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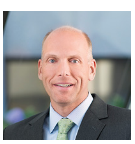
Standing Out in IG Credit

CONVERSATIONS

Current yields and total return prospects are presenting an attractive case for IG credit—but a global and flexible approach is key to capturing the diverse range of potential opportunities to generate alpha.



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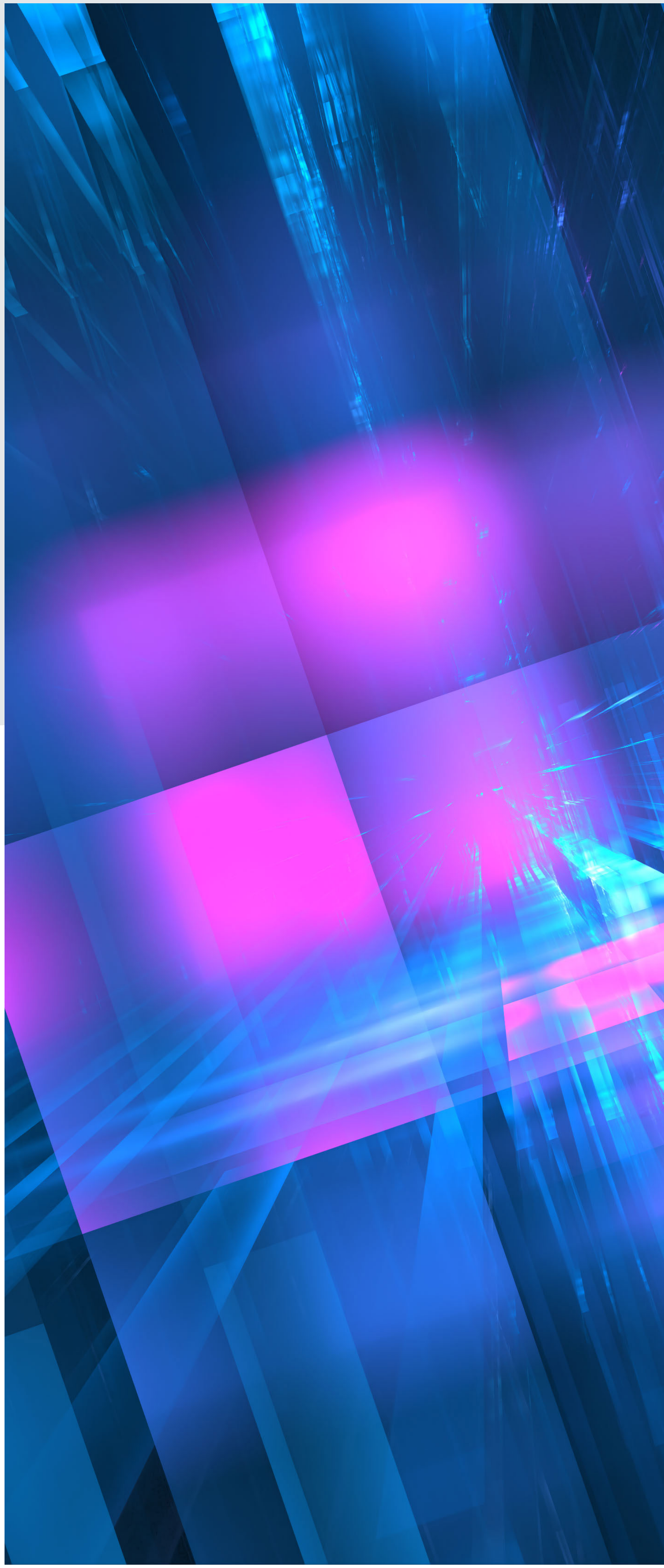


How supportive is the backdrop for IG credit today, and why do you believe now is a good time for investors to consider the asset class?

Natalia Krol: The current macro environment is favorable for investment grade (IG) credit, with expectations for lower policy rates in the U.S. and Europe. Although credit spreads are tight, prompting some investors to question the timing of investing in this asset class, high all-in yields and attractive total return potential make a compelling case for IG credit. Yields on U.S. IG corporate credit are near their highest point in 15 years and nearly double the 10-year average, which has driven strong demand for the asset class **(Figure 1)**.

Figure 1: IG Yields Remain Near Record-Highs

Sources: Bloomberg; Barings. As of June 30, 2024.

