

Willis Towers Watson PODfolio episode 9

So many ways to lend money

[MUSIC PLAYING]

NIMISHA SRIVASTAVA: What we saw in March was so unprecedented. And when you do see these large-scale risk-off movements, there's almost nowhere to hide except safe haven government treasuries.

SPEAKER 1: Welcome to The PODfolio, Willis Towers Watson's investment podcast series where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolio.

[MUSIC PLAYING]

LOK MA: Hi, and welcome back to The PODfolio podcast. I'm your host, Lok Mar. This is our ninth episode already. And we're now starting to get into some of the more specific parts of investment portfolios. And today I'm joined by Nimisha Srivastava, who's our Global Head of Credit Research. So welcome to the show, Nimisha.

NIMISHA SRIVASTAVA: Thanks for having me, Lok.

LOK MA: And so Nimisha and I are going to talk about different types of lending, how things have gone during the COVID-19 crisis so far, and also looking ahead and to the future. Now for me, I've found it takes a little bit of thinking perhaps to get my head around the full variety of investments that fall under this wide banner of credit in terms of who you're lending to, the structure of the lending, and also the level of return versus the level of security. So we'll be trying to avoid getting into jargon as much as possible and just talk about these investments in terms of what they're fundamentally doing.

So Nimisha, first of all, I think most of us are fairly familiar with what's happened to the equity market. Say something like a 30% fall over a very short period of time before rebounding almost just as quickly. Can you just tell us a little bit about what's happened to the credit market since the COVID crisis started, and also how different the experience has been for different types of lending?

NIMISHA SRIVASTAVA: Sure. And I might use high yield as just a very representative index. We saw it drop somewhere in the range of 15%. But the rebound has only been about 12%, so high yield is still sort of 3% off where they started the year. So a bit of room to go.

But the comment I would make is if you look at certain subsectors within, and especially in sectors such as securitized credit, they fell even further, beyond 20%, 30%. In some cases 40%, depending on where you were invested. So a lot more recovery potential in some of those areas.

LOK MA: Uh-huh. So let's talk first of all about that initial downfall, which you know, for high yield you said was of the order of 15%. What were the sorts of things that were driving that fall?

NIMISHA SRIVASTAVA: So initially, they held up quite well in the first half of March when you saw equity markets start to sell off. But then they quickly caught up as investor fear grew, as COVID-19 spread. And then you also saw a large oil price shock, which is quite meaningful to a portion of the corporate credit universe across both investment grade and high yield.

So it sort of created a negative feedback loop where you saw investor risk aversion rise. More selling, more forced selling, causing prices to drop even further. Leveraged players had to de-leverage, exacerbating some of those price drops. So really vicious feedback loop, I would say, in the last 10 days of March.

LOK MA: Yeah. And then obviously, things kind of picked up from there. Not back to previous levels quite, but there was a pretty impressive recovery as well. So what sorts of things are driving that?

NIMISHA SRIVASTAVA: So the key word that just comes to my mind [INAUDIBLE] so government action was a massive part of the reason why in April, you saw some rebound. You saw record rate cuts and the pace of rate cuts. You saw bond purchase programs announced. You saw [INAUDIBLE] 2.0 announced to support consumers and small businesses. And you also had direct household support to consumers with unemployment, with paycheck protection programs. So just a record pace of issuance of support to create some sort of bottom, if you will, for price movements.

LOK MA: Yeah. And I guess, I mean, what's on my mind is no matter how much of this is artificial in a way and how much it reflects the fundamentals. So let's have a think about where things are right now. And obviously, I want to maybe park investment grade credit to one side. So investment grade credit is lending to companies with stronger credit ratings, and those things took a bit of a hit and mostly recovered.

So let's just park that to one side and talk about some of the riskier stuff. So the higher yield but higher risk types of lending. What's your kind of overall outlook standing where we are now?

NIMISHA SRIVASTAVA: Yeah. So the way I think about the higher yielding segments-- so high yields, for example-- is it's really very much an alpha opportunity today. There's still some room to go from a spread perspective as we touched on earlier. Valuations look somewhat attractive, especially if you look at certain quality types or sectors. But there's a lot of dispersion both across sectors and within. And that just means managers who are capable of selecting the best credits and avoiding the weakest ones have room to capture a lot of value.

You do have a bit of technical support as well with said purchasing of certain parts of high yield now, fallen angels. So that's supportive to the asset class as well. But when we look at high yields and the range of possible outcomes that could occur, spreads look pretty attractive to compensate for those.

LOK MA: Yeah. I'm mean, I'd like to tie that back with this overall question of a lot of this stuff has recovered in terms of pricing. And what's not clear is for individual areas of credit, how much of that recovery is kind of dependent on things that may or may not last? And how much is a real reflection on the fundamental credit worthiness of the things?

