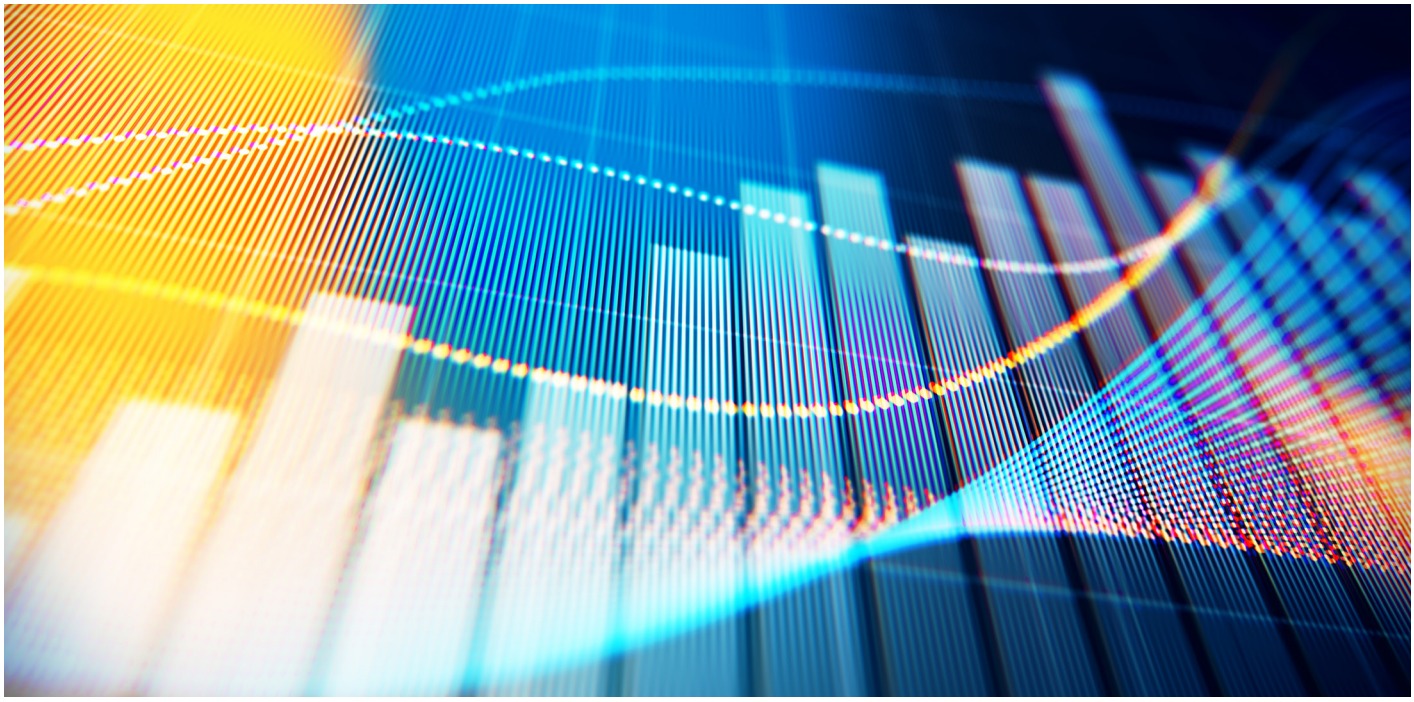
BlueBay
Asset Management

EMBRACING LONG/SHORT CREDIT IN VOLATILE MARKETS

MARK DOWDING
CHIEF INVESTMENT OFFICER

NOVEMBER 2020



Uncertainty creates volatility and for active managers, this can lead to opportunity. While the 'new normal' environment might be characterised by a challenging combination of low yields, political uncertainty and ongoing geopolitical disputes, active long/short credit approaches have the potential to generate alpha both from macro positioning and from harnessing performance dispersion.

Reframing the investment landscape

After more than a decade of relatively settled capital markets, the investment landscape has dramatically changed. The arrival of Covid-19 at the beginning of 2020 decimated large parts of the global economy, introducing volatility not seen since the 2008 global financial crisis (GFC).

