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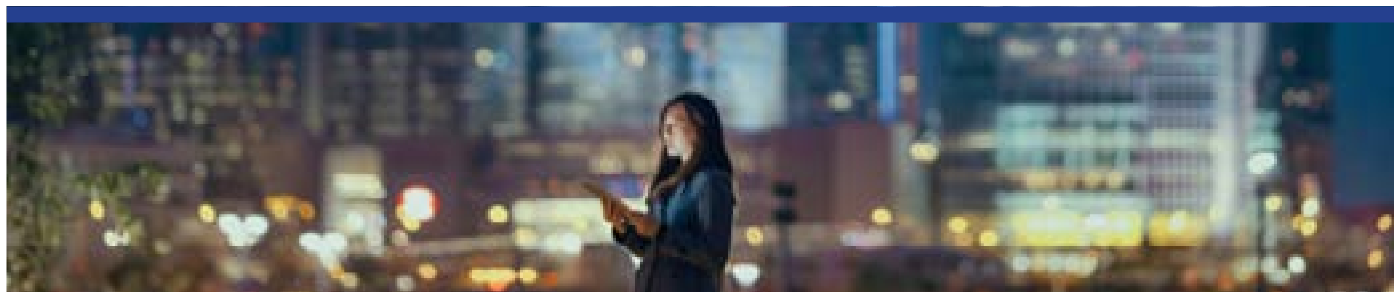

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CIO Strategy Special Report

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Active Bond Management in Less Liquid Markets

SUMMARY

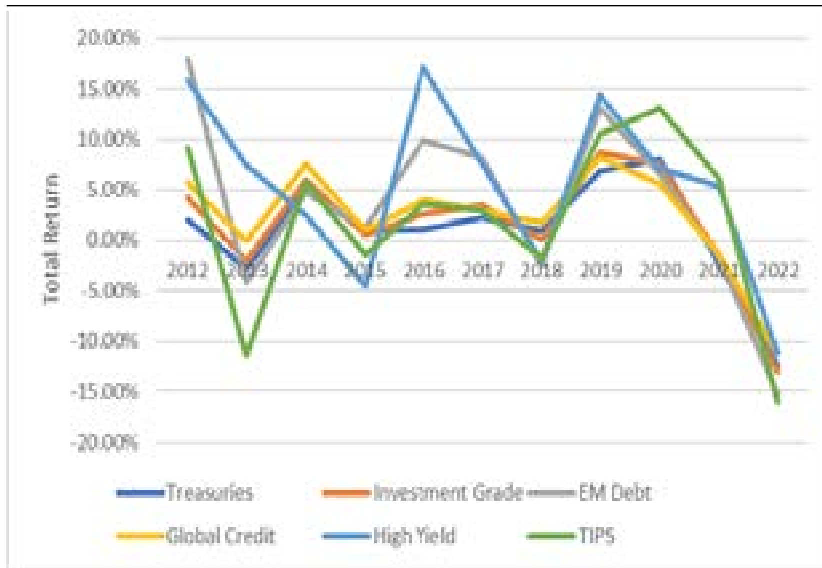
- The weakness in the riskiest elements of credit markets in late 2022 and their rally in January 2023 seem divorced from typical bond fundamentals. Now, demand for new bond issues from traditional buyers has largely disappeared.
- The largest holders of corporate bonds and syndicated loans -- mutual funds, ETFs and collateralized loan obligations -- are sensitive to fund flows and the potential for ratings downgrades, which can distort market pricing for impacted securities.
- These conditions provide a window for hedge funds and private credit managers to buy assets at unusually attractive prices.
- In environments where public credit markets have been volatile, hedge funds demonstrate the utility of active management. Private credit funds are particularly well-positioned to provide liquidity when companies cannot access capital markets.

The 2022 backdrop: Bond headwinds vs hedge funds

Portfolio returns in 2022 and early 2023 have been volatile and painful for many public market investors. An unprecedented degree of correlation between equity and bond markets diminished the apparent value of portfolio diversification, leaving cash as a favored asset class last year. Fixed income investors saw the Bloomberg Aggregate Global Bond Index lost 11.2% with US Treasuries returning -12.5% in 2022 (**Figure 1**). Bond market implied volatility was twice its long-term average as measured by the MOVE Index (**Figure 2**). During the same period, the equity volatility index, the VIX, was broadly within historical norms and stayed +/- 40% of the post-Covid average.[1]

In 2022, hedge funds, on average, preserved capital better than passive equity and fixed income strategies. In this instance, the alternative asset class fulfilled its intended role within portfolios by providing diversification from traditional markets, particularly in Relative Value and Macro strategies. Even more directional strategies such as Event-Driven and Credit hedge funds outperformed the broader bond indices (**Figure 3**).

