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Hunting for yield: The credit market opportunity

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Executive summary

Today's credit market is more challenging than ever, as a prolonged low-rate environment and $15 trillion of negative-yielding debt globally has placed immense pressure on yields. Income investors are also facing additional obstacles caused by the ongoing global pandemic, as central banks have pumped massive amounts of liquidity into the markets and undertook extraordinary accommodative measures in tandem with governments offering large relief programs and fiscal stimulus in order to support struggling economies.

In our view, the credit market remains an attractive option for yield-seeking investors in this low yield environment. This market is certainly not without its challenges, but the Mackenzie Fixed Income Team, with our specialized capabilities in credit, continues to be constructive on this compelling market segment.

In this paper, we address possibilities and potential pitfalls within the credit market by answering three crucial questions:

- How big is the opportunity set in credit?
- Where are we in the credit cycle and how much credit risk should investors consider taking?
- How are we aiming to generate attractive risk-adjusted returns in credit in a low-yield environment?

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While it may be highly challenging to navigate the credit market effectively, we believe investors can still derive many benefits from investing in this space. Professional and expert asset management, in conjunction with personalized financial advice, will help investors take advantage of the many opportunities that the credit market presents for their portfolios.

What you need to know about today's credit environment

For decades, we've witnessed a secular trend of lower interest rates that has posed a significant challenge for yield-seeking investors. The hunt for yield has been exacerbated by the unprecedented monetary and fiscal response to the global pandemic. Interest rates have been cut to historic lows in many developed countries, and governments have been spending unprecedented amounts to keep economies afloat during prolonged lockdowns. Yields on perceived safe-haven government bonds have been driven to all-time lows. In some parts of the world, such as Japan and Germany, yields are in negative territory.

The fallback for yield-hunters has mostly been the stock market. But now equity valuations are stretched and reaching near all-time highs, driven by abundant liquidity. More than ever, we believe this scenario warrants diversifying a portfolio towards other asset classes.

So, where else can you look? Global corporate bonds – also known as credit markets – can potentially offer diversification benefits and enhance risk-adjusted returns. Like stocks, there are certain parts of the credit market that have performed better than others since the pandemic began. Therefore, sector and security selection, along with active management of risk, are essential to make the most of the benefits that the credit market can offer.

We spoke to Dan Cooper, SVP, Head of Credit, Portfolio Manager High Yield Bonds, as he walked us through the three most important things fixed income clients should know about credit in the current environment. Here are Dan's thorough responses to our three overarching questions.

Q1 | How big is the opportunity set in credit?

The credit spectrum is larger than most investors think. It has expanded over the past decade, offering a large opportunity set from public credit to private debt. In particular, the 2008 financial crisis resulted in new banking regulations that created a reluctance of banks to hold risk on their balance sheets, and instead originate and syndicate the debt to other investors. This also resulted in the rapid development of alternative sources of capital for lending, such as private credit strategies that further increase flexibility and return potential.

Credit assets exist along a spectrum across public and private markets, with segments that exhibit different volatilities, return patterns and liquidity, as evidenced by the credit spectrum below (see chart 1). Making the most of the credit spectrum requires a robust framework to analyze macroeconomic and idiosyncratic risks, identify opportunities and swiftly respond to changes in economic and market conditions. You could choose to do it yourself if you have the time and expertise or designate the task to a team of experienced fixed income professionals with extensive resources and the flexibility to make risk-return trade-offs across the credit spectrum.

In the decade before the COVID-19 crisis, all segments of the credit markets – public bonds, leveraged loans and private debt – grew deeper, more specialized, and more integrated. Issuers could increasingly seek out capital on terms aligned with their needs, while investors gained more choices in risk-and-return profiles.

