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Credit Review & Outlook: Hunting for Alpha in a Changing Landscape

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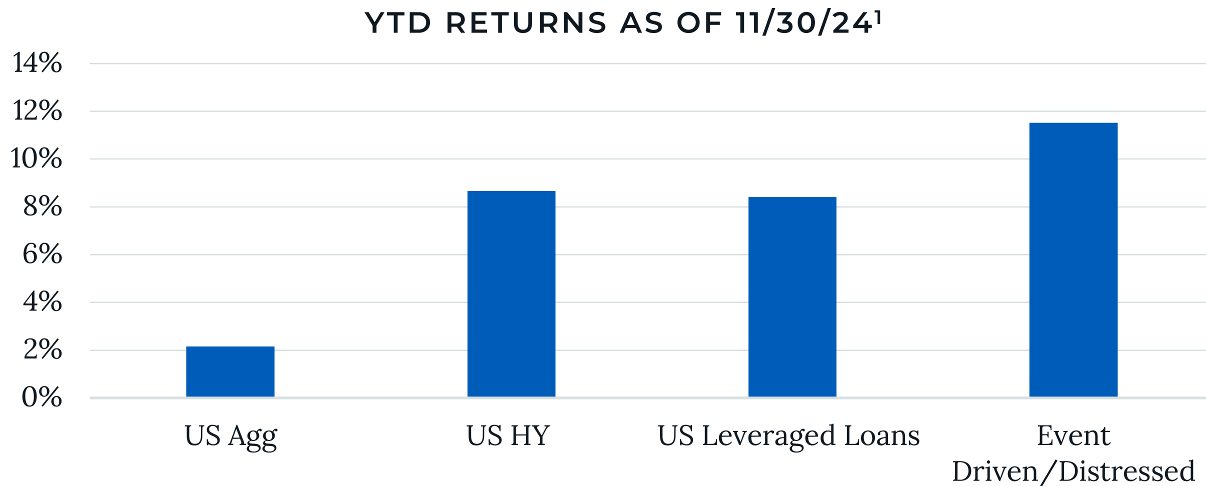
CREDIT IN 2024: EXCITING ONCE AGAIN

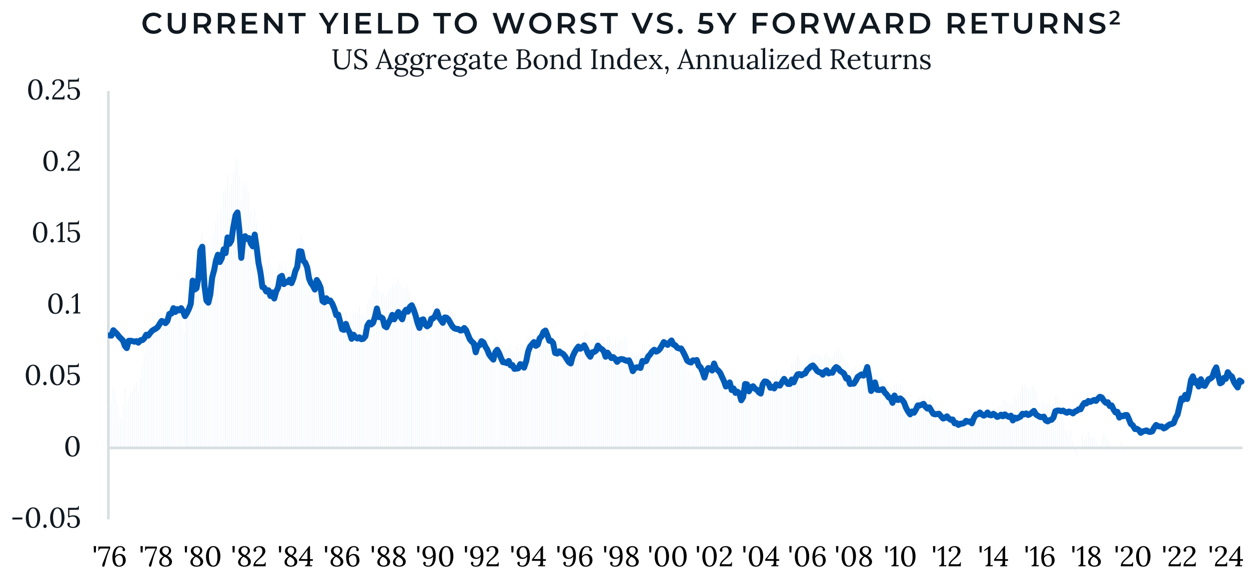
2024 was a strong year for credit.



