CAMRADATA
A With Intelligence Company

Credit Opportunities Whitepaper

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+44 (0)20 7832 6517
info@camradata.com
LinkedIn
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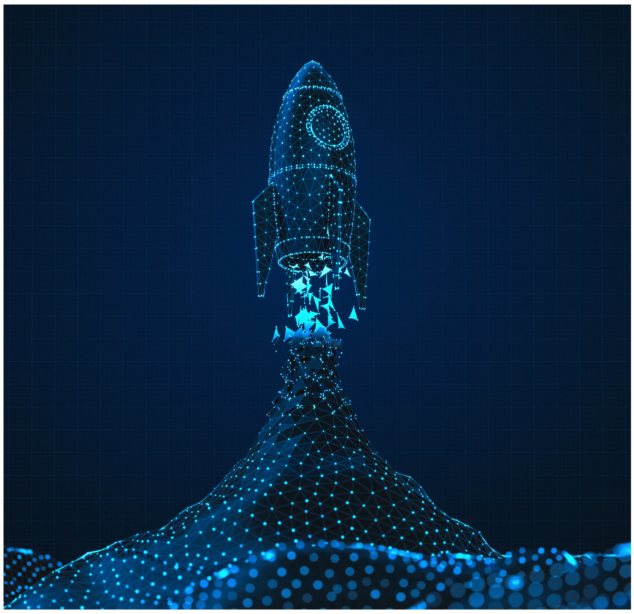

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Welcome to CAMRADATA's Credit Opportunities Whitepaper

Credit has traditionally been the dull cousin of equities. That relationship changed this century as the opportunities for institutional investors in credit have expanded. It is now possible for investors to earn income from car loans, music royalties, underwriting banks and hurricane insurance. Expansion has in part followed regulators' clamping down on the equity risk carried by Defined Benefit pension schemes. In part the expansion has been caused by another form of regulation: banks' diminishing role as lenders of first resort to SMEs.

In combination these two trends have seen pension schemes shift materially from ownership of assets (equities) to lending (credit). After a terrible year for most asset classes in 2022, the question is now how to achieve diversification within credit. It is no longer a cushion for volatile equities but the dominant return-seeking class for many pension schemes, as their asset mix more resembles insurance. Proponents of private debt argue that they provided a safe haven last year in contrast to public bond markets. Managers in public debt counter that the illiquidity and complexity premiums of private debt are just blindfolds over clients' eyes.

Most managers in both camps agree, nonetheless, that duration in these uncertain times is not a good thing, which puts the emphasis on credit selection. That means understanding the resilience of borrowers' business like never before.

We may have the 'income' back in fixed income but it is not the dull asset class it once was.

Meet the Team

Sean Thompson
Managing Director

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Sam Buttress
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

Orin Ferguson
Associate, Business Development

Credit Opportunities Roundtable

The CAMRADATA Credit Opportunities Roundtable took place in London in April 2023

The 2023 CAMRADATA Credit Opportunities roundtable found active credit asset managers confident that this year's volatility, on top of a harsher borrowing environment and persistent inflation, are 'perfect storm' conditions from which they can profit. Consultants and asset owners shared enthusiasm for some opportunities in both public and private markets, although one type of investor, UK Defined Benefit (DB) pension schemes, is more likely to be derisking as conditions for buy-out are reached.

The Roundtable began with the views of owners and consultants. Michela Bariletti is chief credit officer at Phoenix, the UK's largest long-term savings and retirement business, with c.£260bn in assets under administration, as at the end of 2022. Of that, c.£40bn is in shareholder funds of which c£31bn is in credit, comprising both liquid and illiquid credit.

Bariletti told the CAMRADATA roundtable that in public credit, Phoenix sticks to Investment Grade, with only a modest allocation to BBB because "we favour those stronger credits that have resilience to external challenges, such as higher energy costs, higher wage bills, slower supply chains." The current Solvency II requirements support this and also require a much higher capital buffer for High Yield to make it worthwhile. Within Investment Grade, Phoenix is looking for stable, long-term cashflows.

