The Case for Investing in Global Credit

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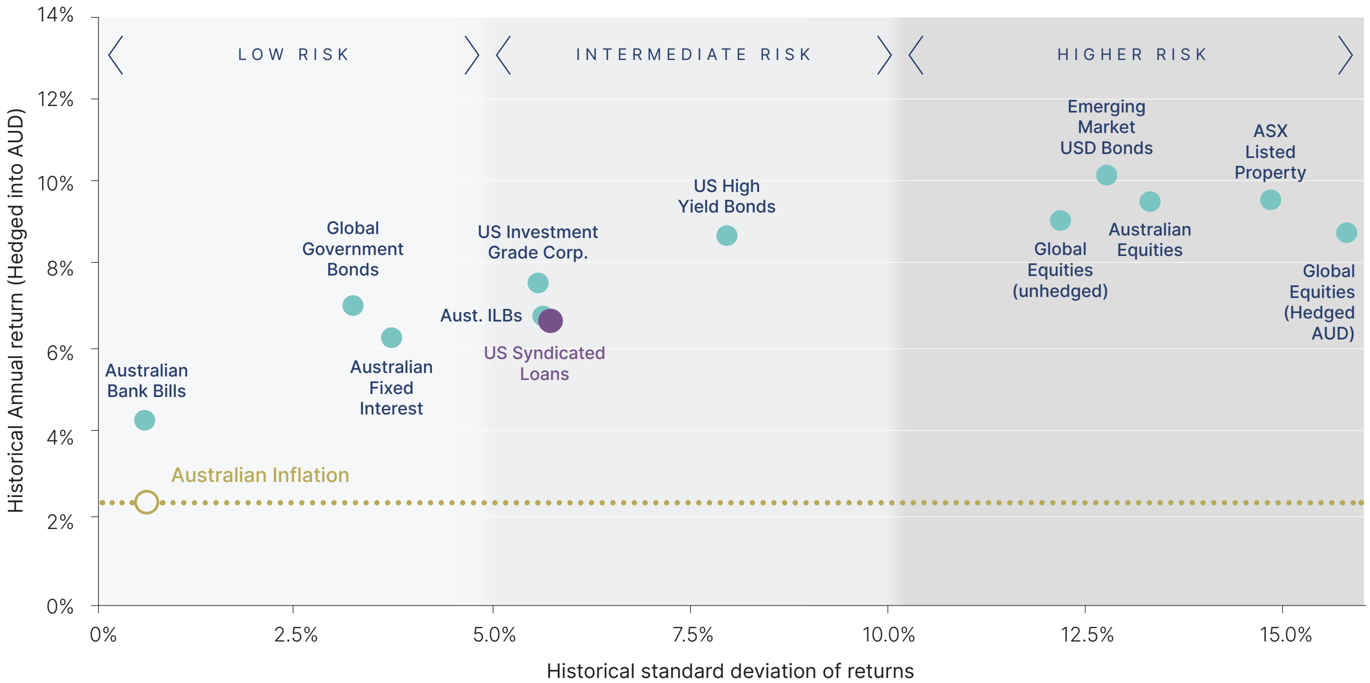
Global credit can be a useful diversifying asset class for Australian investors. It can offer higher income than cash, with less risk than shares, while bringing diversification benefits that can reduce overall portfolio risk.

The long-term performance of different asset classes' historical risk and return trade-off is shown in Chart 1 below. Global credit sectors have an intermediate risk-return profile through different investment cycles.

Chart 1: Historical Annualised Return vs. Historical Risk



Source: Barclay's Capital, Bentham, BoA Merrill Lynch, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley & UBS

As at 31/12/2021

Past performance is not a reliable indicator of future performance.

