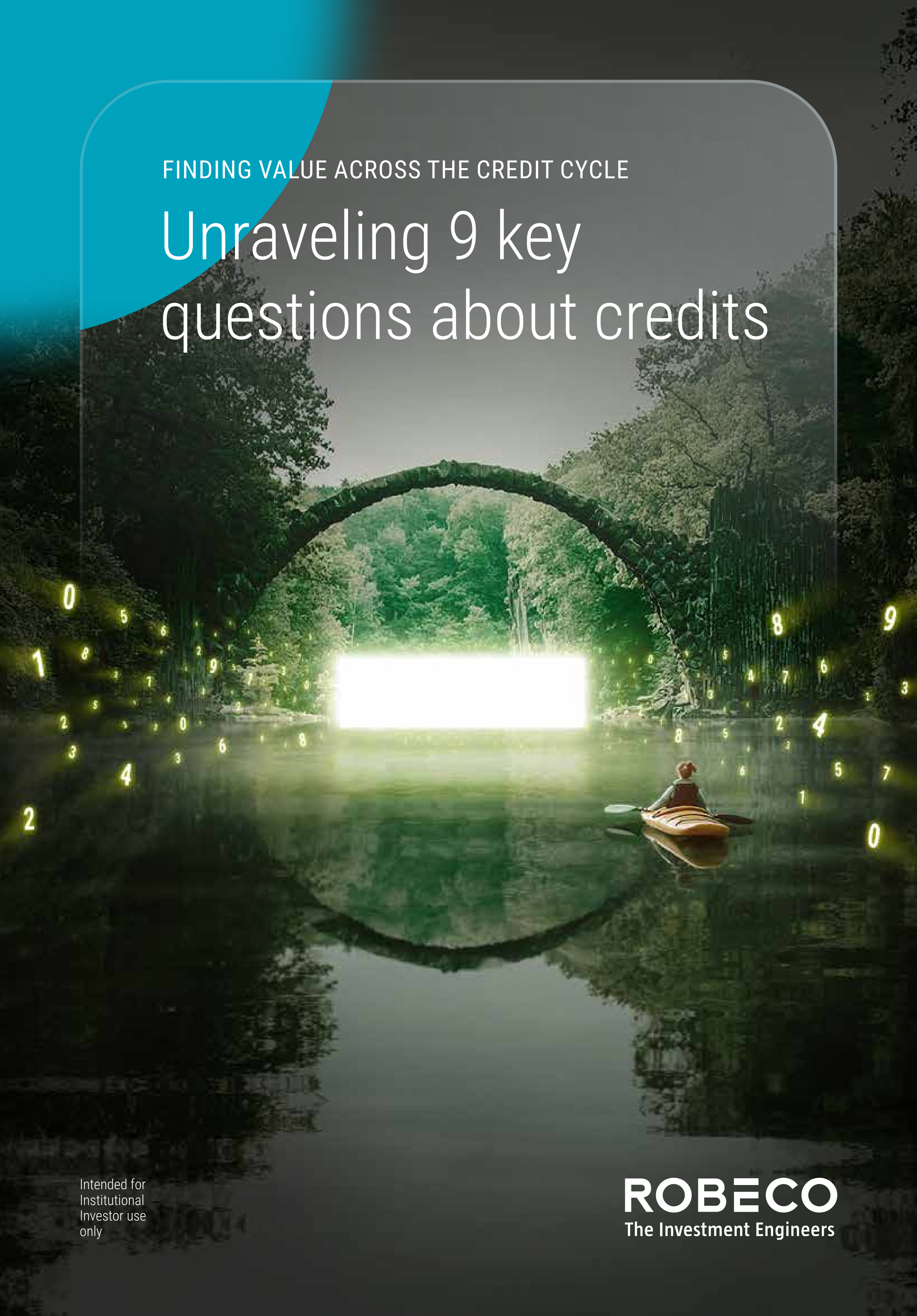
FINDING VALUE ACROSS THE CREDIT CYCLE

Unraveling 9 key questions about credits



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ROBECO
The Investment Engineers

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Unraveling 9 key questions about credits

Following the fiercest hiking cycle by central banks in the past 40 years, the past year has understandably been dominated by rate rhetoric. What is clear is that economic predictions are complex, and the environment is uncertain. Historically, investors have allocated funds to bonds during such periods, seeking not only diversification benefits but also the reliability and steady income that bonds are known to provide. With yields still high, the time to lock in attractive credit returns is now.

To uncover opportunities in the credit market, we asked clients to pinpoint the questions they needed addressed. We then sought expertise from within Robeco to provide the solutions. This question-and-answer series, 'Unraveling 9 key questions about credits', draws from all corners of credit investing to offer accessible and insightful guidance on identifying value in credit markets. It also outlines the processes and analysis used to identify potential and manage risk, as well as guidance on ESG investing and building a multi-asset portfolio.

We hope this series provides knowledge and inspiration for seizing the moment in credit markets.

Is cash still king?

Last year, predictions favored bonds but rising interest rates led to modest bond market flows. Contrary to expectations, 2023 became a year dominated by cash, with record inflows into money market funds and short-dated treasuries, offering investors 4-5% returns without credit or duration risk.

So far in 2024, bond markets have been buoyed by signals of a soft landing for the US economy. As flows typically follow returns, we have seen investors starting to move from cash into credits. This trend poses a critical question: is cash still king, or do credits offer a more compelling alternative?

