US credit strategy: Finding value in investment-grade bonds

Portfolio Manager Interview

April 2016

Charles Tan

Head of North American Fixed Income, Aberdeen Asset Management

Key fund points

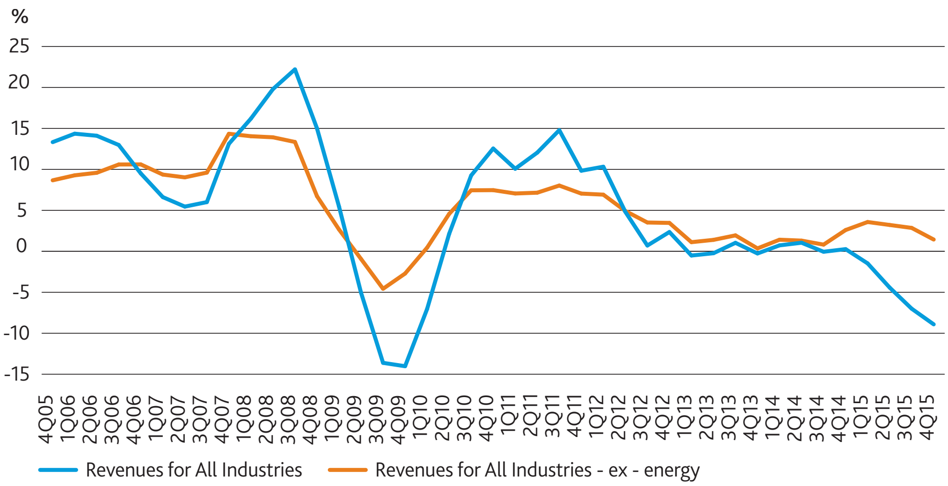
- We believe there is still good value to be found in US investment-grade bonds.
- M&A activity offers additional opportunities to add value to the portfolio.
- Market volatility and rising liquidity premiums are some of the challenges when investing in today's fixed-income markets.
- Aberdeen uses a consistent, disciplined approach to manage US fixed-income portfolios for clients.

Overview of the asset class

Searching for value: What are you most focused on as you look for attractive opportunities within the US investment-grade bond market?

- Corporate fundamentals: After the global financial crisis of 2008-2009, companies cut costs and paid down a large portion of their debts. As a result, corporate balance sheets strengthened significantly following the crisis. Today, we are seeing a slight deterioration in these fundamentals following a period of increased debt loads to finance mergers and acquisitions (M&A), share buybacks and dividend payments. We aren't overly concerned, however, because we see these changes as a typical evolution in a credit cycle. Total revenues for the S&P 500 Index member companies are expected to fall 3.6% year-over-year in the first quarter of 2016.[A] The overall downturn was attributable entirely to declines in energy, materials, utilities and industrials. Revenues are still growing in the six other sectors within the index and interest coverage remains healthy amid the low interest-rate environment, as indicated in Chart 1. To employ a football analogy, we may be entering the 80th minute of the credit cycle, but we don't foresee an economic recession on the horizon. Therefore, we believe there is still good value to be found in the current environment.

Chart 1: S&P 500 Index company quarterly revenue change, year over year



Sources: Aberdeen Asset Management, Barclays, December 31, 2015. For illustrative purposes only.

[A] Source: Thomson Reuters, March 2016.

Aberdeen

Simply asset management.

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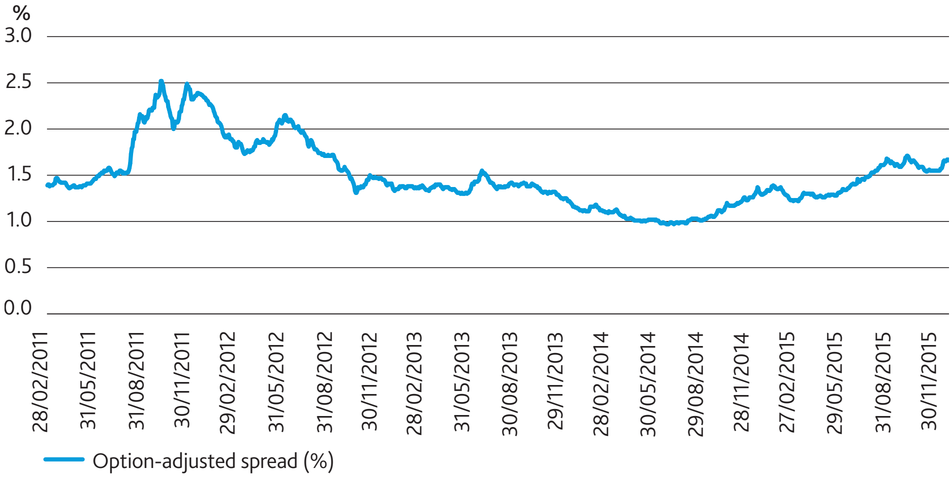
- **Finding value:** Option-adjusted spreads (OAS)[B] on the Barclays U.S. Corporate Investment Grade Index recently widened to their highest levels since 2012, as illustrated in Chart 2, and overall, we think that corporate bonds are looking much more attractive considering the still-solid credit fundamentals. Interestingly, we're finding value in parts of the energy sector, such as master limited partnerships (MLPs) that transport crude oil, liquids, and refining products and are benefiting from continued strong volume despite lower oil prices. Consolidation within the healthcare and insurance companies through M&A activity offers even more opportunities to add value within our portfolios. In our view, the most attractive investments are typically available after an M&A deal is completed. There has been significant new debt issuance in the past 12 months, which has given us a large opportunity set from which to choose.
- **Liquidity concerns:** Given the exponential growth of the buy side and the decline of the sell side, liquidity is becoming more challenging in the fixed income markets. As market volatility has increased, the liquidity premium has followed suit. Ultimately, our investment process is guided by intrinsic value and a disciplined spread-targeting approach. One cannot wait for the market to react in order to reposition a portfolio. We sell when bonds reach our intrinsic value targets, which tends to occur in a credit rally, when liquidity often is more plentiful. We buy when spreads are wide to our intrinsic value targets, and this tends to happen in the midst of market volatility. Because we have done our homework, we can buy with conviction. It allows us to receive–rather than pay–the illiquidity premium. We think it's also important to note that, compared to some of the largest fixed-income managers, our moderate size allows us to be much more nimble to get in and out of positions, and to take better advantage of opportunities in both new-issue and secondary markets, thus creating more value for our clients.
- **Staying the course:** In our view, managing a bottom-up, relative value U.S. credit portfolio requires a consistent, disciplined, and well-executed investment process. Of course, it is always important to be aware of major market trends, but we believe that we are most successful when we incorporate our views of economic cycles and sector trends into analyzing corporate fundamentals and credit profiles at the securities level. Fixed-income markets are inefficiently priced. We believe that fundamental relative value analysis with a particular focus on bottom-up security selection is the most consistent strategy to add value over time.