Similarly, in Europe, economic growth is slightly above expectations, corporate fundamentals are stable, and flows into IG funds are a positive technical. The recovery from the energy crisis and the European Central Bank's rate cuts in response to falling inflation are positive catalysts for European IG spreads. The political uncertainty may cause market volatility, but that can translate into a tactical opportunity. Most importantly, despite tight average spreads, the high dispersion in the market—with many segments trading wider than average—is presenting ample opportunities.

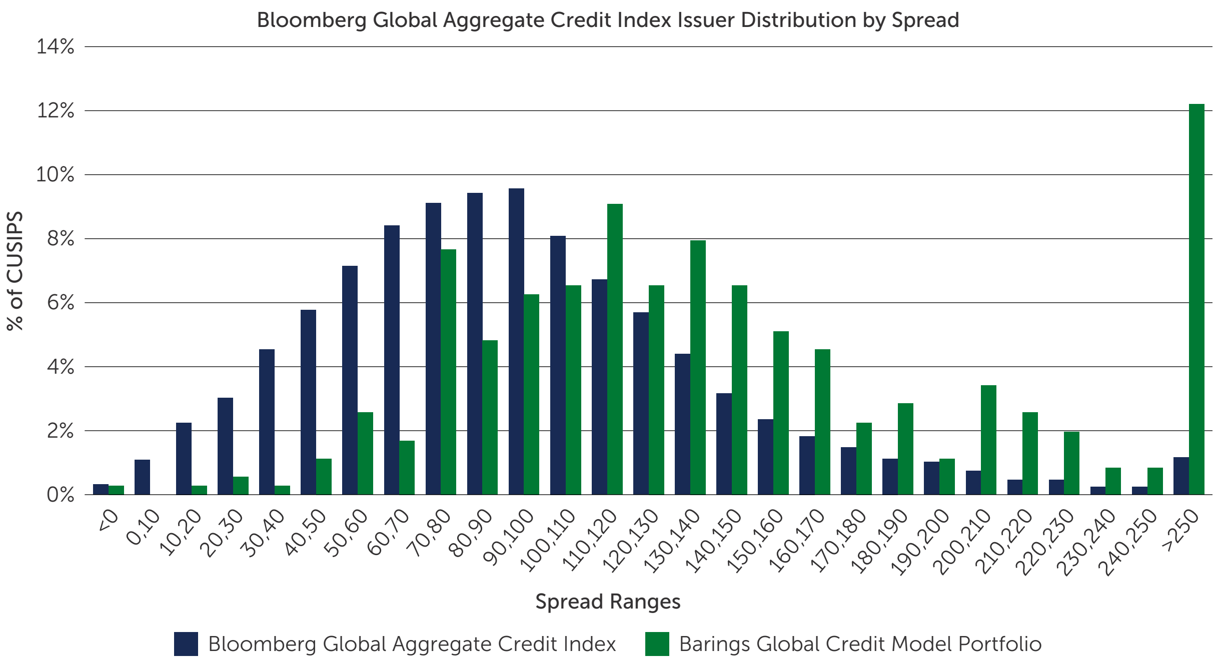
Moreover, history shows that the total return potential for the asset class is attractive following the end of central bank rate-hiking cycles and ahead of rate cuts. Historically, during these periods, the average total return for the asset class was 9%, 15% and 11% in the following six months, one year and three years (annualized), respectively.[1]

1. Source: Bloomberg. As of June 30,, 2024.

Looking across the market, are there particular areas where you're seeing inefficiencies and therefore looking to generate alpha?

Stephen Ehrenberg: With over 2,400 issuers, global IG credit provides a deep and high-quality investment universe with the potential for diversification across regions and sectors, as well as multiple sources of alpha generation. **One of the themes we're focusing on to generate alpha is 'under-followed issuers'**. Only 150 or so issuers make up 50% of the Global IG Corporate Index, but there is a notable opportunity set in the roughly 2,250 less-followed issuers **(Figure 2)**. Many of these names have limited sell-side coverage, but careful, bottom-up credit research can uncover strong fundamentals and growth potential. We see many such issuers across the financial sector, especially in life and property & casualty insurance issuers, as well as in real estate investment trusts.

Figure 2: Potential to Uncover Value in Under-Followed Issuers



Sources: Barings; Bloomberg. As of June 30, 2024. For illustrative purposes only.

