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Credit – more risk than is obvious to the naked eye

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In 2009, I became the lead manager on a fixed income mandate and have continued to pursue my passion of managing client capital in what I have always perceived as the less-than-captivating area of investments – fixed income. These days, my window to the market is the income fund which I'm responsible for.

Although fixed income investing is arguably the domain of the less flamboyant, there is no doubt that it has become a 'go-to' place for many investors over the past five years, particularly as other local asset classes have delivered paltry returns. It has also attracted a wide spectrum of income specialists, with varying approaches and some phenomenal success stories. This article serves to explain why I have, to date, chosen to run a credit light fund, and why I believe deep-seated risks are apparent in SA credit, which are not obvious to many investors. My reasons are as follows:

1. Disproportionate levels of demand

In 2019, investors piled into fixed income products at the expense of traditional investment avenues, and this trend continued in 2020. In Figure 1, we show the ASISA category net flows and assets as at the end of 2019. It is evident that of the 14 categories, four showed negative growth, three hardly budged and five grew between 15% and 50% over the year – four of these being fixed income-related. There is simply no doubt that fixed income is the current asset class of choice and with credit accounting for approximately one-third of the size of the domestic fixed income market (R3.3trn), it is experiencing a significant level of demand.

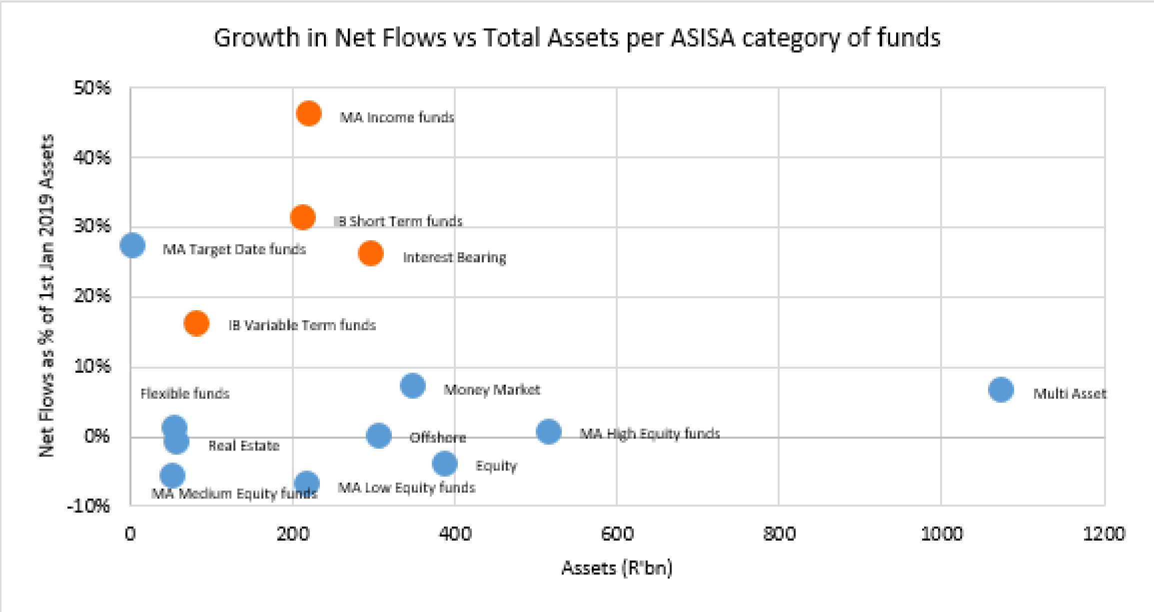

Figure 1. Growth in net flows vs total assets *Source: Asisa statistics*

2. Lack of supply

Against rising demand, net domestic credit issuance has been falling ever since January 2013. At that point it was growing at 20% per annum but hit a low growth point of 0% in October 2018 and has subsequently picked up to around 10%. We expand on the point of poor market pricing in section 4 below, but in a nutshell, the consequence of rising demand and supply shortages is that issuers benefitted by issuing lower quality paper and enjoying lower funding costs as investors lapped this up.

