FINDING VALUE ACROSS THE CREDIT CYCLE

Unraveling 9 key questions about credits – The 2025 edition

ROBECO
The Investment Engineers

Let the numbers
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Following the most aggressive central bank hiking cycle in 40 years and with rate cuts now underway, 2025 promises to be unpredictable and volatile. In such times, investment grade credit remains a reliable income source, offering diversification benefits and the chance to lock in attractive returns.

This updated booklet leverages Robeco's expertise to address client concerns about credit investing. Our goal is to provide accessible, insightful guidance on identifying value, managing risk, and unlocking opportunities. We hope these insights equip you with the knowledge and inspiration to capitalize on today's credit environment.

Is cash still king?

While 2024 brought increased flows into credit and treasuries, money market funds have remained popular. With substantial cash holdings still common in portfolios, investors face a critical question: Is cash still king, or has credit become the more compelling choice?

So far in 2025 cash has continued to offer investors attractive returns relative to government bonds and high-quality credit. However, as central banks begin easing rates in anticipation of a more favorable inflationary environment, the return prospects for cash are likely to diminish, making credit at current yield levels a more appealing alternative.

Better return potential

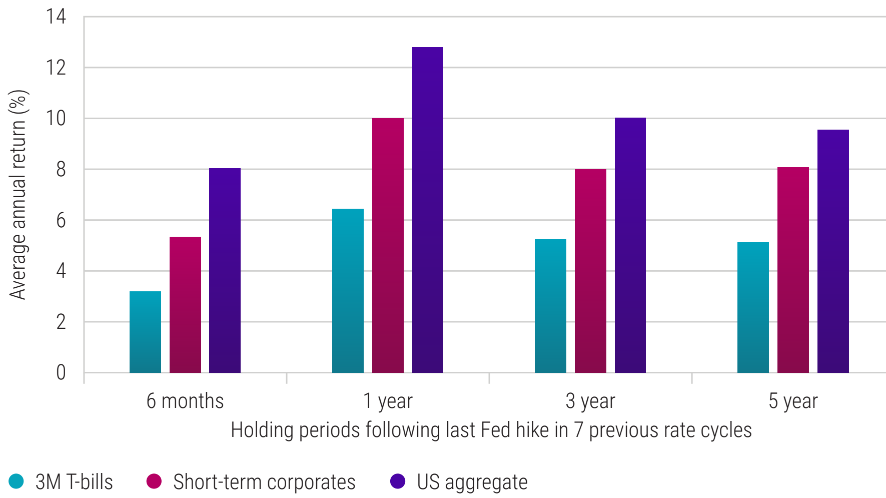
First, investment grade and BB-rated credit offers an attractive yield pick-up over cash, especially in an environment where central banks start easing rates. And it does this while protecting investors against future rate cuts that would immediately reduce the return on money market investments. Within 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.

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 pivot to policy easing.

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

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 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, July 2024

Current market environment remains supportive for credit

The US economy continues to do well and although the Trump presidency does introduce a fresh layer of uncertainly, we view his pro-growth agenda as supportive for corporate America. Growth in Europe has been more challenging but we don't expect a severe recession. More importantly corporate fundamentals continue to look stable and robust especially for investment grade and BB-rated corporates. This does not mean that all corporates will do well. We have already seen some challenges in US retail, UK water companies and the automotive sector but overall the outlook for investment grade and BB-rated companies remains positive.

Some parts of the credit market may be more vulnerable to an economic slowdown or persistently elevated refinancing costs. However, investment grade and BB-rated companies are well-positioned to perform strongly, even in a moderately growing economy or a higher-rate environment because of their conservative debt levels. 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 and alpha opportunities

Thirdly, transitioning from cash to investment grade and crossover credit offers better diversification of issuer risk. Money market investments often involve concentrated holdings in a small number of high-quality issuers or counterparties, resulting in significant exposure to just a few entities.

In contrast, investing in high-quality investment grade and BB-rated credits enables broader diversification across issuers. For instance, our global credit strategy includes investments in over 130 companies across the global investment grade credit market. The great thing about investing in credit markets is the vast universe of thousands of issuers across multiple currencies – there are multiple routes to generating (out)performance.

Does the hunt for yield equal the hunt for returns?

The last few years have been a rollercoaster for bond investors, with yields remaining elevated as markets anticipate further pro-growth policies under a new Donald Trump presidency – policies that could also lead to inflation being stickier than expected. With the rise in bond yields, bonds are back as an income stream for investors. But does the increase in yield imply higher total returns?

> *"We see the most attractive value in high-quality credit*

Typically, yield is the most important determinant of longer-term bond returns. In recent years, however, low and even negative yield environments have made capital gains the primary driver of bond returns. Now, with higher yields, bonds are better equipped to absorb rising yields before total returns enter negative territory. While yields have risen across most segments of the global fixed income market, we see the most attractive value in high-quality credit which we define as investment grade and crossover (BB-rated) credit. These areas of the fixed income market offer attractive yields with limited credit risk.