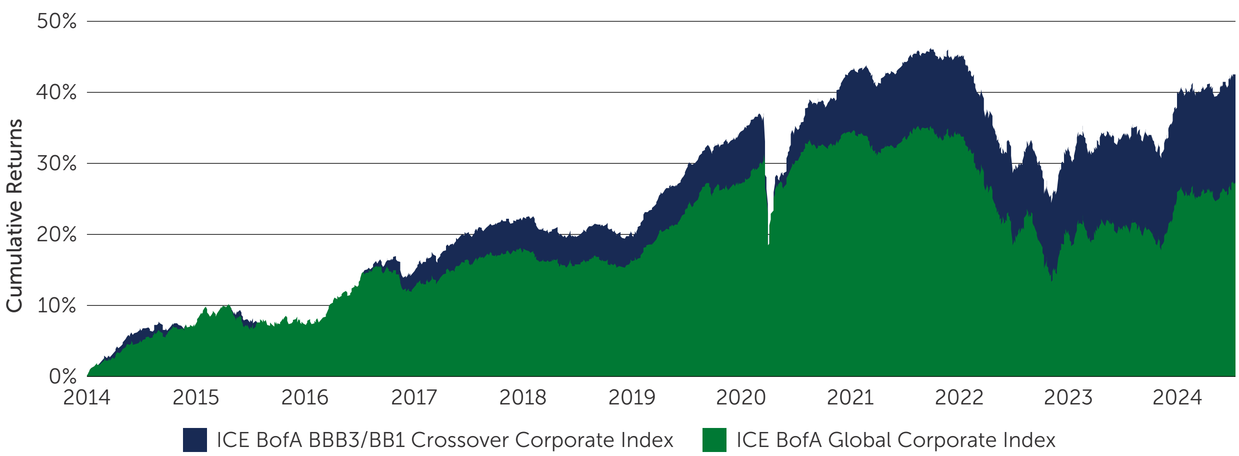
'Catalyst-driven opportunities' such as potential spread tightening driven by corporate events like M&A, tenders, or buy-backs from bank liability management exercises (LMEs) present additional areas of interest. For example, in mid-2023, we identified a U.S. life insurance company, which was part-owned by a PE company, as a potential candidate that the PE firm could fully take over. This happened in late 2023, driving spreads significantly tighter.[2] We see similar consolidation opportunities among triple-net lease REITs.

2. Source: Global Atlantic. As of January 2024.

"History shows that the total return potential for the asset class is attractive following the end of central bank rate-hiking cycles and ahead of rate cuts."

Another opportunistic theme is in 'crossover credits', which have generated 57% higher cumulative returns and have outperformed the broader IG index in seven out of the last 10 years (Figure 3). These "rising stars" and "fallen angels" are companies poised for upward migration in credit ratings and those expected to see a downgrade from IG to high yield. Rising stars tend to outperform six months prior to upgrade. Here, we see some opportunities in the energy sector currently. Meanwhile, fallen angels typically widen by 180 basis points (bps) six months prior to a downgrade, but quickly bounce back and tighten by around 60 bps after the downgrade.[3] A recent example of a fallen angel is Paramount Global. It was downgraded in early 2024, and we took advantage of the spread widening and now expect the high yield investor base to drive the spread tighter.[4]

Figure 3: Crossover Credits: Potential to Deliver an Enhanced IG Portfolio

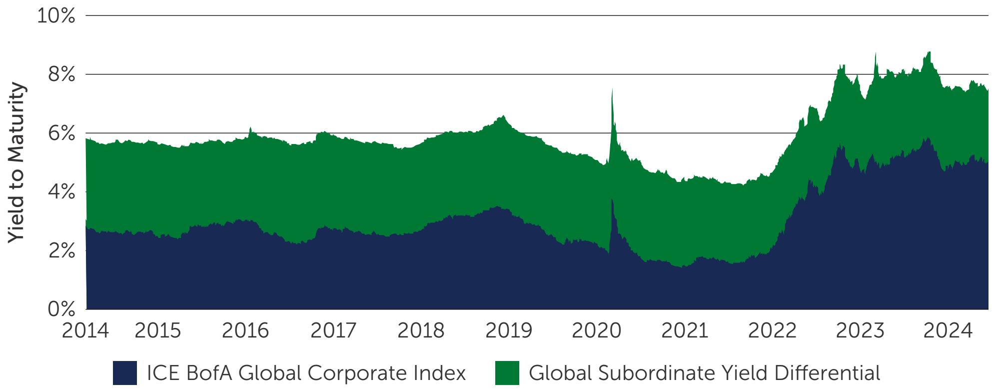


Sources: Barings; Bloomberg. As of June 30, 2024. For illustrative purposes only.

