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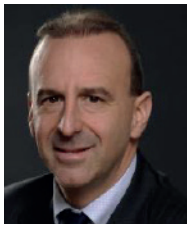
NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Short-term credit: more than a carpark for cash

Investors in short-term securities can beat money-market returns while still minimising volatility



Emmanuel Schatz
Senior Portfolio Manager
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Key takeaways:

- While ultra short-term credit shares some of the safety-first characteristics of money markets, it can generate extra yield by widening its universe of issuers
- Mainstream credit ratings are focused excessively on financial metrics, so do not reflect all the risks of a given credit. Ostrum Asset Management seeks issuers with ratings that underplay a business's intrinsic value
- ESG integration provides additional downside protection and value enhancement. Ostrum AM's investment process embeds three ESG components

Investors in short-term credit seek to avoid volatility in the value of their investments, but are also looking to optimise yield. Are these two aims compatible?

Short answer: yes. It is possible to secure yield that is substantially better than that available in money markets, while keeping volatility and capital risk to a minimum. To do this, individual credit selection is critical, as is awareness of the changing characteristics of credit markets. Credit quality can be further boosted through the integration of ESG factors.

Ultra short credit: like money markets, but with a twist

Institutional clients often need to park cash for the short to medium term, either to meet liabilities falling due in the next six to twelve months, or to wait for better investment opportunities.

Money markets may not be suitable for this purpose – while they offer capital protection (in all but the most extreme circumstances), their ultra short-term horizons and strict regulatory requirements may limit yield. In addition, money market managers must be able to respond to large redemption requests at short notice and this makes them, understandably, very conservative.

Investors in short-dated credit markets seek to generate extra yield through a variety of approaches.

"Our ultra short approach replicates the maturity and interest-rate sensitivity guidelines of money market funds, but is less conservative in a number of ways. We aim to generate stable yield enhancement over time," says Emmanuel Schatz, senior portfolio manager at Ostrum AM, an affiliate of Natixis Investment Managers.

As in money markets, Ostrum AM restricts maturities to a maximum of two years and the average maturity of the portfolio is less than one year. With bonds being very short-term and held until maturity, the portfolio benefits from the pull-to-par effect which tends to limit price volatility.

Another way to control volatility is by hedging to overnight rates. Just as money markets ensure a minimum exposure to interest rate risks, so ultra short credit keeps interest rates risk very low by indexing at least half of its assets to overnight rates. If need be, indexing can rise to as much as 100% of net assets to insulate the portfolio against interest rate variations.

The main difference is that the portfolio management team is free to invest across the full credit spectrum (as long as the issue has a maturity of less than two years). It can invest in investment grade, high yield and non-rated corporate bonds, and in other instruments, including commercial paper and so-called "pure rate" convertible bonds.

Beyond credit ratings

However, the main source of value creation is in the selection of issuers and issues.

The portfolio manager seeks to build a conviction-based portfolio of companies with resilient business models. This requires considerable research resources. With 23 credit research analysts, including sustainable bond analysts, Ostrum AM has one of the largest credit teams in Europe, and has worldwide coverage of more than 1,200 issuers.

The focus is on finding higher-yielding issuers that offer greater security than their credit ratings would suggest. "We generally don't buy the highest-rated corporate bonds," says Schatz. "They are often great companies, but the yield may be low so we can't generate the returns that investors expect with ultra short credit."

At the other extreme, Ostrum AM eschews companies with speculative future profit and cashflow profiles. "This is not like a credit fund where you try to beat an index," says Schatz. "We target a zero-default policy, so we seek only robust companies."

The crux of the Ostrum AM approach is based on a perception that mainstream credit ratings are focused excessively on financials, so do not necessarily reflect the overall picture of a given credit. The challenge for ratings agencies is they need to provide comparability between issues, and this forces them to compare only objective measures, such as commonly used ratios.

Schatz says: "In my opinion, ratings from agencies often do not provide enough information to assess the intrinsic quality of the business and its specific dynamics."

Some companies that defy their credit ratings

Ostrum AM looks for companies with a credit rating which is apparently too low for its risk profile. An example in Ostrum's portfolios include a European company with a leading position in telecoms infrastructure. Emmanuel Schatz says: "Every time you make a phone call, it gets a cut. It's a very defensive business, it doesn't depend on the economy, no-one is going to stop making calls."

Yet, this company has only a BB+ rating, marking it as a high-yield company. Why? Because it carries substantial debt, and agency ratings tend to uniformly punish leverage. Yet the specific cashflow visibility of this business allows the team to be confident that future cashflows will cover debt.

Another example is a large car company, which had a BB+ rating, despite the fact it never had generated higher quarterly cashflows and enjoyed a full order book. "This is an example of the ratings often lagging – agencies need to see several rounds of good numbers before raising ratings and they can be behind the curve in this respect," says Schatz.

Macro-economic volatility throws up opportunities

While bottom-up stock-picking is the prime value add, Ostrum AM also enhances value through its analysis of the macro-economy and of credit markets.

Ostrum AM may reposition its portfolios based on its research-based expectations for short-term central bank rates. Currently (in February 2024), Ostrum AM believes market expectations that ECB will cut rates this year have been over-priced and has positioned its European issues accordingly.

"The jobs market may be slowing a little, but it's still pretty strong and we believe the ECB will do everything in its power to avoid second round inflation effects," says Schatz.

The macro-economic environment can throw up opportunities at sector and company level too. Ostrum AM rationalised that real estate companies had been sold off too aggressively in early 2022 amid rising rates. Schatz says: "Investors tend to sell off indiscriminately and discrimination only comes back slowly. This means you can find hidden gems in beaten down sectors."

Similarly, exposure to high yield was increased significantly over the course of 2020 to selectively buy issues of unloved "fallen angels" during the Covid crisis.

Multi-pronged ESG approach

Additional value enhancement is provided by Ostrum AM's ESG approach. The ultra short investment process contains three main ESG components: ESG scoring; a carbon intensity calculation; and an anti-corruption policy.

The ESG scoring seeks to establish that the portfolio's average ESG Score is better than that of the reference universe, filtered to exclude the 20% worst ESG scores.

The carbon intensity "E-indicator" aims to uncover issuers with a carbon intensity which is, on average, lower than that of the reference universe, based on Scope 1 and Scope 2 of the Greenhouse Gas Protocol.

Meanwhile, the anti-corruption "G-indicator" ensures that the portfolio's anti-corruption score is collectively better than that of the reference investment, based on an MSCI methodology. Only companies with a detailed and formalised anti-corruption policy qualify for this purpose.

Finally, the approach complies with Ostrum AM's sector and exclusion policies including tobacco, coal, oil and gas and controversial weapons.

As a result, the ultra-short approach is classified as Article 8 under the Sustainable Finance Disclosure Regulation (SFDR), and is also compliant with the French government's SRI Label.

Promising signs ahead

All the signs are that 2024 could be a good year for short-dated bonds and the wider fixed income asset class, as interest rates stay relatively high and decline only gradually.

At the same time, the investment landscape remains tricky. So, it's no surprise that short-term credit is seen as a sanctuary and, in Ostrum AM's view, should remain a strong risk-adjusted asset class for the foreseeable future.

For risk-averse institutional investors, such as insurance companies, which are not comfortable with interest rate risk, current yields from a short-dated portfolio of more than 4% remain attractive.

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