Higher base rates in combination with healthy company fundamentals and strong consumer spending meant that credit managers were able to deliver robust performance without needing to take much additional ***credit risk.*** Below are key credit themes that contributed to positive performance in 2024.

HIGHER BASE YIELDS IMPACT FULL CREDIT LANDSCAPE

Piecing together a bond's total return expectation begins with the yield of the investment, and this foundational element provided a good starting point for 2024. After five to ten years of low rates, higher base yields brought higher expected returns for bond investors across the fixed income spectrum. Core bond funds as well as high yield bond funds benefited as they made new investments at these higher yields. As current investments in their portfolios matured or were sold, fixed income managers invested the cash proceeds in higher yielding bonds, boosting overall portfolio yields and returns.



[1] Source: Morningstar Direct. See Appendix 2: Asset Class Benchmark Descriptions.
[2] Source: Bloomberg
Past performance is no guarantee of future returns. As with any investment there is the risk of loss.
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LOW DEFAULT RATES[1]

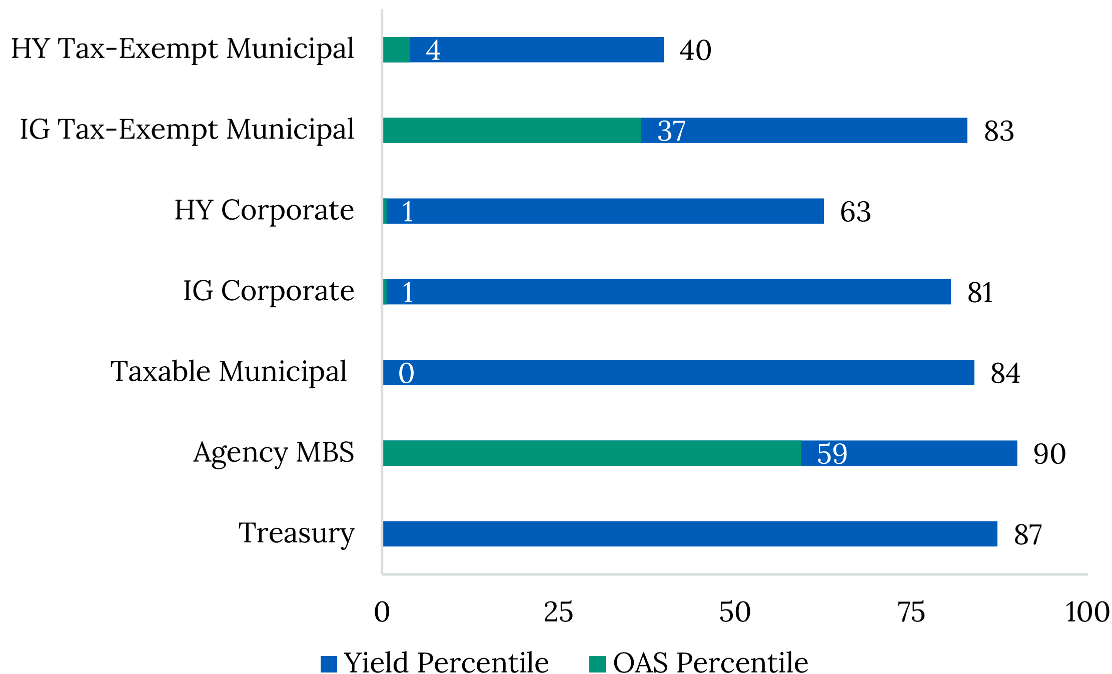
The other foundational element of credit investing is whether or not bondholders will get repaid. Evaluating the risk associated with default is dependent on the mandate of the investment strategy. For example, distressed managers will be comfortable with a higher probability of default whereas an investment grade bond manager would have a lower tolerance for risk. Regardless of an investment manager's attitude toward risk, low default rates benefited all credit investment strategies in 2024. Cash flows benefited from lingering Covid stimulus money that strengthened company balance sheets. They also benefited from the extension of the credit cycle as companies were able to refinance their debt to later maturities. While we don't necessarily think this is a sustainable trend, it was certainly beneficial to 2024 performance. A sub-dynamic in this environment was the improvement of credit quality in the high yield index, as many names were re-rated to a higher quality and many of the lower quality credits went to private credit. As a result, investors benefited from lowered credit risk without giving up much yield in return (not a common dynamic).