3. Overall mispricing of credit (particularly floating rate notes) as an asset class

A drawcard for managers has been to own corporate debt through floating rate notes and this has been an attraction for the following reasons:

- For as long as interest rates stay stable, these instruments give smooth return profiles.
- Their yields are higher than short-term money market investments, and
- In South Africa there has been a tacit acceptance that the SARB would sustain high real yields which has played into the hands of managers that have owned them.

Who's swimming naked?

Warren Buffett so succinctly articulated: 'only when the tide goes out do you discover who has been swimming naked.' On this point, in Figure 2 below, we show the yield of a seven-year senior floating rate note in blue against a seven-year senior fixed corporate paper in orange and the R186 government bond in grey.

In October 2018, floating rate notes provided a yield of 8.5%, whereas fixed bonds offered 10% and government bonds were at 9%. At this point, investors should have bought senior fixed bonds but instead managers continued to favor owning floaters.

By the end of 2019, the smart money should have migrated from senior fixed paper to government bonds because the credit spread between these two instruments became compressed. We would seek a spread of 150bps, through the cycle, whereas in the latter half of 2019, the spread had diminished to 40bps. Our interpretation of this event was that corporate debt was being priced for perfection at the expense of alternative investments.

In the context of Buffett's comments, when COVID struck, although all fixed income assets sold off, floaters had the unfortunate double whammy of the repo rate being cut by 200bps and credit spreads widening. At that point the very essence of owning these instruments was immediately nullified at great expense to investors in funds heavily exposed to FRN's.

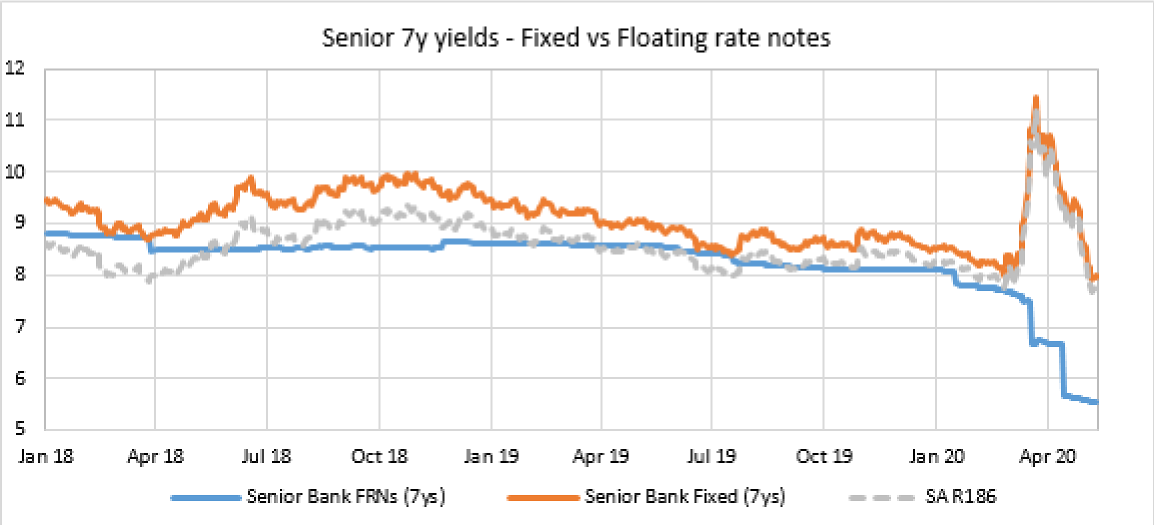

Figure 2. Interest rate cuts and impact on floating rate note yields *Source: JSE, Standard Bank & Northstar*

4. Lack of discriminatory pricing within credit

In Figure 3 we show two floating rate notes issued by one of the four major banks. The blue line represents the credit spread that the bank's subordinated second tier floating rate note (lower credit quality instrument) trades at against 3-month JIBAR (the Johannesburg interbank average rate). The orange line, on the other hand, represents a senior floating rate note issued by that bank and its credit spread against JIBAR.

In early January 2018, the subordinated note traded at a spread of 385bps over JIBAR whereas the senior paper traded at 145bps over JIBAR. This was totally logical – investors demanded a higher yield for the risk they were taking.