Chart 2: Barclays U.S. Corporate Investment Grade Index option-adjusted spreads



Sources: Aberdeen Asset Management, Barclays, February 29, 2016. For illustrative purposes only.

[B] The option-adjusted spread (OAS) is a calculation of the relative value of a fixed-income security containing an embedded option, such as a borrower's option to prepay a loan. The spread is measured relative to comparable-duration Treasury securities. A larger OAS implies a greater return for greater risks.

Impact of market events on the asset class

Macro matters: Which macro events are having the most significant impact on the portfolio? And what are clients focusing on at the moment?

- **Federal Reserve policy:** There remains much speculation in the global financial markets regarding U.S. monetary policy, which has prompted several gyrations in the U.S. and global fixed-income markets over the past several years. As widely expected, in mid-December 2015, the Federal Reserve (Fed) raised the federal funds rate by 25 basis points to a range of 0.25% to 0.50%, noting that it saw the risks to the outlook for both economic activity and the labor market as balanced. However, the Fed soon took a more dovish stance, as its members viewed the downside risks to the U.S. economic forecast as more pronounced than they had observed in December. The central bank subsequently left rates unchanged following its meetings in January and March. Additionally, relatively sluggish gross domestic product growth data and muted inflation expectations have led the central bank to temper its forecast for the federal funds rate to 0.9%, 1.9% and 3.0% by the end of 2016, 2017 and 2018, respectively.
- **Energy prices:** The West Texas Intermediate crude oil price fell to just over $26–its lowest level in nearly 14 years–in mid-February 2016 before rallying sharply towards month-end following an International Energy Agency report forecasting a sharp decline in oil production growth rates over the next five years as drillers cut investment in new production. Our Core Fixed Income strategy's energy positions performed relatively well over the 2015 calendar year, outpacing the aggregate return of the energy subsector within the benchmark Barclays U.S. Aggregate Bond Index. At the beginning of 2015, we had positioned the portfolio with an overweight to the sector, but our intrinsic value-based spread-targeting process led us to exit many of our exploration and production (E&P) positions in the middle of the year when spreads tightened through our target levels. Consequently, we largely avoided the sell-off in energy bonds. After energy bond spreads widened significantly later in the year, we increased our energy holdings selectively, mainly in midstream master limited partnerships (MLPs), downstream refiners, and even some of the same bonds we had sold at much tighter spread levels. We are looking to opportunistically add higher-rated energy credits. We have stress-tested all of our energy holdings to evaluate how they will perform in a distressed environment. Despite continued volatility in the energy sector, we are confident our energy holdings will pay off over the long term.
- **China:** In August 2015, China moved to devalue the renminbi, sending markets into a tailspin. Our view at this time is that the currency devaluation is part of China's long-term plan to internationalize its currency. Fears about a possible "currency war" seem overblown, and are not being incorporated into our views at this time when managing fixed income portfolios. Significantly, the International Monetary Fund (IMF) included the yuan in its global reserve basket, a major vote of confidence in Beijing's economic reforms and its bid to internationalize its currency. Additionally, mainland policymakers announced that the currency would be measured against a basket of 13 currencies instead of just the U.S. dollar. While events in China aren't having a direct impact on the long credit portfolio, slower growth in that nation is weighing on the global economy. Uncertainty surrounding global economic growth supports our view that interest rates will be lower for a longer amount of time. If this is the case, the low-yield environment should continue to support demand for fixed income, particularly long-duration corporates. The need for high-quality assets is especially apparent, in our view.

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The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested

Contact details
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