TIGHT SPREADS[1]

2024 saw historically tight spreads across the credit spectrum, driven by strong corporate cash flow and ample investor liquidity. This dynamic made it hard to find attractive prices and opportunities for capital deployment. The tight spreads within high yield were partly attributable to the improved credit quality as described above as well as government rates coming up on the long end of the curve. Despite the challenges of finding opportunity amid tight ***spreads***, our managers still performed well as higher overall yields and higher bond prices both contributed to returns.

CURRENT OAS[2] AND YIELD PERCENTILE RANKS[3]

(10-Year Period)



[1] Source: AllianceBernstein
[2] The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.
[3] Source: Bloomberg; ICE BofA; Pathstone
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STRESSED SITUATIONS

Over the last few years, many companies with weaker balance sheets or those that had debt maturing (thus needing to re-issue debt to raise capital to run their businesses) experienced difficulty in paying the higher interest costs. Credit investors that focused on the stressed and distressed bonds of these companies benefited from an increase in the number of these bonds and a greater ability to pick through them to identify the best opportunities to generate returns.[1] There were multiple ways these investors generated returns given this backdrop such as via ***pull-to-par, amend-and-extend, and loan-to-own strategies.*** While the details of the above situations are lengthy and complex, the number of occurrences increased as interest rates increased and remained elevated throughout 2024. (*Please see Appendix 1 for definitions of the terms above.*)

CREDIT OUTLOOK FOR 2025: WHEN BETA CREDIT OPPORTUNITIES ARE SCARCE, HUNT FOR ALPHA… BUT BUYERS BEWARE

Ample investor liquidity, continued appetite for yield, and general optimism around the U.S. economy make the broader credit markets appear expensive with much good news priced in heading into 2025. Pathstone's alpha-seeking credit platform aims to be positioned to benefit from this environment. The investment managers seek to uncover hidden value, often away from traditional credit opportunity sets.

Entering 2025, idiosyncratic credit opportunities persist. While numerous disparate opportunities will appear in 2025, we have chosen to highlight three categories of macro themes where interesting investments could surface. First, the crosscurrents in the public equity and credit markets are making obtaining financing for smaller public issuers difficult and expensive. From an individual company's perspective, it is increasingly attractive to raise capital in the ***convertible bond*** market given persistent higher interest rates as well as higher equity volatility. The second theme incorporates a combination of credit market dynamics. A lack of ***bond covenants*** and an increased prevalence of balance sheet stress from persistent high rates have given rise to a more adversarial creditor environment. Finally, implications from quantitative tightening are resurfacing. For example, in October this year we witnessed the breakdown of the relationship between credit spreads and interest rate volatility. Though not necessarily a security-level opportunity, our managers are seeking this type of dislocation as a sign of market stress underneath what otherwise seems to be a stable corporate environment. This third category of hidden stress is more difficult to predict in terms of opportunities for our managers. However, we believe they are well positioned to navigate this dynamic, and we plan to remain in close contact with them as 2025 unfolds.

SAMPLE PORTFOLIO CASE STUDIES INSIDE OUR CREDIT MANAGER PARTNERSHIPS

1. Convertible Arbitrage is Evolving

Traditionally, convertible bond arbitrage managers underwrite a company's convertible bond and its equity, put them both in a model, and see if there is a relative value difference they can arbitrage away for a profit. However, this traditional approach is predicated on a company having a relatively strong balance sheet (to buoy the credit side of the investment) and a reasonably consistent (and preferably low) equity volatility. As one of our preferred managers in the space recently brought to our attention, a new dynamic has emerged, primarily as a result of the Covid pandemic, that has caused them to evolve their approach. There is a growing subset of the convertible bond universe comprised of companies with relatively strong balance sheets paired with very high and unpredictable equity volatility. This presents a difficult scenario for traditional convert managers as their existing models are far less effective in determining the value of the convertible bond. For example, a company with a strong balance sheet and high equity volatility recently issued a convertible bond with a 0% coupon.

