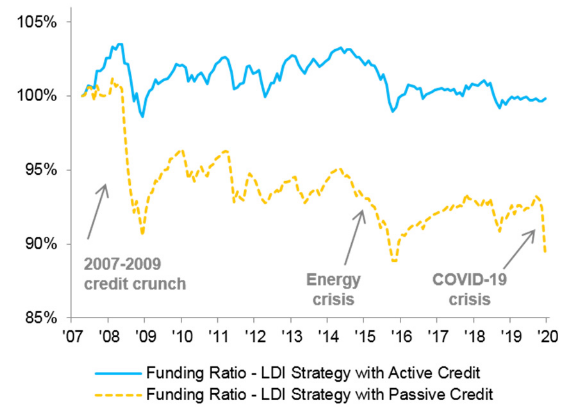
# Navigating Market Volatility: The Importance of Actively Managing Credit

May 2020

During times of high volatility and uncertain market conviction, plans of all sizes look to assess their portfolios, weighing the important risk/return trade-offs inherent in their asset allocation. Corporate defined benefit plans not only have to weigh the decisions in the context of asset selection, they also have to understand how movements in plan liabilities could impact their ability to pay future obligations. When assessing this asset-liability dynamic, the overall performance can be evaluated by observing "funded status volatility", or the aggregate fluctuations in a plan's ability to meet the remaining benefit payments.

**Figure 1. Illustrative impact on funded status when investing in U.S. Long Duration Credit**




Sources: Bank of America Merrill Lynch, Bloomberg PORT and LGIMA. Illustrative representation is net of fees.

To mitigate this inherent risk, LGIMA believes it is imperative to actively manage credit exposure. We believe an emphasis on avoiding downgrades and defaults in credit can signficiantly reduce the drag on performance as well as help to shape funded status outcomes, regardless of where the market stands in the credit cycle. Figure 1 illustrates the impact on a plan's funded status volatility when it is fully invested in fixed income, both actively and passively. Plans that invested passively in the benchmark incurred all the downgrades to high yield which negatively impacted its funded status volatility as shown.[1]

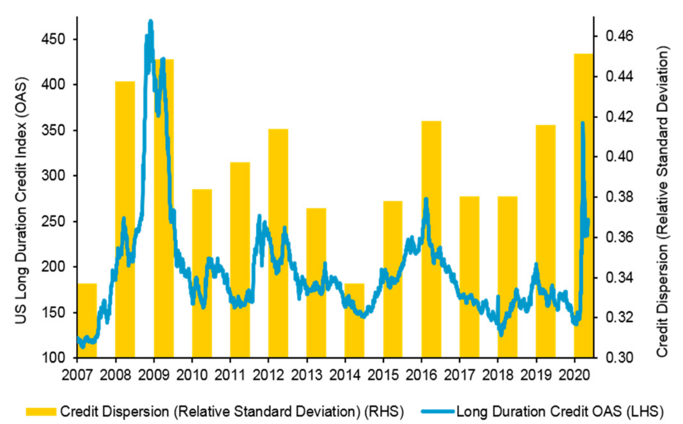
### Active credit management works

Fixed income indices are inefficient. Performance data consistently illustrates this point, as the median active credit manager has outperformed the Bloomberg Barclays U.S. Long Duration Credit index over a rolling ten-year period.[2] Investors who have elected to use active fixed income managers have generated larger excess returns in credit over the past decade relative to passive alternatives. Moreover, the median manager's performance tends to outperform, even when including the typical active management fee.

