Prescient
INVESTMENT MANAGEMENT

Considering credit quality and risk premia

By: Conway Williams, Prescient Head of Credit

Credit quality and risk premia are critical considerations for fixed-income investors in an increasingly uncertain global environment and a South African economy marked by volatility and structural challenges. As South Africa's leading systematic asset manager, we continue to witness first-hand how these factors influence decision-making across portfolios, particularly in the current economic uncertainty and market volatility environment.

Credit quality, or the assessment of an issuer's ability to meet its debt obligations, is the cornerstone of fixed-income investing. When we evaluate investment opportunities, we analyse the issuer's underlying strength—its performance, balance sheet, cashflows, the state of the industry it operates in, and, importantly, the broader economic outlook.

At Prescient Investment Management, credit analysis forms the foundation of our investment process. We deploy a systematic, data-driven approach to ensure we accurately assess creditworthiness, leveraging traditional financial metrics and advanced quantitative models.

This approach becomes even more critical with South Africa's unique political and economic factors. In a world of increasing global uncertainty—whether due to inflationary pressures, geopolitical tensions, or local economic challenges—ascertaining credit quality cannot be compromised. Investment-grade credit has become a key area of focus as we seek bonds that provide stability and predictable returns, even when yields are compressed.

Our model-driven strategies help us distinguish between issuers that may face temporary liquidity issues and those that present long-term default risk. While credit quality is primarily concerned with minimising default risk, risk premia represent the additional compensation investors demand for assuming greater risk. In fixed-income markets, risk premia materialise through yield spreads—the difference between the yield on a corporate bond and a risk-free government bond. The higher the risk of default or volatility in an issuer's credit profile, the wider the spread investors require to justify taking on that risk.

For instance, globally, the spread between investment-grade corporate bonds and US Treasuries widened to approximately 170 basis points (bps) during periods of economic uncertainty in 2023. Similarly, in South Africa, the spread between corporate bonds and the 10-year government bond (currently yielding about 10.5%) has varied significantly, often reflecting heightened concerns about local political risks and structural economic challenges. In 2024, this spread hovered around 250-300 bps for local high-yield corporate bonds, indicative of the perceived elevated risk in certain sectors.

At Prescient, we take a holistic view when assessing risk premia, focusing on striking the right balance between yield and risk. With South African rates currently elevated and potential rate cuts on the horizon, it's crucial to factor this into our thinking. While chasing yield can be tempting, especially in our current interest rate environment, doing so without a rigorous understanding of the associated risks can lead to suboptimal outcomes.

This is where a systematic investment approach provides an edge. We model expected returns across different credit classes and sectors, enabling us to capture attractive risk-adjusted returns for our clients while being mindful of the evolving rate landscape and avoiding undue risks.

In South Africa, the need for tailored risk premia models is particularly acute due to the country's unique economic conditions. Sovereign credit ratings, for instance, have been under pressure due to fiscal constraints, leading to South Africa's long-term foreign currency debt rating being downgraded to sub-investment grade by Moody's, Fitch, and S&P. This, combined with currency fluctuations (the rand depreciated by over 10% against the dollar in 2023) and market liquidity issues, underscores the need for dynamic models that can adjust risk premia expectations in real-time.

Globally, we observe similar trends, where geopolitical risks, inflationary pressures, and central bank policies are key determinants of risk premia. In 2023, as the US Federal Reserve raised rates to combat inflation, credit spreads widened, reflecting increased compensation for risks in a rising interest rate environment. Emerging markets, including South Africa, faced currency depreciation and tightening liquidity, further influencing local credit risk premiums.
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In South Africa, where the economy is marked by volatility and structural challenges, we've developed models tailored to local conditions. These models help us dynamically adjust our credit risk and risk premia expectations based on various macroeconomic factors, including but not limited to our views on our sovereign and market volatility, currency fluctuations, and liquidity. This rigorous analysis is vital for maintaining portfolio resilience in an environment where macroeconomic shifts can be swift and severe.

While noting the above, balancing credit quality with risk premia is essential. This requires not only the approach detailed above but also a patient, disciplined approach. We don't chase the highest yields at the expense of quality. Instead, we leverage our systematic framework to build portfolios that can perform across economic cycles.

For example, high-yield debt offers significant risk premia but requires deep credit research and careful selection. We focus on issuers where the risk premia are justified by the underlying business drivers -- companies that may be undervalued due to temporary issues but have solid long-term prospects. Our models help us identify these opportunities while avoiding pitfalls in sectors or issuers that carry disproportionate risk.

Importantly, as we continue adjusting to a post-pandemic reality, inflation concerns, volatile interest rates, and geopolitical tensions continue to shape the fixed-income landscape. For South African investors, this means navigating local challenges while staying attuned to global trends. Prescient Investment Management's investment strategies are built to withstand these headwinds. We systematically assess both credit quality and risk premia, ensuring our clients are rewarded for the risks undertaken without sacrificing long-term security.

Our view remains steadfast, with the focus on credit quality and risk premia being more critical now than ever. A robust, data-driven approach enables us to navigate complex market environments while delivering consistent, risk-adjusted returns to our clients.

As one of South Africa's leading systematic asset managers, Prescient remains committed to rigorous investment analysis, prudent risk-taking, and fulfilling our fiduciary duty to protect and grow client assets in these uncertain times.