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Nikko Asset Management

GLOBAL CREDIT: NAVIGATING CREDIT MARKETS WITH AN ASIAN EMPHASIS

Global Credit Strategy reaches the three-year mark

Nikko AM's Global Credit Strategy celebrated its third anniversary in 2019 and we take this opportunity to review our investment process and performance.

We were driven by a desire to differentiate ourselves from our peers and to offer clients an alternative to existing strategies when designing our investment process. A lack of a track record is a disadvantage shared by all newly established strategies, and our case was no exception. We still created a best-in-class approach by weaving over 20 years of credit management experience into the investment process.

We will discuss the key factors that differentiate our strategy and highlight its success in this article. Our innovative approach was founded on a conviction that our performance will be superior over the long term.

Strategic Asian credit allocation

Before starting the analysis, we will highlight how Nikko AM differs from its peers. While a majority of our peers focus mainly on the US and European credit markets, we launched the Global Credit Strategy with an emphasis beyond these markets. Notably, we focus on Asian credit.

We took a significant strategic allocation in Asian credit assets for the following reasons:

1) To capture global economic reality within the strategy. This is evidenced by the much higher weighting we allocate to Asian bonds relative to suggestions by benchmark providers. While benchmarks assign significant weight to companies with a high debt pile, we prefer economic growth over debt growth. Currently, Asia accounts for approximately 50% of global GDP growth and China still enjoys a higher growth rate than any of the G7 countries.

2) The alpha opportunities Asian markets offer. Developed markets provide liquidity but their yields range from low to negative. In contrast, Asian credit provides yield but less liquidity and therefore forms an interesting counterbalance to our developed market position. Alpha opportunities can only be harvested with the support of an experienced team of analysts. We have a seasoned Asian credit research team in Singapore which has been together for the past decade, providing valuable insights into the subtleties of Asian credit markets and the multiple investment opportunities within.

3) Asian markets' reduced correlation with mainstream market beta and the benefit they provide for portfolio construction. The correlation among global asset classes has increased because rates have declined and increasingly turned negative. Chinese bonds, for example, can work as a valuable diversifier in the current environment.

Proprietary quantitative tools and a theme-based approach

Together with our investment bias towards Asia, our proprietary quantitative tools are another clear differentiator. Our investment decisions are mostly driven by fundamental research but we also rely heavily on quantitative support. For critical investment process functions such as credit research, relative value analysis and risk management, we opt for proprietary models over third party vendors—primarily to avoid the 'black box' problem. A key example is Nikko AM's Credit Risk Model, designed when the need arose to cover a global credit universe of approximately 1,500 issuers. We tried to rationalise our analytical efforts as such a large universe would have challenged any credit research team. The Credit Risk Model, which benefits from combining a fundamental and a structural model approach, was developed to primarily analyse Investment Grade-rated companies in the US and Europe. The model therefore allows our 20 credit investment professionals to concentrate more on developing markets and Speculative Grade-rated companies.

Our white paper explains in depth the merits of Nikko AM's Credit Risk Model. The model is also included in the risk management process in addition to credit selection. This allows us to rate most of our portfolio holdings on a daily basis, a considerable benefit over traditional credit research methods.

In addition to our Asian research expertise and our proprietary quantitative support, we have a third differentiator: a theme-based approach. Instead of traditional, classic asset allocation—a time consuming process which requires being underweight/overweight on a sector, country or ratings category—we focus on themes that we believe will help generate alpha or mitigate loss. For example, choosing the correct country exposure, rather than picking the right sector, generated performance during the height of the 2011-2012 European sovereign crisis. Either being long or short on Italian (or Spanish) corporates could have made or broken one's performance back then. But when commodities sold off in 2015, country risk exposures were no longer a crucial performance factor, and sector exposures drove returns instead. A theme-based approach gives the investment team the flexibility to focus on factors relevant to the portfolio's performance. When the market is driven by just a few factors, we see limited value in a full allocation approach.

Our key investment themes in 2019 were being overweight in financial and non-financial subordinated bonds, non-cyclical credits and Investment Grade Chinese SOEs; at the same time, we took a cautious stance toward investments in the UK and Italy. We have also gradually reduced our High Yield exposure.

Driven by our three main differentiating factors (Asian focus, quantitative support and theme-based investing) over the last three years our approach has delivered value to our investors despite the volatile market. As of 30 September 2019, our Global Credit strategy has outperformed the Bloomberg Barclays Global Aggregate Corporate by 55 basis points and delivered 3.81% of absolute performance since inception (annualised and gross of fees.) The strategy has established its position in the top quartile of its peer group and generated a since-inception Information Ratio of 0.6.

Portfolio performance contribution data reveal the factors which drove our results since the summer of 2016, with regional investment themes being an important component. Underweighting the US credit market, with its elevated leverage relative to the growth-driven Asian and the QE-supported European markets, has paid dividends over the last three years. In particular, we were rewarded by a cautious stance toward some countries, i.e. the UK. In addition, our research-intensive focus on financial and non-financial sector subordinated bonds delivered value. And our defensive stance towards cyclical credits (i.e. automotive) and asset rotation into non-cyclical domestic focused bonds (i.e. telecommunications) produced positive performance. The rotation also helped shield the portfolio from the global trade war. At the same time, benchmark agnostic investments into Speculative Grade-rated companies have been successful. The spread rally this year, however, made the asset class more expensive and we have since reduced our investments in these names.

Despite the Global Credit Strategy's success, as a portfolio manager we are constantly looking for ways to enhance and improve the investment and risk processes. An example is our increased use of derivatives, an attractive tool for portfolio construction due to their superior liquidity and low transaction costs. Portfolio liquidity and the ability to trade even in volatile and illiquid markets have become very important factors. In addition, the ongoing integration of Chinese bonds into major fixed income indices has prompted us to look more actively for investment opportunities in the offshore bond market and even increase our exposure towards Asia. Furthermore, we will continue to develop and enhance our quantitative models to improve our investment decisions.

We have the potential to further enhance our processes. And considering our performance over the last three years, we are optimistic about the next three and beyond. Interest rates are due to remain low for the long term, but we believe that we have the team and resources to deliver alpha to our clients in exactly such an environment.