Analyzing investment grade credit returns in similar yield environments

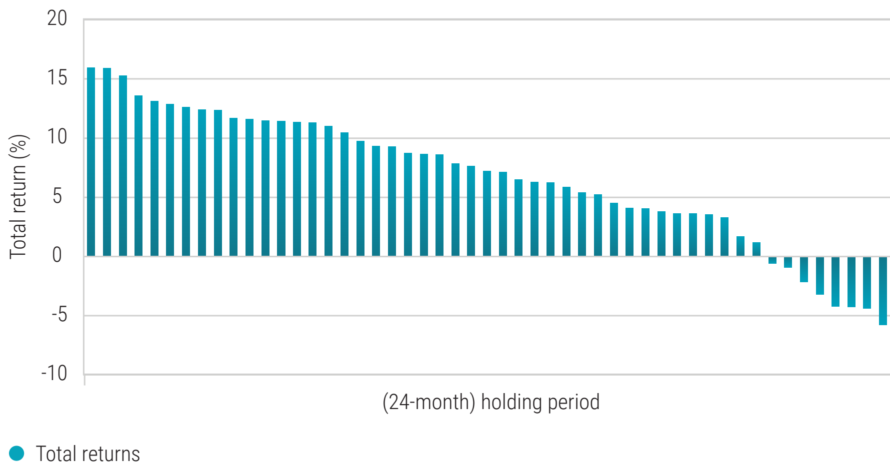
To assess the total return potential of investment grade credit in the current yield environment, we analyzed the twelve-month periods in the past 24 years that started with similar yield levels. We then calculated the total returns in those periods. In Figure 2, we show the distribution of total returns from the 61 twelve-month periods in our research sample, each of which began with a yield level between 4.5% and 5.5%.

We see that the probability of positive total returns is very high. In only three of the 61 periods, the total returns fell between -6% and -3.1%. The lowest total return observed was -5.6% while the maximum total return observed was 15.9%. The average return was 6.7%.

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 2-year period, in most cases when yields were similarly leveled.

Secondly, we mostly observed positive total returns over a 2-year holding period, and in the majority, 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.

Figure 2: Distribution of total returns for global investment grade credit over a 24-month holding period



Source: Bloomberg, Robeco. Research period: March 2001-December 2024. This figure shows the distribution of the total returns of the Bloomberg Global Aggregate – Corporates index of all 61 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.

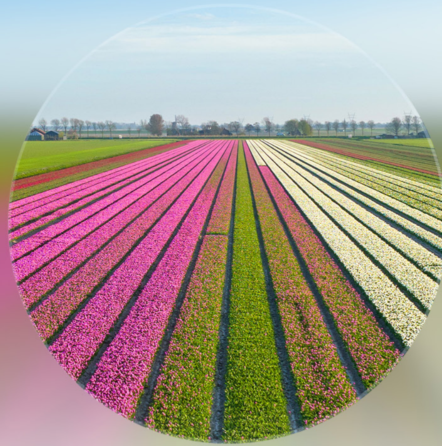
Assessing investment grade credit returns in different economic scenarios

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 an economic scenario of no landing, particularly for the US economy, and more stubborn inflation, bond yields could remain at current levels or even rise. 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. Investors now have the opportunity to lock in attractive yields for multiple years.

In a hard landing scenario where the US economy slides into recession – though this is not our base case – central banks would likely be compelled to cut rates more aggressively, driving bond yields lower. As markets shift from riskier assets to the safety of government bonds, spreads on investment grade credit could widen. However, the drop in government bond yields would help offset the impact of wider credit spreads, supporting total returns. Additionally, the typically negative correlation between equities and investment grade credit in a recessionary environment could make credit an effective hedge against weaker equity performance.

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, bonds have been a cornerstone of portfolios, valued for their income and diversification benefits against riskier asset classes like equities and commodities. However, in recent years, credit has not always delivered the diversification investors expected. Now that 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?

Global investment grade credit markets have experienced significant drawdowns, often coinciding with negative equity returns, as rate volatility impacted both asset classes. This led investors to question the reliability of bonds, and investment grade credit specifically, as a diversification tool. 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.

Investment grade credit performance: a historical perspective

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 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.