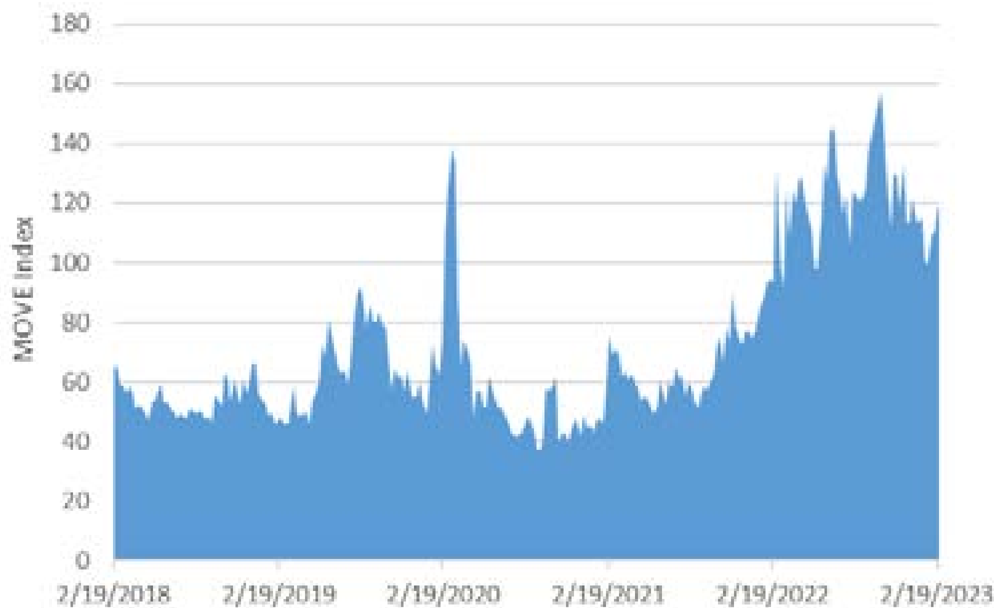
Figure 1: There was no safe harbor in bonds last year



Source: Bloomberg, as of December 31, 2022. Treasuries represented by Bloomberg US Treasuries Index total return. Investment Grade represented by Bloomberg Barclays US Aggregate Bond Index. High Yield represented by Bloomberg US Corporate High Yield Bond Index. EM Debt represented by Bloomberg Emerging Markets Hard Currency Aggregate Index. Global Credit is represented by Bloomberg Barclays Global Aggregate Total Return Index Value Hedged USD. TIPS represented by S&P 10 Year US TIPS Index Total Return. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

[1] Source: Bloomberg

Figure 2: Bond market volatility spiked in 2022



Source: Bloomberg, as of February 22, 2023. Chart shows the ICE BofAML MOVE Index, which measures the volatility of the US Treasury market. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Higher rates and Fed tightening are curtailing demand for new issues

As we begin 2023, a powerful combination of higher rates and quantitative tightening has curtailed demand for new debt issues. This is reflected in their pricing often divorced from company fundamentals. In 2022, spreads for new issue B/B+ loans peaked at 510bps in July, yet dropped to 457bps by December, even as the Fed pressed on with rapid policy tightening (**Figure 4**; and see last week's CIO Bulletin).

During the third quarter of 2022, leveraged credit markets effectively closed as banks found they had no buyers for the loan commitments they signed in the first and second quarters (**Figure 5**). This led to downward pressure on asset prices as banks struggled to syndicate their loans. Issuers had to deeply discount the loans for syndication with pricing in the low 90s relative to par, driving the average yield to maturity to 10.4% in Q4 2022. This was the first double-digit average for any quarter since 2009. Despite the bounce-back in early 2023, over 22% of CCC-rated high yield loans are trading at 60% of par or below (**Figure 6**).

Given such severe syndicated debt-issuance constraints, many companies will need to explore alternative ways of raising capital and extending debt maturities in 2023 and beyond.

