FUTUREGROWTH
/ ASSET MANAGEMENT

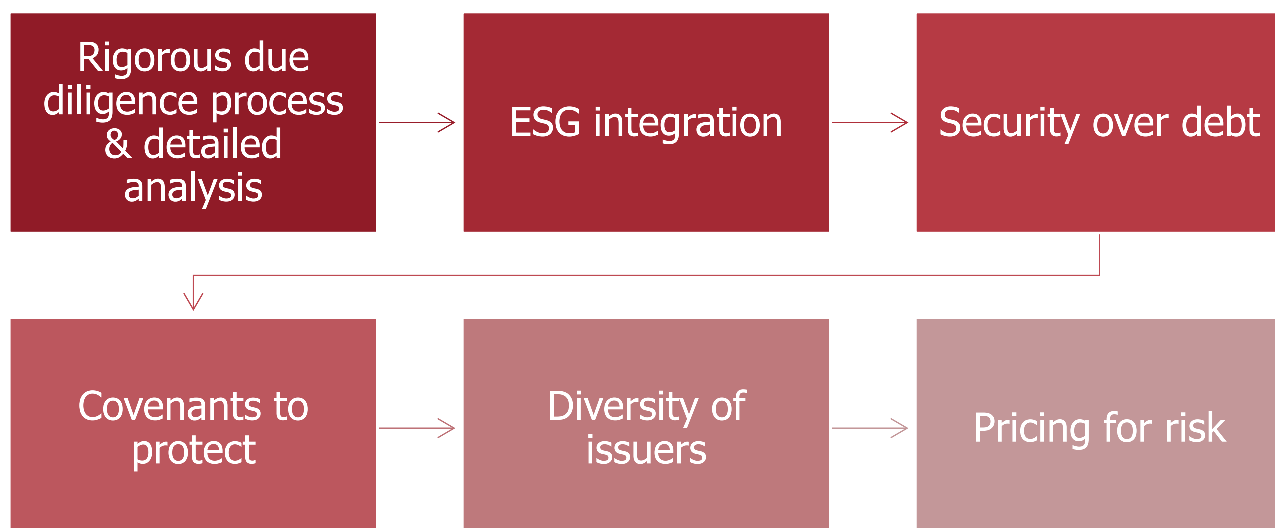
What to ask your manager: Credit as an asset class
Author: Thato Khaole, Investment Analyst @ Futuregrowth
Published: July 2020

A good investment philosophy should keep an asset manager accountable by providing structure, while not inhibiting agility. While most asset managers would agree on the overarching principles, each manager has a unique investment philosophy and may apply it differently. This is why investors should become closely acquainted with their managers' investment views and processes before handing over their hard-earned money to be invested.

Although often less volatile than equity, credit investments are not without risk. Unlike equity, which is primarily driven by a search for "upside" or capital appreciation, credit is underpinned by the investors' need to receive their capital investment back, plus any interest accrued over the investment period. It is therefore important that investors critically evaluate how their managers assess, monitor and protect against the "downside" risks inherent in credit assets.

At Futuregrowth, when we assess any potential credit investment, we identify and evaluate the relevant risk factors to ensure that the reward for our clients is commensurate with the risk they acquire. Our credit mitigation strategy makes use of a combination of the six pillars below:

How we reduce YOUR risk



Here are some useful questions and discussion points when engaging your asset manager - about how it considers both listed and unlisted credit investments.

UNDERSTANDING THE RESEARCH PROCESS

1. **Describe a recent due diligence you have completed on a new borrower, including any red flags identified.**
   Key assessment areas:
   - *Depth of engagement*, including the time and analytical resources dedicated to understanding factors including, but not limited to: the borrower's operations, management team, historical performance, and any existing financial and non-financial risk mitigants in place.
   - *Responsiveness,* or how risks were identified, interrogated by a credit committee and mitigated. Mitigating factors include, but are not limited to, legal protections, limits on deal size, and portfolio construction.

- *Framework*: Is there a due diligence framework in place, and is it appropriately and consistently applied?

2. **What is the level of engagement with a borrower's management team, both before investing and during the lifespan of the investment?**
   Key assessment area:
   - *Desktop review versus personal interaction.* Integration of both desktop analysis and personal interaction aids interrogation of a borrower's leadership character[1] and strategic outlook, and speaks to a more well-rounded credit process.