On 16 March 2020, the CBOE VIX index – widely regarded as the 'fear benchmark' of global investors – hit its highest level for nearly 12 years. This spike came as investors scrambled to reposition amid a dawning realisation of the far-reaching impact of the virus. Unlike during the financial crisis, volatility swept in quickly. The VIX hit 82.69 that day, up from 57.83 the previous day. Just two weeks earlier, it was in the low thirties.

With volatility sweeping in at such speed, investors found they were somewhat stuck with how they were positioned. Unsurprisingly, many fund managers were caught wrong-footed and those invested heavily in long-only trackers or exchange-traded funds saw their portfolio values sink. Conversely, long/short investors enjoyed a degree of protection. For our clients, the short book proved to be a significant driver of returns during March. In April, when markets staged a comeback, we were able to use beta as an alpha source, harnessing vehicles such as credit default swap indices to make further gains as the market moved upwards once more.

The new normal

For investors seeking comfort, it might be tempting to paint the market characteristics of March and April as unusual. Compared to the prior decade, they were. However, what we have seen since, and what we think about the road ahead, suggests that volatility and uncertainty will be with us for some time.

In June, the International Monetary Fund (IMF) warned that a global recession would be much deeper than originally forecast as a result of the coronavirus, with output predicted to shrink by 4.9% in 2020. It also warned that any new Covid-19 wave could shrink

Unlike during the financial crisis, volatility swept in quickly. The VIX hit 82.69 that day, up from 57.83 the previous day. Just two weeks earlier, it was in the low thirties.

growth in 2021 to 0.5%. Ordinarily, investors would expect volatility from the prediction of any recession, let alone one which is forecast to be the deepest since the Great Depression. But there are other factors at play, too. Major events like elections and the ongoing row between oil producers are also likely to fuel volatility.

At the same time, central banks are beginning to recognise the limits of their existing stimulus measures and the detrimental impact of negative interest rates.

With monetary policy interventions failing to have the desired effect, investors can expect more aggressive fiscal policies to follow.

With so many variables influencing this 'new normal', we believe asset owners will need to reconsider their approaches and start to question long-held beliefs to evaluate whether these are still appropriate in this more challenging environment.

We don't believe that it is a giant leap to embracing long/short from long-only. Essentially, you are taking a view on the securities you expect to do well and insulating yourselves against those you expect to do less well.

Rethinking biases

Most investors have a natural behavioural impediment which discourages them from betting that things will turn out badly for a company or sector. A long/short strategy presents a potential countermeasure to this common human bias, providing an option to profit even if market movements aren't upward. We don't believe that it is a giant leap to embracing long/short from long-only. Essentially, you are taking a view on the securities you expect to do well and insulating yourselves against those you expect to do less well.

However, embracing a long/short strategy isn't always as simple as shorting 'bad' companies and going long potential 'good' ones. Opportunities can lie in shorting good companies because they may be overvalued, or going long a company with difficulties because it may seem too cheap.

Additionally, embracing short-selling can also help asset owners with their environmental, social and governance (ESG) aspirations by actively putting pressure on companies to improve their practices. This point was highlighted in a July 2020 report by the Alternative Investment Management Association, which found that short-sellers had the ability to raise the cost of capital for organisations that failed to curb their carbon emissions.

Of course, investor preconceptions are not purely focused on the short-selling aspect. Over the past decade, investors have developed many biases about absolute return strategies. These misconceptions have been fuelled by a relatively predictable market which flattered the returns of beta-driven funds. However, the prospect of a market with more volatility and uncertainty should stimulate a revaluation of views on specific asset types to see if they still ring true. Here are three examples:

1. Government bonds

Investor views on certain fixed income sub-sectors have become deeply ingrained over decades. This is particularly evident with developed market government bonds. These are traditionally viewed as low risk due to the unlikely prospect that the issuing government will default on repayment. However, we think the new market environment requires a re-evaluation of this assumption.

While the risk of repayment default may still be low, duration risk is now a credible threat to returns. As interest rates on developed-market government bonds are at historic lows, the value of these bonds could be eroded if interest rates rise. This duration risk is even higher in bonds with longer maturities.

