

And Now For Something Completely Different

Adding Credit Alpha in the Context of an Institutional Portfolio



In this Strategy Focus we discuss:

- Why there is alpha to be extracted from global credit markets
- Why traditional strategies such as Core Plus tend to mimic beta exposures
- How asset owners can use RP Corporate Index Plus to help diversify against common risks found in Core/Core Plus allocations

What Features of the Corporate Bond Market Make Alpha Generation Possible?

The first criteria in the 'search for alpha' is that a market must present enough opportunities for managers to extract added value. It may sound trivial to make the statement that fixed income is "something completely different" but it is worth highlighting that there are several structural characteristics of bond markets that make the generation of absolute returns possible. There are a number of reasons why active managers have been able to outperform passive strategies over time. These include:

1. **The market is dominated by "non-economic" investors** – The Bank of International Settlements has estimated that 53% of the \$102 trillion global bond market is composed of investors that make decisions based on criteria other than economics / value. This can include participants such as central banks buying or selling corporate bonds as part of a Quantitative Easing program, passive ETFs and pooled/mutual funds looking to simply match a benchmark or insurance companies optimizing book yield against changing regulations and capital charges.
2. **Many of the remaining investors are restricted by strict investment constraints** – Bond managers are typically constrained by investment mandates which are overly focused on benchmark composition and characteristics. This means that even value-driven investors are restricted in terms of the opportunities they can pursue. Furthermore, these investors can be forced to act sub-optimally. For example, bond managers may become forced sellers when positions become "out-of-policy" due to a downgrade or when securities cease to be index constituents.
3. **Security selection can be a game-changer** – Unlike other asset classes such as equities, fixed income managers can express a view on a single company through multiple securities. This includes security selection decisions with regards to currency, maturity, seniority, covenant packages, and other variables. This variety can make security selection a large driver of returns in fixed income portfolios.
4. **High turnover of indices presents opportunities** - Because bonds are not perpetual instruments, the turnover in fixed income indices is often much higher than for equity counterparts (for example the Bloomberg Barclays US Aggregate Bond Index has an annual turnover of approximately 40% versus the S&P 500 at approximately 8%).¹ This higher turnover creates a consistent flow of funds which active managers can exploit to generate returns.



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5. **New issue concessions can be a meaningful return driver** – By some estimates newly issued securities make up roughly 20% of the bond market’s capitalization in any given year. This means that, at times, bond managers can capture new issue concessions which add considerably to returns. This is another unique source of return available in credit markets versus those found in other asset classes as issuers constantly roll over their debt stack.

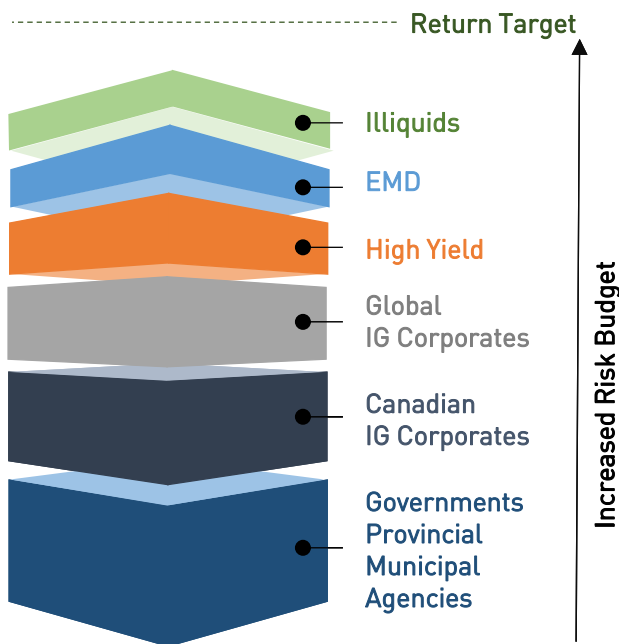
Taken together, these five characteristics mean that fixed income managers positioned to exploit these inefficiencies have some tailwinds in their favour versus traditional active managers. This style of management should be able to produce ‘alpha’ in a multitude of market environments.