Regarding opportunities in Private Credit, which accounts currently for about £8bn or 20% of all shareholder funds, Bariletti said there are certain sectors and maturities available in Private Markets that are not accessible via Public Markets. Having said that, Phoenix takes a Relative Value approach, so exposures will vary depending on conditions in both fields. So far this year, for example, Phoenix's deployment into Private Credit has been super-selective, declining more than 90% of transactions reviewed, of which 50% of opportunities were declined on inadequate pricing, in part because of fears of locking in inadequate returns in Private Credit when returns were improving from fast-changing Public Markets. "There is now income in fixed income," she joked.

Stuart Tipton, associate partner at Aon, said UK corporate DB pension fund clients were still digesting the revaluation of fixed income after last September's gilt crisis. "Going forward, we would expect credit to form a bigger part of clients' portfolios, especially given the increased collateral requirements under 'LDI 2.0'," he said. "This will mainly be through increased allocations to liquid credit as settlement terms on funds will need to be at-worst weekly to meet these requirements."

Tipton added that Aon has seen Diversified Growth Funds lose assets and reckoned that in the short-term at least, the scope for illiquid asset classes was lower, given the percentage weighting of these in pension schemes' growth portfolios has increased. He did note that there was still an ability to supplement returns by moving down the credit spectrum where liquidity requirements are still being met.

> ***"Going forward, we would expect credit to form a bigger part of clients' portfolios, especially given the increased collateral requirements under 'LDI 2.0"***

Following the tumult of last year, Tipton explained that clients needed to allow for gilt market volatility to subside and allow for further direction from the regulatory bodies and LDI managers under the new framework. "We would expect the majority of portfolio moves on new credit opportunities would take place this year," he said.

Vijay Padmanabhan, managing director of private credit manager research at Cambridge Associates,

an investment management firm, explained that there are three distinct types of client portfolio: pension schemes, endowments and foundations and family offices. While UK pension schemes are on a pause, as noted by Tipton, Cambridge Associates has seen an increase in appetite from their other client portfolios for many types of private credit: direct lending, speciality finance, operational leasing, royalty streams, litigation financing.

Padmanabhan surmised that these could go into a diversifying bucket, worth 3-5% of total assets. He said commitments were being funded by reallocation from Private Investments, not just from Investment Grade and High Yield.

For XPS, a consultancy to UK pension funds and charities, Steven Hickey, head of credit research, said that across its client base, credit allocations on average consisted of 70% in IG, 20% in High Yield, Emerging Markets or securitised debt, and 10% in illiquids.

Like Tipton, Hickey said that driving allocations to public credit were strong tailwinds, including the need to derisk to lock-in funding level gains made over the last year or so; an increased need for liquidity; and the new draft Funding Code for UK pensions. “Pension funds are in a position where that need for liquidity is likely to come at a much faster pace,” he said.

On illiquids, Hickey said although there is likely to be an overall reduction, private credit and direct lending still have a role. He sees less of a role for equity-like private assets, however, and expects the number of new allocations to these assets to fall further.

Tipton agreed that even when fully funded, some schemes might seek alternative endgame solutions rather than going to buyout “Without growth, there may not be capacity in the buyout market for all corporate DB pension schemes,” he noted.

Managers Respond

The managers at the CAMRADATA roundtable then responded. For Premier Miton, head of fixed income, Lloyd Harris’ opinion was that right now public markets in the UK make a lot of sense whereas Private Markets made less. “There are high single-digit returns from IG currently right now,” he said. “There has been this risk, but now there is enough money to absorb all the credit, so there is more money flowing into that part of the market. People are looking for liquid assets, so it becomes self-fulfilling.”

Premier Miton has four credit strategies: IG, Strategic, Financials and Money Market. “We work them all quite hard – the IG and Strategic typically have a 300-500% annual turnover,” said Harris.