### How do so many managers do it?

**Market conditions matter**: For active fixed income managers to perform well, it helps to operate in market conditions where credits have low correlation to each other and high dispersion amongst spreads. Correlation measures the degree to which different credits move together whereas dispersion is the degree to which the market differentiates between weak and strong credits. The ideal market environment for a fixed income manager is when correlation is low and dispersion is high because it provides a larger opportunity set for a credit picker to outperform the benchmark. The market environment we are currently experiencing has the highest spread dispersion since the Great Financial Crisis. [3]

**Figure 2. Annual spread dispersion vs. U.S. Long Duration Credit index**




Sources: LGIMA, Bloomberg. As of May 2020. RSD (Relative Standard Deviation) = standard deviation of spread distribution normalized by the mean of the distribution.

**Predictable sources of credit alpha:** Active management in credit is not a zero-sum game. The process of constructing a benchmark credit index is a difficult endeavor. Given the sheer number of bonds within the universe, their varying liquidity characteristics and the frequency that bonds enter and exit the index can be extremely difficult to passively replicate, especially when transaction costs are factored into this process. We believe active managers can consistently exploit inefficiencies related to index construction and can generate alpha using a repeatable process with the right team in place.

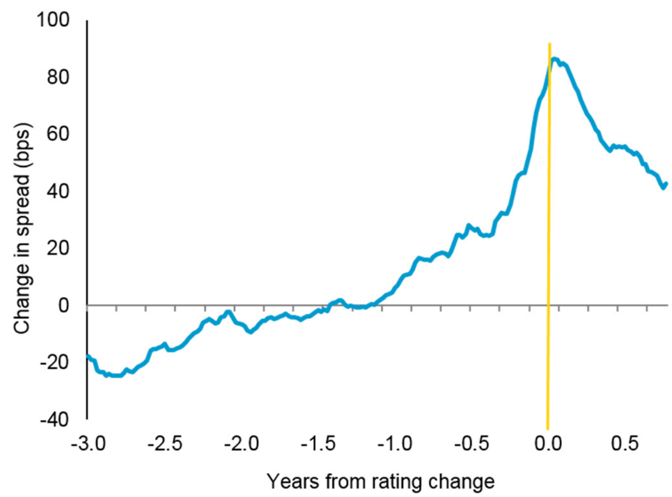
## Structural sources of alpha

During our tenure as an active fixed income bond manager, we have been able to identify four structural sources of alpha: 1) rating agency constraints; 2) issuer size; 3) liquidity; and 4) new issuance.

**Ratings constraints:** Investment-grade credit indices are constructed based on agency ratings criteria. However, rating agencies tend to lag fundamental changes in credit quality, as well as the price of corporate bonds in the secondary market. Active managers can often anticipate ratings changes that would lead to index additions and exclusions.

The market tends to price in the deterioration of credit quality prior to any action taken by ratings agencies. According to Moody's historical data, there is evidence that bond spreads begin to widen nearly three years prior to a rating agency downgrade.[4] This lag is paired with underperformance accelerating between 6 and 12 months before the event.

**Figure 3. Spread performance of U.S. investment grade bonds when downgraded (5-10 year maturities)**




Sources: LGIMA, Moody's. As of July 2019. Note: change in spread is relative to average spread of companies at the rating to which the downgraded company is transitioning.

**Issuer size:** Credit indies are market value weighted. As a result, credit indices are skewed to companies with higher debt levels, as opposed to those that are the most credit-worthy. Much like in the equity market, academic literature has established the presence of a size factor within credit that is negatively correlated to excess return.[5] This means smaller issuers typically outperform their larger counterparts.

Index construction makes downgrade avoidance important. Market-value weighting a credit index creates a more concentrated risk. In an actively managed strategy, it is critical to have a strong sell-discipline and a willingness to take a position to zero if the manager believes a company's credit quality is deteriorating. LGIMA believes following a fundamental, research-driven process is imperative to identify issuers with declining credit quality and avoid defaults and downgrades to high yield. We leverage our experienced team of credit analysts to deliver relative value/catalyst drive research and develop our bottom-up views from a security selection standpoint.