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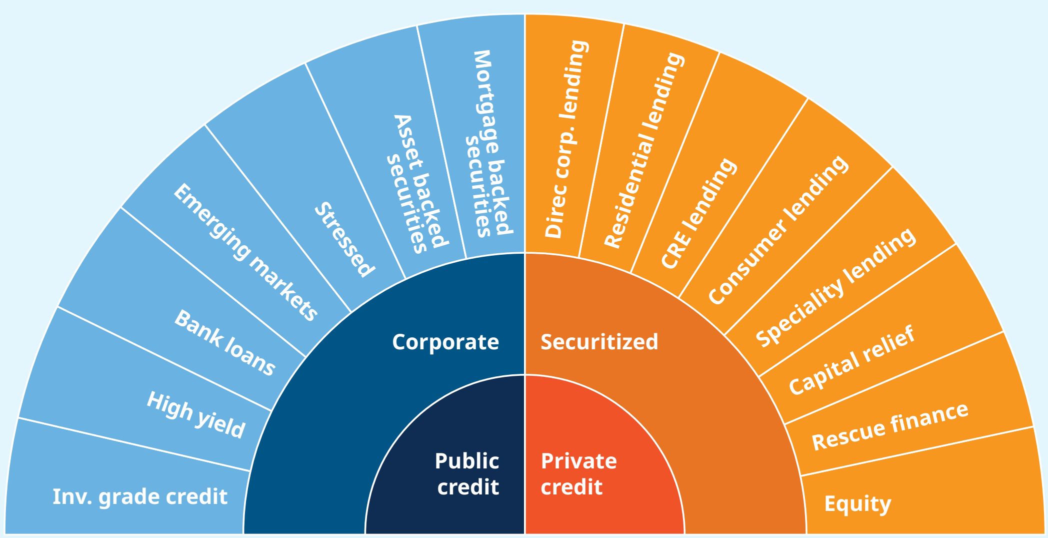
Public credit encompasses traditional segments of the corporate bond market; investment-grade bonds, high-yield bonds and asset-backed securities, which are syndicated to public investors that are free to trade the securities.

As the name suggests, private credit is privately originated or negotiated. Private investments are characterized by potentially higher-yielding deals across a range of the risk/ return spectrum, limited short-term liquidity, structured entry and exit procedures, and different valuation procedures like mark-to-model, comparables, etc. While non-bank investors in search of yield have been increasingly extending loans directly to firms, with limited involvement on the part of banks, private credit has grown in scope and complexity, thereby expanding the opportunity set.

In the current low-yield environment, traditional fixed income needs to be constantly re-evaluated to ensure it continues delivering on the key roles that it's supposed to play in a balanced portfolio, namely income generation and capital preservation, low volatility and equity diversification. We believe **private credit is an increasingly important component of the new "40" in the traditional 60/40 asset allocation**. With historically attractive yields, private credit offers an opportunity to collect an illiquidity premium, shelter from daily market volatility and gain exposure to rapidly growing private equity-backed deals and unique idiosyncratic corporate issuers.

Private credit is an increasingly important component of the new "40" in the traditional 60/40 asset allocation

Spectrum of public and private credit



Liquidity reduces and income potential increases from left to right on the credit spectrum

Source: Mackenzie Investments, for illustrative use only

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We firmly believe that generating good risk-adjusted returns for our clients requires looking at fixed income opportunities holistically and adding non-traditional fixed income to our investable universe. Being flexible in seeking to deliver stable and attractive risk-adjusted returns is at the heart of our investment philosophy. The Mackenzie Fixed Income Team has developed a strong expertise in leveraged loans – also known as bank loans – over the past 10 years. Mackenzie has also extended its footprint in private debt over the past two years given our strategic partnership with Northleaf Capital Partners, one of the largest private credit specialists in the country, thereby enabling more investors to access market segments that are usually reserved for sophisticated institutional firms and large pension funds.

What are the expected benefits of investing in leveraged loans?

Leveraged loans offer attractive yields that are comparable to and sometimes higher than various public market yields (i.e., high-yield and investment-grade bonds). They also benefit from their secured status that is on the top of the capital structure, which can limit volatility and improve recovery values at times of stress. Off-benchmark and middle-market loans have also shown lower default and loss rates than public credit, owing to better lender protections, enhanced loan customization, increased flexibility and better alignment with borrowers.

We have built a strong expertise in non-benchmark, under-the-radar loan deals that are usually well structured and offer a yield pickup with limited default risk.

How do private investments differ from leveraged (bank) loans?

