

Global
Special Report

Changing Trends in Credit Asset Management

Analysts

Paris

Aymeric Poizot, CFA, CAIA
+33 1 44 29 92 76
aymeric.poizot@fitchratings.com

London

Manuel Arrive, CFA
+44 20 7682 7499
manuel.arrive@fitchratings.com

New York

Roger Merritt
+1 212 908 0636
roger.merritt@fitchratings.com

Nathan Flanders

+1 212 908 0827
nathan.flanders@fitchratings.com

Related Research

- [Reviewing and Rating Asset Managers](#), (May 2007)
- [Criteria for Reviewing and Rating CDO Asset Managers](#), (October 2008)
- [European CLO Asset Managers Survival of the Fittest: The Return](#), (July 2008)
- [CDO Asset Manager Trends: Commitment to Business & Related Staffing Needs](#), (July 2008)
- [International Bond Fund Ratings](#), (May 2005)

A Unique Context for Credit Management

- Since July 2007, extensive credit market turbulence has created extremely challenging conditions for many credit asset managers, particularly those operating with leverage. Extreme spread widening coupled with a liquidity and funding crunch and deteriorating economic outlook has forced credit managers, from enhanced cash fund managers to hedge funds, to face an extreme stress situation.
- In Europe, in particular, navigating the credit turmoil is all the more difficult for managers as credit only recently emerged as a mainstream investible asset class in a period of benign conditions. Until the beginning of the decade, European credit markets were dominated by bank lending and any capital markets activity was relatively fragmented and small. Post the introduction of the euro currency, the credit markets benefited from strong momentum and, after 2002, they were driven by a bullish sentiment awash with liquidity. This benign credit environment combined with favourable technical factors (such as inexpensive and abundantly available funding and very high demand for credit) fostered the development of leveraged, structured products long beta across the board.
- At today's level of spreads, credit markets have substantially repriced risk (both credit and liquidity), so that, even assuming no capital appreciation, the roll down and carry may offer equity types of return (absent a large upsurge of credit losses). However, the expected deterioration in credit fundamentals and increased default rates (notably in more leveraged segments of the market such as high yield (HY) and bank loans), combined with continued spread volatility and other near-term uncertainty from unpredictable market technicals, continue to create a challenging environment for both buy and hold and total return managers.
- Based on Fitch Ratings' review of and interaction with credit managers, the following introductory report offers a perspective on the potential future landscape of active credit management. A series of additional reports focusing on credit management will be issued in 2009.

Key Likely Developments

Credit a valuable asset class for investment

- Despite the collapse of the credit markets in 2008, institutional investors still view credit as a viable asset class for investment. It will, however, return to a more traditional buy and hold fundamental approach, reserved more to long-term investors. In that sense, credit might no longer be the liquid asset class widely employed until recently in many investment products, from enhanced cash funds to hedge funds.

Credit investor base undergoes major changes with the departure of bank-funded and short-term investors, leaving real money investors as sole investors

- Leveraged investors, which include financial institutions and leveraged buyers such as hedge funds or structured vehicles, have been forced to substantially retrench from the market and de-leverage existing positions.

- Investors with term funding or low mark-to-market sensitivity are better positioned to invest in credit as an asset class. Investment flows from institutional investors such as pension funds, insurance companies and endowments are being observed, but at a measured pace. Specifically, pension funds are seeking to diversify their duration risk as part of their immunisation strategies. However, the appetite from new and underinvested credit investors is unlikely to return to pre 2007 levels to compensate for the departure of leveraged players.
- The currently modest pace of inflows into the credit asset class is likely to increase incrementally as greater clarity as to future defaults, losses and the extent of the macroeconomic decline in general leads investors to believe that credit fundamentals have or are on the verge of bottoming out. While many investors perceive attractive long and short opportunities in credit, they are not yet ready to actively invest due to near-term uncertainty, resulting from unpredictable fundamental credit conditions and market technicals. Given the uncertainty and unpredictability of market conditions, investors are seeking high premiums and equity-like types of returns to deploy capital into credit at this time. The lack of inflows from distressed or dislocated investors is a good example in this respect.
- Another necessary condition for the return of credit investors is that they have clarity on their own liquidity position and balance-sheet risk. In Fitch's view, leveraged buyers are unlikely to return until the funding access returns and costs come down.