Core Plus Strategies May Be Producing ‘Beta-Like’ Returns

In recognition that managers require greater breadth to exploit the inefficiencies we listed, many investors have turned to Core Plus mandates to capture additional returns from fixed income. While most Core Plus managers have multiple levers through which they can extract returns, we believe that investors may be underestimating the similarity between the final return streams produced by these strategies.

It is our opinion that many Core Plus strategies source a disproportionate amount of their added value through ‘carry’ strategies, employed across core credit and “plus” sectors. This carry focus leads to a return stream that reflects different credit betas rather than alpha exposure, including some more idiosyncratic risks found in markets such as emerging market debt, high yield and illiquids.

Layering Beta to Reach a Return Target



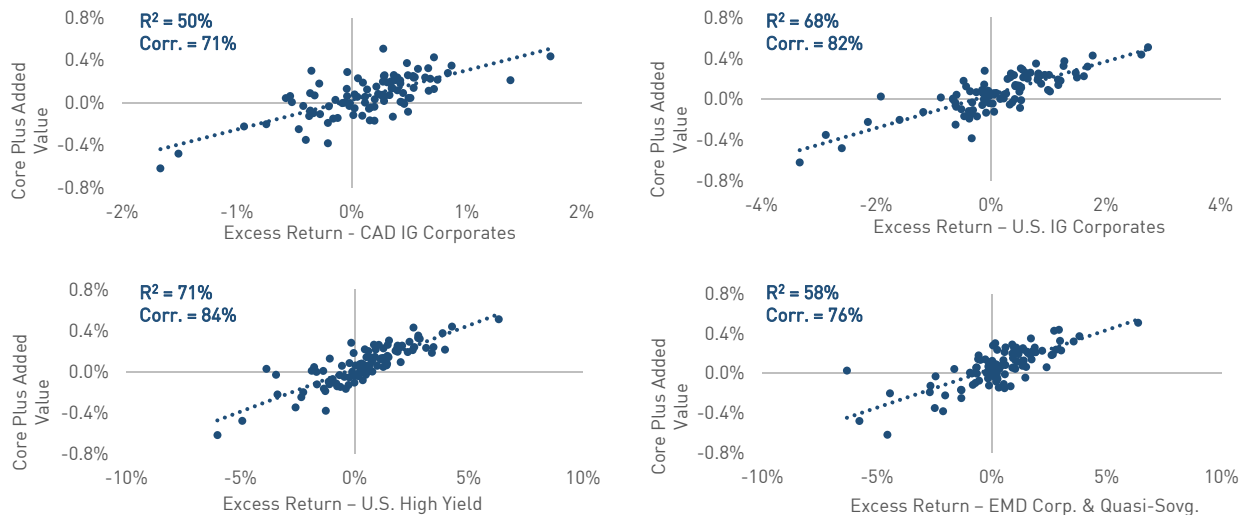
To illustrate this point we regressed the median Core Plus added value against the ‘excess return’ of different core and “plus” credit markets. The ‘excess return’ represents the portion of total return attributed to credit spreads only, removing the rates exposure underlying the constituent corporate bonds.²

Through this analysis we found that major spread markets could explain a large portion of the added value being produced by the median Core Plus manager. This suggests that while investors turn to Core Plus mandates to add alpha to their asset portfolio, the return streams produced are more reflective of “layered betas” sourced from core and “plus” asset classes, irrespective of the active decisions being made within the portfolios. We believe this is due to the reliance on carry strategies as a major source of return within most Core Plus portfolios. This carry focus will often translate into portfolio positioning that requires a persistent overweight to corporate bonds in order to meet added value targets. By relying on carry as the main driver of added value, return streams can begin to mimic the betas of their respective markets.

Whether or not the dominance of carry strategies is pervasive in Core Plus strategies, the final return stream being produced for investors seems to be acting more like beta and less like alpha.

As illustrated below, both domestic credit and “plus” sectors explain a large amount of the median Core Plus managers added value with high R^2 's and correlations. This means that the final return stream experienced by the client is very similar to the betas found in the respective spread markets to which they have exposures.