Investment grade and BB-rated credit offers better return potential

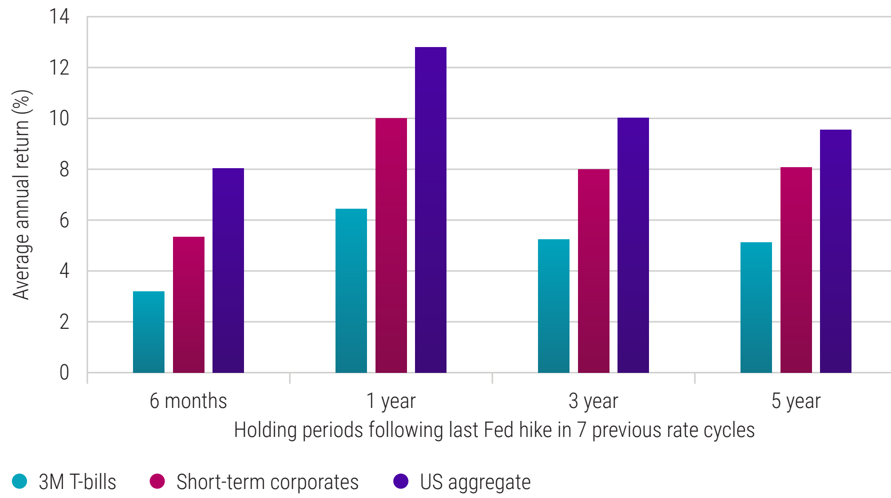
First, investment grade and BB-rated credit offers an attractive yield pick-up over cash, especially in an environment where we expect central banks to stop hiking rates and eventually start easing them. And it does this while protecting investors against future rate cuts that would immediately reduce the return on money market investments. Within the high-quality credit space, the return prospects, particularly for short-dated credit, look increasingly attractive as investors can lock in higher yields than cash for the next 12 months with limited interest rate or spread risk.

> *“ Investors can lock in higher yields than cash for the next 12 months with limited interest rate or spread risk*

Money market funds and short-dated, short-term government bonds have been viewed as a lucrative place to park cash with yields north of 4%. Yet history has shown that these instruments have not been the best place to be when central banks eventually pivot to policy easing.

Comparing the performance of short-dated corporate bonds with money market investments and longer-dated aggregate bonds in periods following the last rate hike by the Fed reveals some interesting trends. As shown below in Figure 1, on average, short-term corporates outperformed money markets by an average 300 bps over different investment horizons (holding periods). Longer duration bonds (US Aggregate) delivered higher returns, however, with increased duration risk, meaning that longer duration bonds would be more impacted if we continue to see interest volatility.

Figure 1: Short-dated bonds have historically outperformed cash



Source: Robeco, Bloomberg, September 2023

Investment grade credit stands up in recessionary environments

Second, investment grade and BB-rated companies should be able to perform well in a recession. We think markets are too optimistic and that the probability of a recession is higher than what is priced in. As history has shown, rate hiking cycles by central banks almost always lead to a recession, with the most recent exception being the 1990s. However, even in a recessionary environment with mild negative growth, investment grade credit and cross-over credit (BB-rated credit) should be able to outperform money market investments.

There are parts of the credit market that are more vulnerable if the economy goes into a recession, but investment grade and BB-rated companies will continue to do well even in an environment of moderate negative growth. These companies, with their conservative debt levels, can weather the impact of a recession on profitability and higher interest rates. They also typically have more longer-term debt outstanding, meaning there is no short-term risk of having to refinance at higher rates.

Better diversification of risks

Thirdly, moving from cash to investment grade and cross-over credit allows for better diversification of issuer risk. Typically, money market investments comprise more concentrated holdings in a small number of issuers or counterparties, and while these issuers are of high credit quality, there can be significant exposure to only a few issuers. Investing in high-quality investment grade and BB-rated credits allows for more diversification across issuers. For example, in our Global Credits - Short Maturity strategy we invest in more than 130 different companies across the global investment grade credit market. Furthermore, we would not advocate a passive approach to investing in credits, as this exposes investors to potentially lower-quality companies with a higher risk of default. Investing in credit markets is about avoiding the losers through active management and fundamental bottom-up research.

Does the hunt for yield equal the hunt for returns?

The last two years have been a rollercoaster for bond investors, marked by 2022 being the toughest year since 1788. However, in the final months of 2023 the tides started to slowly turn, with yields falling from peak levels, as extreme inflation subsided, and investors grew more optimistic about a US economic soft landing.

With the rise in bond yields, bonds are back as an income stream for investors. But does the increase in yield necessarily imply higher total returns?

Analyzing investment grade credit returns in similar yield environments

Typically, yield is the most important determinant of longer-term bond returns, but in recent years, low and even negative yield environments have made capital gains the more important driver of bond returns.

> *“At current levels investment grade credit should be able to absorb most of the negative impact of rising bond yields with the attractive carry return*

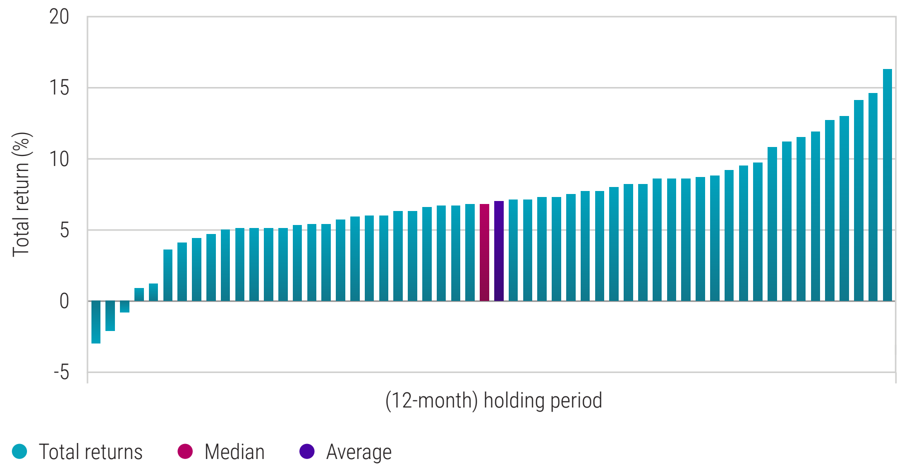
However, now with higher yields, bonds are better equipped to absorb rising yields before total returns enter negative territory. While yields in most segments of the global fixed income market have risen, we see most attractive value in high-quality credit which we define as investment grade credit and crossover (BB-rated) credit. These parts of the fixed income market offer an attractive yield with limited credit risk.

