Credit: Potentially The Best Asset Class Available

BY: **KEVIN FOLEY**

Credit, with exposure to investment grade credit spreads and not to interest rates, may be the best asset class available right now.

Short-term investment grade credit is poised to return 10 per cent or more in the next 12 months, likely better than all other asset classes on a risk-adjusted basis, and even better than most asset classes on an absolute basis. With a continuation of <5 per cent standard deviation, this 10 per cent expected return would improve the performance of almost any portfolio.

Prudent Leverage

High-quality, short-term credit and 10 per cent may sound too good to be true to some investors. This credit strategy applies prudent leverage to low-risk assets to produce a compelling return. Leverage may be construed poorly by some, but let's remember that leverage is not the source of the risk, leverage only magnifies the existing risk. The proposition with the credit strategy is that applying leverage to short-term, high-quality assets is both prudent and astute.

Individuals and companies use leverage in a variety of ways that have proven effective over time; mortgages, car leases, bank balance sheets, margin accounts, options etc. The notion that leverage is bad or risky when it comes to investments is certainly true in some situations, but there are numerous everyday uses of leverage that are now considered common. Magnifying the yield of low-risk assets, to create dependable and effective return, is a valuable and reasonable application in the arena of selecting risks to generate return.

The use of the term credit or credit strategy in this article is specifically referring to Canadian short maturity, investment grade, corporate bond spreads, with the interest rate exposure eliminated. This strategy is not possible to produce for most investors and better sourced through an experienced fund manager. Access to primary and secondary bond liquidity, knowledge of the Canadian corporate issuers, the ability to short bonds, and smart relative value positioning all add to the reason to access this investment via an active, proven fund manager. This credit strategy with a duration of less than three years, without exposure to high yield, private debt, interest rates, or equity can be used to generate returns approaching 10 per cent.

As seen in *Chart 1*, investment grade credit spreads are at historically wide levels, although appropriately not as wide as the levels reached during the global financial crisis and the onset of the pandemic. These levels have baked in too much pessimism for this asset class in this environment, thereby limiting potential for further widening and creating an attractive potential gain when spreads move back toward historical norms. Some would call this a compelling asymmetric risk.

In the 12 months following the peak for spreads in 2016, managers who executed this credit strategy returned more than 15 per cent. We can't know what the next 12 months holds, but current running yields of greater than 10 per cent, which buffer potential spread widening and return even more if spreads tighten, certainly registers as a compelling investment. For further context, this strategy still makes money if spreads widen by 50 per cent on average from these elevated levels.

Better Solution

Credit strategies are built to be a better fixed income solution, delivering low-volatility absolute returns in rising and falling rate environments. Returns for this strategy beat almost all traditional fixed income funds in the past seven-plus years, on an absolute and risk-adjusted basis. It could be included in a portfolio's alternatives bucket or an absolute return bucket, especially right now, while it is designed as a replacement for or a complement to traditional fixed income.

I would encourage you to compare a likely 10 per cent return in this low-vol and low-risk asset class to your assumptions for return and risk projections for major asset classes. This is a moment in time where this all-weather strategy is asymmetrically setup to outperform, while also attractive for those looking to add defence to a portfolio in lieu of other debt or equity alternatives during these volatile times. **BPM**

Kevin Foley
is a managing director, institutional accounts, at YTM Capital.

kevin.foley@ytmcapital.com

Chart 1: Canadian Investment Grade Spreads