What's Really Driving Returns – Alpha or Beta? ³



Source: Barclays, Mercer Insight
For the period from Jan. 2010 through Dec. 2018

Applying an Absolute Return Framework to Create Credit Alpha

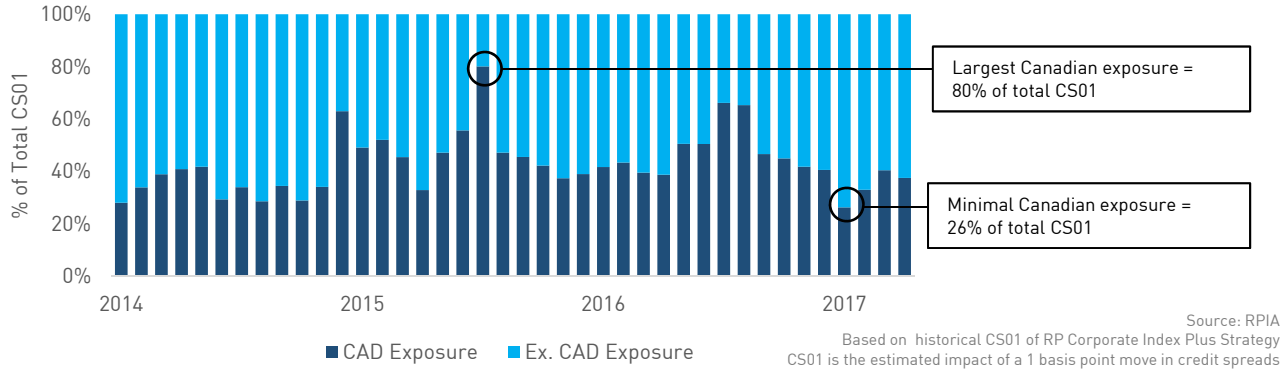
The RP Corporate Index Plus Strategy (“CIP”) was designed to help institutional investors target outperformance without using an overweight credit position to generate this added value. We aim to achieve this by utilizing the same style as our long-short credit portfolios within a long-only context – creating “something completely different” from traditional mandates. The portfolio was designed with the breadth to:

- Explore G7 credit markets and capture pricing inefficiencies across geographies
- Explore the ratings spectrum down to Crossover names (split rated BBB/BB bonds) to exploit pricing inefficiencies caused by out of benchmark situations
- Explore concentrations in issuers and industries that are not restricted to benchmark relative positioning but rather, managed to absolute risk levels
- Use credit derivatives as a way of efficiently gaining long credit exposure and capturing basis opportunities
- Remain duration neutral to the benchmark to avoid uncompensated interest rate risk
- Fully hedge all holdings back to CAD to avoid uncompensated FX risk

We believe this flexibility leads to a credit portfolio which derives returns from sources of added value beyond carry and produces a return stream that differentiates itself from receiving credit betas. Specifically, our active style can produce a majority of its returns via security selection and relative value trading across geographies and security types. We achieve this objective by employing a relative value framework that sources attractively priced bonds across markets and frequently expresses issuer views by rotating through that issuer’s different funding markets and capital stack. This style is a result of exploiting the mis-pricings caused by the structural inefficiencies we discussed in the first part of this paper.

Below we highlight this style by showing the credit exposure of the CIP strategy split between domestic and global credit markets and the change over time. This profile may differ from a more traditional Core Plus style which would typically exhibit a more static mix across geographies. Through dynamically allocating capital across geographies, the portfolio management team are able to “go where the value is” at any given time. Appendix II shows a specific trade example which represents the investment style used in this strategy.