Intricacies and opportunities

The rout in lower credit bonds now appears somewhat indiscriminate, with investors overlooking firm specific factors that may influence when and how borrowers repay their outstanding debt. One of the technical factors driving these pricing and demand dynamics in bond markets are the share of these loans held by Collateralized Loan Obligations (CLOs) and mutual funds/ETFs. CLOs hold 73% of the syndicated loan market in the US, and US mutual funds and ETFs hold 45% of US corporate bonds.[2] (A collateralized loan obligation is a single security backed by a pool of debt. CLOs are often backed by corporate loans or loans taken out by private equity firms.)

The divergence between public market investors – like ETFs and CLOs – and private market buyers has created a notably favorable landscape for alternative managers seeking to capture better risk-adjusted and absolute returns relative to published bond indices.

2 Source: Pitchbook/LCD as of Dec. 31, 2022

Why it's a bond picker's market

Given the sensitivity of mutual funds and CLOs to fund flows and ratings downgrades, prices of poorer quality bonds often get hit disproportionately. For example, CLOs face restrictions around CCC ratings that often leads them to sell higher-rated bonds well ahead of any potential or perceived earnings risk of their issuers. The outflows from high yield retail bond funds have totaled $38.2 billion since the beginning of 2021.[3]

Spooked by this credit and liquidity shakeout amid an uncertain outlook for corporate profits, certain capital markets have largely closed to some companies wishing to raise capital. For investors, the absence of bank lending, lower ETF and CLO purchases and concerns about corporate profits going forward, have created a series of related opportunities.

Looking back at similar periods

In our view, this is a time when opportunistic alternatives managers can use their expertise to underwrite loans and pursue event-driven strategies in both public and private credit markets. Managers who have insight into issuer quality and potential capital structure events – including refinancings, debt exchanges and outright restructurings – may be able to generate strong total returns.

In periods of uncertainty and volatility, skilled bond managers with stable capital and expertise in security selection can often take advantage market dislocations. To be able to acquire the credits of fundamentally sound companies at attractive valuations is unusual. Such opportunities include purchases in the secondary market at prices that may provide both downside mitigation and potential future appreciation.

Previous periods of market stress have translated into opportunities for hedge fund managers with credit market expertise. We examined the high-yield bond market's five biggest declines: four recessions including the global financial crisis as well as the 2015–2016 wave of energy sector defaults. Following those episodes, the average 24-month return for the HFRI ED (Distressed/Restructuring Index) was approximately 45% (**Figure 7**).

Why private credit may outperform public markets

As we emphasized last week, we are still erring on the side of caution in fully invested portfolios, seeking to earn investment grade bond and dividend income to generate returns even as markets speculate about a return to bull market conditions we think seems premature. For high-yield bonds in the public markets, we prefer managers who can evaluate absolute and relative value, and who focus on events that may provide idiosyncratic upside.

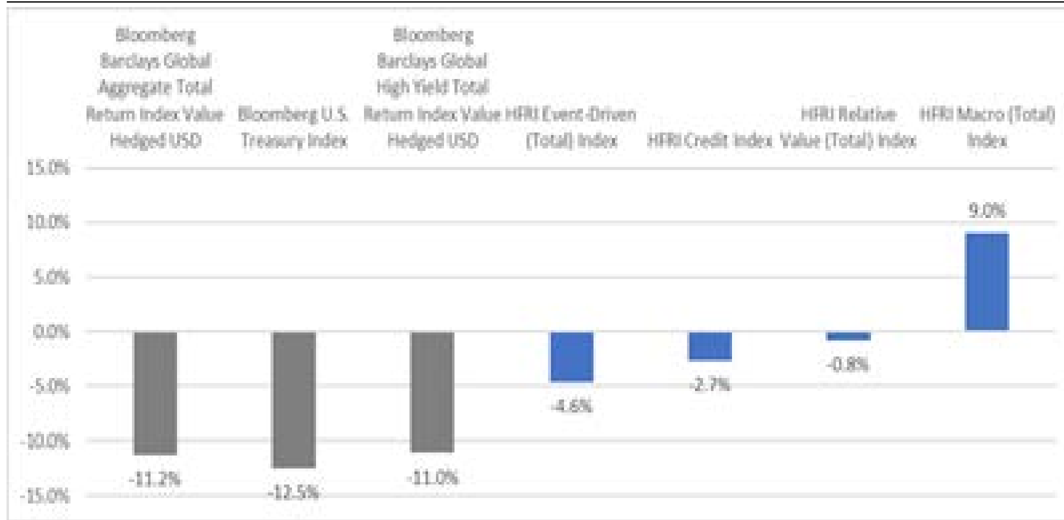
Yet with today's heightened uncertainty, qualified investors may be able to access active management via alternatives managers focused on private market opportunities. Alternative fixed income managers can be rewarded for providing liquidity in times of limited capital markets availability, allowing them to evaluate financing solutions across the risk continuum while patiently awaiting the emergence of potential stressed/distressed opportunities.