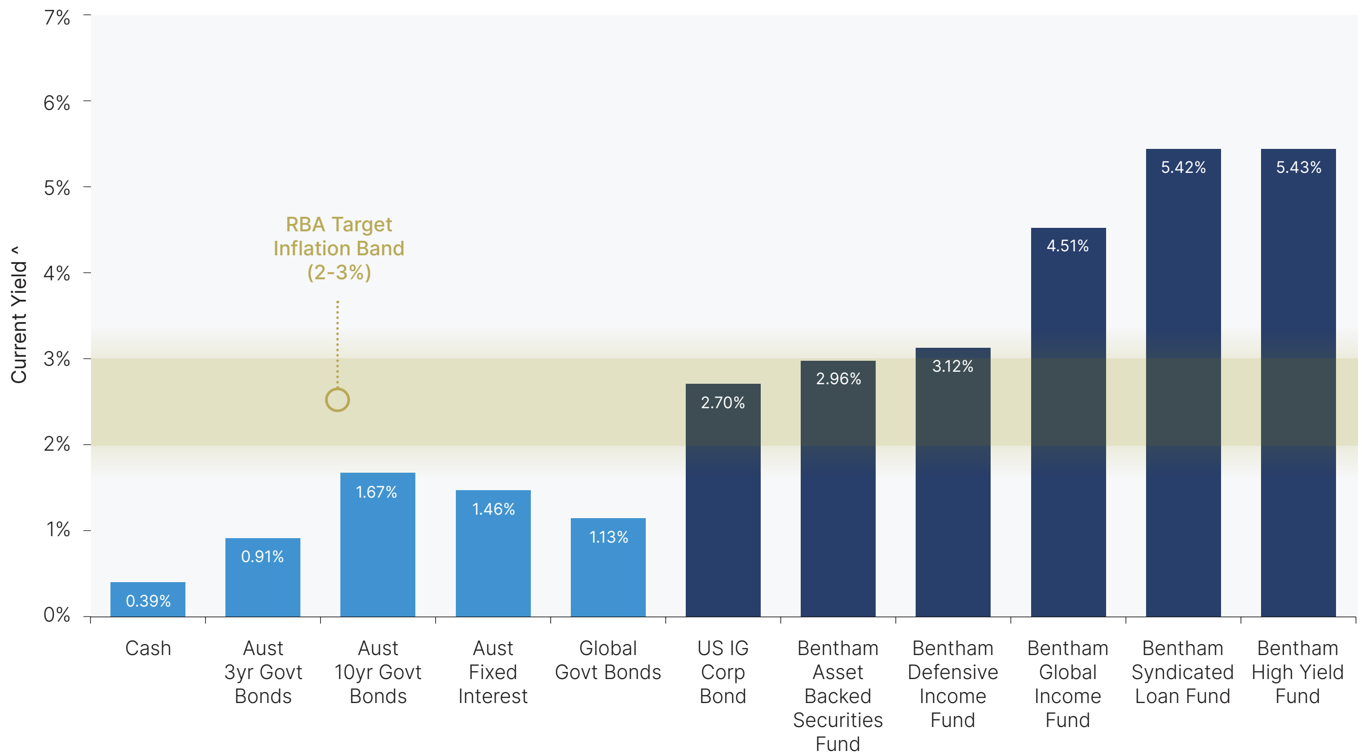
Overseas index returns (except World Equities) are fully hedged into Australian dollars.

Optimising asset allocation is particularly important in the current environment, because forward-looking asset class return profiles are likely to differ from the past. Government bond yields are at record lows, while sharemarkets globally are reaching peaks.

Chart 2 below shows how Global Credit sectors are producing higher yields compared to cash and government bonds.

Importantly, when allocating a portfolio across cash, fixed interest and equities, adding global credit has historically improved returns for a given level of risk, because global credit can perform well at different times to share, fixed income and other asset classes.

Chart 2: Current yields of cash, fixed income and global credit (A$ hedged)



^ The yield of global indices are hedged into AUD.

Index definitions: Cash is AUD 1yr Swap, Aust Fixed Income is Bloomberg AusBond Composite 0+ Index, Global Govt Bonds is JPM Govt Bond Index (GBI) Global, US IG Corp Bond is Bloomberg Barclays US Corporate Bond Index.

This prospective yield chart does not consider the differing risk profiles of the fixed income and credit sectors shown.

Source: Bentham, Bloomberg Finance LLP and JP Morgan.

Introducing Global Credit investments to portfolios adds five key benefits:

1. Income generation

Corporate bonds, loans and high-yield securities tend to pay investors regular coupons, with a higher yield than cash or fixed interest. A diversified portfolio of such coupon-paying instruments allows for the smoothing out of all those cashflows, which can be paid out as regular, high-yielding income (i.e., through monthly global credit fund distributions).

