

## Corporate Credit ... Really? Yes Really!

Saul Doctor of J.P. Morgan, in his recent report titled '*What Your Great-Grandfather Should Have Bought: Analysing a Century of Asset Returns*' comes to the fascinating conclusion that **'over the past century, corporate credit has outperformed government bonds, equities and gold on a volatility adjusted basis, and if we take inflation into account and consider real returns, we find that this outperformance is even more pronounced'**.

### Real Returns and Information Ratios<sup>1</sup>

The following table illustrates that while US Equities have generated the highest absolute annualised real return for the period of this study (1919 – 2009), corporate credit has been the top performing asset class on a risk adjusted basis, with an Information Ratio of 0.54.

Asset	Credit	US 10 Year Treasuries	US Equity	Gold
Return	4.2%	2.5%	6.9%	1.7%
Volatility	7.8%	6.2%	18.7%	14.2%
Information Ratio	0.54	0.41	0.37	0.12

Source: J.P. Morgan

### How then to access this top-performing asset class

While there are limited dedicated corporate credit investment vehicles in South Africa, Cadiz Asset Management (CAM) has developed an enviable track record of analysing and investing in corporate credit. The Cadiz Absolute Yield Fund, which invests extensively in corporate credit opportunities and was recently the recipient of a Morningstar Fund Award in the Cautious Balanced category, is the most visible evidence of this skill.

The Cadiz Absolute Yield Fund is a flexible fixed interest fund that aims to provide investors with a return of 3% in excess of inflation (as measured by the Consumer Price Index) over rolling three years, and a positive return over any rolling twelve months, by investing across the fixed interest universe. The fund focuses on maximisation of total return over the long term, while preserving capital. It is important to have no negative returns, which means minimising volatility. We believe that minimal interest rate risk is optimal, and that we can outperform a target return of CPI+3% (as we have done) by focusing on yield, rather than by taking large duration bets. The risk return trade-off for long duration bonds for this type of investment mandate is not appealing. Yield enhancement is key, and rather than managing the fund against a specific benchmark, we focus on achieving a high total return for investors by using a wide range of fixed interest instruments (cash and bonds), property stocks and preference shares. The downside market risk is managed through diversification across a broad spectrum of instruments, and by using derivatives to minimise interest rate risk.

Since the Cadiz Absolute Yield Fund is focused on yield enhancement, corporate credit bonds are a very important part of our investable universe. Here it is important to make sure that we receive a sufficient yield spread above the risk free (government bond) rate. To do this we have a thorough credit valuation process, which focuses on fundamental analysis of companies and ultimately a fair value yield spread, which forms the basis of all our investments. Our aim is to make sure that we are fairly compensated for the credit risk assumed, and that there is minimal downgrade or default risk.

### Current Credit Valuations and Positioning

Credit spreads peaked in the first half of 2009 and the Cadiz Absolute Yield Fund took advantage of this and invested heavily in credit at that time. We are now seeing the benefit of those spreads narrowing and the capital profit flowing through to the fund. Our macro factor model is currently pointing to a positive environment for credit and further potential for spread narrowing. However, we feel that much of this positive news is being priced in. Apart from measuring a fair value credit spread, we estimate that the liquidity premium that investors are receiving for investing in credit has narrowed to the extent that it is close to zero, which is indicating that credit is starting to look expensive. However, we still scan the credit market and use our valuation process to identify anomalous opportunities that exist across the credit curves.

The fund is currently sufficiently diversified across the investment grade universe with a very small portion in BBB assets. Given the extensive downgrades that the credit market has seen and the fact that the growth cycle has turned, there are now opportunities in the lower grade credit space and this is probably where the fund will pick up some more exposure. Having said this, we are mindful that lower grade credit carries a higher risk and our fundamental valuation process and in depth analysis of credit risk always ensure that we go to lengths to not dilute the credit quality of the fund.

Paul Hutchinson  
June 2010

<sup>1</sup> The Information Ratio is simply annualised returns divided by annualised volatility. It tells us our return per unit of risk or volatility.