In particular, funds that specialize in credit underwriting, capital strategies and distressed restructuring may be well-placed to add value for investors in 2023 and 2024. With locked up capital, they may exploit wide dispersions between the best and worst performing credit securities.

For qualified investors who can look beyond short-term holding periods and don't require liquidity in all components of their portfolios, private market strategies will seek to exploit market dislocations and leverage returns. This is reflected in our higher 10-year return estimates for these asset classes (**Figure 8**).

[3] Source: Morningstar as of Feb. 15, 2023

Figure 3: Hedge funds delivered alpha in 2022

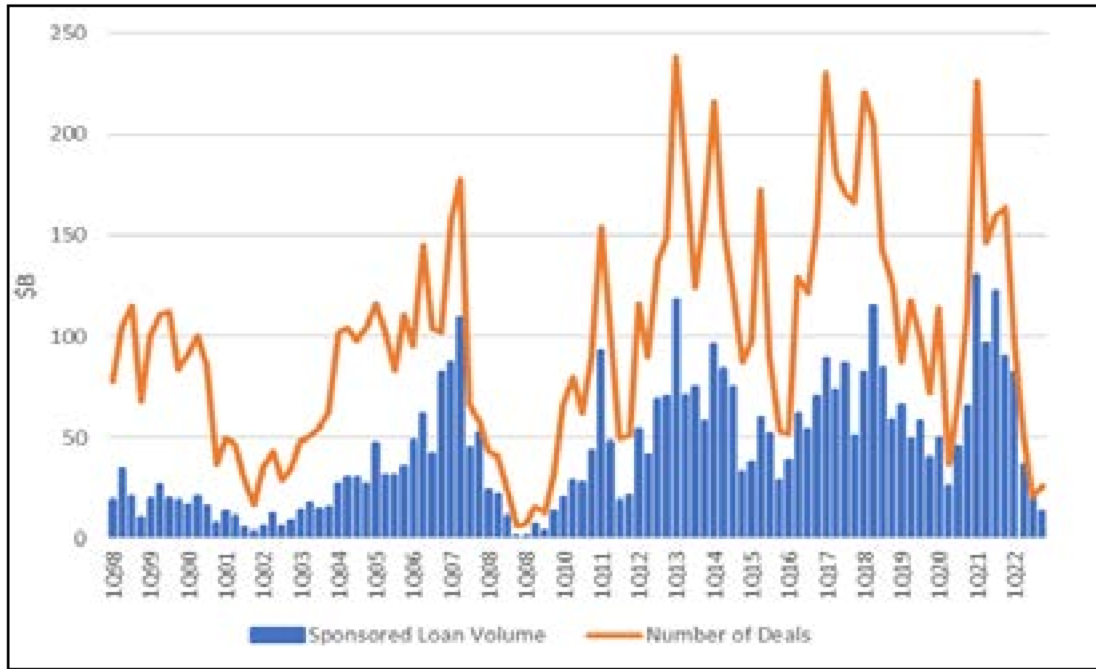


Source: Bloomberg, HFRI, as of December 31, 2022. Treasuries represented by Bloomberg US Treasuries Index total return. High Yield represented by Bloomberg US Corporate High Yield Bond Index. Global Credit is represented by Bloomberg Barclays Global Aggregate Total Return Index Value Hedged USD. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 4: Lowest tier high-yield leading credit trading