Private debt consists of non-bank direct lending to predominantly private companies that rely on relationships with various parties to access new deal flow. The debt is non-syndicated, non-quoted and are either not-rated or privately rated by the rating agencies. Compared to bank loans, private credit is bespoke and usually more complex, favouring experienced private debt managers in the negotiations. Private credit has more flexible terms and repayment schedules, and are often part of a longer-term multi-transaction partnership between borrower and lender. As a result of the illiquid nature of private debt investments, yields are often higher to compensate lenders for the inability to actively trade the security through the cycle.

To allocate effectively across the different areas of credit and use sub-asset classes adequately to build diversified portfolios and deliver desired outcomes, it's important to understand risks specific to each segment. Default risk is critical to consider, especially as you move down the rating spectrum, as it leads directly to potential capital loss if the issuer cannot pay the coupon or repay the principal.

In addition, three other main risks to consider when evaluating the credit opportunity set are:

- Volatility risk
- Correlation risk with equities
- Liquidity risk

It is essential for credit investors to understand where each credit asset class sits on the spectrum of risks, and what the various risk-return outcomes can be through the cycle.

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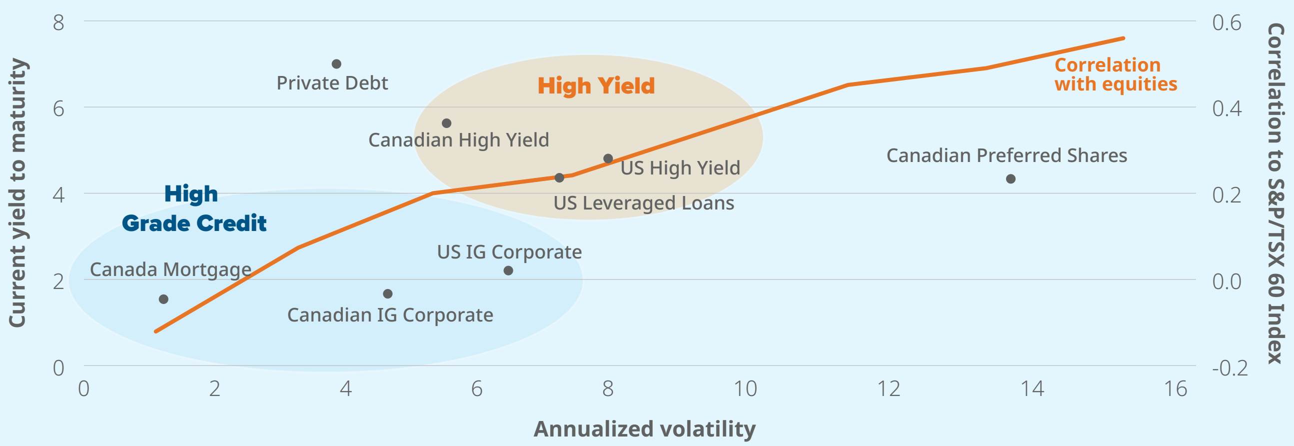
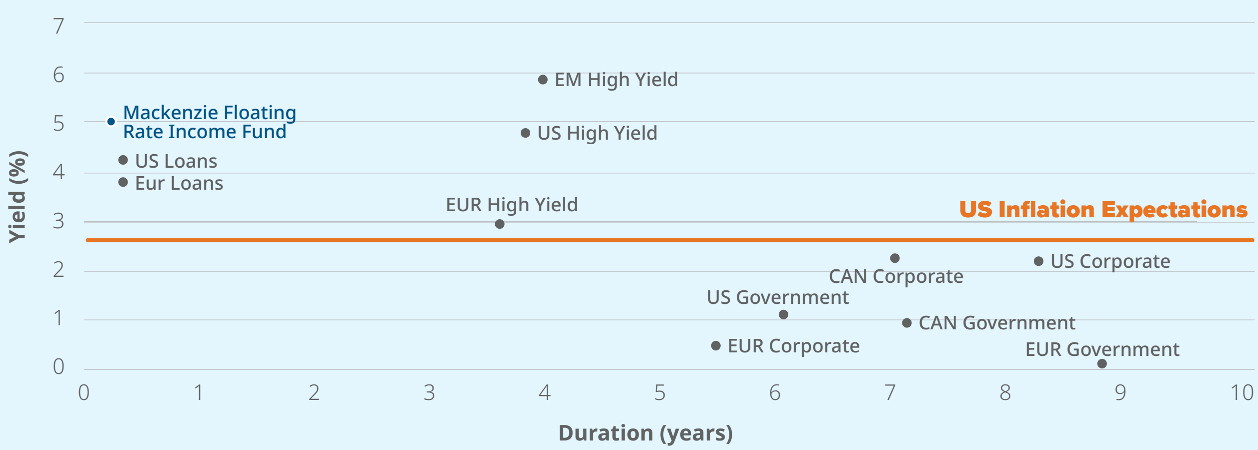
The credit spectrum offers various risk-return outcomes and helps achieve income generation goals