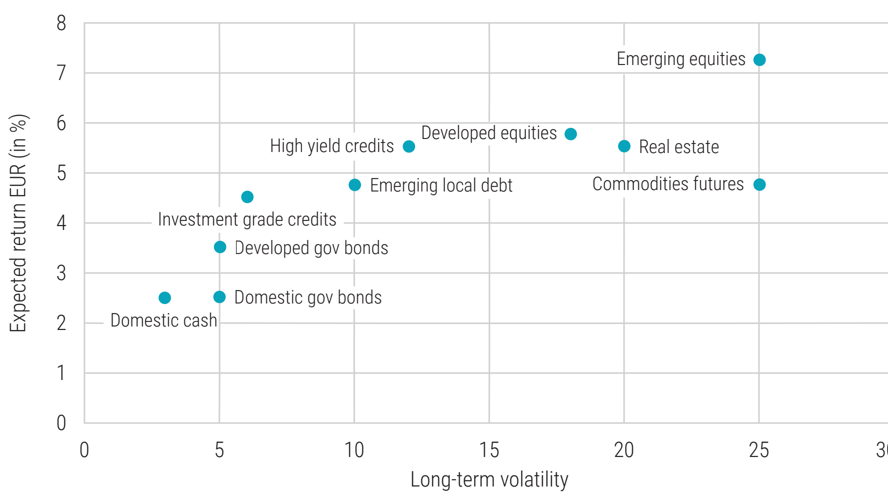
The only bear market during this period in which global investment grade credit failed to provide diversification benefits was in 2022, when drawdowns reached -16.7%, nearly matching those of global equity markets. This sharp decline in global investment grade credit was primarily due to its higher duration sensitivity, which made it more vulnerable to the steep 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, providing valuable diversification benefits to investors. At the beginning of August 2024 when market volatility resurfaced in response to weaker US macroeconomic data and geopolitical risks in the Middle East, investment grade credit provided diversification delivering positive returns while equity markets dropped.

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

Let's take a forward-looking approach to assess the diversification benefits of investment grade credit guided by Robeco's multi-asset team's 5-year outlook. This includes expected returns, and long-term volatility estimates across various asset classes. These projections are based on a combination of internal Robeco models and external studies, using diverse market indices and a blend of historical data and forward-looking metrics. The resulting risk/return profiles are illustrated in Figure 3.

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



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

This chart clearly highlights the superior risk/return profile of investment grade credit compared to other asset classes. It offers one of the lowest long-term volatility profiles while providing higher return potential than government bonds. Additionally, its long-term return potential is only slightly lower than that of most riskier asset classes, with the notable exception of emerging market equities.

Based on this forward-looking analysis we can conclude that investment grade credit has a very appealing risk/return profile and is therefore deserving of its place in a balanced portfolio. It has the potential to significantly reduce volatility while maintaining strong long-term return potential.

The size of the exposure to investment grade credit 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 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 important, 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.

> *“The real opportunity lies in ensuring a credit is a value opportunity, not just ‘cheap’*

To identify whether a category is cheap or not, we compare the current spread (as of 8 January 2025) 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 0.62, this ratio illustrates that the market is roughly 38% more expensive versus its long-term history.

Table 1: OAS for various market segments

Index OAS (bps)	EUR					USD			
	EUR IG Corp.	EUR Covered	EUR Bank Senior	EUR Sub. Financials	EUR HY ex. Fin.	USD IG Corp.	USD Fin. Institutions	USD HY ex. Fin.	USD EM Corp.
Current OAS	102	56	101	160	312	79	82	281	207
Median OAS	121	57	102	249	384	127	123	427	341
Current/ Median OAS	0.84	0.98	0.99	0.64	0.81	0.62	0.67	0.66	0.61
Percentile (low = rich)	33%	49%	48%	10%	21%	1%	17%	4%	9%

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 8 January 2025. Data going back to 2005.

EUR financials and covered bonds in focus

The spread ratio for EUR senior bank debt is currently 0.99, indicating that the average credit spread in this part of the global credit market is trading in line with long-term median spread level. We currently consider this part of the market attractive, certainly relative to the other parts of the global credit markets, therefore we have an overweight in EUR senior bank debt in our credit portfolios.

Additionally, from a fundamental credit perspective, we favor European banks. The broader EUR investment grade credit market, with a ratio of 0.84, also trades below the long-term median spread level but significantly less compared to USD investment corporates. 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. One other segment that we also like is EUR covered bonds which is also trading more in line with longer term average spread levels and not as expensive as many segments of the US market.

In conclusion, combining the above approach with top-down assessments of macro and corporate fundamentals and technical factors helps identify attractive and overvalued segments in the credit market. While credit markets may appear expensive, strong demand, limited issuance, or accommodative central bank policies can sustain high valuations. This highlights the complexity of credit investing and the importance of active management in identifying market winners.

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 credit classes for overlooked value due to biases and segmentations. Often, opportunities can be found in shorter-dated bonds with attractive valuations relative to other corporate bonds, and history shows that these premiums tend to mean revert.

> *“The key to success is balancing value and risk through active management, uncovering opportunities while controlling for risks.*

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):** 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[1] 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 be detrimental, particularly for polluting companies, which are likely to face regulatory pressures as the transition to a low-carbon economy gathers pace.

By managing market and credit risks, investors are adequately compensated. Our proprietary risk management system measures and monitors credit risk across portfolios, enabling oversight of market, sector, and company-specific exposures. Risk is assessed based on the weight, spread, and duration of each investment, translating into risk points. These points reflect the portfolio manager's conviction when allocating risk to a holding.