3. **What does your ongoing credit monitoring process look like?**
   Key assessment areas:
   - *Emphasis placed on macroeconomic and sectoral influences:* How do macroeconomic and sectoral views influence asset selection, risk pricing and portfolio construction?
   - *Spread views:* If you are trading credit, you need to make sure it is priced correctly. We have seen occasions when a listed credit instrument has traded periodically, yet its pricing has remained unchanged for over 12 months, in some instances. In a recent example of the pricing lags that characterise the listed credit market, it took a defaulted borrower's bond prices three weeks to fully reflect the borrower's weakened credit fundamentals. Therefore, investors should critically evaluate the manager's monitoring of spread cycles, its spread view and its ability to price credit internally, should it believe pricing to be stale.
   - *Analytical team:* What is the size, skill set and experience of the asset manager's team?
   - *Frequency:* How often are exposures and credit inputs reviewed?
   - *Process:* What are the criteria for credit committee consideration versus delegated authority decision making?
   - *Incentive:* What is the investment team incentive structure and is this aligned with your manager's philosophy as well as your investor needs?

FAST FACT
The quantitative and qualitative factors that determine your credit quality are called the **Three C's of Credit**. This framework highlights key categories a lender should assess in determining whether or not a borrower would be a good investment - Character, Capital and Capacity.

- **Character**: Track record and trustworthiness of the borrower.
- **Capacity**: The borrower has the financial means to repay the potential loan with interest.
- **Capital**: The amount of personal financial resources the borrower puts towards the investment.

CREDIT VERSUS EQUITY

1. **How do equity views influence credit decisions?**
   Key assessment area:
   - *Independence:* As the prominence of multi-asset funds grows, it is not uncommon for managers to invest in several financial instruments across a borrower's capital structure. It is therefore important that investors understand the processes in place that allow for independent and unconflicted decision making across asset classes.

2. **In what ways does your credit process differ from your equity process, and in what ways are they the same?**
   Key assessment areas:
   - *Risk assessment and how that translates into pricing:* Listed versus unlisted dynamics (such as the greater negotiating power usually available in the unlisted space) and emphasis of different financial metrics in the debt versus equity space.

[1] Refer to the definition of the "Three C's of Credit" fast fact box.

- *Monitoring:* There is greater access in the public domain to information on listed companies versus unlisted ones, which can influence deal turnaround times. Listing requirements are also far more robust for listed equity than for listed debt.
- *Consistency* in the application of appropriate principles, such as how ESG risks are priced.

CREDIT RATINGS

An asset manager's approach to credit ratings speaks to its ability to assess the probability of a specific borrower defaulting on its debt obligations. This, in our view, forms the basis for pricing credit risk in portfolios.

Asset managers typically make use of a combination of official ratings and internal ratings, given that some investment mandates limit investments to instruments with an official rating. Official ratings are produced by credit rating agencies. These agencies serve as information intermediaries, collecting and assessing data on the relative credit risk of various borrowing entities – thereby theoretically reducing information costs for investors. Their rating methodologies are based on internal models and assumptions. Your manager's models and assumptions may differ from – and supplement - those of the rating agencies, hence the benefit of having internal rating capabilities, too.

1. **How do you use official credit ratings in your credit process?**
   Key assessment areas:
   - *Breadth:* How many rating agencies are used?
   - *Emphasis:* How much weight is placed on official ratings?
   - *Engagement*: Desktop versus personal interaction with rating agency analysts and their methodologies: in our engagement with rating agencies in the past, we have found that they often have valuable borrower and sectoral views and insights.

2. **What is your internal rating process?**
   Key assessment areas:
   - *Capability:* Does the manager have rating tools to enable the assignment of internal ratings?
   - *Agility:* How often are these ratings reviewed?
   - *Ability to hold a different view:* Notwithstanding their insights, we have noted that rating agency actions, historically, tend to be more reactive than proactive. In light of this, how do your manager's internal ratings differ from those of rating agencies, if at all, and why?

ESG INTEGRATION

Assessing Environmental, Social and Governance (ESG) risk is an important aspect of assessing a borrower's credit risk. It has been found, if left unattended, that non-financial risks will likely translate in some capacity into financial deterioration. Futuregrowth has been on the journey of integrating ESG risks into our credit analysis process for the better part of the past 20 years. We understand and have observed first-hand how non-financial risks can translate into financial risks. Hence, investors must be comfortable that their manager not only knows what questions to ask borrowers in this regard, but also knows how to critically assess the answers provided.