[1] Source: Barclays Credit Research

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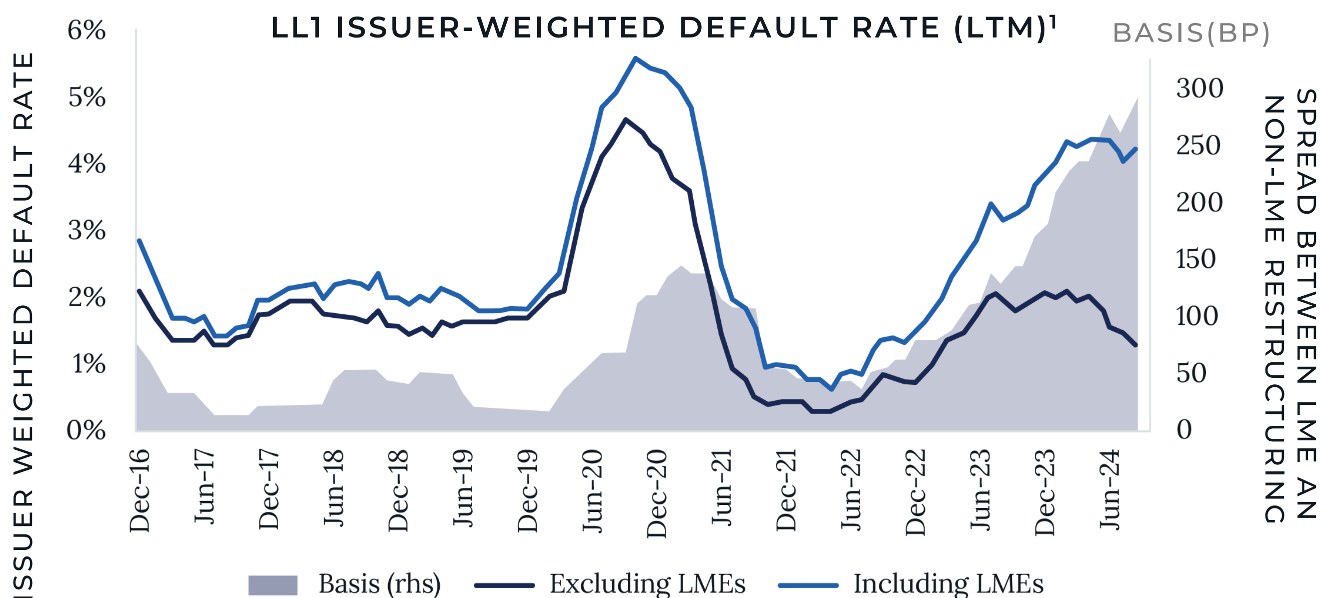
Traditional investors may avoid buying such an issue as they feel they are not being compensated appropriately given the lack of coupon. However, our manager has been happily buying the issue because they can use the high equity volatility to actively manage their hedge and drive returns for clients through the trading of the company's equity. The most attractive element of this opportunity is the lack of correlation with or reliance on the broader credit opportunity set and the economic backdrop in general.

2. Stressed and Distressed Credit Investing Continues to be Feisty

Credit managers investing in debt securities of companies either undergoing or heading towards a bankruptcy/***restructuring*** used to rely on strong bond covenants or seniority in the capital structure (or both) in order to receive compensation for the risk and effort of shepherding a company through such a complex process. In the last few years, however, bond covenants have largely disappeared (known as a ***"cov-lite"*** environment) and companies have started working with investors to front-run the bankruptcy process and restructure their balance sheet outside of court. This has resulted in an artificially low official default rate and a reduced awareness of overall risk in parts of the system. These out of court restructurings that help companies avoid the costly and complex process of bankruptcy restructuring are often referred to as ***"Liability Management Exercises"*** (LMEs). LMEs are processes in which investors effectively compete to recover their debt investments in distressed companies by negotiating changes to benefit their position at the expense of other creditors. The managers we partner with in this arena have been discussing LMEs and this adversarial creditor environment since 2022 and have incorporated this new paradigm into their investment processes to give themselves and their clients what they believe is the best opportunity to end up on the right side of these transactions, or to avoid them entirely if they feel it is too great a risk.