1. 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?

Effective credit analysis goes beyond numbers to assess an issuer's ability to generate sustainable cash flow and repay debt. At the core of our approach is a fundamental score (F-score[1]), which evaluates five key factors, including an issuer's ESG profile. By integrating ESG alongside business strategy, financial strength, corporate structure, and covenants, we uncover risks and opportunities that drive long-term value in corporate bond investments. But how does ESG integration enhance decision-making?

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.

> *"Integrating ESG factors helps identify risks and opportunities while aligning with societal goals.*

The four pillars of ESG integration explained

1. The first pillar examines the financial materiality of a company's products and services, assessing whether they pose business risks for credit investors. Companies producing unsustainable goods may face challenges, such as declining sales or earnings pressure from carbon taxes. For instance, an oil company could be impacted by the environmental footprint of its offerings, leading to regulatory or market-driven headwinds.

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 assesses an issuer's exposure to climate change and its readiness to mitigate related risks. Analysts use a climate score to evaluate both the financial risks climate poses to the company and the company's impact on the environment. This includes reviewing carbon intensity and the credibility of its 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 above to assess the merits of the carmaker's ability to finance its transition to electric vehicle production. The numbers are run to estimate the cost of setting up production facilities for batteries and battery cars, and the implied capex requirement for the next five years. This is then compared to what has been communicated to the market. If the capex budget falls short, it is flagged in the SI research report, and the credit analyst may adjust their opinion if this risk poses a material financial impact.

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 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.

Is investment grade credit still worth considering?

Throughout 2024 we highlighted the opportunities in high-quality investment grade and cross-over BB credits, noting how significant yield increases have enabled investors to earn quality income. Now, as we step into a new year, where do we stand?

Inflation, rate cuts, and the bond diversification comeback

Bonds have historically served as a diversifier against riskier asset classes such as equities and commodities. However, in 2022, this relationship broke down as both bonds and equities sold off substantially due to spiking inflation and subsequent rate hikes. Typically, as shown in the chart below, correlations between equities and bonds have historically been negative when inflation eases, allowing bonds to regain their diversification benefits.

This dynamic has recently re-emerged, as central banks cut rates last year and core inflation eased below 3%. As a result, stock-bond correlations are expected to return to negative territory, allowing high-quality fixed income to reclaim its role as a portfolio diversifier.

In August 2024, markets experienced a brief sell-off due to weaker US labor market data and geopolitical risks. During this period, high-quality fixed income investments, such as US government bonds and investment grade credit, delivered positive total returns as Treasury yields declined. While both equities and Treasury yields have since resumed their upward trends, driven by markets pricing in pro-growth policies of a second Trump presidency, we still expect inflation to gradually ease and recognize the potential for negative growth shocks.

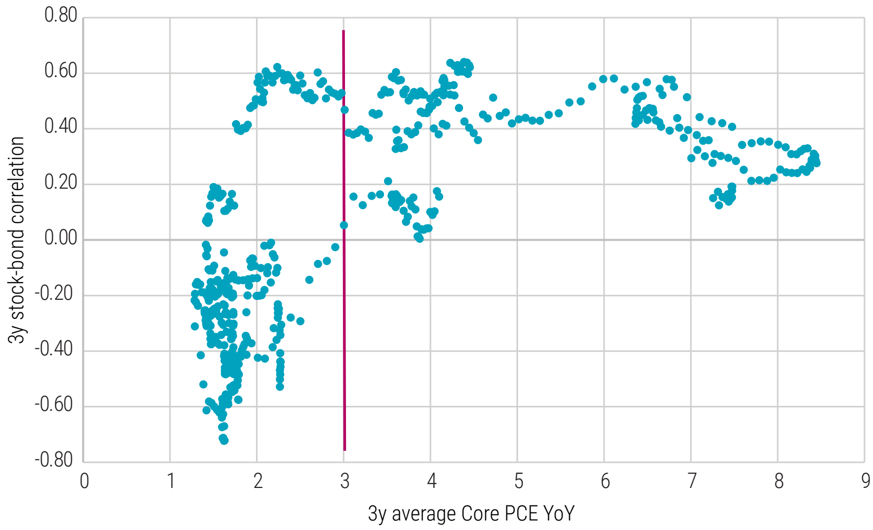
With its duration exposure, investment grade credit has a built-in diversifier. This means that although corporate spreads might widen in response to disappointing economic data or volatility, investment grade credit also benefits significantly from a drop in interest rates, which protects total returns.

Why not just Treasuries?

If yields are now more attractive and high-quality fixed income is expected to be a better diversifier going forward, why not invest in government bonds like US Treasuries rather than investment grade credit?

The answer lies in the long-term performance of investment grade credit. It's not so much about timing the market as it is about time in the market. Over the long term, investment grade credit has delivered higher total returns than government bonds. For example, global investment grade credit has delivered an annual total return of 4.5% over the last 24 years (2000-2024)[1], compared to an average of 3.7% for global government bonds.[2] Over the last five years, global investment grade credit has outperformed global government bonds by an average 0.7% per year.