The Financials strategy includes Contingent Capital (CoCos), where Harris saw very good opportunities in the aftermath of the Credit Suisse crisis. “When the asset class gets stressed, it’s always a good entry-point. You’re looking at 13.5% to call and 10% to provide. That’s the bonus, not the cover rating.”

Harris explained that contrary to some perceptions, CoCos are a very liquid part of the credit market, particularly in dollars and euros. “There is real market depth due to the involvement of major investors such as Sovereign Wealth Funds, private banks, hedge funds and

> *"We are buy and hold: you keep in the back of your mind that you don't want to be in a fire sale"*

real money asset managers, which allows us to be dynamic," he said.
He distinguished between financial-sector specialists and "tourists" who do not fundamentally understand all the conditions of what they are buying. "The team with me at Premier Miton has long experience," said Harris. "Rob James, who co-managers the CoCos fund, has covered financials' equity and credit for 35 years. Simon Prior used to work for Old Mutual treasury before becoming a corporate credit and insurance analyst."

Adam Phillips, head of BlueBay Developed Markets Special Situations ("DMSS") debt, then explained his team's approach. "On the liquid side, we buy stressed bonds we just think are intrinsically good value but for idiosyncratic reasons they have dropped in value, from par to 50-75c typically. For more distressed situations, we are buying in the 20c-50c range. In these situations, we roll our sleeves up and can end up owning part of the company via the back door, ie. buying from . administrators."

This describes the existing investment strategy, with names coming from High Yield and Leveraged Loans markets, although some from IG. From the private side, Phillips said opportunities were coming from all over the place, including banks. "The banks are in a different place," explained Phillips. "They have slimmed down their work-out departments. They are penalised more these days for Non-Performing Loan books. So they sell more quickly than before."

Phillips is now raising capital for a fund more focused on illiquid opportunities. "We are making excellent returns in our existing liquid special situations fund. But the one thing we cannot do in this fund is longer-term, more illiquid investments," he explained. "Clearly, we would expect to make even higher returns in the illiquid fund but either way, in the liquid or illiquid fund, there is a great opportunity for investors to improve portfolio returns by adding special situations exposure."

Harris countered with two more Premier Miton credit strategies. The first is in short-dated credit where Harris noted that there are hundreds of bonds to choose from just a single issuer like Barclays – in contrast to their equity or many issuers in private market deals.

Moreover, in the current macro-environment, Harris said that you can earn 8% for a duration of 1.5 years. "Short-dated credit is a pure form of our expression on the markets. It is very hard to make the case right now to go out of the credit curve and to take the additional credit duration."

The other product Harris mentioned was a money market fund with a Weighted Average Life of c.100 days, currently yielding 5%. "That's not a bad return for money markets," he said. "There are dislocations at the short end. For example, we picked up a one-month Close Brothers senior IG credit at 9%."

Phillips then introduced the challenge of inflation. He asked whether consultants and asset owners think in terms of real rates or just nominal.

Tipton responded that Aon's clients hedge both the nominal and inflation exposures via their LDI managers.

Bariletti agreed.

Tipton asked her whether Phoenix had used any structured solutions to provide more certainty within its Relative Value policy between Public and Private Credit.

Bariletti responded that Phoenix did, but not so actively. "We structure ourselves for the balance sheet to make capital more efficient, specifically seeking out inflation-linked asset cashflows to match our inflation-linked liabilities." Bariletti mentioned Credit Tenant Lease transactions and income strips as examples. That will grow as the inhouse capability develops.

This time feels different

On the conditions for distressed debt specialists, Phillips reckoned this time feels different because the world seems to be stumbling from crisis to crisis. "It's a perfect storm for corporates," he explained. "They were highly levered before COVID 19, then borrowing to survive, so even more highly levered coming out of the pandemic. There was a perception that the world would bounce back to 2019 levels but many sectors - leisure, food & beverages, entertainment - were hit by inflation, wage demands and higher interest rates. The difference from previous crises is that this time multiple sectors have been affected at the same time: for instance, the many industries which have high energy usage. We have a war going on in Ukraine and just recently a mini-banking crisis."