1. **In your view, are ESG risks appropriately factored into official credit ratings?**

2. **In your view, can ESG risks be appropriately priced or should they be avoided altogether?**

3. **How are ESG factors integrated into your investment process?**
   Key assessment areas:
   - *Integration:* Assess whether ESG is a fundamental consideration in the risk analysis process or not.
   - *Engagement*: To what extent does your manager track ESG performance, have internal ESG expertise and/or engage ESG research and experts as part of its credit analysis?
   - *Emphasis:* How much weight is placed on ESG factors in making investment recommendations and pricing credit risk?

4. **Describe recent engagements with borrower management teams regarding ESG risks.**
   Key assessment areas:
   - *Use of examples:* Reference to specific examples can help you gauge if your manager's previous responses regarding ESG have been applied consistently and how its approach has evolved.
   - *More than a checklist approach:* While regulation such as King IV sets out guidelines for achieving sound corporate governance, our experience is that many borrowers apply this regulation loosely, if at all. Therefore, investors need to evaluate the manager's implementation of its stated ESG process and its interrogation of a borrower's ESG data - as opposed to accepting it at face value.
   - *Recency:* How often are ESG risks assessed, and when last did this happen?

SECURITY PRESERVATION

As mentioned earlier, credit assets are not without risk. Therefore, further to its ability to estimate the probability of default for an asset, the manager's process should be probed around assigning value to the collateral provided against debt obligations and assessing a borrower's loss given default (LGD) - the portion of an asset that is written off if a borrower defaults.

1. **How do you value the security provided against debt?**
   Key assessment areas:
   - *Independence:* Is this security valued by the borrower or a qualified and independent third party?
   - *Critical analysis*: How does your manager verify the valuations provided by the borrower?

2. **Describe a recent example where you have needed to enforce security.**
   Key assessment areas:
   - *Insights:* This question provides an opportunity to gather additional information on how distressed assets are handled.
   - *Legal robustness:* The type of legal protections anticipated and incorporated when making a decision to invest may come to light here.

3. **What factors do you consider when pricing for an asset that has security versus one that does not?**

SELL DISCIPLINE

The ability to exit investments in an orderly, disciplined manner is just as important to the long-term performance of your investment portfolio as the decision on which assets to buy. The macro environment changes, the regulatory environment changes, fundamentals change and valuations change. Your manager should therefore be able to update its investment thesis, remain objective should the original view no longer show value and recognise when it is time to move on.

1. **Talk me through a recent sell decision or a security you are actively trying to sell.**
   Key assessment areas:
   - *Evidence of process*: This question is particularly interesting in the current COVID-19 environment, as liquidity in listed and unlisted credit has reduced significantly, requiring managers to adopt a temporary buy-and-hold strategy.
   - *Agility:* Engagement with risk-reward dynamics.
   - *ESG:* Is this considered as part of selling decisions?

DISTRESSED ASSETS

1. **How do you currently manage distressed assets and debt restructures?**
   Key assessment areas:
   - *Level of support:* Single analyst versus a team of individuals, as well as the extent to which additional upskilling is provided.
   - *Engagement:* How much analytical time is currently spent on distressed debt and debt restructures?

2. **Discuss one of your worst performing credit investments.**
   Key assessment areas:
   - *Accountability:* The extent to which your manager takes responsibility for the investment choices made.
   - *Actions taken in relation to the exposure,* both prior and subsequent to the investment deterioration.
   - *Learnings:* The ability to take learnings forward.

3. **What aspect of your sell discipline didn't work effectively in the aforementioned investment?**
   Key assessment area:
   - *Consistency:* Do they do what they say?

TO WRAP-UP

An asset manager's investment philosophy should be consistent and structured in such a way that ownership, incentives, teams and fund capacity are aligned. Due diligence is not something that is done before the initial point of investment and then forgotten. A good manager should be able to provide proof of consistent application of its stated philosophy. This is something investors should ask for and evaluate periodically. At the end of the day, you are paying for your manager's process. It is the engine used to both grow and protect investor capital. Therefore, your manager should be able to provide examples of when its process succeeded, failed and was improved.

Published on www.futuregrowth.co.za/newsroom.

Futuregrowth Asset Management (Pty) Ltd ("Futuregrowth") is a licensed discretionary financial services provider, FSP 520, approved by the Registrar of the Financial Sector Conduct Authority to provide intermediary services and advice in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. The fund values may be market linked or policy based. Market fluctuations and changes in exchange rates may have an impact on fund values, prices and income and these are therefore not guaranteed. Past performance is not necessarily a guide to future performance. Futuregrowth has comprehensive crime and professional indemnity in place. Performance figures are sourced from Futuregrowth and IRESS.