Figure 4: Stock-bond correlation



Source: Robeco, Bloomberg, as of 29 November 2024. Data 1973 onward monthly. Correlations have been calculated for the US stock and bond market. Core PCE: US Personal Consumption Expenditure Core Price Index.

Our base case anticipates moderating global growth without a recession, ongoing disinflation, and a pivot by central banks to a less restrictive policy stance. This creates a supportive backdrop for high-quality fixed income in general, and investment grade credit in particular. In this scenario, investors can enjoy both an attractive yield and yield pick-up over government bonds, and perhaps also benefit from further compression of credit spreads. If we are wrong and encounter much weaker growth or a recession, leading to some credit spread widening, a likely more aggressive response from central banks would lead to a rally in government bonds, protecting total returns on investment grade credit.

Standing out in today's market

Technicals are also favorable, as the demand for credit remains strong with investors looking to lock in higher yields. Barring a major shock, there is little reason to think credit spreads should widen meaningfully from here. Corporate fundamentals for investment grade companies are very solid. The recent hiking cycle by central banks has not inflicted pain like previous cycles, as investment grade corporates were proactive in managing their debt levels and issuing debt at low yields during the low-rate environment of the Covid pandemic. Therefore, interest rate costs for investment grade companies are manageable.

> “ *Investment grade credit offers attractive yields, strong fundamentals, and a built-in diversification advantage*

Lastly, we expect increased dispersion in credit markets, which is good news for active and skilled credit managers. By focusing on high-quality credit selection, managers can identify resilient issuers, avoid potential pitfalls, and capture attractive risk-adjusted returns, ensuring that investment grade credit remains a compelling option even in uncertain times. ●

1. As measured by the Bloomberg Global Aggregate Corporate Total Return Index (USD)
2. As measured by the Bloomberg Global Aggregate Government Bond Total Return Index (USD hedged)

The hidden gem in today's bond market?

In the current phase of the credit cycle, investors can achieve attractive yields by focusing on higher-quality credits and avoiding the riskier, lower-quality segments of the credit market. But where can investors find an attractive yield?

There has been a strong emphasis on the opportunities within (subordinated) financials. While maintaining a constructive outlook on this segment of the global credit market, investors may also find an attractive, high-quality yield opportunity in another area: the corporate hybrid market.

So, what are hybrids, how do they function and are they the answer for those looking to strike the balance between yield and risk to optimize returns?

Decoding corporate hybrids

A corporate hybrid is a form of subordinated debt that sits below senior bonds in the capital structure. This means that in the event of financial distress, hybrid bondholders are paid after senior bondholders but before shareholders. To compensate for the added risk, hybrid bonds typically offer higher yields. However, in practice, companies issuing hybrid debt are rarely at financial risk, as these are usually large, high-quality firms, mainly in the utilities and telecommunications sectors. These companies are less exposed to credit or macroeconomic cycles compared to high yield companies, which often operate in more cyclical sectors. Hybrid issuers are less impacted by market fluctuations, have low default risk and maintain steady consumer demand.

> *“Hybrids deliver high yields with less volatility*

They are called ‘hybrids’ because they blend features of both debt and equity. These characteristics include the ability to defer coupon payments and the absence of a set maturity date or longer final maturities. However, unlike contingent convertible (CoCo) debt issued by banks, deferred coupons on hybrids accrue interest and must eventually be paid. With corporate hybrids, no regulator can block coupon payments, prevent the issuer from calling the bonds, convert them into equity, or write them down.

Call feature

Hybrid bonds may seem like long-term investments because in theory they can have 30-year, 60-year, or even perpetual maturities with no fixed end date. In practice they don’t last that long. Most hybrid bonds are repaid or ‘called’ by the issuer at their first opportunity, typically after five to ten years. The somewhat predictable call dates give investors a clearer idea of when they can exit. If the bonds are not called, investors continue to earn higher interest, though extension risk has remained low throughout the cycle.

Why consider hybrids now?

In the current uncertain macro environment, moving up in quality away from high yield and into corporate hybrids makes sense, especially given expensive valuations and the minimal yield sacrifice. With market consensus pricing in a soft landing, reflected in compressed high yield credit spreads, corporate hybrids offer a chance to capture attractive yields while avoiding lower-quality market segments most exposed to tail risks. In a market with little room for error, hybrids provide a higher-quality alternative.

Yield and risk balance

When it comes to income, investment grade credit yields are above 4%, while corporate hybrid yields range from 4% to 8%, depending on factors such as currency, call date, and other structural or fundamental considerations. In the current uncertain macro environment, corporate hybrids present an attractive investment opportunity relative to other bond types, including high yield. The current yield premium of high yield over corporate hybrids is near historical lows, enhancing the appeal of hybrids on a risk-adjusted return basis.