And I think what you're saying about alpha opportunities is from the outside, these things look all kind of similarly priced. But you know, if you have the right kind of investors, you could actually pick the opportunities that reflect the fundamentals rather than this kind of general rise back up in the credit markets. I mean, is that a fair thing to say?

NIMISHA SRIVASTAVA: Yeah. I think that's fair, Lok. And I think we're just about to see Q2 earnings being reported. We saw the banks' earnings this week. We're seeing more corporate earnings next week. That's when we will actually start to see some of the impacts COVID-19 and oil have had on some of these names. So to some extent, I think it's fair to say the broad support from the government has helped these companies and securitized instruments' rebound.

The real question, the \$54,000 question will be, what happens when government support fades? And we may not start to see the real impacts until, you know, call it September when we see more of the stimulus fade and we start to see the real economic fallout. Might not be the most chipper answer.

[LAUGH]

LOK MA: No, I completely agree. I mean, I think the test is still to come, so to speak. And sticking with these kind of riskier, higher return, higher risk bonds, I think one of the main arguments for investing in them is that they can provide you with a kind of in quotations "equity-like return," but which is still less correlated with the main equity markets.

I've got to say, throughout this particular crisis, I wouldn't say that statement has held up particularly well, because both markets took a pretty big hit. Any thoughts on that?

NIMISHA SRIVASTAVA: Yeah. And I think it's fair, I think. What we saw in March was so unprecedented. And when you do see these large-scale risk-off movements, there's almost nowhere to hide except safe haven government treasuries. So having that as part of the toolkit can be quite valuable, or having managers who are pretty active can be valuable.

But I think that the takeaway that I see is when we look at a blend across alternative credit-- so having enough exposure across corporate credit, consumer credit, country credit-- can actually help build more resilient portfolios. And we've seen that performance fare much better than any one of those individually.

LOK MA: Yeah. So it's not just credit as something that diversifies away from equities, but also having enough diversification within your overall credit investment as well, which I think very makes sense. So do you-- you know, given where we are now, do you expect to see maybe higher credit allocations and smaller equity allocations go forwards? Or the other way around? Do you feel like the balance between equities and credit is going to change in future?

NIMISHA SRIVASTAVA: I think so. And when you opened this up and talked about the equity market drop and subsequent rebounds, we've already seen a shift in many portfolios moving a portion of equities towards return seeking credit for that very reason of performance may be a bit on par between a diversified basket about credit and equities. But as I noted, there's a lot more room to go in credit, especially in some of these sectors that still remain wide.

And so there's a good argument from a portfolio standpoint to start to shift some portion of equities towards that and build a bit more resiliency to future downsides. So we've already started to see that. I think it's fair to say we'll see a bit more going forward.

LOK MA: And as I mentioned at the beginning of our discussion, there's so many different types of credit, different types of lending. Obviously, over the space of a podcast, I haven't got time to go through all of them individually to talk about what they mean. But I'd like to just get and paint an overall picture of the credit landscape, if you like. You know, try something a little bit different, Nimisha. I'm going to try a bit of a quickfire round, if that's OK with you.

So I'm just going to fire at you a few choices and comparisons between different types of lending. And obviously, it goes without saying that the correct answer will depend on client circumstances and market conditions at the time. But I just wanted to see whether it's possible to get a general feel from you, whether you've got a leaning or preference of one thing or the other, just to get a lay of the land. So if you're up for it, just going to fire some different ideas at you.

NIMISHA SRIVASTAVA: Yeah. Do it.

LOK MA: Yeah.

[LAUGH]

So the first one is, who do you prefer lending to? And I'm going to summarize the three Cs. So do you prefer lending to corporates or to consumers or to countries?

NIMISHA SRIVASTAVA: I would pick consumers today. Lots of government support and lots of room to add value.

LOK MA: Yeah. So I mean, for the same kind of-- I mean, we're talking the riskier stuff. For the same kind of yield, you're saying lower risk of default or downgrade essentially then, compared to lending to corporate.

NIMISHA SRIVASTAVA: Yes.

LOK MA: And where were you getting-- yeah. And where is that coming from? Is it the level of debt or financial difficulties, support?

NIMISHA SRIVASTAVA: It is-- yep, I agree. And I would say this is the same tilt we had pre-crisis as well of consumers just looking from a fundamental standpoint better than corporates. Less leverage. We went through a massive de-leveraging post the global financial crisis. Actually, pre-COVID, savings and unemployment were looking good. Post-COVID, those are questioned. However, you have strong government support helping them in the near term. But you also have some of those fundamental buffers with less debt helping them.

