

As has always been the case, investors, generally speaking, seek stability without sacrificing growth potential. While equities typically dominate the spotlight, credit investments offer a compelling alternative that is both resilient and adaptable, especially when included as part of a diversified portfolio.

The above is however shared with the following caveat – The South African corporate credit market is currently marked by (i) excess demand; (ii) limited new issuance, and (iii) continued depressed credit spreads. This has, in our analysis, led to increased demand for alternative options, including but not limited to longer-dated and riskier bonds and also structured products, as managers seek to capitalize on the term and credit premia embedded in these instruments.

However, in order to achieve consistent, long-term outperformance, it is crucial for managers to understand the various return drivers within their portfolios, exploit these drivers effectively, and importantly identify and mitigate the associated risks.

This article explores why credit investments deserve more attention, and how they can be strategically employed to enhance portfolio construction.

#### **The appeal of credit Instruments:**

Credit investments, including corporate bonds, floating-rate notes (FRNs), and structured notes, present unique opportunities for generating returns above the general market while offering stability and predictable income streams. These features make credit particularly attractive, and across macroeconomic cycles. Unlike equities, which can be highly volatile, credit instruments, despite glaring shortcomings (i.e., liquidity), are able to provide investors with a smoother ride, with the added benefit of capital preservation.

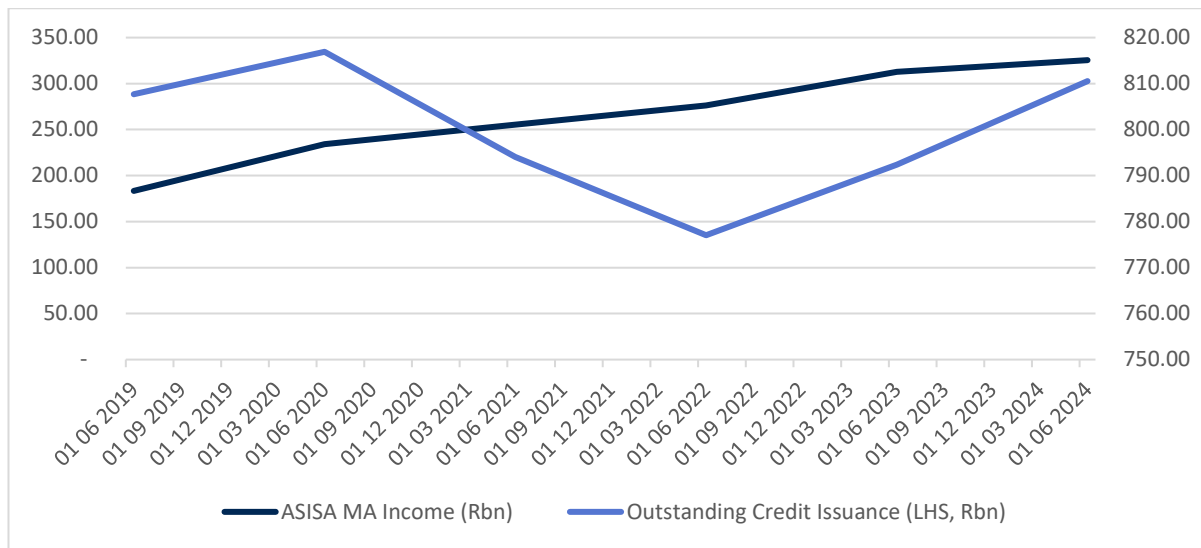
For investors, credit instruments have, and continue to, serve as a counter to market turbulence, offering consistent income while minimizing exposure to the ups and downs of the equity market. This stability is underpinned by the fact that credit assets are less susceptible to the speculative pressures that often drive equity prices. As a result, they can provide a more predictable performance, which is especially valuable for conservative investors or those nearing retirement. This should however be juxtaposed with an understanding of the liquidity (or at times, lack thereof) embedded in these instruments.

#### **Credit – market dynamics:**

Incorporating credit into a diversified portfolio is not just a defensive strategy – it is a means whereby investors are able to optimize risk-adjusted returns. As alluded to in our previous views on credit, alongside diligence and research, diversification remains a fundamental principle of sound investment practice, and credit thus plays a critical role in this regard by reducing overall portfolio volatility.

Consider the current South African debt capital market - characterized by suppressed credit spreads and limited new issuance; and growth of funds within the Association for Savings and Investment South Africa (ASISA) Multi-Asset Income category, highlighted below:

Figure 1: Outstanding Credit Issuance vs ASISA Multi-Asset Income Funds



Source: JSE, ASISA, Prescient Investment Management (June 2024)

Over the past five years, credit issuance has all but stagnated. As of June 2024, there is R811 billion of corporate debt outstanding, compared to R808 billion in June 2019. New entrants into the market have been scarce, with existing issuers mainly refinancing maturing debt. This subdued issuance is partially due to a high interest-rate environment and a weak macroeconomic backdrop, limiting opportunities for expansionary debt issuance.

In contrast, data from ASISA shows robust growth in total assets held by funds in the Multi-Asset Income category.