What do hybrids bring to a portfolio?

In a nutshell: income, low duration exposure and diversification. Corporate hybrids provide an attractive yield relative to traditional corporate bonds with a relatively low duration (the duration of the Bloomberg Global Corporate Hybrids Index is less than four years). They offer similar spreads and yields to high yield debt with lower volatility. As their price movements don't always align with either asset class, they can reduce overall portfolio risk because they react differently to market fluctuations.

While corporate hybrids carry certain risks, such as potential coupon deferral and call extension, these risks are minimal. Their strong performance potential, especially in volatile markets, makes them a valuable addition to any portfolio seeking for enhanced returns.

What does it take to excel in credit investing?

One of the primary tasks of fixed income investors is to identify securities that appear undervalued relative to their intrinsic value – a concept often referred to as the Value factor. This can be monetized through either quantitative or fundamental investment approaches, with the latter being the focus here. So, how can investors best leverage the value factor to consistently deliver outperformance across the market cycles?

The answer lies in embracing a contrarian investment approach. Credit markets are often shaped by behavioral biases, leading to periods of over- and undervaluation. Investors frequently overreact to market or macroeconomic events, driven by home-market preferences and a stronger emotional response to losses than to equivalent gains. This fear-driven selling, often at any price, exposes market inefficiencies – and it is within these inefficiencies that contrarian investors can uncover compelling value opportunities.

> *“ Market inefficiencies create opportunities – our contrarian strategy turns fear-driven selling into value*

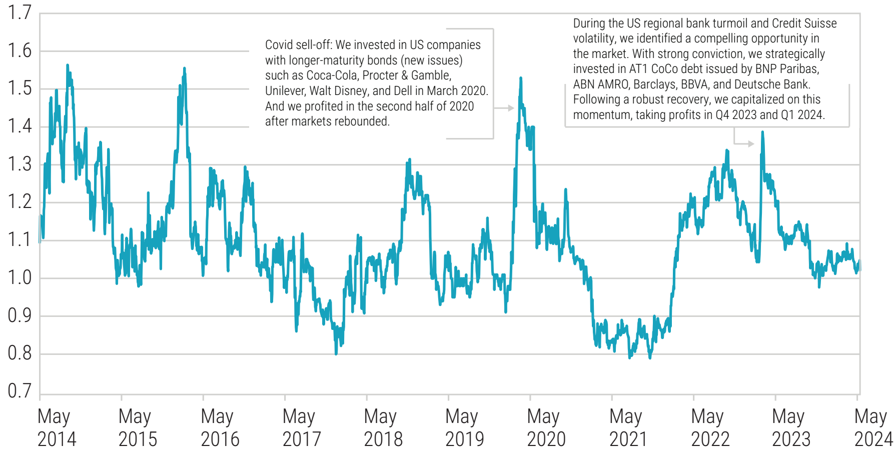
A proven strategy to consistent outperformance

When seeking alpha, we avoid following the herd. We have been employing a contrarian investment strategy for the past 15 years, supported by comprehensive top-down macro research and in-depth company analysis. Our ability to add credit risk in volatile, cheapening markets, while reducing exposure in expensive markets, has been crucial in achieving consistent outperformance throughout different market cycles.

Figure 5 below illustrates our top-down risk (beta) positioning in our global investment grade credit strategy over the last decade. A beta above 1 indicates that the portfolio holds more credit risk, measured by duration times spread (DTS), compared to the broader market. Conversely, a beta below 1 signifies that the portfolio carries less credit risk than the broader market.

With a long-standing tradition of applying contrarian strategies to uncover opportunities in credit markets, the following two examples illustrate how value was effectively harnessed during periods of market disruption.

Figure 5: Historical beta for Robeco Global Credits strategy, we add risk when markets are weak, sell risk when markets are strong



Source. Robeco, Bloomberg, May 2024. Past performance is no guarantee of future results. The value of your investments may fluctuate. Returns gross of fees, based on gross asset value. If the currency in which the past performance is displayed differs from the currency of the country in which you reside, then you should be aware that due to exchange rate fluctuations the performance shown may increase or decrease if converted into your local currency. Performance since inception is as of the first full month. Periods shorter than one year are not annualized. Values and returns indicated here are before cost; the performance data does not take account of the commissions and costs incurred on the issue and redemption of units.

Capitalizing on the pandemic market dislocation

When the Covid pandemic struck at the start of 2020, governments responded by locking down economies, and financial markets reacted sharply, causing equity and corporate bond prices to plummet. Using the Credit Quarterly Outlook as a starting point we began to identify value opportunities in global credit markets. Given the commitment of governments and central banks to support the economy through financial aid measures and easing monetary conditions, we were confident that larger, well-managed investment grade companies could withstand prolonged lockdowns.