Active Positioning Across Domestic and Foreign Credit Markets

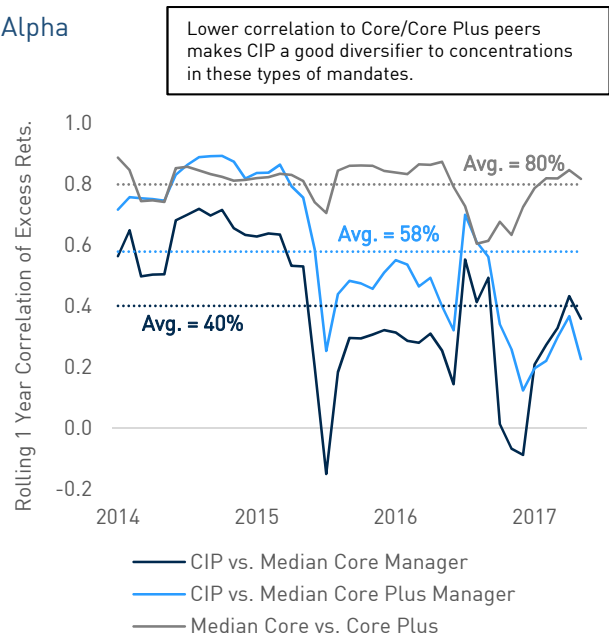
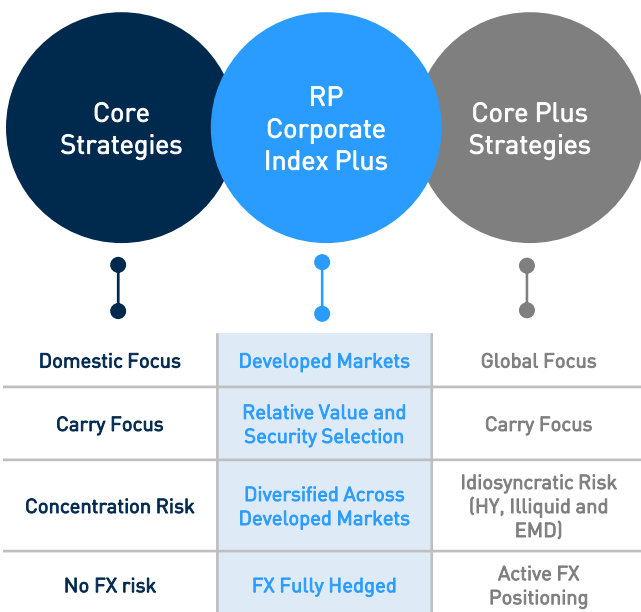


The Role of a Credit Alpha Strategy Within the Institutional Portfolio

a) A Complementary Strategy Alongside Core or Core Plus

The shift to Core Plus by many institutional investors in Canada has stemmed from their desire to diversify their fixed income exposures away from domestic risks. While this is achieved through the allocation to “plus” components, we believe most investors are underestimating the similarity in return stream produced by these managers. As we have shown, this can be due to an over-reliance on carry strategies to produce outperformance. Therefore, we believe clients can use ‘credit alpha’ strategies such as CIP to gain exposure to a return stream with a lower correlation to domestic and foreign spread markets as well as diversify the returns they are already receiving from Core and Core Plus managers.

Offsetting Common Core/Core Plus Factors With Credit Alpha



Source: RPIA, Mercer Insight

To illustrate the diversification benefits, we combine a static 80% allocation to the median Core and Core Plus managers with a 20% allocation to CIP. This hypothetical model produced additional excess returns over the benchmark, lower volatility and a higher risk adjusted return (via Sharpe and information ratio).

Improved Return Profile by Adding CIP to Core and Core Plus Exposures

	FTSE TMX Canada Universe Bond Index	Core Median	80/20 Core Median & CIP	Core Plus Median	80/20 Core Plus Median & CIP
Abs. Return	4.09%	4.15%	4.55%	4.64%	4.94%
Volatility	3.98%	3.67%	3.59%	3.83%	3.51%
Tracking Error	-	0.25%	0.59%	0.55%	0.82%
Sharpe	0.86	0.95	1.09	1.04	1.22
Info. Ratio	-	0.26	0.77	1.02	1.04