Current yield, annualized volatility and correlation with equities across credit assets



Source: Bloomberg, Morningstar June 30, 2021

Credit markets demonstrate various interest rate sensitivities - leveraged loans are best positioned to outperform in a rising rate environment



Source: Bloomberg, S&P Global Market Intelligence. As of June 30, 2021. US High Yield = ICE BofA US High Yield Index, US Corporate = ICE BofA US Corporate Index, US Government = ICE BofA US Government & Securitized Index, CAN Corporate = ICE BofA Canada Corporate Index, CAN Government = ICE BofA Canada Government Index, EUR Government = ICE BofA All Euro Government Index, EUR High Yield = ICE BofA Euro High Yield Index, EUR Corporate = ICE BofA Euro Corporate Index, Emerging Markets High Yield = ICE BofA High Yield Emerging Markets Corporate Plus Index, US Loans = S&P/LSTA Leveraged Loan Index, US Inflation Expectations = US Breakeven 5 Year.

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Q2 | Where are we in the credit cycle and how much credit risk should investors consider taking?

Various terminologies are used to categorize the credit cycle into four distinct phases. Some strategists describe the credit cycle phases as early stage, middle stage, late stage, and recession. Others describe it as the repair phase, recovery phase, expansion phase and downturn phase. No matter how the credit cycle is described, identifying themes influencing the cycle and where we are in the credit cycle are important analytical inputs in the estimate of near-term and medium-term default risk, and to determine how to allocate flexibly across the credit spectrum.

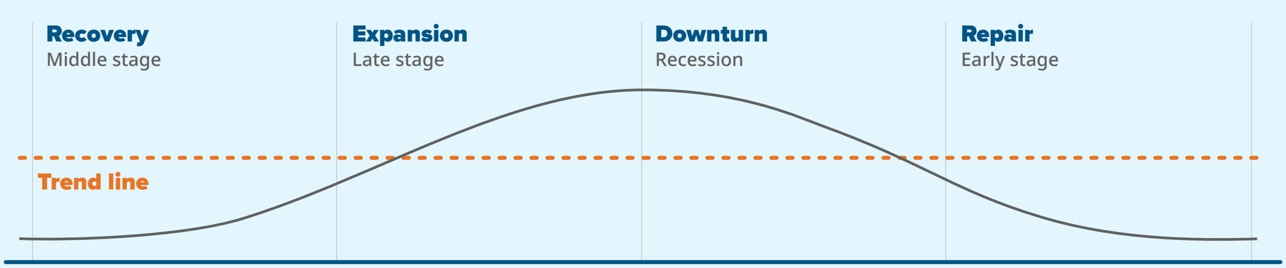
In our view, the current credit cycle is somewhere between a repair and recovery phase that follow recessions, a time when default volume declines.

Even if some segments of the credit market fare better in a rising rate environment, we resist the temptation to invest only in that particular segment. We believe that its important to make various risk-return trade-offs across the credit spectrum in pursuit of generating strong risk adjusted returns, so it's important to be active in all of them. Companies tap different parts of the market as they evolve, lender interest shifts, and the economic backdrop changes. Today's direct lending borrower may be tomorrow's high-yield issuer, while yesterday's high-yield issuer may be tomorrow's bespoke-solution seeker. We believe generating strong risk-adjusted returns over a full cycle is all about diversification and managing risks.