Additionally, in the bank and utility sectors, there are opportunities in 'capital-structured trades', which offer potential spread pickup as issuers adjust their capital structure and buy back bonds (Figure 4). In particular, we see numerous shorter-duration AT1s and preferreds that we believe have a high probability of being called over the next two years. There are also relative value opportunities across an issuer's capital structure, created by the spread differential between the subordinated debt and the senior debt. For example, in the European utilities sector, many of these high-quality and defensive companies issue hybrid securities, which have historically offered substantial spread pickup.

3. Source: J.P. Morgan. As of June 30, 2024.
4. Source: S&P Global. As of March 27, 2024.

Figure 4: Global Subordinated Bonds Have Historically Offered a Yield Advantage Over Global Corporate Bonds



Sources: Barings; Bloomberg. As of June 30, 2024. For illustrative purposes only.

Those are some interesting themes indeed, but when combined, do they result in a more aggressive approach to IG credit investing?

Stephen Ehrenberg: In our view, they do not. These are four areas of inefficiencies we are looking to exploit, but they do not constitute the entire portfolio. These inefficiencies are layered on a bedrock of high-quality, IG-rated corporate bonds. We believe this approach will serve as a highly diversified, core fixed income building block for asset allocators. We expect this strategy will function as ballast and diversify against riskier allocations, while offering the potential for compelling yield pick-up versus government bonds.

When it comes to investing in IG credit, what are some of the differentiating factors investors should look for in a manager?

Natalia Krol: Despite the supportive macro environment, there are several risks ranging from elevated geopolitical tensions to the impact of elections globally, which could drive spreads wider. Consequently, taking a fundamental, bottom-up approach to credit investing, while being open to opportunistic and idiosyncratic opportunities, is paramount.

This is why at Barings, we take a research-oriented, team-based approach to generating investment ideas, with rigorous risk management at all stages. The result of this is a strong track record and rich legacy in managing IG credit over four decades and through multiple credit cycles. While we began managing assets in the 1990s on behalf of our parent company, MassMutual, we have since grown to manage over $61 billion of global IG credit, leveraging our deep bench of investment resources across the U.S., Europe and Asia.

5. Note that there is no guarantee the target return will be achieved.

What are the key highlights of the new Barings Global IG Credit Strategy?

Natalia Krol: Over the years we have delivered innovative, customized solutions designed to meet our institutional clients' long-term objectives. This strategy aims to bring our innovative approach to IG credit investing to a broader global investor base.

The SFDR Article 8-rated strategy seeks capital appreciation through fundamental, bottom-up credit selection in global IG credit markets and is benchmarked to the Bloomberg Global Aggregate Credit Index. It aims to generate around 100 bps of alpha over the index, over a market cycle. The portfolio will be IG average rated at all times, with below IG-rated holdings capped at 10%. The latitude to own up to 10% below-IG prevents investors from becoming forced sellers in times of stress. Nominal allocations to CLOs and CoCos are expected from time to time, both capped at 10%. In addition, the strategy will aim to be highly diversified, with no single theme, trade or idea dominating potential returns.

Barings Investment Grade Credit

MANAGING INVESTMENT GRADE SINCE THE EARLY 1990s THROUGH MULTIPLE CREDIT CYCLES AND PERIODS OF VOLATILITY

30+	17	$106 B	59+
Dedicated IG Investment Professionals	Years Average Industry Experience	AUM Across Corporate & Securitized Credit	Global Credit Analysts Collaborate with our Dedicated IG Analysts to Identify Best Opportunities

Source: Barings. As of June 30, 2024.

Barings is a $409+ billion global asset management firm that partners with institutional, insurance, and intermediary clients, and supports leading businesses with flexible financing solutions. The firm, a subsidiary of MassMutual, seeks to deliver excess returns by leveraging its global scale and capabilities across public and private markets in fixed income, real assets and capital solutions.*

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**As of June 30, 2024*

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