Source: RPIA, Mercer Insight
Based on the 4 year period ending Dec. 2017

~30 to 40 bps in return pick-up

~8 to 30 bps in vol. reduction

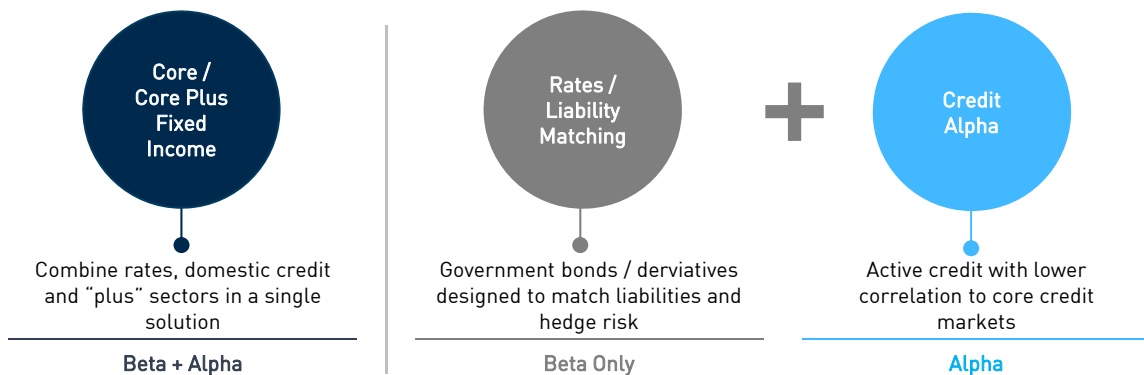
Increase in tracking error due to benchmark agnostic style of CIP

Highest risk-adjusted returns by both measures

b) Using Corporate Index Plus to Decompose Your Fixed Income Allocation

Alternatively, for investors looking to take a more granular approach to their fixed income portfolio, we believe credit alpha strategies such as CIP can be used in the context of a broader re-design of the bond allocation. A core Canadian bond allocation is approximately 73% government bonds and 27% corporate bonds. However, if the majority of return produced by traditional strategies comes from carry/persistent overweights to credit, an investor may benefit from “decoupling” their rates and credit exposures. An asset owner could replace a combined allocation with a low-cost government bond component (also customizable in terms of duration exposure) alongside a credit alpha vehicle such as CIP for their corporate bond component, accessing the former in beta format and the latter via alpha. This is the exact strategy used by a major Canadian university which gave rise to the CIP strategy as discussed in Appendix I.

Decoupling Rates from Credit



Conclusion

We believe that many asset owners can benefit from adding credit alpha strategies to their portfolios, to help diversify some of the betas to which they are exposed through Core/Core Plus sleeves and other traditional mandates. Global bond markets have shown that there are structural inefficiencies that can be exploited to produce a return stream that complements the types of exposures found in the common institutional portfolio.

Appendix I – Case Study: Use of CIP in the Context of a Broad Portfolio Restructuring.

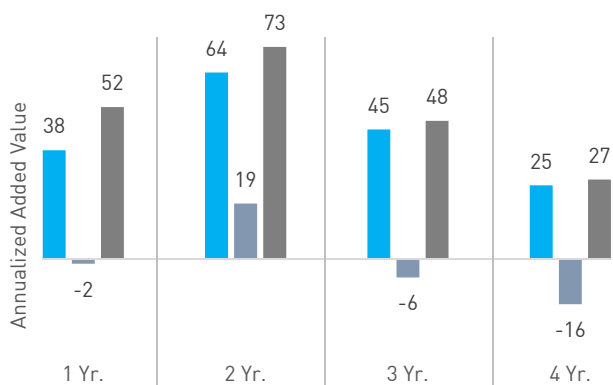
The CIP strategy was originally designed for a large university endowment and pension plan who were re-thinking their core bond allocation. The client wanted to access the rates market passively, at a lower cost, to both match known liabilities and hedge risk assets held in other parts of the portfolio. For their credit allocation, the client was looking for an alpha vehicle that produced “true” active returns and was less reliant on carry as the sole source of added value. Having invested in our original long-short credit strategy, the client engaged RPIA to design a long-only mandate which utilized the same absolute return style in the context of developed credit markets. The fee structure of CIP was also designed to reflect the alpha focus of the strategy with minimal base fees and a focus on performance fees as a way to align our interests with our clients. This ensures RPIA is only paid on outperformance and not just the growth of the asset base. This resulted in the launch of the RP Corporate Index Plus Strategy (“CIP”).

By decomposing their portfolio into rates versus credit exposure, our client was able to apply a more granular approach to how they accessed different asset classes, whether by receiving beta in efficient markets or accessing inefficient markets through alpha vehicles. The client preferred this more granular approach compared to a Core Plus portfolio which they saw as a “levered beta” solution which provided carry exposure to different spread markets.