Demonstrating sound knowledge of the various industries and the companies that comprise them can build confidence and trust, as can interacting with these companies over time and amid changing circumstances. The more bespoke the credit, the deeper the requirement for company-level due diligence, and the more important it is to reflect this diligence in how the credit is structured. Complexity is an opportunity, but it requires original work and a willingness to dive deep to identify diamonds in the rough.

At Mackenzie we take a holistic approach to risk management. We seek to capture all material risks, including emerging risks like ESG risk, when analyzing an issuer and before adding any position to our portfolios. While we aim to mitigate risk through active engagement with companies, we also identify opportunities (mispriced by the market, in our view).

Four phases of the credit cycle



Source: Mackenzie Investments, for illustrative use only

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Key themes influencing the credit cycle

Phase of the credit cycle	Recovery, Middle stage	Expansion, Middle stage	Downturn, Recession	Repair, Early stage
Themes				
Economic Growth	Strong - Improving	Very strong - Peaking	Weak - Deteriorating	Weak - Stabilizing
Central Bank Policy	Start to tighten	Tightening	Easing	Easy
Inflation Pressure	Moderate - Rising	High - Rising	High - Breaking lower	Low - Stabilizing
Risk Appetite	High	High - Irrational	Low	Low - Improving
Fundamentals	Profits grow faster than debt growth – Leverage decreases	Debt grows faster than profits – Leverage increases	Profit contracts sharply	Debt contracts and leverage starts to reduce
Credit conditions	Lenders are cautious	Lending standards loosen and corporate leverage increases	Lending is tightened	Tightening of lending conditions
Valuations	Near average - Rising	Above average - Rising	Falling to below average	Below average- Rising
Credit performance expectations	• Credit performed well along with equites • High-beta credit (High Yield, Emerging) and cyclical sectors outperform high-grade and defensive sectors	• Risk assets continue to perform well, but at a slower pace • Lower duration credit like leveraged loans and floaters fare better as rates rise • Safe fixed income assets like government bonds deliver negative performance owing to their higher sensitivity to interest rates	• Divestment from risk assets and flight to quality result in pronounced drawdown across risk assets, with significant underperformance for high-beta credit • High-grade and long-duration credit perform better, supported by lower rates	• Undifferentiated asset rally with outperformance for riskiest assets that typically suffered the deepest drawdowns • Rotation into risk assets leads to underperformance of safe assets like government bonds

Source: Mackenzie Investments, as of May 31, 2021

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The impact of COVID-19 on credit markets: An uneven recovery

Looking back, a 20% selloff in leveraged credit as lockdowns began in early 2020 soon reversed, with credit markets rallying by double digits since the low point in March 2020. The recovery in credit markets has been as dramatic as the original downturn at the onset of COVID-19. In 2020, we saw double-digit yields in new issuance of companies that were severely affected by the pandemic, such as airlines, airplane manufacturers and cruise lines, but that has now normalized, and the expected economic recovery has been priced in.

The recovery has been uneven, as highlighted on the table below that shows the wide range of returns by sectors of the U.S. high-yield market. While credit markets appear likely to see a robust economy and strong demand from yield-hungry investors, some issuers may still face challenges. Active management and prudent security selection remain paramount given current valuations and economic uncertainties.

Returns for high-yield bonds across industry sectors

Impact	Most COVID Impacted Sectors	% of Index (Dec 2020)	Mar-20	FY 2020	YTD 2021
Winners	**Food beverage Tobacco**	6.10%	-4.70%	10.10%	1.20%
	Auto parts	5.30%	-13.50%	9.60%	2.10%
	Healthcare	8.90%	-6.60%	9.10%	0.20%
	Tech	5.00%	-4.80%	8.60%	0.80%
	Homebuilders	6.00%	-12.40%	8.00%	1.30%
	Super Retail	2.60%	-17.40%	7.60%	4.30%
	Cable Satellite	4.40%	-2.80%	6.60%	-0.10%
Losers	**Midstream distribution**	3.80%	-25.20%	5.30%	3.40%
	Leisure	0.90%	-15.00%	4.90%	1.30%
	Telecom	6.80%	-8.30%	4.90%	0.00%
	Gaming	3.10%	-18.80%	4.60%	2.50%
	Hotels	2.00%	-21.00%	-5.60%	3.90%
	Energy	13.40%	-33.80%	-6.60%	7.30%
	Energy - E&P	3.10%	-38.80%	-7.00%	8.30%
	Air transport	0.80%	-25.30%	-18.70%	7.00%