To assess the total return potential of investment grade credits in the current yield environment, we analyzed the twelve-month periods in the past 22 years that started with similar yield levels. We then calculated the total returns in those periods. In Figure 2 below, we show the distribution of total returns from the 56 twelve-month periods in our research sample, each of which began with a yield level between 4% and 5%.

We clearly see that the probability of positive total returns is very high. In only three of the 56 periods, the total returns fell between -6% and 0%. The lowest total return observed was -3.0% while the maximum total return observed was 16.3%. The average return was 7.1%.

So, what does this mean for investment grade credit? Firstly, at current yield levels, investment grade credit has historically delivered positive total returns over a twelve-month period, in most cases when yields were similarly leveled. Even in years with further rises in bond yields, such as 2005.

Figure 2: Distribution of total returns for global investment grade credit over a 12-month holding period



Source: Bloomberg, Robeco. Research period: March 2001-December 2023. Figure 2 shows the distribution of the total returns of the Bloomberg Global Aggregate – Corporates index of all 56 twelve-month periods that started with a yield level between 4 and 5%. The displayed returns are unhedged and may differ from the currency of your country of residence. Due to exchange rate fluctuations, the returns shown may increase or decrease if converted into your local currency. Periods shorter than one year are not annualized. The value of your investments may fluctuate. Past performance is no guarantee of future results. This analysis does not represent a Robeco investment strategy and is for illustrative purposes only.

Secondly, we mostly observed positive total returns over a twelve-month holding period, and in the majority of periods we saw annualized total returns between 6-12%. We must be cautious when replicating past returns to make predictions about future returns, but the direction of travel is clear. The current yield level on investment grade credit is very supportive for future total returns in various market environments.

Assessing investment grade credit returns in different economic scenarios

In a soft landing scenario where the US experiences sustained but moderating growth and inflation, central bank policy rates and bond yields are likely to gradually decline from current levels, while corporate spreads will trade more range bound. This environment is supportive for total returns on investment grade credit.

In a hard landing scenario where the US economy slides into a recession, central banks will likely be forced to cut rates more quickly causing bond yields to drop faster, as markets steer away from riskier assets into government bonds as a safe haven. Although spreads on investment grade credit could widen in this scenario, the drop in underlying government bond yields would mitigate the negative impact of the widening in credit spread and support total returns. Return correlations between equities and investment grade credit are typically negative in a recessionary environment, hence an allocation to credit could act as a hedge against softer returns in the equity space.

In an economic scenario where we see a strong rebound in inflation, we could see a further rise in bond yields. Yet, at current levels, investment grade credit should be able to absorb most of the negative impact of rising bond yields, thanks to the attractive carry return.

If history is any guide, and by looking at the different economic scenarios, we can conclude that in the global bond market, investment grade credit offers an attractive yield and total return potential with limited credit risk. In any market environment an active approach and thorough bottom-up fundamental research is always key to ensure that quality yield and return can be achieved without too much credit risk.

Is investment grade credit the great diversifier?

Historically, investors have allocated to bonds and more specifically to credits, for income and diversification against other (risky) asset classes, such as equities and commodities. However, during the 2022 market sell-off, credit did not bring the portfolio diversification that investors sought. Global investment grade credit markets experienced significant drawdowns, alongside negative returns for equities. Investors began to question the diversification ability of bonds in general, and investment grade credit more specifically.

Now yields have risen, can investors rely on investment grade credit for diversification in the coming years or should they be more skeptical about its diversification merits?

Investment grade credit performance: a historical perspective

To answer this question, we first need to look at how investment grade credit has performed compared to other asset classes over the last 25 years, especially in years when equities delivered a negative performance.

Equity markets (MSCI World Index) experienced negative returns in the years 2000-2002, 2008 and 2022. The sell-off in equity markets in 2001/2002 and 2008 coincided with a recession in the US and in 2000, equity markets sold off due to problems in the technology, media and telecom sectors. The equity market sell-off in 2022 was the result of a fierce rate hike cycle imposed by central banks to stem the surge in inflation.

> *“Investment grade credit has a very appealing risk/return profile and is therefore deserving of its place in a balanced portfolio*

In the more challenging equity bear market of 2000-2002 global investment grade credits delivered positive returns. For example, in 2002 global equity markets declined by almost 20%, whereas global investment grade credits (Bloomberg Corporate Index USD-hedged) delivered a positive return of 14.8% and provided those investors that were holding global investment grade credits with diversification benefits.

The bear market of 2008 saw substantial drawdowns for most asset classes. Global equity markets dropped 40.7%, commodity and global high yield markets declined respectively by -46% and -27%. Global investment credit also delivered a negative return of -8.6%. However, this was a milder drawdown compared to other asset classes.