Fast-forward to the end of 2018 and one starts to observe compression between these two yields – the market began to diminish its discrimination for the risks that were clearly apparent between these two instruments. The spread differential moved from 245bps in February 2018 to 85bps in November 2018. By January 2020, the differential spread reduced to an insignificant 67bps. In our opinion, clearly mispricing the inherent relative risks in the two instruments and indicating that lower grade paper was being mispriced.

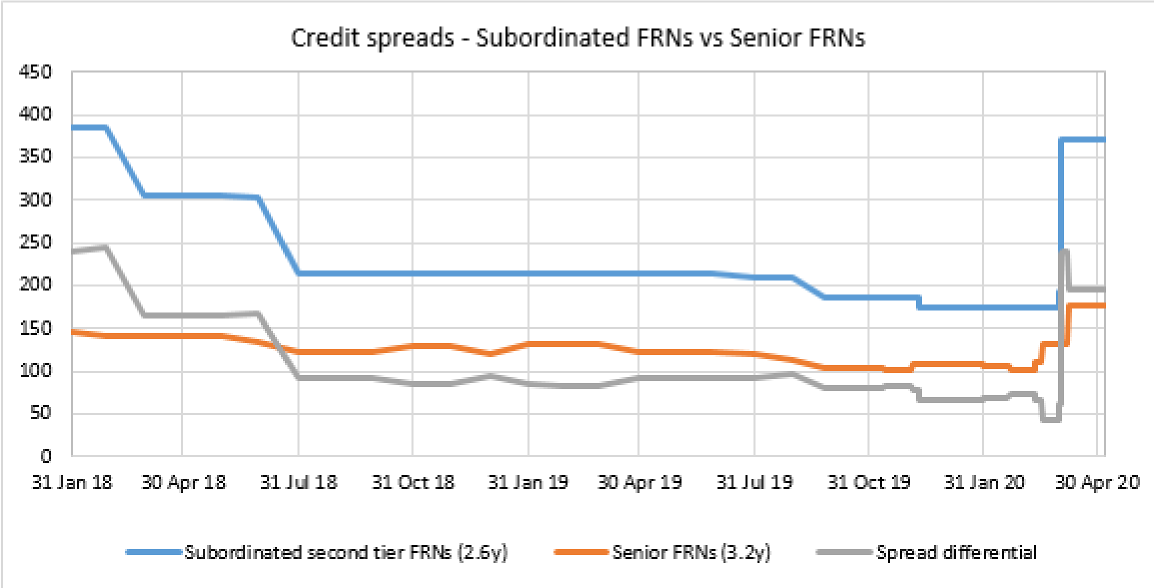

Figure 3. Lack of discriminatory pricing within credit *Source: JSE & Northstar*

5. Liquidity

Figure 3 depicts another interesting characteristic around credit and notably lower grade credit – that being diminished liquidity.

Considering all investments, given time, are crystalized (sold), particular care must be taken when investing into illiquid instruments and the best means of protection is to buy these at a deep discount to their true values – the concept of applying a margin of safety.

As we discussed earlier, the irony within the domestic credit market leading into COVID is that the market participants applied no margin of safety to pricing many of the credit instruments that were in vogue and the absolute lack of liquidity is revealed in the severe sell-off of bank subordinated second tier paper (blue line) in early April of this year.

In conclusion, we have demonstrated that the domestic credit market in the last number of years held more risk than was obvious to the naked eye. A robust ecosystem focusing on valuation modeling would have unearthed these risks and prevented many unsuspecting investors from being exposed to them.

Glacier Research would like to thank Mark Seymour for his contribution to this week's Funds on Friday.

Mark Seymour

Director of Fixed Income

Mark is director of Fixed Income at Northstar Asset Management and portfolio manager of the Northstar SCI Income Fund. Mark joined Northstar in December 2012. Prior to joining Northstar, Mark worked for PSG Asset Management as portfolio manager of the PSG Optimal Income and PSG Equity Builder funds. Previously he spent 7 years with Alphen Asset Management managing domestic equity and income unit trust portfolios. Mark has 19 years' investment experience. Mark holds a B.Sc in Electro-Mechanical Engineering