Source: Bloomberg, CreditSights, ICE BofA US High Yield Index TR as of May 31, 2021

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We are in an unusual, somewhat unique cycle in terms of speed. Employment in many countries remains far below pre-pandemic levels, which would normally suggest that we are in recovery. However, massive job and economic gains have facilitated a quick transition into expansion.

The repair phase was also compressed by the nature of the policy response, which saw not only record volume of fiscal aid, but unprecedented Fed intervention in credit markets. The policy response caused asset prices to recover quickly, reflecting growth well into the future and the technical impact of overwhelming market liquidity. **In our view, the current credit cycle is somewhere between a repair and recovery phase that follow recessions, a time when default volume declines.** From a fundamental perspective, however, we believe we are still in the recovery phase, which typically sees strong earnings growth, falling defaults and credit rating upgrades outpacing downgrades. Notably, the pace of improvement in high-yield credit metrics accelerated during the first quarter of 2021.

Also, we acknowledge that credit spreads are now at the lows for the last 12 months. We also think that credit is well positioned to deliver attractive carry relative to other fixed income alternatives. We are constructive on credit markets amid an environment of improving fundamentals and given our ability to invest flexibly across the entire credit spectrum. We have reduced our exposure to interest rate sensitive areas of the market in favour of corporate credit. This reallocation allows us to pick up yield and benefit from the ongoing and robust economic recovery. BB-rated bonds – the highest bucket in the high-yield category – have a higher weighting in the ICE BofA US HY Index than during the peaks of the energy crisis and the global financial crisis. This weighting reflects how the high-yield market is now of higher quality than in previous crises. The BB bucket has been growing amid some pandemic-induced downgrades of strong companies from the investment grade space to high yield, known as fallen angels. Also, the CCC bucket (lowest in the high-yield category) has shrunk as a result of an elevated level of CCC defaults in 2020 owing to the challenging pandemic conditions.

We are constructive on credit markets amid an environment of improving fundamentals and given our ability to invest flexibly across the entire credit spectrum.

Therefore, even if credit spreads look tight relative to historical levels, we believe credit markets remain attractive given the risk-return profile they offer today. With government bond yields expected to trend higher, we are mindful of the duration risk associated with specific areas of the market; investment grade and higher quality high yield. Investment-grade spreads are currently near record lows, providing very little buffer from rising government bond yields, which would result in falling bond prices given the inverse relationship between prices and yields. As a result, we have a preference for other higher-yielding alternatives within credit. We expect leveraged credit markets (high yield and leveraged loans) to outperform investment grade given the additional spread buffer to higher rates. We do however expect some flow through of higher rates to impact high yield bonds and thus currently have a preference for leveraged loans which have virtually zero duration and sensitivity to rising rates. Since loans are floating rate, they don't face the same headwinds that fixed rate does in a rising rate environment, but they've shown historically that they can perform well in both rising and falling interest rate environments. Given that they are secured and positioned at the top of the capital structure, loans have historically shown less volatility than other areas of fixed income with equivalent credit risk. In the last two-plus decades, floating rate loans have only delivered negative returns in two calendar years despite the various credit and interest rate cycles.

With the case for credit investing made, the following question needs to be answered next.

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Q3 | How are we aiming to generate attractive risk-adjusted returns in credit in this low-yield environment?

Alpha generation is becoming increasingly important in fixed income, as yields have fallen globally and the income generation potential of bonds shrinks. We believe credit markets from public to private credit offer an opportunity set for alpha generation and income enhancement that is attractive in the current environment. Diversity of return/risk properties in credit underlines the opportunity set for fixed income managers with a flexible approach. Here are the five key components of our flexible approach to fixed income:

Fundamental research and security selection

Our team conducts a thorough fundamental credit research and analysis process in seeking to avoid unattractive businesses, determine the optimal position in a capital structure, and identify attractive risk-return opportunities. Given current valuations, credit selection is important because there is still a disconnect between trading levels and fundamentals which are still catching up as the recovery continues.