As is evident in the above, credit issuance grew by just 0.35%. On the other hand, the cash available for investment in credit assets has increased by 77.5%. This significant growth, combined with the stable return profile of floating-rate notes (FRNs), has led to a compression in credit spreads despite economic headwinds. Auction participants in the primary market have demonstrated increased demand for longer-dated credit assets, as evidenced by healthier bid-cover ratios for long-term notes compared to shorter-dated ones.

**Why credit continues to makes sense:**

Despite the subdued growth in credit issuance over the past five years, the South African market still offers attractive opportunities for credit investors. It is key to highlight that while the theme of suppressed yields and heightened risk continues to abound, our analysis shows that corporate South Africa remains cash-flush, with default probabilities across listed debt capital market participants remaining stable.

Further to this, over and above the consideration of stable risk-adjusted returns, various other opportunities abound. The key is to be selective, understand the various risks, and be strategic.

For instance, structured notes, which allow for repositioning cash flows based on the shape of the swap curve, can be a powerful tool for managing interest rate risk. Similarly, leveraging the unlisted credit market can uncover high-yield opportunities that are not available in the listed market.

Moreover, credit's role in a diversified portfolio extends beyond just generating returns. It also provides a cushion against market volatility, which is particularly important in today's uncertain economic climate. By carefully selecting a mix of credit instruments, investors can achieve a portfolio that not only delivers steady income but also mitigates risks associated with equities and other more volatile assets. By combining credit instruments with other asset classes such as equities and government bonds, investors can achieve a more balanced risk profile. Credit assets typically perform well when equity markets are underperforming, providing a counterbalance that can help smooth overall portfolio returns. Additionally, the inclusion of credit holdings has the impact of protecting against inflation and interest rate risk, particularly through instruments like FRNs, which adjust payouts according to prevailing interest rates.

### **Building a robust credit portfolio – the basics:**

Constructing a credit portfolio requires a nuanced understanding of the market and a strategic approach to asset selection.

In the South African context, investors have access to a diverse array of credit instruments, from corporate bonds to more complex structured notes. However, not all credit assets are created equal, and careful consideration must be given to the creditworthiness of issuers, the liquidity of the instruments, and the prevailing economic environment.

For instance, the JSE mark-to-market (MTM) file, which includes nearly 2,400 debt instruments, offers a treasure trove of opportunities for investors. This file covers RSA government bonds, inward-listed Protea bonds (issued by Namibia and eSwatini), corporate credit, asset-backed securities, and various structured notes such as credit-linked notes. A well-constructed credit portfolio might include a mix of these instruments, cycle dependent. Floating-rate notes as an example are particularly valuable in a rising rate environment, as they offer protection against interest rate risk by adjusting their payouts in line with market rates. Fixed-rate bonds on the other hand, can provide higher yields in a stable or declining rate environment. Structured notes, while more complex, can offer additional return potential by taking advantage of specific market conditions or unique credit structures.

While the MTM file provides yields, it does not indicate the risk associated with each instrument. Credit risk—the risk of loss due to a borrower's failure to repay—is a critical factor. Investors should not only rely on ratings from credit agencies but also perform their own due diligence. This includes assessing the borrower's creditworthiness, business model, cash flow stability, and overall financial health. Additionally, credit risk is intertwined with liquidity risk; the South African market is less liquid than more developed markets, making a "buy-and-hold" strategy sometimes necessary. Thus, evaluating credit instruments should involve a comprehensive risk assessment to ensure risk-adjusted returns are appropriate. Considering these through a systematic approach allows for easy comparison of pricing relative to peers across multiple risk dimensions. Successful credit investing is about more than just picking the highest-yielding assets.

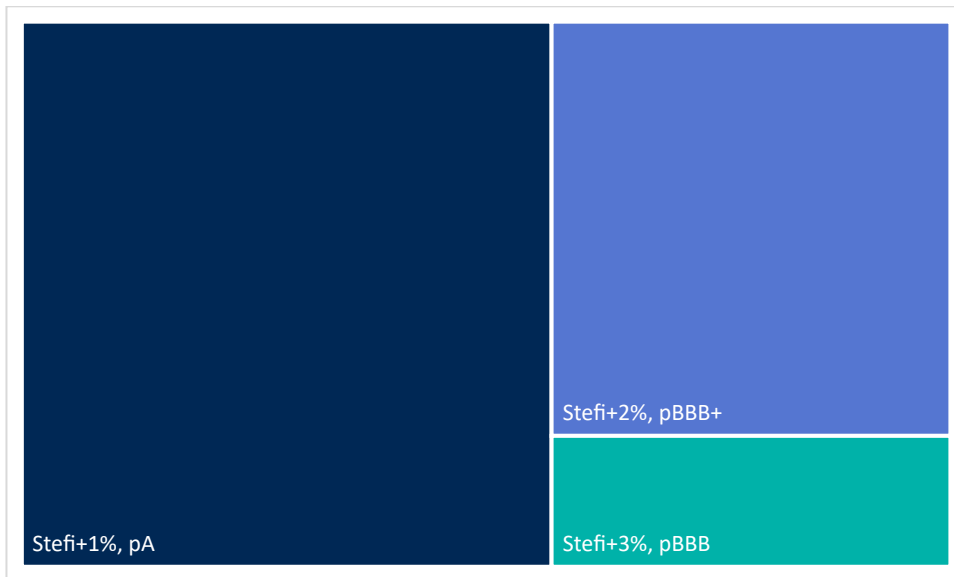
### **Building a robust credit portfolio – examples:**

For a portfolio aiming to achieve a return of STeFI Call + 1% before fees, a mix of FRNs can provide a stable return profile with low interest-rate sensitivity and minimal credit risk, assuming an average rating of pA, as derived by Prescient's proprietary in-house credit rating methodology. Higher return targets (e.g., STeFI Call + 3% before fees) are achievable but require leveraging additional strategies.