2. Capital resilience - seniority and security

Credit investors benefit from having priority of payment above equity investors for payment of coupons and repayment of principal. Senior credit investors rank ahead of hybrid and subordinated debt investors. A credit investor's ranking in the company's capital structure is a key determinant of their recovery of investment if a company gets into trouble, and their certainty of receiving ongoing distributions.

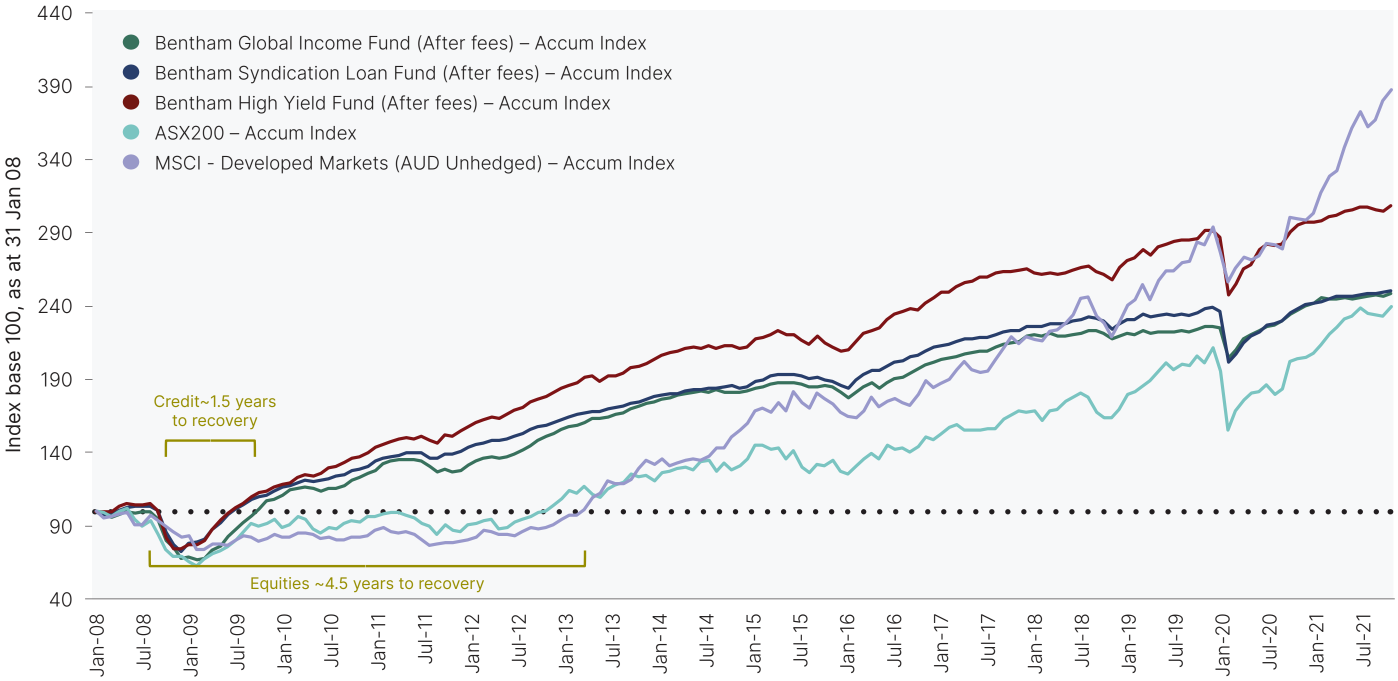
In addition to seniority, some credit investments also provide investors with the benefit of security over specific assets of the borrower, providing further protection to the investor. This normally takes the form of a mortgage over property and other realisable assets. These factors mean the capital value of credit investments has been more resilient than equities.

3. A liquid and resilient asset class

Global credit is a large and deep market and significantly larger than global sharemarkets. It has many different investor types, including asset managers, banks, insurance companies, pension funds and sovereign wealth funds. This diversity of investors means credit investments are traded between buyers and sellers even in difficult times.

Global credit has been a more resilient asset class than equities, recovering far faster than equities after the GFC. Global credit is regarded as intermediate risk with an investment horizon of three to five years.