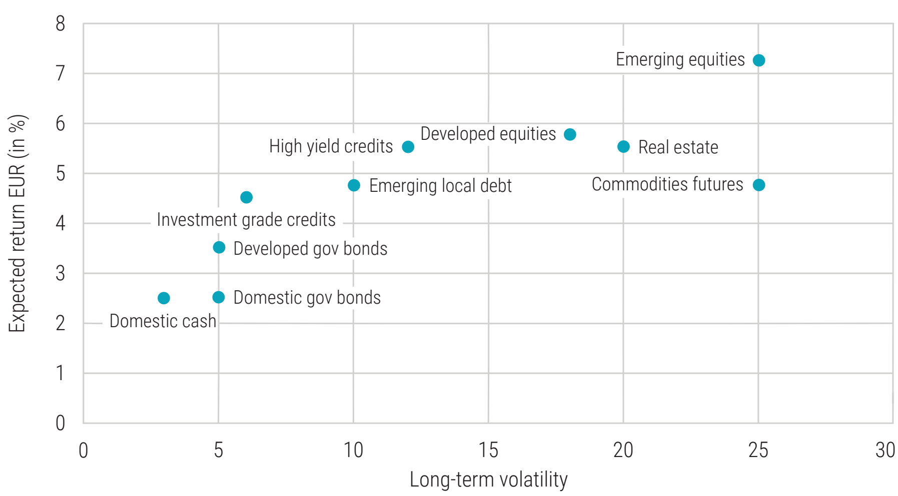
The only bear market over this period in which global investment grade credits did not deliver diversification benefits was 2022, as drawdowns were -16.7%, almost as large as those in global equity markets. The sharp drawdown in global investment grade credits can be attributed to its higher duration sensitivity, which made it more vulnerable to the sharp rise in bond yields that year.

Looking back at the risk-off periods over the last 25 years we see that in most periods investment grade credit has delivered positive total returns, or in one instance (2008) delivered a milder drawdown compared to equities and commodity markets, hence providing valuable diversification benefits to investors.

Investment grade credit's risk/return profile in a multi-asset context

Let's now take a more forward-looking approach to assess the diversification benefits of investment grade credits. In September, Robeco's multi-asset team published their 5-year Expected Return outlook where they calculate expected returns and long-term volatility for the various asset classes over the next five years. These return estimates and volatilities are based on both internal Robeco estimates and external studies. They utilize different market indices and incorporate a mix of historical data and forward-looking metrics. We have plotted the risk/return results in Figure 3 below.

Figure 3: Asset class expected returns vs long-term volatility



Source: Robeco, 5-year Expected Returns publication. September 2023.

What becomes immediately clear from this chart is the aberrant risk/return profile of investment grade credit compared to other asset classes. It has one of the lowest long-term volatility profiles, but provides higher return potential than government bonds and a long-term return potential that is not substantially lower than most riskier asset classes, with the exception of emerging market equities.

Based on this forward-looking analysis we can conclude that investment grade credit has a relatively appealing risk/return profile and is therefore deserving of its place in a balanced portfolio. It has the ability to substantially lower volatility, without a significant give-up in longer-term return potential.

The size of the exposure to investment grade credits in a balanced portfolio is also dependent on the short-term tactical view of the investor. If the view is that economies will see a significant slowdown or even hit a recession, then investment grade credit has the potential to outperform more riskier asset classes such as equities, commodities and even high yield, delivering the diversification benefits that investors will be seeking in such a market environment.

How do you assess value?

Establishing that a credit is undervalued (or ‘cheap’) is an important step, but it is not enough. The real challenge – and opportunity – lies in conducting thorough fundamental research to ensure that the credit is indeed a value opportunity and not cheap due to underlying issues that could pose significant risks. So, where do we currently see value in global credit markets?

Understanding market valuations

As an active credit manager, we focus on the relative value of issuers compared to a benchmark. This is best captured by comparing the credit spread of an issuer or specific sector to the index spread. For example, we can compare the credit spread on a BBB-rated corporate bond versus the average spread on a comparable BBB index. If the corporate bond trades at a higher credit spread compared to the index and relative to its own history, then this signals potential attractive value in the bond.

Our simplified valuation table below shows the option-adjusted spread (OAS) for various segments of the market, indicating which global credit market segments are undervalued and those that are overvalued.[1] This is a measure used in credit analysis to compare the yield of a bond with the risk-free rate of return.

> *“To identify whether a category is cheap or not, we compare the current spread with its long-term median*

To identify whether a category is cheap or not, we compare the current spread (as of 31 January 2024) with its long-term median – in this case we go back to 2005. We prefer median over average spreads, as this dampens the impact of spread peaks caused by sudden spikes in volatility and/or gaps in liquidity.

The comparison, expressed as a ratio, clearly shows if a category is cheap (ratio above 1) or expensive (ratio below 1). For instance, if we look at USD investment grade credit, currently trading at a spread ratio of 0.72, this ratio illustrates that the market is roughly 30% more expensive versus its long-term history.

Table 1: Modified valuation table

	EUR investment grade credit	EUR senior bank debt	EUR high yield	USD investment grade credit	USD high yield	USD EM credit
Current credit spread (bps)	129	130	336	95	346	271
Current/median OAS	1.01	1.25	0.82	0.72	0.76	0.76
Median OAS	128	104	407	133	452	356
Data since	2005	2005	2005	2005	2005	2005

● Relatively cheap ● Relatively expensive

Source: Robeco, Bloomberg. Credit spread is defined as the option-adjusted spread over similar duration government bonds. Credit spreads shown here are based on the index spread for the relevant market. Credit valuation table as of 31 January 2024.

The spread ratio for EUR senior bank debt is currently 1.25, indicating that the average credit spread in this part of the global credit market is trading 26% above the long-term median spread level. We currently consider this part of the market attractive, therefore we have an overweight in EUR senior bank debt in our credit. Additionally, from a fundamental credit perspective, we favor European banks. The broader EUR investment grade credit market, with a ratio of 1.01, trades in line with long-term median spread level. This market includes financials and corporates. Notably, financials, as we have seen with EUR senior bank debt, trade at more attractive levels, whereas EUR corporates are at less appealing spread levels. Consequently, we are overweight financials and underweight corporates in the EUR investment grade credit market.

In conclusion, the approach above combined with top-down assessment of macro and corporate fundamentals as well as technical factors, is used to understand the segments, regions and sectors in the credit market that are currently attractive, and too expensive. While credit markets can appear to be expensive, strong demand for credit, lack of issuance, or accommodative central bank policy can keep these markets expensive for a prolonged period. This highlights the complex nature of credit investing and illustrates the importance of active management when identifying the winners in the credit market. ●

1. Please note that this table is not exhaustive, as we typically assess many segments and sectors of the global credit market.

