

Managing credit risk during periods of high uncertainty**Author: Sithembiso Garane, Head of Listed Credit @ Futuregrowth****Published: June 2021**

The main objective of investing is to maximise return at the lowest possible risk. Managing risk in a credit portfolio becomes even more important when the market is characterised by diverse and uncertain risk factors, such as we are experiencing right now.

The current scenario

The South African credit market remains plagued with negative sentiment. Changes in the demand structure for credit has led to changes in credit pricing/spreads across different ranges of credit quality. In the secondary market, we continue to observe relatively higher levels of liquidity in the higher quality counterparties, lower levels for State Owned Companies (SOCs) and almost zero trade activity in the lower quality issuers. The credit spreads remain high for the latter two categories while the former has seen continued compression in spreads, especially banks.

It is, therefore, important to understand that the spread movements are due to changes in the underlying risk factors. Credit risk has two fundamental risk factors, namely:

- Default Risk - Probability of Default (PD)
- Term Risk - Credit Spread Duration (CSD)

However, credit price/spread is made up of the above risks plus a liquidity premium, which is significantly driven by both market activity and underlying counterparty credit risk.

We often hear of market dislocation or excess supply/demand to justify changes in the pricing of instruments when their underlying risk changes. This actually means there is a mispricing of either the default risk and/or the credit liquidity premium, due to demand and supply imbalance.

TTC vs PIT default risk

Credit risk is estimated through either point-in-time (PIT) or through-the-cycle (TTC) probability of default. According to Moody's Analytics "a complete (credit) risk management system requires both PIT and TTC probability of default". By definition, PIT default risk is determined by utilising stand-alone balance sheet data and other credit enhancements to determine the likelihood of default in the future. This default measure is highly sensitive to short-term changes. TTC default risk infuses additional stable factors that affect the credit market over and above the PIT default components. These generally include economic and other qualitative factors, such as Environmental, Social and Governance (ESG) aspects.

In a volatile market, PIT's neglect of other exogenous factors may be somewhat unreliable as a risk measure for medium- to longer-dated instruments. Futuregrowth has anchored itself in the South African market as a leader in ESG investor activism. It is in our credit analytical DNA to utilise educated judgement with regards to counterparties' qualitative factors - ESG in particular. This, together with our forward view on the economic performance and the underlying sectors ensures a TTC default risk view. However, because secondary market activity is generally propelled by short-term default risk views (PIT), it is prudent to actively monitor it. This is largely due to the fact that it is the major driver of the liquidity premia in the credit market. The market is in unison that there has been a general decline in PDs due to COVID-19 pandemic and this resulted in general credit spread widening in the first half of 2020. Although this quality decline is still ongoing, spreads movements have not been consistent.

Liquidity premium

Liquidity is defined as the ease with which an investor can sell an instrument within a specific period. The potential inability to sell this instrument is liquidity risk, and is priced in the credit spread in the form

of a liquidity premium. It is important to understand the drivers of liquidity risk and how these may change over time. The theoretical guiding principles of the view on credit liquidity are liquidity premium theory (LPT) and expectation theory (unbiased). Liquidity risk comprises both the observed instrument (and market) liquidity and sentiment (market, sector or counterparty).

In a market such as ours (which is generally illiquid), sentiment is the order of the day. A recent Chinese study has shown that the sentiment-driven component of liquidity is increasing. This is mainly fuelled by the economic uncertainty precipitated by the COVID pandemic which has injected a potent dose of pessimism in the economy and market. The result is that the market is currently pricing a high liquidity premium for longer-dated, lower credit quality and SOCs, due to sentiment. The SOC sector also has its own idiosyncratic drivers of pessimism. Ordinarily during a crisis, this sector ought to be investors' safe haven, along with Banks. However, due to the prevailing negative sentiment, the liquidity premium - and by extension credit spread - will remain high.

The higher quality counterparties have bid down liquidity premia. This is mainly the result of high trade activity in the secondary market that has also impacted the primary issuances. Notably, there is currently very little positive credit risk sentiment, and counterparties/sectors with relatively less negative sentiment (banks and other high quality liquid asset issuers) are benefiting through tightening of spreads.

Credit portfolio risk factors

It is crucial for investors to be aware of the impact of sentiment-driven liquidity risk on the credit portfolio. This shows itself through changes in credit spread duration (CSD). Generally, credit spread change is followed by CSD change. The two fundamental credit risk factors (PD and CSD) are pivotal when actively managing in a credit portfolio. The downward migration of counterparties' default risk and credit spread widening in the credit portfolio increases credit portfolio risk. However, market dislocations and excessive negative sentiment may have portfolio risk impact without any changes in credit quality.

Market uncertainty can lead to panic selling and undue or uninformed risk aversion. A credit portfolio ought to be actively managed and attuned to the impact on risk-adjusted running yield, with the above risk principles applied when onboarding new credit instruments that are valued at mark-to-market and/or mark-to-model.

Managing uncertainty now and ahead

In uncertain times and during crises, correlations in the underlying risks become very significant. At Futuregrowth we believe that, as a listed credit investor, it is crucial to be positioned appropriately to avoid taking undue risk. Similarly, as a market leader in fixed income, we pride ourselves in staying ahead by relentlessly monitoring the market in order to be ready for a possible turnaround. This involves an informed forward view that is accompanied by the right timing to enter/exit the market. Although this is often easier said than done, in actively monitoring all the risk factors discussed above, we believe we are not only best positioned for now, but best prepared for the future, uncertain as that may be.

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