For BlueBay DMSS, the upshot is that one year ago it had 80 names in our deep dive universe. Now it has 300. "That gives you a sense of how much is out there," noted

Phillips. He added that he doesn't get much push back from clients on the opportunity set. "Central Banks have thrown money at the problem for the last 14 years. Quantitative Tightening began prior to COVID but then stopped. "The excess has to now unravel," he said. "Rates are not dramatically high – mortgage rates were 14% when I started in the 1990s - but we accept that higher inflation means rates could go up."

Padmanabhan noted that a huge maturity wall is due in the next three years, 2024-6. He pondered how it was going to be addressed.

Quality avoids risk

Harris followed Padmanabhan's query by questioning why investors would want to take on credit risk. Harris argued it was far better to stay high quality, doubting that private credit was as insulated from public credit as some claimed.

Bariletti agreed. "They are not mutually exclusive. If you are an asset manager, there are challenges in raising funds. For asset owners, we look at illiquids or private credit but are very conscious of relative value." She stressed flexibility. "Every time we price a transaction, our measure of success is whether you are able to price a Bulk Purchase Annuity, given that you can typically generate a 60-70 bps illiquidity premium on these private credit portfolios."

Bariletti added that Phoenix was well positioned through the LDI crisis. "We are buy and hold: you keep in the back of your mind that you don't want to be in a fire sale," she said.

Tipton said that for Aon clients, there were tactical constraints, given relative value between public and private at different points in the cycle. "We would focus on how markets price illiquidity premia over a longer time horizon as timing these points is often challenging for clients," he said.

In Aon's fiduciary management, Tipton said that at the current time the main tactical view in credit is to use Asset-Backed Securities (ABS) for spread pick-up versus equivalent corporate credit and because the floating-rate characteristics made the asset class attractive ahead of a rate hiking cycle. In contrast to ABS, other credit assets like Leveraged Loans, Tipton saw falling between two demands: they are not liquid enough for collateral but neither are they "illiquid". He added that within fiduciary, return-seeking portfolios have been maintaining an allocation to liquid alternatives for diversification benefits and to achieve absolute returns, given valuations of traditional market betas prior to 2023.

For XPS, Hickey said that managers with exposure across a broad spectrum of credit were normally sufficient compared to standalone specialist strategies, although the broader manager could sub-allocate to specialisms. XPS itself does not manage or oversee a fund of credit opportunities fund; nor does it take tactical allocation decisions. The argument rests on the fact that managers are closer than consultants to the markets, although Hickey said markets are difficult for anyone to call. "There have been times in the past where it has looked like a large distressed market opportunity was on the horizon, but this hasn't materialised e.g. with the onset of COVID in May 2020, until Central Banks stepped in."

Hickey reiterated Tipton's point that for DB pension schemes the credit spread over gilts is the focus. He noted however that higher overall yields benefit through higher income payments and also a cheaper entry-point for those looking to invest. On private markets, Hickey admitted that pension trustees are not set up like Phoenix to act on relative value opportunities in this universe and therefore often delegate this to a manager.

Phillips said that even within private markets, there is undue attention on larger deals when there was so much more going on in the mid-cap and smaller tiers than "the market" perceives.

Bariletti agreed with Phillips. "There is no analyst coverage of the European mid-market in bank lending," she noted. "Ratings agencies do not have product, even for Germany's Mittelstand. We are talking about businesses with an Enterprise Value greater than E500m."

Bariletti said that the result is that ratings of mid-sized credits tend to be overgenerous and not reflective of their relative vulnerability and lack of access to wider capital markets than larger enterprises.

The managers nevertheless felt that one popular sector had been overbought and was vulnerable: direct lending. Phillips likened the credit testing of many investment platforms matching lenders and borrowers as "black boxes". He said that visibility was lacking and observed that almost all of the loans are to mid-market firms, making the portfolio less diversified and many of which have experienced challenges. "Although some managers will have the ability to deal with problematic loans, this will not always be the case," said Phillips. "From the outside, it is difficult to know how many problems the direct lenders will encounter. Intuitively, I would expect lots of these mid-market companies to experience problems, but to be fair, it is probably also the case that the direct lenders may have done a better job of underwriting their loans than the banks, and may be more inclined to lend new money into problem situations than the banks."