2. ETFs

Another factor for investors to consider is the liquidity risk that may exist within their portfolios from exchange-traded funds (ETFs). Over the past decade, bond ETFs have soared in popularity as investors sought cheap access to fixed-income markets. These vehicles are still in their infancy and have not yet been

tested during a sustained period of stress. In March 2020, a Bloomberg report highlighted some extreme gaps appearing between the price and value of assets in some investment-grade ETFs, fuelling anxiety about a future illiquidity event. Bloomberg's consensus of market analysts concluded that the authorised participants who usually equalise the value of the ETF and the underlying bonds were less keen to do so during periods of volatility.

3. Structured credit

Many investors have had their views of structured credit coloured by the performance of residential mortgage-backed securities and collateralised loan obligations during the GFC. As a result, many jettisoned structured credit entirely without recognising the numerous asset types that fall under this umbrella term.

Since the GFC, regulators have put dozens of safeguards in place to strengthen the protection for investors and improve risk transparency for market participants in structured credit. In our view, this, coupled with the new Covid-19 market landscape, has ensured structured credit has become a powerful part of the asset mix for fixed-income investors seeking alpha.

A note on costs

Some institutional investor groups have previously been cautious about embracing strategies that include a short-selling element. During periods of steady incremental market returns from long-only funds, this hasn't posed a problem. In fact, for most of the past decade, funds operating an absolute return or long/short strategy have found themselves out of favour, as they have been overshadowed by low-cost beta strategies that harnessed the upwards trajectory of the indices they track.

However, the new market environment is unlikely to be as linear in terms of year-on-year gains, meaning investors may have to pay more in order to secure the outperformance that was previously so cheaply available.

While diligent investors will continue to be cost-focused, we anticipate attitudes towards mandate allocations will no longer focus on fees alone. Instead, we believe the focus for the coming years is likely to move towards value for money.

In our view, structured credit has become a powerful part of the asset mix for fixed-income investors seeking alpha.

Understanding the opportunity

Allocations to long-only fixed income strategies may come under pressure in the months ahead. Central banks have reduced interest rates to historic lows as part of unprecedented accommodative monetary policies, in an attempt to stimulate the global economy. For investors, this means that yields have collapsed to their lowest level in the modern era. When traditional corporate or government bonds were still generating yields that met their liabilities, investors had little interest in absolute return-style strategies. But in our view, this is likely to change.

In the short term, we believe central banks are unlikely to hike interest rates. At the same time, fixed-income trackers and passive funds are no longer operating in a beta-driven market, prompting investors to review their allocations to these vehicles.

Attention is instead turning to actively managed absolute return and long/short credit strategies that are able to translate opportunities at each stage of the credit cycle. Investors are weighing up the duration risk to which they are exposed and considering whether there is liquidity risk in the fixed-income ETFs that they may hold.

The investment cycle

That said, the investment opportunity that exists right now is not purely about the economic reactions to the Covid-19 pandemic. While the virus has exaggerated the cyclical aspect of some opportunities, the market was already in late cycle. Covid-19 has effectively exacerbated the trends that were brewing in the market prior to the outbreak.

Pre-virus, structural changes were already taking place in numerous industries. For example, in the automotive sector, the electrification and self-driving revolution was taking place, while in retail, online sales were challenging traditional high-street outlets. The arrival of Covid-19 has only served to intensify these trends. The cyclical versus non-cyclical theme has been rejuvenated and the virus has acted as a catalyst to transform the landscape in some other sectors, such as aviation, travel and tourism.

A long/short focus

A limitation to note is that these themes assess the market opportunity from a purely macro and top-down credit standpoint. For long/short credit, the picture is more nuanced and requires individual fundamental

In the short term, we believe central banks are unlikely to hike interest rates. At the same time, fixed-income trackers and passive funds are no longer operating in a beta-driven market, prompting investors to review their allocations to these vehicles.

and bottom-up assessments. Technical analysis is also very important and there are plenty of distorting factors. Central banks have committed to being the buyers of last resort and are continuing to purchase a substantial amount of assets in the market. The European Central Bank, for instance, has purchased around 30% of all new credit since 2016.