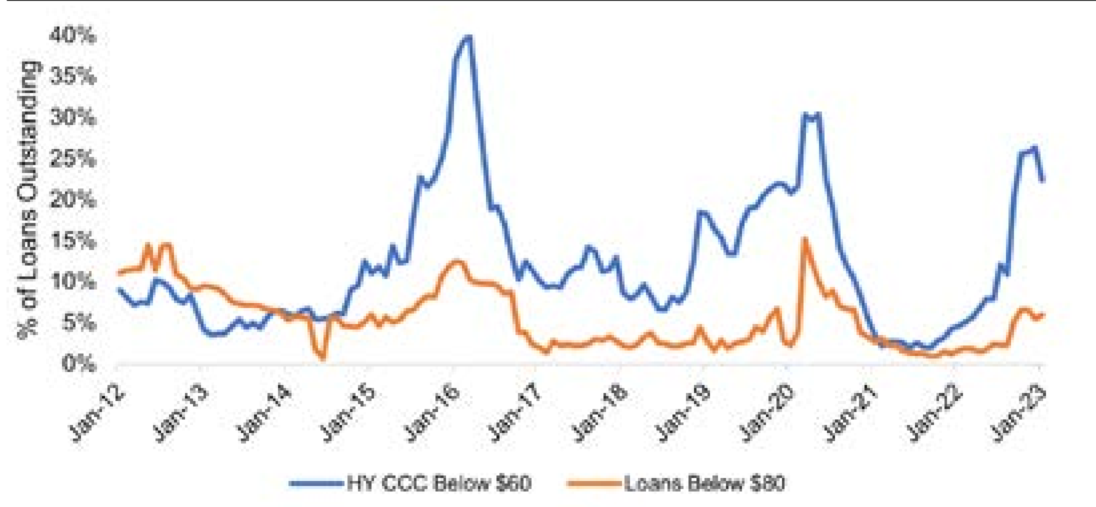
Source: Bloomberg as of February 23, 2023. Indices are unmanaged. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 5: The syndicated loan market is effectively closed



Source: Leveraged Commentary & Data as of Jan. 27, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 6: Over 25% of CCC-rated high yield loans are trading below $60



Source: Moody's as of January 27, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 7: Historical distressed hedge fund performance after difficult periods for high-yield bonds

	BEGIN	END	HY INDEX DRAWDOWN	HFRI FORWARD 24M RETURN
Early 90s recession	7/31/1990	10/31/1990	-11.2%	66.0%
Dot-com bust	2/28/2001	9/30/2001	-8.7%	30.7%
Global financial crisis	5/31/2007	11/30/2008	-33.2%	34.8%
Energy sector's wave of defaults	5/31/2015	1/31/2016	-9.8%	27.8%
Early COVID pandemic	1/31/2020	3/31/2020	-13.1%	48.2%

Source: Bloomberg, HFR, as of Dec. 31, 2022. All forecasts are expressions of opinion, are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. Table shows five significant selloffs in high-yield bonds and the subsequent 24-month returns of the HFRI ED Distressed/Restructuring Index.

Figure 8: CGWI's 10-year strategic return estimates

	STRATEGIC RETURN ESTIMATES IN USD FOR 2023
GLOBAL EQUITY	7.6%
GLOBAL FIXED INCOME	5.1%
DEVELOPED MARKET EQUITIES	7.0%
EMERGING MARKET EQUITIES	12.9%
INVESTMENT GRADE FIXED INCOME	4.6%
HIGH YIELD FIXED INCOME	7.4%
EMERGING MARKET FIXED INCOME	7.8%
CASH	3.4%
HEDGE FUNDS	9.1%
PRIVATE EQUITY	17.6%
REAL ESTATE	10.6%
COMMODITIES	2.4%

Source: Citi Global Wealth Investments Global Asset Allocation Team. AVS is our proprietary strategic asset allocation methodology. 2023 SREs are based on data as of 31 Oct 2022. Global Equity consists of Developed and Emerging Market Equity. Global Fixed Income consists of Investment-Grade, High Yield and Emerging Market Fixed Income. Strategic Return Estimates are in US dollars; all estimates are expressions of opinion, are subject to change without notice and are not intended to be a guarantee of future events. Strategic Return Estimates (SREs) are no guarantee of future performance. Strategic Return Estimates based on indices are Citi Private Bank's forecast of returns for specific asset classes (to which the index belongs) over a 10-year time horizon. Indices are used to proxy for each asset class. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes utilize a proprietary forecasting methodology based on the assumption that equity valuations revert to their long-term trend over time. The methodology is built around specific valuation measures that require several stages of calculation. Assumptions on the projected growth of earnings and dividends are additionally applied to calculate the SRE of the equity asset class. Fixed Income asset class forecasts use a proprietary forecasting methodology that is based on current yield levels. Other asset classes utilize other specific forecasting methodologies. Each SRE does not reflect the deduction of client advisory fees and/or transaction expenses. Past performance is not indicative of future results. Future rates of return cannot be predicted with certainty. The actual rate of return on investments can vary widely. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index. SRE information shown above is hypothetical, not the actual performance of any client account. Hypothetical information reflects the application of a model methodology and selection of securities in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. SREs are in US dollars. SREs are generally updated on an annual basis, however they may be updated off cycle based on market conditions or methodology adjustments. **Note, the SREs provided here have been updated relative to those published in Outlook 2023.**

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Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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