We are excited about the opportunity set for our alpha-seeking credit managers in 2025 even as many investors are hesitant about index level credit metrics. Our managers are keenly aware of the risks to their strategies, and we are confident in their ability to steer their portfolios towards areas of opportunity in order to generate returns for our clients.

Please reach out to your Pathstone advisor if you would like to speak with us in more detail about any of the concepts referenced in this piece.

[1] Source: Barclays Credit Research

APPENDIX 1: DEFINITIONS

TERM	DEFINITION	INVESTMENT IMPLICATION
Credit Risk	The risk of a company defaulting on its debt obligations.	
Spread	The difference in yield between two bonds that have similar maturities and liquidities, compared to a reference rate.	
Covenant-lite	Refers to the market environment in which there are loose legal bindings between bond owners and bond holders.	
Stressed Credit	Credit of companies that have significant financial struggles but are not yet near bankruptcy.	
Distressed Credit	Credit of companies that are nearing default and which need significant intervention to turn the state of the company around.	
Pull-to-par	Refers to the bond's price returning to par at maturity without any intervention. These are situations in which the bonds of a company are trading at a discount, indicating a risk of default between now and maturity; i.e., when a high yield bond issue is bought at a steep discount relative to par and accretes back to par as the time to maturity shortens.	For sophisticated investors willing to perform in-depth research and due diligence, these discounts can be opportunities to buy cheap bonds that will ultimately be paid in full. This may sound simple, but it is far from it. These investors, some of whom we partner with, must not only perform in-depth research on the company, but also its peers, its industry, and often the economic environment. We believe our managers are the best in their field at performing this in-depth due diligence and can add value by finding attractive pull-to-par investments that are less likely to default or run into other issues.
Amend-and-extend	These are situations in which a company needs an amendment to its balance sheet or to a specific bond issue to avoid a default and potential bankruptcy.	In these scenarios, sophisticated investors can work directly with the company to come up with a solution and allow the company to continue as a going concern. These can be lucrative for the investors as they can earn increased yields on newly issued bonds or even receive cash, stock, or other securities in exchange for existing holdings, potentially allowing the bond investors to also participate in future upside of the firm if it does well.
Loan-to-own	These are situations in which the investor is making an investment into a company that is clearly heading towards bankruptcy or already in the process, at significant discounts to par.	These are typically highly complex processes in which the investor has to spend significant time working with the company, other creditors, and lawyers to restructure the company.
Convertible Bond	Convertible bonds are considered hybrid securities as they are bonds which can be exchanged for a predetermined number of equity shares of the issuing company.	Convertible bond arbitrage managers underwrite a company's convertible bond and its equity, put them both in a model, and see if there is a relative value difference they can arbitrage away for a profit.
Bond Covenants	Legal contracts between bond holders and bond issuers that outlines what the bond issuer can and cannot do.	Bond covenants are protective mechanisms for investors.
Restructuring	The reorganization of a company's balance sheet, management, and/or operations in order to achieve greater efficiency and profit, or to adapt to a changing market.	
Liability Management Exercise (LME)	Out of court restructurings that help companies avoid the costly and complex process of bankruptcy restructuring.	

APPENDIX 2: ASSET CLASS BENCHMARK DESCRIPTIONS

ASSET CLASS & INDEX NAME	DESCRIPTION OF INDEX
US Fixed Income Bloomberg US Agg Bond TR USD	Aggregate index which includes fixed-rate taxable, investment-grade US dollar-denominated bonds.
US High Yield ICE BofA US High Yield TR USD	Index includes below investment grade, US dollar denominated, corporate debt publicly issued in the US.
US Leveraged Loans S&P/UBS US Leveraged Loan USD	Market weighted index that measures the investable universe of leveraged loans denominated in US dollars.
Event Driven/Distressed Credit HFRI Event Driven Distressed/Restructuring	Index tracks the performance of hedge funds with event driven, distressed, and restructuring strategies – i.e. strategies that focus on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or at maturity as a result of either formal bankruptcy proceeding or financial market perception of near-term proceedings.[1]

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[1] Source: 2024 HFRI Incides- chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.hfr.com/pdf/HFRI_formulaic_methodology.pdf