The folly of forecasting, multi-asset credit

October 2014

Forecasting is a popular pastime for credit investors seeking an extra edge, particularly in fully valued fixed income markets. From predictions of economic growth to gilt yields, investors are conditioned to follow forecasts and invest in the expectation of resulting outperformance.

Yet even forecasters with access to the widest range of information sources have a far from perfect track record. Central banks, for instance, set monetary policy based on growth forecasts that in hindsight can be far removed from the real level of expansion.

Even simple predictions can be far off course. In December 2013, economists’ consensus forecast for 10-year gilt yields at the end of 2014 was an average 3.2%\(^1\). For the following eight months, yields remained below 3% - and sank to 2.3%\(^2\) as of 31 August 2014.

So if we can’t be confident of where we stand today, let alone where we will be in future, why not go back to first principles: where is risk adequately rewarded, and where is it not?

This leads to a ‘bottom-up’ approach to investment in credit based solely on the value that opportunities present. It responds to events rather than trying to predict them and selects stocks at attractive prices. It is resource-intensive and requires patience, but delivers repeatable excess returns.

Investing based on value can bring a clear-sighted perspective to the contradictions in credit markets. For example, investors typically place funds into multiple asset classes to reduce risk exposure. After all, investing across nearly the full spectrum of credit is a compelling proposition – it is one reason multi-asset credit funds are so sought after.

But it is vital to focus on value in this approach to ensure that the different asset classes are not exposed to the same sources of risk. Viewing the market as a series of asset ‘silos’ misses the fact that beneath the surface, assets’ credit risk can be highly correlated. In these cases, diversification provides little protection. For instance, property-related debt is a huge part of bank balance sheets. It’s also the largest element in the ABS market – and dominates the assets underlying most of Europe’s covered bonds.

Since the risks in these silos overlap, logically, so should buyers’ investment decisions. By breaking down the risks into their constituent elements, investors can understand which are being fairly compensated. Removing constraints on investment strategy frees the manager to select value-based opportunities across credit asset classes based solely on the underlying risks and avoid those that are unrewarded.

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1 Source: Consensus Economics Inc, as at 9 December 2013.
2 Source: Bloomberg, as at 31 August 2014.