At the same time, there are now significant amounts of assets sitting in passive strategies that completely ignore the aforementioned sector themes. Their focus is purely on whether something is a constituent of the benchmark index they are obliged to track.

These market behaviours all create anomalies for us, from which to potentially capitalise. These market participants can be big buyers or sellers of bonds, driving valuations in the opposite direction to credit trends. In fact, passive investment is increasingly showing itself to be an opportunity source for long/short managers.

Positioning and risk

In order to achieve an optimum balance between risk and reward in long/short credit, we believe it is important to diversify strategies within a portfolio and treat them as separate – but interacting – sections.

Within our own long/short strategy, the sub-strategies are segmented to ensure we can spot investment prospects as they arise. The event-driven book allows us to potentially take advantage of merger and acquisition activity, stressed and distressed opportunities in overly levered companies, or from significant credit-market dislocations.

Relative value is often overlooked by investors in the context of long/short, but we've found it to be a powerful strategy to have for all market environments. In this sub-set, we choose assets on the expectation that they will eventually revert to their long-term average (mean reversion). Having identified a range in which an asset typically trades, we will look for behaviours where assets trade on the relative-value side. Changes in market dynamics can mean bond curves steepen or flatten dramatically. It is here where investors can potentially benefit.

The distressed debt sub-sector typically does not have capital allocated to it all the time. Instead, we find it optimal for allocations to be made selectively according to the stages of the market cycle. In the early part of 2020, for example, as the economic repercussions of the novel coronavirus swept through various company sectors, our long/short credit team made several opportunistic distressed allocations as they saw opportunities unfold.

In addition to capital allocations to these specific segments, it can be helpful to take an overall view of the long/short book. This allows for an analysis of risk levels and the addition of tactical positions. Credit default swap indices can be used as a hedge for the broader book, for example.

We believe it is important to build from the bottom-up and then look at overall strategy positioning. This approach offers a good way to hedge any bias.

To achieve an optimum balance between risk and reward in long/short credit, we believe it is important to diversify strategies within a portfolio and treat them as separate – but interacting – sections.

Harnessing volatility and dispersion

Since the GFC and until the outbreak of Covid-19, credit investors had seen fairly limited dispersion between the best and the worst performers in the investment-grade sector. For active managers, this was bad news. It meant a very limited opportunity to show their talents as specialist credit managers.

But we believe that the credit cycle is now maturing – we are already seeing a greater dispersion of returns and higher levels of volatility and we anticipate this continuing over the months ahead. The economic fallout from the coronavirus heralds a new world in which we will likely see a stark difference between the credit success stories and the failures.

Fund managers – the active ones in particular – have always focused on generating alpha. In this new world, investors will need to consider specifically where alpha is generated. We believe capturing alpha is only possible if you have volatility in your opportunity set and the talent in your investment team to harvest it.

However, this does not mean the overall volatility of a long/short portfolio will be higher than other fixed income or absolute return funds. An allocation to long/short credit should be complementary to the overall risk level of a portfolio, as well as increasing return diversification.

The global pandemic triggered a huge flight to quality followed by a speedy recovery, which provided the perfect environment for skilled long/short credit investors to exploit opportunities presented by the volatility, while also managing overall risk effectively. However, we see market volatility persisting for some time yet, and with it the demand for skilled investment teams that are supported by talented traders and risk managers.

We believe that the credit cycle is now maturing – we are already seeing a greater dispersion of returns and higher levels of volatility; we are anticipating this continuing over the months ahead.

Embracing and managing risk

Traditionally, risk teams are perceived as a group of policing personnel employed to admonish investment team members when they do something wrong. Our mindset towards risk management takes a completely counter view to this approach. The BlueBay risk team set internal guidelines and policies that relate to our in-house risk framework and review and approve counterparty relationships. However, it is the guidance they provide to investment professionals that is crucial in volatile markets in order to generate alpha.

In Formula 1 motorsport, racing drivers are supported by a network of engineers, analysts and mechanics. Their roles are to consistently monitor the performance of the car, the driver and the dynamics of the race, feeding information back to the driver in real-time. We believe an effective long/short strategy requires a risk team that works in a similar way.