We incorporate emerging risks, such as ESG, as they are growing in importance and need to be considered when assessing risk and the compensation (credit spreads) for risk. ESG analysis may also present opportunities when these risks are overstated by the markets, or create an opportunity for our team to engage with a company to influence change.

Relative value analysis

Relative value analysis helps us identify securities that offer attractive risk-adjusted returns and create an investable universe. Relative value analysis will be informed by:

- Historical total returns analysis to uncover a pattern
- Outlook for the sector and issuer
- Risk metrics like credit quality, duration, currency, liquidity, etc.

Relative value trades can be carried from a few days to a few months, depending on the drivers and investment rationale.

The factors we look at to implement trade-offs include:

Sectors

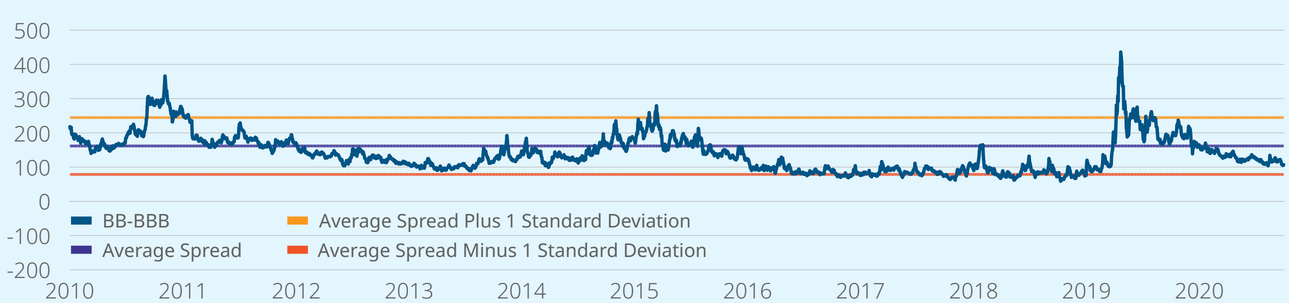
Geographical

Credit curve

Capital structure

Rating (see chart below)

Relative value trade-offs between BB and BBB credit



Source: Bloomberg, as of August 31, 2021

Idiosyncratic opportunities: The Canadian preferred shares market

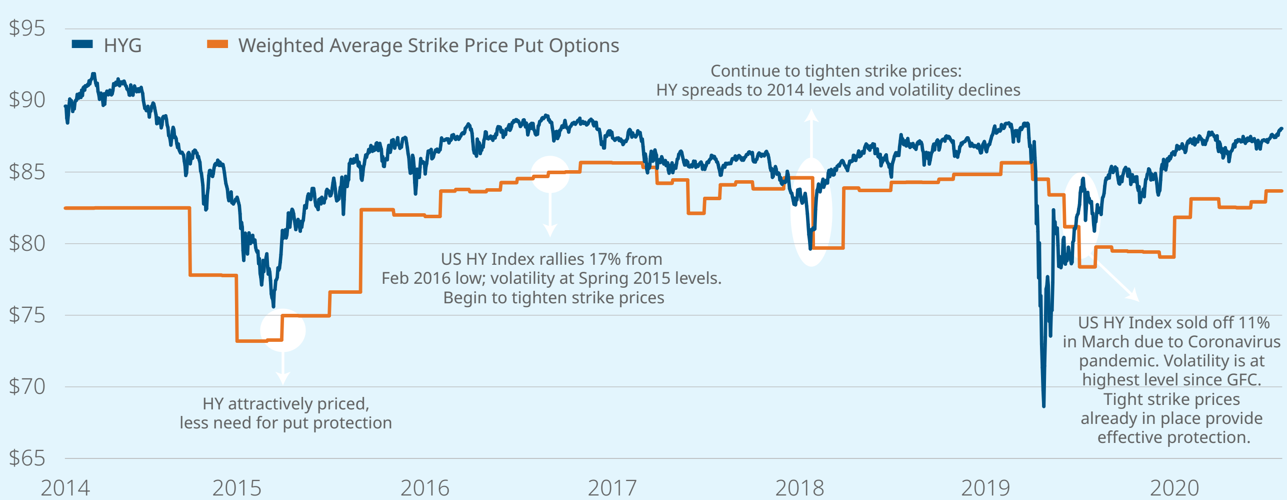
Idiosyncratic opportunities usually arise in an increasingly late-cycle market, exhibiting rising dispersion and periodic bouts of volatility during a market downturn. Idiosyncratic opportunities can exist in sub-asset classes or sectors that are not demonstrating attractive risk-adjusted returns due for instance to lack of liquidity, excessive volatility or poor performance over a full market cycle. Exceptions can stand out with out-sized return potential and prices heavily dissonated compared to their fair value The Canadian preferred share market (prefs) is one of the most illiquid markets in public credit. While we believe that prefs offer a poor risk-adjusted return, we were able to identify unique idiosyncratic opportunities in the space.