What strategies are used to manage risk?

Investors typically want to be rewarded (preferably over-rewarded) for taking risk. While corporate bonds can be valued attractively for good reasons, value credits often have lower market valuations due to investor fears or behavioral biases. Bonds that exhibit value characteristics in the corporate space tend to have slightly higher volatilities, but also higher returns. This raises the question: how can risk be managed effectively to improve investment outcomes?

Balancing value and risk through active management

We seek to build a portfolio that is sufficiently diversified to minimize the impact of negative credit events and concentrated enough to benefit from active management. To do this we screen global credit markets across various credit classes for overlooked value due to biases ad segmentations. Often, value opportunities can be found in shorter-dated bonds with attractive valuations relative to other corporate bonds, and history shows that these valuation premiums tend to mean revert.

> “ *We seek to build a portfolio that is sufficiently diversified to minimize the impact of negative credit events and concentrated enough to benefit from active management*

We apply three main principles to effectively manage and control risks:

1. **Diversification:** By spreading investments across different issuers, we reduce concentration risk. For example, if the issuing company faces financial distress, bondholders may not receive the full repayment. By creating diversified portfolios investors can limit the impact of credit risks on performance. Consequently, our portfolios are typically diversified across more than 100 different issuers.

2. **Issuer limits:** Imposing strict line limits, such as absolute or relative concentration limits based on ratings, protects investors when strategies and/or mandates grow in size. Selling a large amount in an AA-rated corporate is easier than selling the same amount in a lower-rated credit. Liquidity becomes especially relevant when investing in lower-quality credits as the probability of defaults increases disproportionately.

3. **Duration Times Spread (DTS)**[1]: Fundamental bottom-up credit research is important to understand relevant credit risks and avoid the value trap of buying credit that is cheap due to a higher risk of default. Investors should understand how volatility in credit spreads impacts performance, and how a credit portfolio can be constructed to reduce volatility.

Rewarded risks

It is important for investors to distinguish between rewarded and unrewarded risk factors. In our view, rewarded risks are those harvested by taking a contrarian approach, founded on rigorous research. If we believe the F-score[2] for an issuer indicates a fundamental improvement overlooked by the market because of recession fears, bad earnings cycles or a slow ratings agency, we perceive this as rewarded risk.

Moreover, subordination risk can also be rewarded. Solid companies with sound fundamentals can issue different types of debt instruments – such as senior, subordinated, first-lien or second-lien debt or payment-in-kind notes. Senior and subordinated debt have the same probability of default, and if an issuer's default probability is extremely low, it can be beneficial to invest in its subordinated debt. This is particularly true when spreads widen, offering investors attractive entry points.

Unrewarded risks

There are a handful of unrewarded risks, such as idiosyncratic risks, that are more prevalent in certain market segments, including real estate, retail, and leisure. Historically, defaults have been clustered in these industries, however, they remain viable for investment with due caution.

Moving too low in the capital structure can also be unrewarding. Highly indebted companies could face challenges in paying coupons and servicing debt obligations, and weak governance is disadvantageous as it can expose credit investors to material downside risk. Sustainable risks can also be detrimental. For instance, polluting companies are bound to face regulatory pressures as the transition to a low-carbon economy gathers pace.

To manage risks, we primarily focus on market and credit risk for which we believe investors are compensated. To measure and monitor the inherent credit risk in our portfolios we use a proprietary risk management system. This allows our portfolio managers and risk management department to keep an eye on market, sector and company-specific risk. For each of these factors, the risk exposure depends on the weight, spread and duration of individual investments, the product of which translates into an amount of risk points. Whenever the portfolio manager allocates risk to a portfolio holding, the conviction level is expressed by the number of risk points. ●

1. Read more about how we use DTS to measure credit volatility.
2. The Piotroski F-Score is a financial tool developed by Joseph Piotroski that assesses a company's financial strength based on nine criteria covering profitability, leverage, liquidity, and operating efficiency. Scores range from 0 to 9, with higher scores indicating better financial health.

What role does ESG play?

Credit analysis assesses an issuer's capacity to generate cash, the quality of cash flow, and their ability to repay debt. Our credit analysts evaluate five factors that contribute to a fundamental score, known as an F-score.[1] One of which is the issuer's environmental, social and governance (ESG) profile, alongside its business position, strategy, financial status, corporate structure, and covenants. How does ESG information, being a significant component, aid in identifying the risks and rewards of corporate bond investments?

Integrating ESG factors in credit analysis

Since 2010, our credit team has integrated ESG analysis into bottom-up security selection to assess the risk and reward of corporate bond investments. This involves evaluating four key elements: the impact of the product or service, the company's governance system, the position of the business in relation to key ESG criteria, and its climate resilience and decarbonization strategy. We also apply fundamental analysis to ESG, as the data quality is not always as rigorous as it is for financial indicators. Every company report produced by the credit analyst has an ESG integration section that includes a climate score and an SDG score to assess the company's alignment with the 17 UN Sustainable Development Goals.

> *“ The analyst draws a conclusion on the issuer's carbon intensity as well as the credibility of the company's decarbonization strategy*

The four pillars of ESG integration explained

1. The first pillar looks at the impact of the products a company sells to determine whether these entail financially material business risks. Companies that produce unsustainable products and services could face financially material risks which could impact credit investors. For example, an oil company might come under pressure because the environmental impact of its products and services could lead to reduced sales, or carbon taxes could dilute its earnings.

2. The second pillar focuses on corporate governance, an essential element because any issues in this area are almost always financially material, affecting a company's operational and financial integrity.