LOK MA: OK. And then the second question in my quickfire round is your preference for, I guess, the structure of the lending. So on the one hand, you've got bonds, which are more publicly available and traded, or loans which are more private arrangements between the borrower and lender. Do you have a preference at the moment?

NIMISHA SRIVASTAVA: I like bonds for many aspects. First, you've got the fundamentals going for you. Leveraged loans do you have more fundamental issues with weak or covenant structures in recent years. Just less protection. They don't have the same backstop from the government that bonds do. I.e., there's no government program buying loans. And there's a lot more dispersion on the bond side to make the alpha story quite interesting. So my bias would be high-yield bonds.

LOK MA: OK. And then the next one, Nimisha, is securitized versus unsecuritized. So by that, securitized, I just mean the contract is set up in such a way that if the borrower doesn't pay you back, then you can go in and take over some of the assets to compensate for your loss. Have a preference for either structure?

NIMISHA SRIVASTAVA: I would say securitized just for that structural security you mentioned. So obviously, in securitized, you can take the very bottom piece of the structure. That's not what I would say is attractive. But some of the more mezzanine or higher up and seniority sectors look quite compelling from a spread standpoint to compensate for a wide range of outcomes that could unfold.

LOK MA: All right. And then the next one on my list is liquid versus illiquid. So liquid is just instruments you can get into and out of easily, whereas illiquid is something that you're expected to hold over the longer term. Under these conditions, I guess there's a fair amount of uncertainty. Where do you sit on that one?

NIMISHA SRIVASTAVA: I really want to say both, but I know you're going to make me pick.

LOK MA: No, I think you're allowed-- you're allowed one both, Nimisha. That's absolutely fine.

[LAUGHTER]

NIMISHA SRIVASTAVA: It depends. I would say that the illiquidity premia looks pretty interesting right now across a wide range of sectors. So we're looking at more illiquid opportunities today than we ever have. That's not to say the entire portfolio should be illiquid, but that there are some interesting premias to be captured there.

LOK MA: Cool. And then the last one for you then. There's quite a lot of talk around whether there are opportunities with bonds have, I guess, dropped a bit in value, whether you could pick up some bargains. And I've got two examples. One is fallen angels say these are kind of formerly highly rated investment-grade bonds that have just dropped out of the investment grade bracket through some downgrade.

But then at the far end of that spectrum, you've got kind of distressed credit, which is bonds that are close to default or have already defaulted, so you could pick them up at a really good price and try to get as much back as you can. Do you have a preference between those two types of strategies, picking up bonds that have suffered a little bit?

NIMISHA SRIVASTAVA: I would say fallen angels today and distressed to come. So we don't yet see a ton of distressed volume today, but you want to start setting up some ways to capture the opportunities when and where it unfolds. But the real opportunity today in my

mind is in fallen angels to capture, as you noted, just securities that have traded significantly wider than where they probably should be.

LOK MA: Cool. I mean, those are my quickfire questions. I think you've gone through the quickfire round with flying colors, Nimisha. So congratulations.

[LAUGHTER]

I think we've got time for a final question, and it's something that's, I guess, a theme that's gone through all of our podcasts, the theme of sustainable investment. I think investors are increasingly kind of interested and passionate about sustainable investment. But there's also a growing realization, I think, that from a pure investment standpoint that these things really do matter, especially to the longer term investors that hold on to, in this case, credit for quite a long time. Do you want to just give us a picture of how sustainable investment has evolved within the credit space?

NIMISHA SRIVASTAVA: Yeah, for sure. It's a space we're spending a lot of time on and where we've seen a significant amount of movements from managers. I would say three or four years ago, it was more simplistic of you saw fixed income managers applying equity screens, not really embedding the philosophy of sustainability. Fast forward to today, and where we're seeing the most development is actually managers finally training staff, hiring dedicated resources, and isolating ESG risks, and how those would affect an issuer's probability of default.

And even in segments such as sovereign debt, we're starting to see managers think more creatively about how they engage with sovereigns, working with multilateral organizations, et cetera. So I think in my view, sustainability will be the biggest differentiator in what will drive fixed income managers' success over the next five years.

LOK MA: Wow. OK. And I think those are the kind of things I wanted to talk about. So I just want to thank you, Nimisha, for your time and for kind of laying out the lay of the land with the various areas of credit investment for us. So thanks for your time.

NIMISHA SRIVASTAVA: Thank you, Lok. A pleasure to be here.

LOK MA: And so this is the end of this episode as well. As I said, I think for future episodes, we're going to look into different specific areas of investment, and also different specific areas of kind of portfolios as well. So please do tune back in. And in the meantime, thank you for listening.

[MUSIC PLAYING]

SPEAKER 1: You've been listening to Willis Towers Watson podcast. For more information, visit willistowerswatson.com