To ensure this original concept was proven-out over time, we completed analysis which took the FTSE TMX Canada Universe Bond Index and replaced the corporate bond component of the index with our CIP strategy. We then back-tested this combination (referred to as the “CIP Sector Neutral Model”). By following the index historical weights between government and corporate bonds we were able to isolate the added value coming from our security selection/relative value decisions within CIP rather than the allocation decision to overweight credit employed by traditional managers. The CIP Sector Neutral Model was able to produce returns in line with Core Plus peers without overweighting credit (much lower CS01*) or importing the idiosyncratic risks associated with “plus” sectors such as lower rated high yield and emerging market debts.

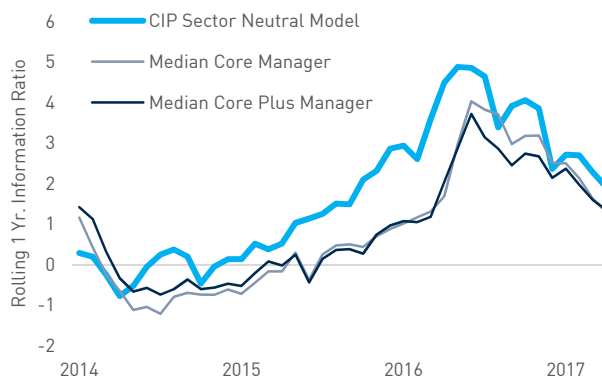
Producing Risk-Adjusted Returns Without Overweighting Credit

The CIP Sector Neutral Model produced returns (net of fees) above those of Core peers and in-line with Core Plus peers without over weighting credit or accessing more “exotic” exposures such as low-quality high yield and EMD.



■ CIP Sector Neutral Model ■ Median Core Manager ■ Median Core Plus Manager

By focussing on alpha generation (via security selection and relative value trading) the CIP Sector Neutral Model produces better risk adjusted returns versus peers.



Source: RPIA, FTSE TMX Debt Capital Markets & Mercer Insight
Net of fees calculations based on CIP net of fee returns and median fees for a \$50M account size as published in Mercer Pooled Fund Survey – Dec. 2017

*CS01 is the estimated impact of a 1 basis point move in credit spreads

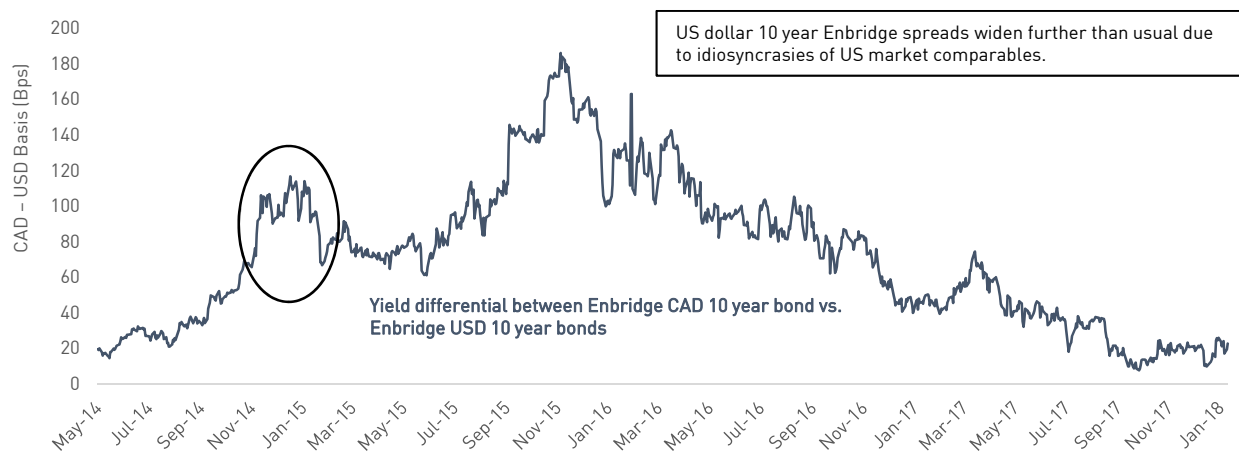
Appendix II – Trade Example: Enbridge Inc.

The CIP strategy places an emphasis on relative value and security selection as the main driver of added value. We achieve this by exploring developed market spread products to exploit pricing inefficiencies. This style is best represented by a trade opportunity which arose in late 2014 involving the Enbridge complex.