Harris was more frank: "It's a good time to get out of direct lending." Phillips then gave an example of how the

“Padmanabhan added that private markets give an alternative means of hiding from volatility. He said that sometimes having just one borrower, one sponsor and maybe even just one lender, could be a more efficient route to solve stressed situations than a public issue with 15 interested lenders”

DMSS team works with distressed enterprises. “A year and a half ago, we owned two offshore construction vessels. The company had a $120m bond issue and the bonds were trading at 16 cents on the dollar. Effectively we created the vessels for $19m versus a professional valuation that was undertaken at the time of the purchase of $80m.” The BlueBay team’s own assessment was that it would recover 10% on the bonds even if the vessels were scrapped (which was never going to happen). The vessels have now been sold and DMSS will have recovered 120 cents on the dollar. Bariletti added that the probability of default was already priced in at 16 cents.

The CAMRADATA roundtable then reverted to contingent capital instruments (CoCos) and the mini banking crisis. Harris was asked whether investors have to stomach a bit more volatility to get the attractive returns from CoCos. He responded that the volatility was symptomatic of the tradeability of these instruments, i.e. a good thing, and reiterated that the key was to know what you were buying.

“You don’t get that same degree of transparency with High Yield,” he noted. “In a crisis like March 2020, there were gaps of 20 points between what the screen told you and the actual price to trade. In periods of stress, smaller bonds won’t even trade at all.”

Padmanabhan added that private markets give an alternative means of hiding from volatility. He said that sometimes having just one borrower, one sponsor and maybe even just one lender, could be a more efficient route to solve stressed situations than a public issue with 15 interested lenders. He agreed with the rest of the table that the next 12-18 months look difficult at the macro level. Harris described it as a slow-burn default cycle and Padmanabhan reckoned things are going to be bad for all credit. He questioned who was best positioned to handle that. “Large lenders, on multiples of four or five times EBITDA, have enough of a cushion to keep the business going through tough times,” he said.

Looking at the broader, deeper trend of private-equity buyouts, growing the possibilities for private lending, he cautioned that asset owners needed to see defaults coming through before committing significantly to special situations and distressed strategies.

Padmanabhan made the point that private credit focused more on sectors such as healthcare, technology and business services, rather than being caught up in the uncertainty of consumer spending.

He also reiterated the attractions of speciality finance such as royalties or asset backed, litigation financing, noting that these offered decent distribution and described them as non-correlated.

The CAMRADATA roundtable closed with Hickey endorsing one stream of opportunities in private markets – secondaries. He noted that the gilts crisis had seen some Limited Partners, i.e. pension funds, selling private assets at considerable discounts. XPS believe this selling pressure will continue, albeit at a slower pace, and will provide an additional strong tailwind to an already attractive market for those pension schemes who are willing and able to participate.

Roundtable Participants

Adam Philips

Partner, Head of DM Special Situations

Personal Profile

Adam Phillips joined BlueBay in October 2020 as Head of Special Situations within Developed Markets. Adam has 30 years' experience in special situations and distressed investing having previously been Head of Investments at Blantyre Capital, European CIO of Marathon Asset Management and Head of European High Yield & Distressed at Lehman Brothers.

Prior to that, Adam was Head of the Asian Distressed team at Standard Bank and he started his career at British & Commonwealth Merchant Bank in structured and property finance.

Adam holds an MPhil in Land Economy from Cambridge University and BA in Economics from Heriot-Watt University.

Company Profile

RBC Global Asset Management (RBC GAM) offers a comprehensive range of investment solutions and services to clients and investors. We operate as a global firm of specialised investment teams, with localised expertise – including our fixed income platform BlueBay – with more than US$390 billion in assets under management as of 31 December 2022.