By monitoring the vitals of investments, the structure of portfolios and the dynamics of the wider market, risk analysts can offer information outside of the data upon which the portfolio managers and analysts will be focused. By regularly offering such detailed information, it allows the investment managers and traders to make additional tweaks and changes that may drive performance.

While it may be controversial, we believe risk teams should also be encouraged and enabled to challenge investment management professionals on their views and decisions to ensure that they retain a complete understanding of the risks involved in any investment.

Liquidity risk

When the effects of the global pandemic started to filter through into credit markets, there were plenty of market participants who were caught wrong-footed. In addition to the triggers from Covid-19, there was also an oil price battle playing out. What followed was a sharp repricing of bonds across the board. This reflected an environment in which investors were seeking liquidity and there was very little time to reposition.

To guard against this risk, we view liquidity management as vital. This can come in the form of efficient trading, but also through careful management of income from coupons and maturing bonds. There will inevitably be times at which it is not possible to trade as desired. This makes it even more important for liquidity management to be partnered with rigorous portfolio construction and diversification to ensure that investors are protected as much as possible from sharp price movements.

Our dedicated risk teams ensure we keep a very close track of the liquidity that exists within our long/short strategy, using a proprietary model that calculates a liquidity score for each holding. Our in-house algorithm allows us to calculate the bid-ask spread for each holding, keeping in mind the size of the trade, the number of market makers and the amount outstanding. The risk team also considers how long it would take to sell in different market scenarios, as well as the impact of significant funding or margin shocks.

Volatility

For several years, pricing volatility in credit markets has been quite benign. This year, however, it has spiked amid the global impact of the coronavirus pandemic – and there are several other significant factors that indicate a higher level of volatility is here to stay.

In the US, the transfer of leadership from the Republican Party to the Democrats is likely to be an ongoing source of volatility. Ahead of Biden's inauguration, current president Donald Trump's feud with China could also provide both downside and upside momentum for companies depending on their exposures to Asia and North America.

Meanwhile, Brexit negotiations are at a critical stage in the UK and, whatever the outcome, the fallout is likely to be a multi-year, complex story. Through all of this, tensions between several major oil-producing countries have also driven volatility this year and will likely continue to do so.

To successfully navigate these geopolitical risks, as well as the bottom-up, company and sector-specific risks that will undoubtedly emerge, we believe robust processes are required in combination with a well-resourced team with a focus on downside protection as much as capturing upside.

Strategy-level liquidity scores

We use a proprietary liquidity model in order to calculate liquidity scores for our credit long/short strategy holdings. The model aims to dynamically assess – for any size – the bid-ask spread based on observable and quantifiable parameters, as well as qualitative inputs.

Based on modelled bid-ask spreads, the positions are then classified into four different liquidity buckets (daily, weekly, monthly and over one month) depending on the estimated time it would take to sell in normal market conditions without material transaction costs.

Source: BlueBay Asset Management, October 2020

ESG risks

We believe that environmental, social and governance (ESG) analysis plays a critical role in the modern analysis of securities in a long/short strategy. To be able to fully understand the risks that exist, investors need to go beyond traditional credit research. They need to understand how ESG factors are changing investor attitudes and demand for certain securities.

For fund management groups, this means cultivating relationships with policymakers, bankers and regulators to understand their priorities and anticipate how these might change the corporate environment. This groundwork will likely prove vital in the months following the global pandemic as all market participants will be trying to identify those credits that will survive the crisis. We believe there may be some value in the restructuring cycle, with opportunities for refinancing. However, only those investors with the ability to fully understand governance risks will be able to participate.

To successfully navigate these geopolitical risks, as well as the bottom-up, company and sector-specific risks that will undoubtedly emerge, we believe robust processes are required in combination with a well-resourced team with a focus on downside protection as much as capturing upside.

Comparing strategies

Historically, a long/short approach has – inaccurately – been used by fund management groups to emphasise strategies that are actually long-biased. Were an asset owner or a consultant to dig deeper, they may find that some of these strategies are actually long on high-yield securities and short on investment-grade securities. We believe that is nothing more than being market directional and not what long/short should be about.