Consequently, we started investing in high-quality corporate debt in the US and Europe. As a result, the beta of the portfolio increased from below 1 at the start of the year to 1.5 by the end of March 2020. Following the initial shock and subsequent interventions to support the economy and markets, we observed a significant rebound in financial markets, and the corporate bonds we acquired performed exceptionally well. As these corporate bond holdings reverted to normal or fair value, we took profits and reduced our positions. Then, the portfolio's beta was brought back to below 1.

Rebounding from the 2023 bank debt selloff

In March 2023, following a series of failures among US regional banks and the forced rescue merger of Credit Suisse with UBS, subordinated debt (AT1 CoCo) was completely written down. The market reacted sharply, placing pressure on bank debt, in particular AT1 CoCos. In line with our contrarian investment strategy, we started adding risk to larger, well-diversified European banks, where our bottom-up credit analysis indicated no fundamental concerns and bond valuations became very attractive. We avoided troubled US or European banks, focusing instead on larger, stable institutions. Following the initial shock, once it was clear that the larger diversified banks were not affected, we observed a strong rebound in the prices of bank debt, benefiting our performance. As our holdings in AT1 debt from these large, diversified banks outperformed the market, we gradually took profits.

Opportunities in every market

Being contrarian goes both ways. When credit markets or segments in the credit markets trade weak, we are actively looking to add risk in undervalued corporate bonds. However, when markets appear to have priced in all the good news and become complacent, we take risk off the table and wait for better value opportunities.

This contrarian approach is deeply embedded in our investment strategy, extending beyond portfolio-level risk adjustments to individual securities. If corporate bonds weaken due to market overreactions, such as profit warnings, we view this as a potential buying opportunity – provided our credit research confirms they are not value traps. Similarly, when corporate bond prices become overinflated due to excessive optimism, we reduce exposure.

By diligently applying this approach daily, alongside strong risk management, we aim to deliver consistent outperformance through market cycles while maintaining controlled risk. ●

Credit solutions for every investment goal

In the following section, you can find our extensive range of credit solutions. Our strategies are underpinned by consistent alpha generation based on rigorous fundamental research and a contrarian investment style. We integrate top-down beta positioning, bottom-up issuer selection, and sustainability research into our strategies, using fundamental credit analysis to assess downside risk.

WHY ROBECO

A strong and proven record in credit investing, with more than a decade of experience in top-down analysis for assessing credit cycles, which are an important driver of the asset allocation.

Our credit strategies are managed by a well-resourced and experienced global credit team, comprised of 40 credit investment professionals, with an average of 18 years industry experience.

A history of successfully integrating sustainability in credit portfolios since 2010.

Strategies that have been recognized by external parties: Morningstar has awarded a silver rating to Robeco Euro Credit Bonds and a gold rating to Robeco Financial Institutions Bonds.

GLOBAL SDG CREDITS

A sustainable focus that applies Robeco's SDG Framework

In June 2018, Robeco became one of the first asset managers to launch a strategy that invests in the bonds of companies that contribute to the SDGs. We developed a methodology, the Robeco SDG Framework, to select credits based on clearly defined sustainability criteria. Using a three-step approach, the framework investigates the extent to which a company has a positive or negative impact on each of the 17 UN Sustainable Development Goals, on a scale of -3 (very negative) to +3 (very positive). This provides an objective, consistent and replicable approach to assessing positive and negative SDG contributions in a credit portfolio.

The Robeco Global SDG Credits strategy predominately invests across global investment grade credit markets in the bonds of companies making a positive or neutral contribution to the SDGs. The sustainable objective and the sustainability indicators are monitored on a regular basis as part of the investment process.

Key features

Objective: Target long-term capital growth while also contributing to the SDGs.

Approach: Pursues a value-focused and contrarian investment approach and is managed by a very experienced and well-resourced global credit team.

Benchmark: Aims to outperform the Bloomberg Global Aggregate Corporate Index through active credit selection over a full credit cycle. The strategy has some flexibility to invest off-benchmark in high yield, emerging credit, and securitized debt and invests at least 10% in green, social, sustainable and sustainability-linked bonds.

GLOBAL CREDITS

A pure-play global credit solution that seizes opportunities

We strongly believe in the benefits of taking a global approach to investing in credit markets. Launched in 2010, the Robeco Global Credits strategy has the benefit of geographic diversification. As some market segments are much better represented in one region than in another and various regions are in different stages of economic and market cycles, this offers opportunities for uncorrelated positions. With our research set-up, which consists of investment grade, high yield, emerging and developed credit analysts, we are well positioned to capture these opportunities.

In our global credit strategy, we pursue an active, value-focused and contrarian investment approach underpinned by thorough fundamental credit research. Sustainability is incorporated in the investment process via exclusions, ESG integration, a minimum allocation to ESG-labeled bonds, and engagement.

Key features

Objective: Provide long-term capital growth by investing primarily in a diversified portfolio of global investment grade corporate bonds.

Approach: Pursues a value-focused and contrarian investment approach and is managed by a very experienced and well-resourced global credit team.

