A Long/Short Approach to Credit Investing

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Insight

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Prior to joining Muzinich, Brian worked in Leveraged Finance at J.P. Morgan for five years with a primary focus on high yield bonds and leveraged loans. Prior to that, Brian was an investment analyst at Korsant Partners and Zephyr Management. Brian holds a B.A. in Psychology from Princeton University and an M.B.A. from Emory University.

While the global pandemic resulted in another risk-off scenario for financial markets, risk events are a common occurrence that investors need to navigate to capture value in yields and credit spreads, while containing volatility.

The term liquid alternatives can incorporate a broad array of investment styles, one of which is a long/short approach to credit investing. This approach seeks to exploit sources of return away from just carry and pure market beta. It utilizes a broad set of instruments that offer the potential to capture returns while at the same time preserving capital.

A long/short credit approach may combine the upside potential through direct, actively managed exposure to credit markets and/or specific sectors/issuers. Portfolio hedges, through dynamic management of short positions, aim to materially reduce downside risk and volatility.

Following last year's pandemic-induced disruption, market volatility has lessened due to the vaccination rollout, subsequent global economic reopenings and ongoing monetary, fiscal and regulatory support from central banks and governments.

This has provided a relatively supportive backdrop for credit markets so far this year. However, we believe valuations have become particularly stretched in certain areas of the market and we are now thinking about how a slowing of US monetary and fiscal stimulus might impact fixed income markets.

We expect rate volatility will return as monetary stimulus is scaled back and as prospects for rate normalisation arise in the next couple of years. Investors are reaching for yield and are increasingly taking too great speculative risk. We question whether they are truly being properly compensated in this everchanging risk environment.

Despite central bank stimulus, we believe market dislocations will emerge, which may offer numerous opportunities to incorporate positive convexity without increasing tail volatility risk.

Against a backdrop where valuations are tight, we believe additional portfolio tools are helpful in extracting return, such as the ability to use pair and credit curve arbitrage trades.

While the Federal Reserve has asserted that inflation will be "transitory," we believe the inflation risk is real, given continued massive stimulus (even as economies are well on the path to recovery) and pent-up consumer demand. An excess of liquidity, coupled with improved cost structures and increased demand, suggests strong corporate earnings and a benign default outlook.

Our credit research seems to suggest that corporates believe they will be able to pass on a large part of input costs to consumers, preserving profit margins.

However, what if rates increase? We believe spread products like high yield can help offset rate increases, and that there is still some room for spread tightening in the asset class.

Nevertheless, investors should note that with prices converging at ever-higher levels, there is also potential for increased volatility. A long/short approach with an extended toolkit may be well equipped for the challenges ahead.

Important Information