While we recognise that market direction is an alpha source, we believe it to be a poor one. In our view, it is important to be able to demonstrate where you are generating alpha, which means being uncorrelated to your underlying asset class. The focus therefore should be on the relative performance of long positions versus short positions, as these are the best way of identifying whether an investment team's process is working. The acid test is not only how a long/short strategy performs when the market is rising, but how it performs when it falls. We believe that, without this symmetry, it is not a true long/short strategy.

The acid test is not only how a long/short strategy performs when the market is rising, but how it performs when it falls. We believe that, without this symmetry, it is not a true long/short strategy.

What to look for in a long/short credit manager

- **Does the manager have a skilled team?** The portfolio manager(s) are not the only important individuals in the team. The strategy needs to have the support of a well-resourced risk analysis function, experienced traders who can access liquidity and execute efficiently and skilled analysts who can get close to companies and identify long and short opportunities.

- **Is there a true balance between long and short positions?** Long/short credit strategies should be a complement to your traditional long-only fixed-income exposures, not replicate them. Be certain that the portfolio is built with a balanced approach to long and short positions so the allocation will perform properly alongside other holdings and not inadvertently increase your exposure to market beta.

- **Is liquidity properly managed?** When market sentiment is switching so quickly between 'risk-off' and 'risk-on' – as has been the case through 2020 – long/short credit strategies need to be assured of liquidity. This can be accessed in several ways, including prudent management of income from coupons, efficient trading and management of deal and portfolio size. Too small and a strategy will struggle to achieve sufficient diversification. Too big and it will struggle to trade efficiently.

- **How does the manager harness volatility and mitigate risks?** Volatility is likely to remain elevated for some time to come as the global economy adjusts to the impact of the Covid-19 pandemic. Default rates are also likely to rise. With this new world ahead, long/short managers must be able to demonstrate agility and effective risk management to help generate returns now that directionality is less reliable.

- **How are managers remunerated?** Many investment management companies, particularly hedge funds, motivate individuals by offering them substantial personal gains for outperformance. However, in a strategy that is so reliant on teamwork and risk management, such an approach can skew incentives towards shorter-term gains. Make sure your long/short manager has an appropriate reward structure that benefits the team and does not compromise the strategy or culture.

Conclusion

Unprecedented in its nature, the Covid-19 outbreak has reshaped the investment landscape, bringing with it elevated volatility levels which look set to remain the status quo for the foreseeable future. Few were expecting the violent market moves that followed the spread of the virus, but long-only investors notably suffered, having to endure some radical downturns while those with long/short exposure were more insulated from the worst of the undulations.

Facing a deep recession, historically low rates and an unexpected 'new normal' environment that could be further rocked by geopolitical events, investors must accept the reality that market returns could be challenged for a while to come. As such, possessing the ability to position long/short can not only insulate portfolio performance against companies you expect to do poorly, it can also help you avoid successful-but-overvalued names and apply pressure on firms which have scope to improve their ESG credentials.

We believe successful long/short credit strategies require clearly segmented sub-strategy constituents managed by a skilled investment team where risk considerations are used to refine, rather than constrict, return potential.

In uncertain times, it doesn't need to be all in or all out. As well as being held as dedicated diversifiers, combining long/short credit strategies with traditional long-only approaches can help refine fixed-income portfolios so they are able to perform better in the 'new normal', having the potential to benefit from volatility rather than being at its mercy.

Mark Dowding
Partner, Chief Investment Officer, Senior Portfolio Manager

Mark is Chief Investment Officer at BlueBay. He has over 25 years' experience as a macro fixed income investor and has been a senior portfolio manager at BlueBay since 2010. Prior to joining BlueBay, Mark was Head of Fixed Income in Europe for Deutsche Asset Management, a role he previously occupied at Invesco. He started his career as a fixed income portfolio manager at Morgan Grenfell in 1993 and throughout this history, Mark has participated in Asset Allocation for multi asset funds, a role he maintains at BlueBay within the Multi-Asset Decision Group. As a macro risk taker, Mark has actively pursued an open dialogue with policy makers and opinion formers, believing that proprietary research is key to generating insights in order to generate strong investment returns. He holds a BSc (Hons) in Economics from the University of Warwick.