# Schroders
# FundFocus

## Schroder Credit Securities Fund

Credit markets have recently been buffeted by a number of global factors. This recent volatility and widening of credit spreads may feel uncomfortable for many investors. However we believe it provides welcome opportunities to those who can identify and act on them. We caught up with Mik Kase, Portfolio Manager, Fixed Income, as he discusses how we identify and capture opportunities through active management and research driven stock selection to provide a long term, 'through-the-cycle' approach to credit investing.

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### We've seen increased volatility in markets recently. How has the Fund performed during this period?

Recent market volatility and the widening of credit spreads over the past 12 months has put some pressure on Fund returns with the 1 year performance positive, but lagging the RBA cash rate. Its worth nothing that over this period Global High Yield returned -4.34%* and Global Investment Grade returned -2.71%^. We have been defensively positioned for an extended period with higher cash levels and predominantly investment grade exposure, however the Fund still has credit beta exposure and hence short term performance has been pressured. That said, the widening of credit spreads is potentially setting markets up for the next run and given we have a good amount of "dry powder" with our elevated cash levels we are in a good position to take advantage of opportunities and deliver future returns for clients.

### What are the challenges facing credit investors given current market conditions?

The challenges facing credit investors are similar to those faced across the investment landscape - forward looking expected returns for all asset classes are looking subdued given the starting valuations we face. In terms of credit I believe investors have a rates problem rather than a credit problem. By that I mean the low level of interest rates globally means that outright yields and expected future returns are moderate. Contrast this with current credit spreads, particularly in the investment grade space, the risk premium on offer is around fair value and attractive when compared to longer run averages. In essence, investors need to be patient and open to identifying opportunities. The recent widening in spreads has started to see opportunities open up however the higher risk segments of credit markets still need to be treated with some caution.

### How are you managing the Fund to compensate for rising risks?

We have been defensively positioned for some time now. In practice that has meant holding higher levels of cash in the Portfolio to provide liquidity and insulate against volatility and our overall bias towards investment grade exposures. This has meant that as credit risk premia compressed over time we held less subordinated instruments and reduced significantly our exposure to sub investment grade risk. Consequently we held a more liquid and higher quality portfolio, reducing the underlying portfolio risk. We have also held a small short duration position. This reflects the stretched valuations we see in sovereign bonds and hence we have removed the duration exposure that would be a negative in a period of rising interest rates.

### How important is stock selection within the current market environment?

In our view stock selection always plays an important role in credit portfolios so investors can minimise the probability of being exposed to default and hence capital loss. Stock selection based on fundamental credit research brings with it a discipline that requires the company to be able to pay back its principal at maturity along with the appropriate coupon to compensate for the risk of default. Periods such as the one we have seen where capital is cheap and plentiful for companies, it is inevitable companies that should not have access to capital are able to source it to fund businesses that are not sustainable and ultimately fail. Stock selection aims to identify these companies and to not loan them money. As they say in credit investing "it's the companies that you don't lend to that make you money" and stock selection in our view is the best approach to systematically achieve this.

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### You mention credit valuations have improved—what opportunities has this created?

With the recent improvements in credit spreads we are seeing value re-emerge across the capital structure. The dispersion in investment grade issuers is increasing as investors become more discerning in where they price capital. This provides opportunities where we can identify securities that have been mispriced by the market. For example the recent poor performance by Woolworths has resulted in their senior bond repricing to much wider levels. We believe market pricing is overly pessimistic on the company and we have been adding exposure. Another opportunity is emerging in the listed hybrid space. The new financial hybrid issuance credit risk premia has in some cases widened to close to 5% which is also starting to look interesting in some respects.

In the high yield space we have moved from being negative to more constructive on valuations given recent credit spread widening. As such we are considering adding some exposure to take advantage of the rebuild in risk premia following a period where our exposures have been minimal.

*"Credit as a component of the Fixed Income asset class…has an important role to play given its depth and breadth across different geographies, risk spectrums, capital structure and different maturities"*

### We keep hearing about reduced liquidity in credit markets—is this still the case?

In a post Basel III world where the banks are required to hold a higher level of regulatory capital it has become more expensive for banks to hold inventory on their balance sheets. This means there is likely to be less transactional liquidity than would otherwise be the case. However it is not clear if this is the full picture. It may also be the result of other factors including transaction costs or the demand for credit based assets has meant holders prefer to buy and hold rather than actively trade.

That said liquidity is a fickle friend in that it's there when you don't really need it, and it's not there when you do. In periods of market stress liquidity in credit market tends to evaporate and the regulatory changes do not change that dynamic. The way we construct portfolios is to not be solely reliant on market available liquidity for individual bonds. Hence the amount of cash held, the maturity profile of the portfolio and, the quality of the security are all important portfolio construction decisions that look to deal with the vagaries of market liquidity.

### Are we seeing a turn in the credit cycle? Are we heading to higher default rates?

By virtue of the incredibly loose monetary conditions, default rates across credit markets are currently below average. Credit, as we know, goes in cycles and we expect we will see a more normal level of defaults going forward, particularly as capital becomes less available and more discerning in which companies it funds. For example the energy sector in the US the recent drop in oil prices has made a component of the sector uneconomic and hence higher defaults more likely as companies can't make interest payments or roll existing debt. The best way, we believe, of managing this higher risk of defaults, is through the stock selection process. Being able to identify companies with heightened probabilities of default and not invest in them is vital as you move through a default cycle.

### What is the outlook for credit over the next 12 months?

We have been saying for some time that valuations in credit had become stretched and that volatility was unusually low, hence our defensive positioning in the Portfolio. The last quarter has seen a widening in spreads and a lift in volatility and whilst for many investors this may feel uncomfortable, we view it as an opportunity given improved valuations. It is not possible to tell exactly where spread widening will end. However because we see the probability of recession as low, we subsequently also view the likelihood of a credit melt-down as unlikely, and the two tend to be closely linked. As such we see an environment of opportunity unfolding though it won't be without risk and it will pay to be patient and selective in where capital is invested.

### Is now the time for clients to be investing in Fixed Income, particularly credit?

We believe Fixed Income as an asset class has a role to play in client portfolios. Credit as a component of the Fixed Income asset class also has an important role to play given its depth and breadth across different geographies, risk spectrums, capital structure and different maturities. Credit provides investors with a source of income from corporate cash flows which are senior to equity. Credit is also before equity in accessing company assets in the case of distress.

Exposure to different segments of the credit asset class does however need to be actively managed as you don't necessarily want to hold the entire spectrum at all points of the cycle. Currently investment grade credit valuations have rebuilt and investors are still being compensated for default risk and the current point of the economic cycle should be constructive for credit. The rebuild in high yield and hybrid spreads has made us more constructive on these segments of the asset class. In terms of Emerging Markets we remain cautious and continue to avoid exposure in these markets.

*"…with our elevated cash levels we are in a good position to take advantage of opportunities and deliver future returns for clients."*

**Barclays Global High Yield Index (Unhedged)*
*^Barclays Global Aggregate Corporate Index (Unhedged)*

**Fund Manager Biography: Mik Kase – Portfolio Manager, Fixed Income**
Mik joined Schroders in June 2003 and is responsible for Schroders' Australian credit portfolio management and construction including the Schroder Credit Securities Strategy. Prior to joining Schroders, Mik spent 6 years at BT Financial Group, most recently as the Head of Credit Wealth Management and prior to that as a credit analyst in BT's Funds Management Division. Mik holds a Bachelor degree in Economics and Government from the University of Sydney. He is a qualified chartered accountant and a member of Institute of Chartered Accountants.