In addition to broad-based capabilities in equities, credit, liquidity management and alternatives, we have expertise in ESG-integrated, and impact investing strategies, enabling us to respond to a full range of client requirements around responsible investing.

RBC BlueBay Asset Management represents RBC GAM outside North America, and collaboration is the cornerstone of our business. We aim to make life easier for clients and seek optimal outcomes through partnership, transparency, and engagement.

Being part of RBC, the large global bank, provides financial stability, security, and scale, enabling us to invest in top quality proprietary research, advanced IT platforms and ESG practices, which provides comfort to clients and supports our growth.

Lloyd Harris
Head of Fixed Income

Personal Profile

Lloyd Harris joined Premier Miton in August 2020. He was previously at Merian Global Investors (2012-2020), where he was manager of the Merian Corporate Bond Fund and co-manager of the Merian Financials Contingent Capital Fund.

He has also worked at Cutwater Asset Management (2007-2011), initially as an asset-backed CP/MTN trader, then as a European financials credit analyst, and before this, he worked in structured capital markets at Deutsche Bank (2002-2007).

Company Profile

Premier Miton Investors is an active investment manager, with capabilities across equities, fixed income, multi-asset and absolute return strategies.

Our culture provides a platform for our investment teams to flourish and perform. We are independent thinkers, unconstrained by a house view. We take our role as stewards of assets very seriously, and focus on responsibly allocating capital, engaging with companies and considering our impact. We are active members of responsible investing initiatives including Climate Action 100+, the Investor Forum and the Carbon Disclosure Project (CDP). Additionally, we are signatories to the Financial Reporting Council's UK Stewardship Code and the UN's Principals of Responsible Investing.

Our institutional strategies encompass:

1. Sustainable Equities (Global, UK & Europe)
2. Financials Capital Securities (Cocos)
3. Small Cap (Global, US & UK)
4. European Opportunities
5. US Opportunities
6. Corporate Bonds
7. Strategic Bonds

Premier Miton
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Roundtable Participants

Stuart Tipton

Associate Partner Fixed Income Manager Research

Vijay Padmanabhan

Managing Director, Private Credit

Personal Profile

Stuart serves as a Associate Partner in Aon's Fixed Income Investment Manager Research team. He is responsible for sourcing, evaluating, conducting due diligence, and monitoring Fixed Income Funds on a global basis across both liquid and illiquid solutions.

He holds a BSc (Hons) degree from Loughborough University and is a CFA charterholder.

Personal Profile

Vijay is a Managing Director at Cambridge Associates and leads the manager research for European private credit. Vijay has over 15 years of experience as a credit investor. He helps lead the firm's private credit efforts in Europe, performing due diligence on investment opportunities in credit, special situations, and distressed markets. Vijay is based in London.

Prior to joining CA in July 2022, Vijay spent 15 years in credit investing, most of which was in London. Vijay also spent a couple of years in Mumbai and Hong Kong investing in credit markets in the Asian region. During his career in investing, Vijay deployed over $5bn across various types of credit – both public and private - across credit cycles. Vijay worked on credit teams at Citigroup, Post Advisory, Fidelity and KKR. He has held a number of senior roles on credit committees, including overseeing restructuring situations across different jurisdictions.

Previously, Vijay was a Partner at PwC leading restructuring efforts in India, where he managed one of the largest insolvencies in the country.

AON

CAMBRIDGE ASSOCIATES

Michela Bariletti

Chief Credit Officer

Personal Profile

Michela joined Phoenix Asset Management as Chief Credit Officer in May 2021. In this role, Michela is leading the Credit Research and Ratings team for all asset strategies pursued by Phoenix Group, which have capabilities to assign internal ratings to private credit and illiquid assets in an approach consistent with industry peers and adhering to regulatory requirements.