New Credit-oriented Investment Products Likely to be Simpler, less Leveraged and more Transparent

- At current spread levels, investors are looking for low to no leverage and greater transparency. Furthermore, they are more ready than in the past to accept lower liquidity to lock up current spread levels while offering good capital protection over a given period. As such, demand for credit-oriented investment products will focus on unleveraged funds of defensive portfolios, generating returns from yields and carry rather than capital appreciation and gains through trading. For example, funds with an explicit term (such as five years) have already emerged, designed to carry current asset yields to final maturity via convergence to par.
- While plain vanilla, transparent investment products are expected to dominate the demand, financial engineering efforts might focus only on structuring the pay-off profile requested from investors, which may include some capital protection or volatility reduction features at the overall fund level.
- In terms of formats, early indications point toward investors favouring open- or closed-end institutional funds and dedicated separate account mandates.

Investment Strategies will Focus on Carry, Recovery and Dispersion

- The investment strategies will try to extract performance from carry (i.e. crystallise the yields of bonds carefully selected to minimise credit events), recovery (in distressed debts, bank loans with restructuring and working out) or dispersion (playing one name against another, or a name against its sector, essentially in the investment grade space where the deleveraging has been across the board, irrespective of the intrinsic credit quality).
- The use of credit derivatives is not ruled out but will serve, at least in the short term, predominantly for shorting and hedging and no longer as a substitute for sourcing assets on the cash market or execution of complex trading strategies, given expectations of continuing basis volatility and absence of liquidity premium to capture, for example. Furthermore, absent any centralisation of clearing, counterparty risk still makes investors and managers cautious.

- Total return strategies with more short-term investment horizons, including technical arbitrage, are not seen by investors and managers as a valuable investment proposition for the time being, as long as liquidity and spread volatility remain uncertain, although this could change abruptly once it is felt that credit conditions are on the verge of bottoming.
- Liquidity conditions may have changed structurally compared to the exceptional conditions that prevailed until summer 2007. This is likely to impact not only redemption terms and structuring of credit-invested products but also the ability to trade at a reasonable cost, in the absence of active market making from fewer and more risk averse dealers.
- Leveraged, complex, expensive investment strategies are unlikely to reappear in the foreseeable future.

Credit manager platforms to adapt to a new credit market paradigm

- To date, the key differentiator in credit management has been the degree of leverage and the ability to cope with mark-to-market losses without being forced to sell. Investor stability and quality of the funding structure were key to limit or avoid any forced sale of assets in the portfolios.
- As such, other attributes that credit managers often emphasise such as credit research, portfolio construction, allocation skills or diversification have played a secondary role so far. However, those attributes will constitute major differentiators between managers. Furthermore, these elements are likely to challenge more those credit managers that opportunistically entered the market recently.
- Going forward, rising idiosyncratic default risk will call for the development of more intensive research, including an increasing role of fundamental research, as opposed to quantitative analysis and modelling, which may have prevailed in the past. Investment based on historical default and recovery assumptions may prove hazardous. In the higher yielding space (loans and HY), restructuring and workout capabilities will be essential. Distressed debt restructurings are expected to not only be much more prominent, given current trading levels and the absence of other alternatives short of bankruptcy, but also may prove more contentious than in the past in some instances given the potential conflict of interest in the agendas of the different investors (loan holder or CDS investors, and across the capital structure). Furthermore, should liquidation occur, value recovery might be far lower than historically given the current downward pressure of asset prices.
- Risk management processes are being revisited in a context of heightened tail risk and are likely to be less reliant on modelling, and build in greater use of “what if” scenario analysis and stress testing outside the models.
- Overall, an institutionalisation of credit managers is in progress and accelerated with the crisis, as reflected by the growing importance of the infrastructure (research, trading, pricing, screening). Successful credit asset managers will be expected to exhibit access to primary and secondary markets, critical mass and track records across the credit spectrum or very specialised focus on a small segment (such as distressed). Such specialist shops may be opportunistically founded by (structured) credit market veterans.

Areas of Focus Emphasised by Fitch in Reviewing Credit Asset Managers

Fitch emphasises the following metrics to evaluate the capabilities of rated credit asset managers:

- Impact of the credit turmoil on a manager’s business franchise, financial condition and reputation.

- Ability to adapt or rebuild credit platform and raise capital to ensure long-term business viability, launching new funds or investment solutions that match investors' revised risk-adjusted return expectations.
- Nature of and ability to retain existing investor base.
- Adequacy of fund structures, including features of the underlying portfolio and funding.
- Fundamental credit analysis skills, experience and resources to ensure increased selectivity and anticipation.
- Access to primary and secondary markets (network and dedicated resources).
- Fundamental investment risk management, as a complement to quantitative risk management based on modelling.
- Ability to maintain integrity and structure of portfolios in a deleveraging and deteriorating credit fundamental context, including ability to meet liquidity calls and redemptions.
- Portfolio transparency and valuation.

Copyright © 2009 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.