Summary
- The investment-grade bond market spluttered in 2015 and 2016 is not expected to be much greater.
- Appetite is still strong in household names as the triumph of the Anheuser-Busch InBev's $46 billion bond shows.
- Research is fundamental even in a low turnover, buy and hold portfolio.
- The Barclay's U.S. Corporate Investment Grade Index and the Bloomberg EUR Investment Grade European Corporate Bond Index both reported returns of negative 0.68 per cent and 0.99 per cent respectively in 2015.
- The downfall of Volkswagen and Swiss-based commodity firm Glencore both hit the market.
- It is expected that investment-grade credit will perform better than high yield but investors need to look at fundamental analysis as there are differences between industries, companies and monetary policies.

Huffing and puffing

The investment-grade bond market performed poorly in 2015, with indices reporting negative returns. Lynn Strongin Dodds outlines the problems for this market and what investors must do to ensure it remains an important part of their portfolios

The investment-grade bond market spluttered last year and 2016 is not expected to be much better. However, the triumph of the Anheuser-Busch InBev's $46 billion bond in January in a jittery market shows that appetite is strong in household names with healthy balance sheets and cash flows.

"The selection and stability of the balance sheet that you are lending to is crucial," Schroders head of the UK business development group Neil Walton says. "The research is fundamental even in a low turnover, buy and hold portfolio. This is because there is liquidity in good names and these companies can weather periods of stress."

Performance

Last year was a case in point. The Barclays U.S. Corporate Investment Grade Index returned a negative 0.68 per cent for the sector—the second worst annual showing since 2009. Spreads widened by 10 basis points to 165 basis points in December, underperforming duration-matched Treasuries by 62 basis points, according to research from Guggenheim Partners. The Bloomberg EUR Investment Grade European Corporate Bond Index reported an even worse set of results with a negative 0.99 per cent. The last time performance was this weak was 1999. Figures from Bank of America Merrill Lynch show that even at the height of the eurozone crisis in 2011 and 2012, returns were 4.18 per cent and 10.59 per cent respectively.

"Despite the differing views on investment grade, all fund managers agree that they remain an important part of the portfolio but that investors need to be realistic about performance expectations"

The inevitable flight to quality ensued to companies such as Anheuser-Busch InBev, whose issuance was the second biggest corporate offering in history. Investors took comfort in the long track record –its origins can be traded to the mid 1850s –plus its easy to business model and product range. Priced across seven US dollar tranches of maturities ranging from three to 30 years, almost all of the proceeds are slated to fund the company's planned £77.3 billion takeover of SABMiller, enabling the company to refinance part of a $75 billion syndicated loan struck in November 2015 when it announced the takeover, the largest syndicated loan on record.

A smaller craft beer manufacturer may not have garnered as much as attention although the scale of the success at Anheuser-Busch InBev was not expected. "We have been in a bear market in credit over the past 18 months and I was surprised at the huge demand that allowed the company to upsize the deal so considerably," BlackRock Global Bond Portfolio Team portfolio manager Owen Murfin states. "It just goes to show that there is demand for the right name at the right price. However, I think investors in general are more interested in buying companies post- versus pre-transaction."

J.P. Morgan Asset Management executive director and member of the global fixed income, currency & commodities group Andreas Michalitsianos, also believes that 'idiosyncratic stories' are becoming more prevalent, as demonstrated by the downfall of German automaker Volkswagen, which was hit by the emissions rigging scandal, and Swiss-based commodity firm Glencore, which has been hit by plummeting oil prices. Markets went into a tailspin, not only

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due to these two blue chips, but also Anglo American, who slashed dividends and sold a slew of assets, Petrobras, which was engulfed in a Brazilian political scandal in the wake of plunging crude oil prices and Yum Brands, which levered up and announced it was hiving off its Chinese operations.

"They have shaken the market and the result is that you never know what is around the corner," says Michalitsianos, who is more cautious about US issuers because of the leverage that is being built up for share buybacks and dividends. "It is fine when growth is good but you need a perfect environment for that kind of leverage and there are headwinds. Companies can only cut so much versus ballooning debt. Instead we prefer the fundamental backdrop for the euro and sterling than the dollar."

Michalitsianos is not alone in his views. Lombard Odier Investment Managers head of fundamental fixed income Kevin Corrigan also thinks that there are more risk factors across the Atlantic and that diverging monetary policies should also be factored into any decision-making process. At the end of last year the US finally had lift off but only by 0.25 basis points while Europe is still in a quantitative easing state of mind.

As for the UK, sentiment has recently shifted with Bank of England Governor Mark Carney recently announcing the country will not be following in the US' footsteps as expected this year. A weaker than expected economy coupled with the continued fall in the price of oil and volatility in China could push it out to early next year if that.

"Increasingly we think we are getting to the end game of fixed income but financial repression remains a core driver in our universe," says Corrigan. "Central banks own 25 per cent of the bond markets in the developed world. The biggest asset managers are central banks, so we are all following them to a degree. I think investment-grade credit though will do better than high yield but investors need to look at fundamental analysis as there are differences between industries, companies and monetary policies. In general I prefer long-dated bonds in the US and UK and shorter-dated bonds in Europe."

Caution

Others are looking farther down the curve but with caution. PGIM (formerly known as Pramerica) managing director

and head of the European corporate bond team Edward Farley notes that with credit spreads widening and pension funds increasingly looking to use investment-grade debt as a tool for liability debt matching, there are opportunities in the long-dated corporate arena.

Farley notes: "Comparing the Barclays US IG corporate benchmark versus the Barclays IG Long Corporate Benchmark - spreads are all over the place but as of the close on 15 January, the respective numbers were 171 over government versus 244. That difference is exaggerated versus euro paper as there is very little long-dated paper."

Some fund managers are also taking more of a sector view with utilities proving popular as a safe haven although financials are closer to the top of the list. Ongoing restructuring and de-leveraging to meet the more onerous Basel III requirements are making bank debt attractive especially in the triple B space. This is because on average they are offering higher yields than the Barclays US Corporate Investment Grade Index plus they tend to carry less interest-rate risk than utilities.

"There is one caveat to the financial sector," Newton Asset Management's fixed income team portfolio manager Howard Cunningham comments. "We focus on high quality companies up the capital structure because since the crisis we have been in a bail in and not bail out environment and we want to avoid those institutions that could run into trouble. As for utilities, I do not think they are as safe as often painted. As we have seen in Germany where nuclear power had been extended and then shut down, the level of government intervention can be significant."

Although most participants are mostly avoiding emerging markets due to falling oil prices and China's sluggish growth prospects, Neuberger Berman senior portfolio manager Jon Jonsson believes there are some opportunities as long as investors choose the right country. For example, Turkey and South Africa would be off the list but Mexico, which is in better economic shape, is home to investment grade bonds yielding 4 per cent to 5 per cent.

Despite the differing views on investment grade, all fund managers agree that they remain an important part of the portfolio but that investors need to be realistic about performance expectations. "We are in a phase of low investment returns and markets have become more volatile due to low levels of liquidity. Also, markets have not priced in inflation, which adds to the challenging environment," Royal London Asset Management fund manager Eric Holt concludes.

Written by Lynn Strongin Dodds, a freelance journalist