Benchmark: Aims to outperform the Bloomberg Global Aggregate Corporate Index. The strategy invests across global investment grade credit markets with some flexibility to invest off-benchmark in high yield, emerging credit, and securitized debt.

GLOBAL CREDITS - SHORT MATURITY

A low-risk strategy to profit from higher yields

The Robeco Global Credits - Short Maturity strategy is a good solution to benefit from the value in short-dated credit. It also represents a unique solution for investors who want to benefit from the current higher yield environment without taking too much interest rate or credit risk.

It is a global credit strategy that invests in low-duration, high-quality global corporate and financial bonds. The low-duration approach implies reduced sensitivity to interest rate volatility and widening credit spreads. In essence, it offers a solution for investors concerned about market volatility while gaining exposure to credit markets. Compared with fixed income portfolios with a longer-dated profile, it tends to be more liquid and has lower portfolio turnover and therefore also lower transaction costs. Downside risk is further managed by ESG screening, which is an integral part of the fundamental credit research process.

Key features

Objective: Provide long-term capital growth, with the flexibility to invest in other fixed income asset classes such as high yield, emerging credits and asset-backed securities. The strategy can take limited active duration (interest-rate sensitivity) positions with a maximum maturity of six years.

Approach: The strategy is actively managed and benefits from the long track record of an experienced credit team, and from a proven global credit strategy which integrates ESG.

Benchmark: The Robeco Global Credits - Short Maturity strategy is managed against the Bloomberg Global Aggregate Corporate 1-5 Year Index.

CREDIT INCOME

A flexible multi-asset credit strategy with a strong sustainability focus

The strategy invests in companies that contribute positively to the SDGs while optimizing yield and income investing in global credit markets. The Credit Income strategy invests across global high yield, emerging credit and global investment grade credit markets. Based on our top-down view, the asset allocation can be adjusted to optimize the strategy’s income and return potential while minimizing downside risks in a more adverse market environment. A broad investment universe also helps to diversify risks. Interest rate duration is managed within one to seven years although typically duration will be between three and five years.

Key features

Objective: Maximize current income through the cycle, and the portfolio is built on the basis of the eligible investment universe and our in-house SDG Framework.

Approach: This multi-asset credit strategy follows an active approach, based on the investment team’s views on overall market conditions as well as thorough analysis of companies’ fundamental and sustainability features.

Benchmark: The investment policy of the strategy is not constrained by a benchmark.

FINANCIAL INSTITUTIONS BONDS

Quality approach to investing in subordinated financials

Robeco Financial Institutions Bonds is an actively managed strategy that invests in subordinated bonds issued by financial institutions, such as banks and insurance companies, primarily from Europe. The strategy offers a diversified exposure of around 70 issuers, predominantly in investment grade-rated Tier 2 bonds, while it has the flexibility to allocate to CoCos (up to 20%) and senior bonds. Therefore, the strategy is able to shift gears in terms of overall risk and position itself in those parts of the capital structure that offers best risk/return.

The strategy has a much higher exposure to insurance companies than most of its direct peers, which provides diversification benefits to the portfolio. This broadens the opportunity set as both behave differently through the credit cycle. The strategy incorporates sustainability in the investment process via exclusions, ESG integration, a minimum allocation to ESG-labeled bonds, and engagement.

Key features

Objective: Provide long-term capital growth through diversified exposure to subordinated bonds issued by banks and insurance companies.

Approach: Pursues a value-focused and contrarian investment approach and the strategy is managed by a very experienced and well-resourced global credit team.

Benchmark: Aims to outperform the Bloomberg Euro Aggregate Corporates Financials Subordinated 2% Issuer Cap Index, with some flexibility to invest off-benchmark in CoCos, senior bonds, high yield-rated securities and non-euro denominated bonds.

EURO CREDIT BONDS

Unconstrained approach across different segments of the European corporate bond market

The Robeco Euro Credit Bonds strategy invests in euro-denominated investment grade corporate bonds. In addition, the strategy selects from the best opportunities across credit markets, including potential rising stars, subordinated financials, securitized bonds and non-euro denominated bonds. With our research set-up, which integrates investment grade, high yield, emerging and developed credit analysts, we are well positioned to capture these opportunities.

In our euro credit strategy, we pursue an active, value-focused and contrarian investment approach underpinned by thorough fundamental credit research. Sustainability is incorporated in the investment process via exclusions, ESG integration, a minimum allocation to ESG-labeled bonds, and engagement.

Key features

Objective: Provide long-term capital growth by investing primarily in a diversified portfolio of euro investment grade corporate bonds.

Approach: Pursues a value-focused and contrarian investment approach and is managed by a very experienced and well-resourced global credit team.

Benchmark: Aims to outperform the Bloomberg Euro Aggregate Corporate Index and invests across euro investment grade credit markets with some flexibility to invest off-benchmark in high yield, securitized debt and non-euro denominated bonds.

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