Figure 2 decomposes the listed credit FRN universe into three buckets based on the current yield in relation to STeFI. We apply a liquidity overlay to select the most liquid instruments only – Those that have been issued or traded within the last three months. Credit spreads typically adjust only at the point of trading; therefore it is key to ensure that stale pricing is excluded when analysing the current state of the market.

Intuitively, higher credit spreads are associated with higher levels of risk, and this is evident through the figure below. Instruments in the lowest yielding bucket have an average credit rating of pA, whereas the highest yielding bucket is pBBB. Extending this analysis to the availability of credit, we see that only 10% of liquid FRNs would fare favourably against a more austere benchmark.

Figure 2: Floating Rate Credit – Market Composition



Source: JSE, Prescient Investment Management (August 2024)

### **So how would a manager targeting a STEFI + 3% return profile build a balanced portfolio without taking undue credit risk?**

Once diversification requirements and regulatory constraints, such as Regulation 28 and Board Notice 90, are accounted for, the pool of credit assets shrinks considerably. This is especially true of larger portfolios. One thus must look at alternative avenues – this comes in the form of fixed rate notes. A carefully considered blend of fixed and floating rate assets allows the manager to capture the smooth accrual return profile of floating rate notes, as well as the higher interest rate accrual of fixed rate notes, especially as we enter into an interest rate cutting cycle.

While a significant portion of the fixed-rate market consists of state-owned enterprises (SOEs) and municipalities, which may be avoided by risk-averse investors, there are still valuable opportunities, such as borrowers with more stable credit profiles, or alternatively, those with government guarantees.

A further trend that gathered momentum recently is that of structured notes. These are typically issued by a bank and will carry credit risk to both the bank, and to a reference entity such as a corporate or the RSA Government. Mixed rate notes are one such example, whereby one faces RSA risk, but the cashflows are transformed to floating profile for an initial period before switching back to a fixed rate (or vice versa) for the life of the note. While complex structures like these perform well in the short term, they should always be thoroughly analysed and evaluated to ensure that there aren't any "hidden" or misunderstood risks that can be detrimental in future.

An experienced investment team doesn't and shouldn't rely only on secondary market opportunities (such as those on the MTM file) or structured products but has the ability to go out and originate opportunities through reverse enquiries and relationships with syndication teams.

A data-driven approach to analysing opportunities and evaluating risk allows for a fast and accurate turnaround on potential value-accretive opportunities. Despite limited high-yield options in the listed market, utilizing the unlisted allowance within regulatory frameworks can help construct a balanced portfolio and support economic growth.

### **Where to from here?**

Acknowledging the points discussed above, it's important to recognize that delving into the realm of credit instruments entails navigating a landscape rich in intricacies. These complexities encompass a spectrum of factors, including the continuous assessment of the ever-evolving state of the market, to the nuanced understanding of credit quality.

Credit investments offer a compelling mix of stability, income, and potential for capital preservation, making them a vital component of any diversified investment portfolio. By carefully constructing a credit portfolio and strategically incorporating these instruments, investors can enhance their risk-adjusted returns while navigating the complexities of today's financial markets.

At Prescient Investment Management, we understand the intricacies of credit investing and are committed to helping our clients unlock the potential of this often-overlooked asset class. Whether you are a conservative investor seeking stability or a more aggressive investor looking for high-yield opportunities, credit can play a pivotal role in achieving your financial goals.

**Disclaimer:**

Prescient Investment Management (Pty) Ltd is an authorised Financial Services Provider (FSP 612).

Please note that there are risks involved in buying or selling a financial product, and past performance of a financial product is not necessarily a guide to future performance. The value of financial products can increase as well as decrease over time, depending on the value of the underlying securities and market conditions. There is no guarantee in respect of capital or returns in a portfolio. Graphs are included for illustrative purposes only. No action should be taken on the basis of this information without first seeking independent professional advice. \*Representative acting under supervision.

This document is for information purposes only and does not constitute or form part of any offer to issue or sell or any solicitation of any offer to subscribe for or purchase any particular investment. Opinions expressed in this document may be changed without notice at any time after publication. We therefore disclaim any liability for any loss, liability, damage (whether direct or consequential) or expense of any nature whatsoever that may be suffered as a result of or which may be attributable directly or indirectly to the use of or reliance upon the information. For more information, visit [www.prescient.co.za](http://www.prescient.co.za)

\*Sajjad is under supervision.