Chart 3: The resilience of credit



Source: Bentham, Bloomberg

As at 31 Dec 2021

4. Diversification

Global credit allows Australian investors to diversify away from Australian shares and achieve a broader spread of exposures across issuers and economic/geographic areas. Industry diversification is particularly important, because corporate failures may occur in clusters - the technology crash in the early 2000s, or financial institutions during the GFC, for example.

Industry diversification is difficult to achieve in the Australian market. Australia is a small economy with a heavy concentration to financials and miners. Far greater diversification is available by investing in global asset classes.

There are many types of credit investments within the global credit asset class, including investment-grade bonds, global syndicated loans, convertible bonds, high-yield bonds, securitised debt, capital securities, and fixed-rate and floating-rate securities. They offer different types of credit risk and return opportunities.

Chart 4: Diversification

Correlation of returns between various asset classes January 1992 to January 2022

	Australian Bank Bills	Global Govt Bonds	Australian Fixed Interest	Australian ILBs	US IG Corporates	Leveraged Loans	US High Yield	World Equities (Unhedged)	Australian Equities	US Preferred Securities	Emerging Market Bonds	Australian Property
Australian Bank Bills	1.00											
Global Govt Bonds	0.26	1.00										
Australian Fixed Interest	0.27	0.69	1.00									
Australian ILBs	0.15	0.52	0.67	1.00								
US IG Corporates	0.06	0.63	0.43	0.46	1.00							
Leveraged Loans	-0.06	-0.21	-0.14	0.13	0.39	1.00						
US High Yield Bonds	-0.03	-0.05	-0.03	0.20	0.56	0.81	1.00					
World Equities (Unhedged)	-0.09	-0.13	0.03	0.10	0.08	0.25	0.33	1.00				
Australian Equities	-0.04	-0.04	0.07	0.16	0.34	0.47	0.58	0.54	1.00			
US Preferred Securities	-0.05	0.12	0.07	0.19	0.69	0.60	0.65	0.25	0.46	1.00		
Emerging Market Bonds	0.09	0.22	0.28	0.32	0.50	0.30	0.56	0.23	0.51	0.60	1.00	
Australian Property	-0.07	0.17	0.23	0.32	0.45	0.49	0.49	0.42	0.66	0.50	0.40	1.00

# of years: 30.1 to 31-1-2022
Overseas returns (except World Equities) are fully hedged into Australian dollars
Sources: Barclay's Capital, Bentham, BoA Merrill Lynch, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley & UBS
Past performance is no indication of future performance
US Preferred Securities return data is only available from Feb-1997
Australian RMBS AAA/AA return data is only available from Jan-1998
Asian Convertible Bond return data is only available from Feb-1994

5. Managing credit risk

Like all investments, there are risks to consider. The key one is credit risk, where a company fails to repay coupons or principal in full and on time. Credit risk can be best managed and mitigated through careful investment analysis and security selection, thorough review of creditor protections in any security (i.e., seniority, security), a focus on rated, liquid investments, and significant diversification.

Accessing global credit with sufficient diversity and liquidity

Retail investors cannot effectively access global credit investments directly because

- **There is a lack of credit assets domestically**. Banks dominate lending in Australia, which limits the issuance of credit in public capital markets as in the US and Europe.
- **Credit markets are largely institutional.** Credit securities are typically only sold to wholesale investors and/or have large minimum investment sizes (A$500,000 plus). The small number of individual credit securities made available directly to the retail market in Australia are often of "non-institutional quality", being subordinated, unrated and without a liquid, traded market.
- **Credit investing requires considerably more diversity than equity portfolios.** Diversity is more important in credit portfolios than in equity portfolios but less recognised. A credit portfolio with 20 to 50 securities is not diversified enough to reap the full benefits of diversification. The diversity required to create a robust credit portfolio is simply not possible to replicate with a small portfolio (for context, Bentham's credit funds typically have between 150 and 600 unique issuers in each).

This is why global credit has historically been a more institutional market. Even the larger institutional investors, such as industry superannuation funds in Australia, will typically invest in global credit via managed portfolios, not through selecting a small number of individual bonds.

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ASSET MANAGEMENT

Fidante Partners

Fidante Partners Services Limited is the responsible entity of the Fund and issues units in it. Fidante Partners has appointed Bentham Asset Management Pty Limited as the Fund's investment manager. A related entity of Fidante Partners holds a partial equity stake in Bentham.

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