3. The third pillar evaluates key ESG risk factors, which differ by sector. Robeco's SI Research team features prominently here, as they provide a materiality framework per sector, in each case reflecting elements critical to that industry.

4. The final pillar concentrates on the issuer's exposure to climate change and their readiness to mitigate those effects. Here, the credit analyst uses an issuer-specific climate score that reflects the company's impact on the climate. This pillar tackles double materiality by addressing both the financial risks of climate for the company *and* the company's impact on climate. The analyst then draws a conclusion on the issuer's carbon intensity as well as the credibility of the company's decarbonization strategy.

Case study: the automotive industry

An example of the importance of the fourth pillar can be seen in the automotive industry, which is currently facing challenges amid its significant transition. Most automotive manufacturers are currently ill-prepared to face union-related concerns about what the energy transition implies for the labor force. Launching battery cars is a huge human capital risk: with such a large workforce, the issue of reskilling employees is both challenging and critical.

The analyst then applies the methodology described above to assess the merits of the carmaker's ability to finance its transition to electric vehicle production. The numbers are run to estimate what it would cost to set up production facilities for batteries and battery cars, and the implied capex requirement for the coming five years. This is compared to what has been communicated to the market. If their capex budget falls short, this is flagged in the SI research report and the credit analyst will potentially adjust the credit opinion if they see a financial material impact on the credit from this risk.

The integration of ESG factors into credit analysis is not just a trend. By incorporating ESG considerations, particularly in sectors undergoing significant transformation, analysts are better equipped to identify risks and opportunities. And by combining fundamental analysis with ESG insights, we are more informed and aligned with broader societal goals, and better prepared to enhance long-term value for investors. ●

1. The Piotroski F-Score is a financial tool developed by Joseph Piotroski that assesses a company's financial strength. Scores range from 0 to 9, with higher scores indicating better financial health.

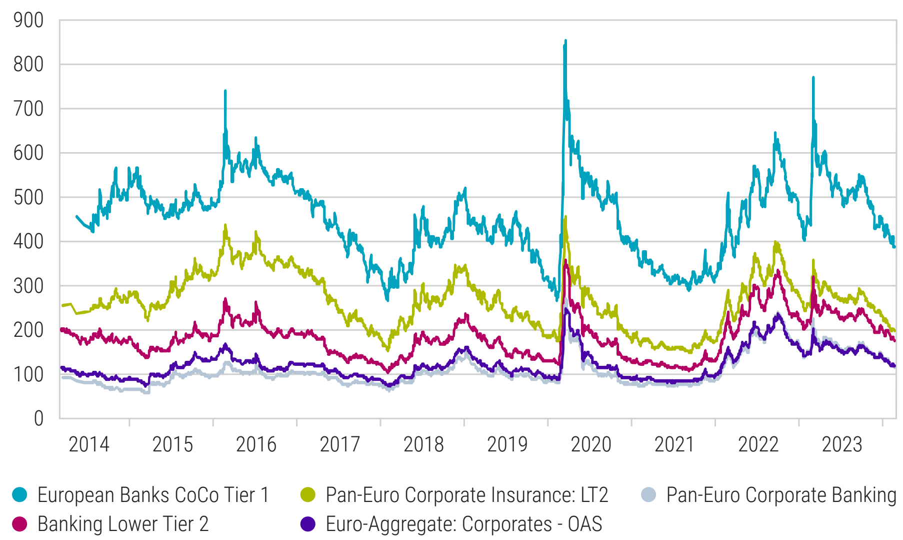
Are financials a value trap?

The 2023 US banking turmoil created the most significant upheaval in financial systems since the global financial crisis. This impacted risk perceptions, credit market valuations and regulatory dynamics. More importantly, it raised questions about the stability of the banking sector. Although much of this upheaval seems well and truly in the past, the question remains: Are European financials undervalued opportunities or value traps with hidden fundamental issues?

European financial debt: the current landscape

Although financial spreads have tightened since the concerns with US regional banks and the write-down of AT1 CoCos issued by Credit Suisse in March 2023, we believe European bank and insurance debt still provides an attractive premium over corporate debt. This is illustrated in the figure below that shows the credit spread for different types of subordinated bank and insurance bonds.

Figure 4: Financial spreads



Source: Robeco, Bloomberg. As of February 2024. Indices used: Bloomberg European Bank AT coco index. Bloomberg European Bank LT 2 index. Bloomberg European Bank Senior Debt. Bloomberg European Insurance debt index.

Despite the recent market rally, financial spreads are still trading wide compared to the sector's median levels, as well as to corporate spreads. Several factors contribute to this phenomenon. Firstly, the banking sector is a higher beta sector and therefore is more volatile and reacts more sensitively to market movements than the average industry. Consequently, concerns about the growth outlook in Europe tend to widen financial spreads, as investors worry about potential credit losses.

Additionally, the European growth outlook has been more sluggish compared to the US, further contributing to the expansion of financial spreads. Furthermore, specific concerns about individual banks, such as the case with Credit Suisse and the US regional banks last year, or banks overly exposed to commercial real estate, can lead to wider financial spreads. Lastly, the premium in bank debt is partly due to the substantial issuance of bank debt in recent years relative to corporate debt.

The best risk-reward in financial institutions

Firstly, let's examine the fundamentals of the European banking sector. Most European banks have benefited significantly from the recent rise in interest rates, resulting in increased earnings. While we do not anticipate further rate increases, banks can still rely on other sources of income to support their earnings. European banks maintain robust capitalization levels, allowing them to absorb losses before capital ratios become critical. Overall, asset quality remains strong.