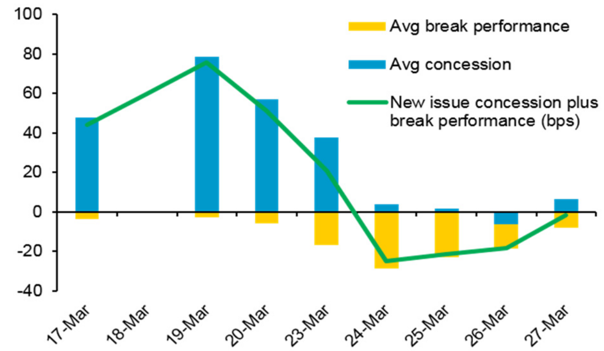
**Liquidity:** Fixed income markets have entirely different liquidity characteristics than equities. Corporate bonds are far less liquid as they are traded in an over-the-counter (OTC) market versus equities on an exchange. Moreover, that liquidity is not evenly distributed throughout the index. Bonds that are more seasoned, or smaller in issue size, are often more difficult to buy and sell. As a result, these securities command a larger bid-ask spread to trade. Managers can actively control for liquidity to mitigate these transaction costs. Furthermore, as the size of the bond market universe has grown significantly over the past decade, credit has become less liquid. The level of bond liquidity varies in different economic and market environments. This range in liquidity serves as another opportunity for active managers to outperform as liquidity premiums are part of the compensation investors receive for investing in credit.

Our flagship strategy, LGIMA's US Long Duration Credit, has historically invested in approximately a third of the issuers in the total index. This selection is skewed towards the most liquid bonds in the index, where our credit analyst team and portfolio managers have the most credit conviction.

**New issues:** Credit indices are constantly being rebalanced as new bonds are issued. However, this process takes place at the end of each month, which means that the performance of newly issued bonds is excluded from the index. As new issues often come with a concession to the secondary market, managers that buy new issues have the unique ability to create outperformance.

In the COVID-19 selloff, active managers had the opportunity to invest in the primary market with significant new issue concessions. In mid-March, at the height of the challenging bond liquidity conditions, new issue concessions ranged between 50-100 basis points.[6] Before the Federal Reserve announced its support of the corporate bond market via primary and secondary facilities, liquidity was extremely challenged. These volatile market conditions provided active managers a very rare opportunity to generate alpha by participating in these primary deals with massive new issue concessions.

**Figure 4. U.S. IG new issue performance**




Sources: Source: Bank of America Merrill Lynch, March 2020.

### Learn how we can help

Regardless of the market environment, the inclusion of actively managed credit can provide various advantages to institutional funds of all types and sizes, but especially to defined benefit pension plans. Expertise, longevity and success in exploiting market inefficiencies has positioned LGIMA as a market leader in the long duration credit space.[7] The avoidance of downgrades and defaults – especially in volatile markets, where liquidity becomes most challenged – is of the utmost importance to pension plans. As a custom LDI provider, LGIMA aims to utilize our expertise in order to partner with plans of all sizes, ultimately mitigating funded status volatility and positively shaping funded status outcomes. Our approach to active fixed income complements this objective where a responsible framework is used to add value in client portfolios.

**For further information about LGIMA, find us at www.lgima.com.**

1. Sources: Bank of America Merrill Lynch, Bloomberg PORT, LGIMA. Illustrative representation is net of fees.
2. Sources: LGIMA internal data and eVestment as of December 31, 2018. Performance is annualized.
3. Sources: LGIMA, Bloomberg. As of May 2020. RSD (Relative Standard Deviation) = standard deviation of spread distribution normalized by the mean of the distribution.
4. Sources: LGIMA, Moody's. As of July 2019. Note: change in spread is relative to average spread of companies at the rating to which the downgraded company is transitioning.
5. Houweling, Patrick. Van Zundert, Jeroen. "Factor Investing in the Corporate Bond Market." September 2016.
6. Source: Bank of America Merrill Lynch, March 2020.
7. Source: eVestment, March 2020.