Moreover, valuations were supported by the emergence of new instruments called Hybrids in 2017 and "Limited Recourse Capital Notes" (LRCN) in 2020. The abundant issuance of LRCNs by Canadian banks and insurance companies represents the institutionalization of the Canadian pref market, and is expected to lead to the early redemption of old prefs and the shrinking of an already small and illiquid market.

Hedging market risk with derivatives

Downside protection is crucially important when the end of the expansion phase is nearing, and signs of a late cycle are forming. Having protection against the downturn becomes increasingly vital in a credit portfolio with an asymmetrical return profile. To help manage the downside risk inherent in riskier areas of credit, such as high-yield bonds, certain mandates employ discretionary or always-on protection dependent on specific fund objectives. For example, we can use a long puts position on HYG ETF – the largest high-yield bond ETF in the U.S. – to help protect from the downside on U.S. high-yield exposure in a portfolio. HYG put options are liquid derivatives and easily tradeable. They generally rise in value when the price of the underlying asset (HYG ETF) declines or when market-implied volatility rises, thereby acting as a portfolio ballast.

Example of always-on strategy for High Yield market risk mitigation using HYG Puts



Source: Mackenzie Investments June 30, 2021

Alternative strategies: Going beyond long-only strategies

In alternative credit, fixed income managers are equipped with an enhanced set of tools to capture alpha from their highest conviction investment ideas in terms of tactical asset allocation and credit selection. The ability to short and employ leverage opens up new avenues for return generation. In an additional bonus, these new avenues of return can potentially be uncorrelated to traditional long-only equity and fixed income markets.

Absolute return funds in particular are typically not benchmarked to public credit indices and therefore can use their expanded tool kits with a high degree of freedom as they seek positive total returns, regardless of the general path of interest rates or credit spreads. This feature makes them powerful tools for total return and income generation as well as traditional equity and fixed income diversification.

Liquid alts and conventional funds

	Liquid alternative funds	Conventional mutual funds
Borrowing	50% of NAV	5% of NAV with restrictions
Access to physical commodities	Generally limited to 10%	no limit
Leverage	300% of NAV	None
Illiquid assets	20% of NAV at time of purchase	20% of NAV at time of purchase

Source: Ontario Securities Commission (OSC), National Instrument 81 – 102 as of June 30, 2021

Conclusion

The Mackenzie fixed income team maintains a strong focus on credit through the cycle. For the past decade we have been invested holistically across credit sub-asset classes in seeking to make outsized contributions to the attractive risk-adjusted returns delivered to clients.

Collecting stable income has grown more complicated over the years in the face of declining overall yields and increasing volatility. We believe in enhancing income through diversification across the entire credit spectrum while implementing active trade-offs.

Investments must be added thoughtfully, with investors understanding which underlying risk drivers have the most influence on the overall portfolio.

Given today's highly complex markets and challenging macroeconomic conditions, we firmly believe this is not a time for investors to do it alone. It's more important than ever to work with an experienced, skilled financial advisor and a proven team of professional asset managers to develop truly diversified income portfolios.

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