> *" European banks maintain robust capitalization levels, allowing them to absorb losses*

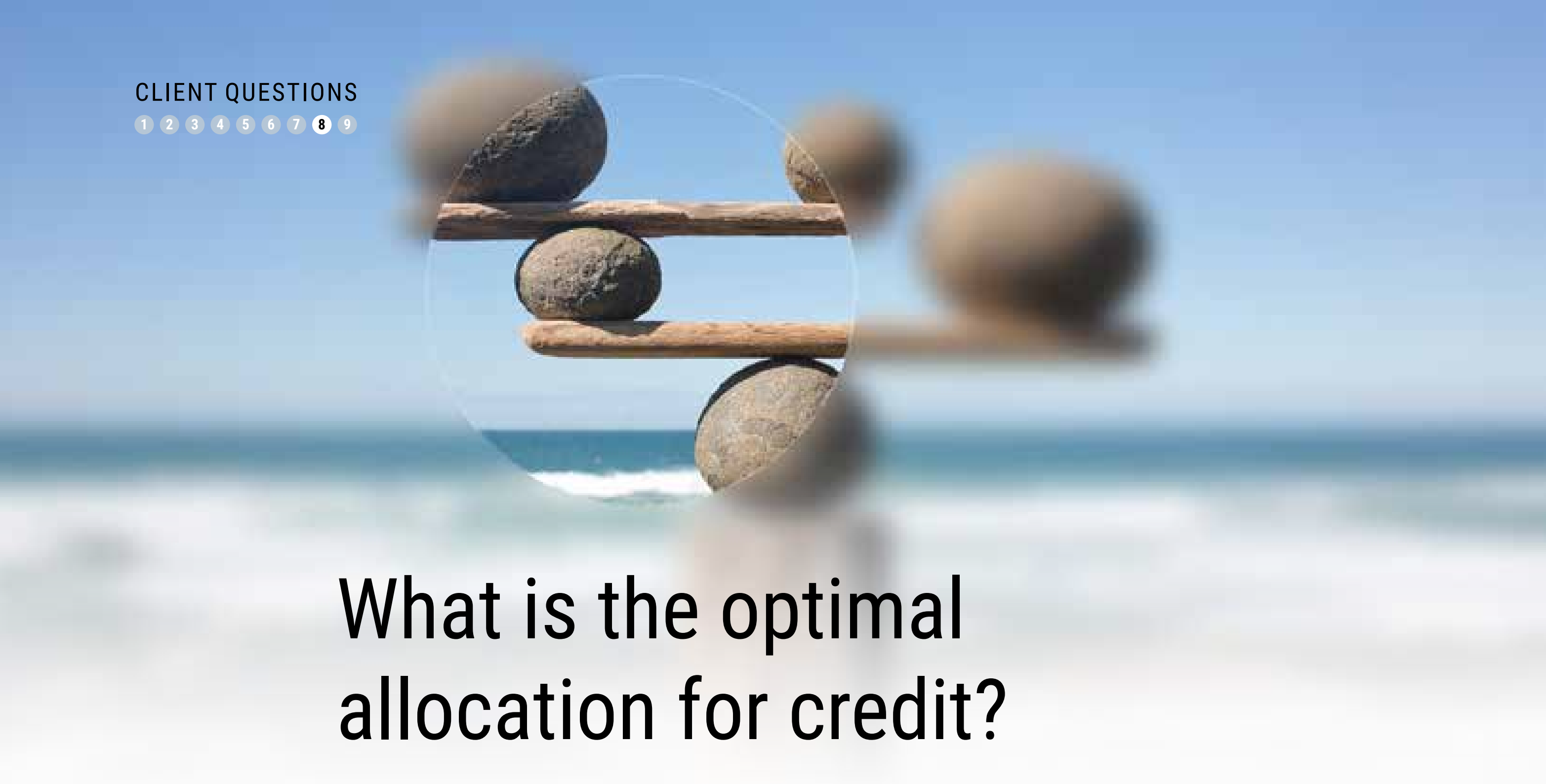
However, as credit investors, it is crucial to conduct thorough due diligence. We avoid banks that are overly exposed to commercial real estate, such as certain German specialist banks with concentrated CRE loan portfolios or less-regulated regional banks in the US. Our preference lies with larger European banks that have limited or manageable commercial real estate exposure.

In terms of the capital structure, we currently favor senior bank debt over lower Tier 2 debt and AT1 CoCos. The latter have performed well and recovered to pre-March 2023 levels, but we have become more selective in our investments in these instruments.
Aside from bank debt, we also find the fundamentals in the insurance sector favorable. Our exposure is concentrated on insurance companies with balanced business models, diversified earnings profiles, and robust capital positions. Despite the backdrop of gradually declining rates in 2024, insurers' earnings are unlikely to be materially challenged, and most firms will maintain solid capital positions.

For insurers, we anticipate price discipline to support the sector's top line. After two years of elevated claims inflation, the normalization of prices should contribute to the recovery in underwriting profitability. Additionally, the current high-interest rate environment remains favorable for investment income.

Looking ahead

As a credit investor, it is crucial to avoid falling into the value trap, as credits that appear cheap may have underlying reasons for their low valuation. However, we do not believe this is the case for European financials. Despite the lower growth outlook for the European economy compared to other parts of the world, the fundamentals for insurance and bank debt in Europe remain solid. In our view, current valuations still provide ample compensation for the risks associated with a slower-growth environment. Nevertheless, it is essential to recognize that not all financials are equal. As a credit investor, conducting thorough credit analysis before investing in bank and insurance debt is imperative.



What is the optimal allocation for credit?

Cash rates won't last forever, prompting investors to reconsider traditional holding strategies like savings accounts, money market funds, and other short-term liquid investments. A prudent asset allocation strategy, diversifying across various asset classes according to risk tolerance and investment horizon, becomes essential. How should investors position their portfolios in response to credit markets?