The issuer came under pressure due to oil price weakness and a proposed restructuring of their different operating entities. After our credit analysts conducted their fundamental analysis on the proposed restructuring (with the belief that the market was not properly pricing the credit risk involved) the CIP strategy rotated our pre-existing CAD 10 year Enbridge positions into 10 year USD bonds to capture the additional basis available by expressing our view on Enbridge in Dollar terms. Approximately three months later our relative screens also discovered a breakdown in the dynamic between the USD bonds and their corresponding CDS spreads due to an increased demand from U.S. banks looking to hedge their exposure to Enbridge by buying protection. This demand caused large pricing dislocations between cash and CDS markets, allowing us to sell 2 year CDS protection at the same spread levels as the 10 year USD cash bonds.

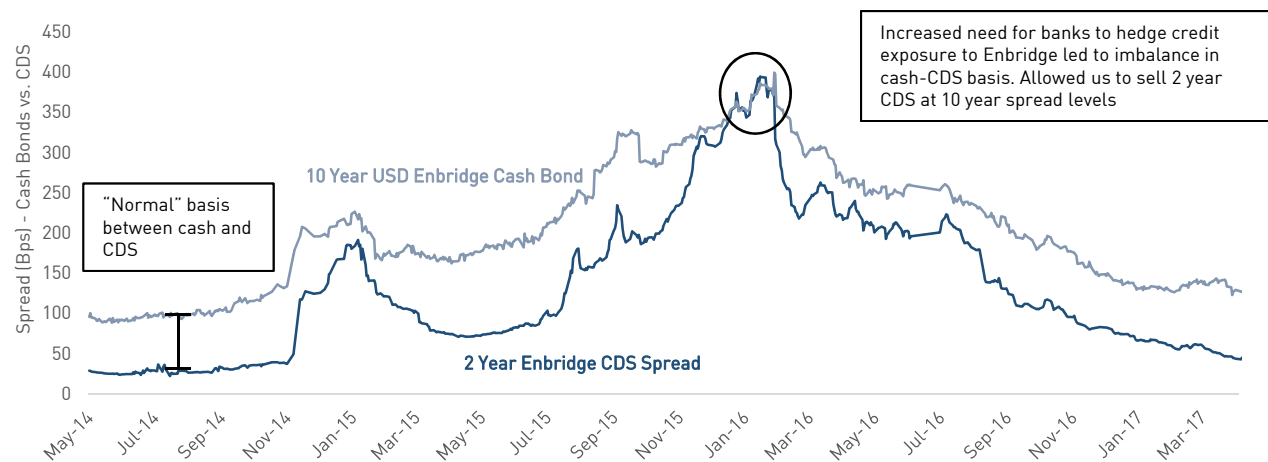
We covered our short CDS position in September 2017 as the basis renormalized.

Leg I – Buy “Cheap” Dollar Bonds vs. Canada



Source: Bloomberg & RPIA Calculations

Leg II – Rotate Into Shorter Tenor CDS to Capture Basis With Less Term Risk



Source: Citi Bank & RPIA Calculations

¹ Based on Bloomberg Barclays Global Aggregate Bond Index and S&P 500 Index. Source: Bloomberg

² Excess return¹ represents the curve-adjusted excess return of the given index relative to a term structure-matched position in Treasuries or corresponding government securities. For U.S. indices and EMD Corp. and Quasi-Sovg. Index excess return uses the key rate duration method. The yield curve exposure of any single security is described by a set of six key rate durations. Then a hypothetical Treasury portfolio is created to match this key rate profile. Excess return for the constituent security is the difference between its total return and the return of the Treasury portfolio. For the Canadian index the average return on Government of Canada bonds is calculated with half-year duration cells from 0 through 15 years. The excess return is calculated for each index security as the difference between the corporate bond's total return and the total return on the Government of Canada bond in the corresponding duration cell. Method based on Bloomberg Barclay's 'Excess Return Computation – Sept. 2000' Utilized the same analysis technique as 'The Illusion of Active Fixed Income Diversification – AQR' – 4Q17.

³ Median Core Plus Manager is defined by Mercer's Canadian Fixed Income (Core Plus) Universe
Median Core Manager is defined by Mercer's Canadian Fixed Income (Universe – PFS) Universe

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