and business demand which did not lend itself to a great need from issuers to raise capital. In this type of environment, it is likely that credit spreads would narrow due to the limited supply of credit in the market.

Figure 1 shows how local credit spreads, made up of Financials, SOEs and Corporate bonds, have changed since 2003, and how credit spreads across the sectors were closely correlated until 2014: widening through the financial crisis and narrowing after the risk aversion abated. Since 2014, however, SOEs have been excluded from the market due to the large-scale governance and financial mismanagement issues that have plagued the sector.

Figure 1 credit spreads



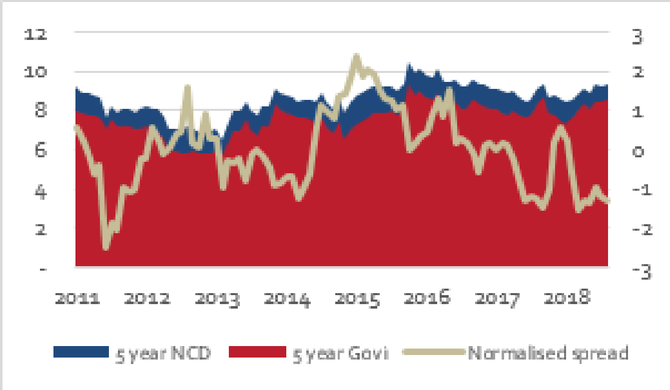
Source: Standard Bank Research

Therefore, SOE credit spreads have been widening whilst financials and corporates have been consistently narrowing. We are now at the point whereby banks and corporate debt are pricing similarly to government guaranteed SOE debt. While this may seem anomalous, the lack of demand for SOE debt has been replaced by demand for financials and corporates. This has been further compounded by the lack of supply of corporate and financial debt due to the subdued economic environment.

Government Bonds are more attractive

The poor state of SOEs and their lack of proper governance has spilled over to government bonds and we have also seen government bonds significantly underperform as the fiscus grapples with low growth prospects and a growing deficit as a result of an underperforming economy. Government bonds have underperformed to such an extent that we are now seeing them as more attractive on a risk adjusted basis when compared to corporate bonds.

Figure 2 Government bond and NCD yield spread



Source: Bloomberg

In Figure 2 we use bank Negotiable Certificates of Deposit (NCD's) as a proxy for liquid credit and compare their yields to government bonds over time. The normalized spread between these two assets should give us an indication of relative value, which is now at extreme levels of around -2, indicating that credit is overvalued relative to government bonds.

How does our Income Fund respond?

Our models tell us that income funds should target a high weighting to credit-type assets as their low volatility means that investors can enjoy an enhanced and stable income over time. We base our asset allocation in income funds on historic risk adjusted returns for different classes of income producing assets. This means that we need to keep interest rate risk low in an income fund which naturally restricts the amount of fixed rate government bonds you can have in a portfolio. It is important that we do not fully replace credit with government bonds, thereby introducing too much interest rate risk into income funds. There are other ways in which we can reduce our exposure to credit whilst not increasing interest rate risk.

Reduce credit duration

By reducing a fund's credit duration, and on the margin up-weighting our exposure to government bonds in the current environment, we would enhance the yield of the fund and this would position us for a potential future widening in credit spreads. Credit duration is the fund's sensitivity to credit spread movements. In the case where credit has become overvalued, we would look to reduce a fund's sensitivity to credit spread widening. This is done by selling credit, or by reducing the term of credit investments in the fund. We will be looking to invest into higher quality and more liquid credit opportunities and avoid the lower rated corporate bonds. This enables the fund to be more flexible and take advantage of opportunities when credit offers better value.

Having explained why we believe credit is currently overvalued, there is always opportunity to add alpha in the credit space, as long as the risks are appropriately priced. It is a constantly evolving market which offers an interesting and innovative space for investors and contributes significantly to investor returns in our funds.

Glacier Research would like to thank Bronwyn Blood for her contribution to this week's Funds on Friday.

Bronwyn Blood – B.Com (Hons)

Prior to joining Granate Asset Management in December 2015, she was the Portfolio Manager of the Flexible Fixed Interest Funds and the flagship Absolute Yield Fund at Cadiz Asset Management. When Cadiz bought African Harvest in 2006 Bronwyn took over the management of the Flexible Fixed Interest funds. Bronwyn holds a B.Com (Honours) degree from the University of Natal.