Before deciding on the optimal credit allocation in our multi-asset strategies, we must first consider what asset mix is most likely to offer the best risk-adjusted returns to investors. In all walks of life, we focus on value for money, and investments should be no different. More risk-sensitive investors will want to be sufficiently compensated in return terms for every additional unit of risk taken. This optimal allocation decision has three main drivers:

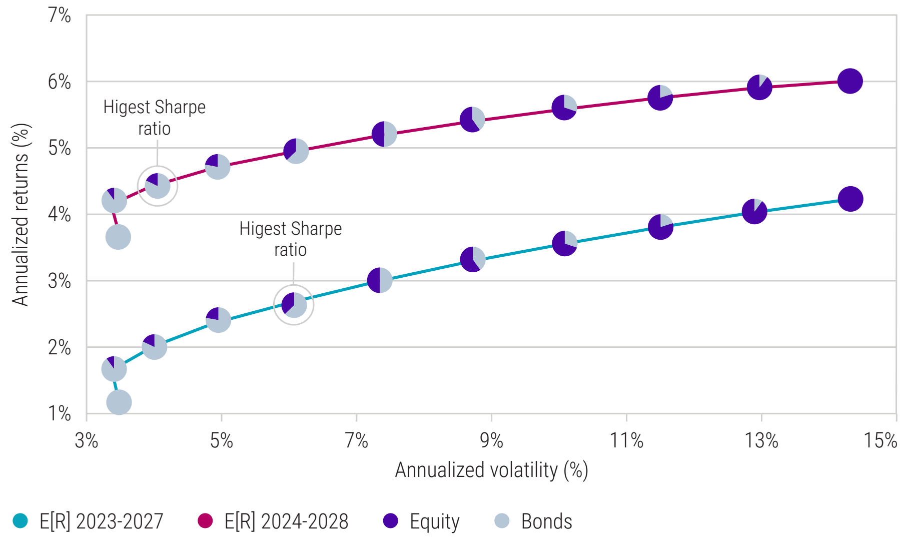
1. Expected risk and return for each asset class
2. Opportunities for active management in different asset classes
3. The diversification benefits of combining different asset classes

Expected risk and return for each asset class

Each year, Robeco produces its 5-year Expected Returns publication for all major asset classes, considering valuations, macro scenarios and climate factors. These forecasts suggest that the best risk-adjusted returns over the next five years will come from a mix of 25% equity and 75% fixed income. This allocation is reflected in the bond and equity efficient frontier chart below. Another interesting observation is that this research advocates for a 20% increase in bond allocation at the expense of equities compared to last year. This in part reflects valuations for the most concentrated part of the equity markets closing in on historical peaks, and with it a more challenging upside/downside asymmetry versus credit right now. Credit spreads are well placed and not super tight and for the most part, investment grade companies should manage the refinancing risk, which for many will happen further down the track. So, for those investors looking to move from cash and back into the market, the 25% equity/75% fixed income asset allocation appears optimal.

> *“Forecasts suggest the best risk-adjusted returns over the next five years will be a mix of 25% equity and 75% fixed income*

Figure 5: Bond and equity efficient frontiers for Expected Returns 2023-27 vs 2024-28



Source: Robeco, as of September 2023. Note: volatility based on average historical data from October 2000 to September 2023. Equity is represented by MSCI AC World and Bonds is represented by Bloomberg Global Aggregate Corporate and Bloomberg Global Aggregate Treasury indices. In portfolio optimizations, we combine the 5-year Expected Returns with long-term steady state returns.

The diversification benefits of combining different asset classes

Historically mixing different asset classes has provided diversification, and with it improved risk-adjusted returns. However, there is an exception to the rule. During periods of elevated inflation, assets typically become correlated – just like we have witnessed over the past two years. However, looking forward, we expect those diversification benefits to make a comeback. We anticipate Core CPI inflation forecasts of circa 2.5%-3% for the next five years, and historically that level has supported diversification between bonds and equities. For lower-risk investors, a multi-asset portfolio with a majority allocation to bonds should stand to perform well.

Does a top-down view matter?

While active credit managers typically add the most value through bottom-up security selection, we firmly believe that maintaining a top-down view is crucial for delivering sustainable outperformance in credit portfolios. Different phases of the credit cycle require varying risk stances. So, how do we adjust beta to mitigate risk and capitalize on opportunities?

Optimizing credit portfolio performance

As active credit managers, it is essential to steer the risk profile of the portfolio in a way that optimizes relative returns in a positive credit environment, while also mitigating negative impacts during adverse market conditions. Our top-down approach revolves around quarterly credit outlook meetings, where all members of our credit team engage in in-depth discussions, challenging and scrutinizing views on both the market and macro environment. Discussions are structured around three main factors that drive credit markets: fundamentals, valuation, and market technicals. This includes investor positioning, flows, and market liquidity.

> *“The beta can be adjusted by incorporating specific strategies into credit portfolios*

The quarterly credit outlook serves as valuable input for positioning within the market cycle. Guided by their assessment of market attractiveness, credit portfolio managers determine the overall risk positioning of portfolios, which is defined as the portfolio’s beta. Specifically, beta is calculated as the Duration Times Spread (DTS) of the portfolio divided by the DTS the relevant market index. When the top-down view suggests a preference for higher risk, portfolio managers increase the portfolio’s beta to above 1. Conversely, in a more defensive risk stance, the portfolio’s beta can be reduced to 1 or below 1.

Strategic beta positioning: responding to credit market dynamics

The beta can be adjusted by incorporating specific strategies into credit portfolios. To increase beta, one could add to the portfolio corporate bonds with higher credit spreads, off-benchmark positions such as AT1 CoCos, or bonds with higher-spread duration than the index. Conversely, to reduce beta, outright de-risking, or adding higher-quality bonds with lower credit spreads and/or shorter-dated bonds are options. Additionally, beta can be efficiently managed by using credit index derivatives, like CDX or iTraxx. The benefit of this strategy is quick and cost-effective in comparison to using cash bonds.

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