Michela joined Phoenix from Pension Insurance Corporation where she served as Head of Ratings and Credit Research. Prior to that, Michela spent 14 years at S&P Global Ratings, London, most recently as Senior Director, Infrastructure Ratings – EMEA Analytical Head, managing a team of 20 analysts and a portfolio of over 150 issuers in the infrastructure sector. The portfolio included corporate and project finance transactions covering social infrastructure, road, transport and renewables. Michela started her career at Goldman Sachs within the Equities Division. She holds a DEA en Analyse et Politique Economique (Master in Economics) from EHESS, Paris and a Specialization in Finance as a Ph.D. candidate from HEC, Paris.

Phoenix

Steven Hickey

Head of Credit Research

Personal Profile

Steve leads XPS's Credit research and, more generally, works with the Chief Investment Officer to drive forward XPS's research efforts across the team. As such, he has vast research experience across the key public and private asset classes utilised by UK DB pension schemes. Alongside his research responsibilities, Steve is responsible for the day-to-day management of a handful of trustee clients, advising them on a full range of investment related matters.

Steve joined XPS in 2015. He is a CFA Charterholder and holds the CFA UK Level 4 Certificate in Investment Management (formally IMC).

XPS Investment

Moderator

Brendan Maton
Freelance Journalist

Personal Profile

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

The case for CoCos

Premier Miton
INVESTORS

We believe now is an opportune time to consider an allocation to Contingent Convertible bonds (CoCos). The asset class offers diversification versus traditional fixed income strategies and provides access to a high yielding pool of bonds, with the backing of predominantly investment grade national champion banks and insurers. The rising rate environment is a strong positive for the profitability of the banking industry.

“Our competitive advantage lies in the combination of our ability to identify quality and the security of coupon streams, overlaid with tactical positioning”

Profitability and capital in the banking sector is moving in the right direction. It is said that the banking system offers a leveraged exposure to the economy. This is true, but to a far lesser extent than in the past. Balance sheets have transformed in strength (see example on the right), but also in composition, with many of the opaque structured assets now gone.

For more than a decade, the returns in the banking sector have been depressed by low interest rates. These were further hampered by the need to build capital levels and pay fines for prior misconduct.

These substantial headwinds are now in the past – capital levels are high and above requirement, and the large conduct fines are behind us. Most importantly the interest rate environment is changing, and for the banks this is for the better.

For insurers too, higher rates allow for the reduction in the value of their future liabilities.

As interest rates rise, banks will once again be able to earn a profit from the substantial deposit balances on their balance sheets. While rates have been low, this has not really been possible.

Already, very early in the rate cycle, banks are reporting a widening of margins. Profitability is the first line of defence against coupon defaults. Capital is the second. Both are moving in the right direction.

Author:

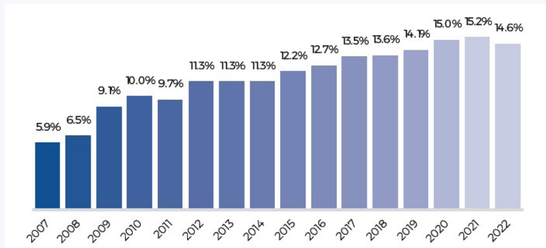
Lloyd Harris
Head of Fixed Income

Balance Sheet Improvement

The core measure of a bank’s balance sheet strength, and hence the security of any bonds issued by the bank, is its common equity tier 1 ratio. The progression in that ratio is shown below:

European banks - CET1 ratio evolution

Banks’ capital buffers rose significantly in the aftermath of the financial crisis, giving them a much safer footing to weather a future storm.



Source: Company data and Citi Research estimates. Aggregated data for banks under Citi coverage. 2020, 2021 & 2022 based on the results of banks comprising 81% of the CoCo universe by AT1.

Pre-global financial crisis the ratio was below 6%, and the way it was measured benefited the banks relative to current methodology. Another key improvement is liquidity – that is the proportion of a bank’s balance sheet that can be turned into cash to satisfy depositors’ withdrawals - which is now strongly regulated. In short, balance sheets have undergone a complete transformation.

Premier Miton INVESTORS

As well as offering a high yield, CoCos also exhibit a relatively low volatility versus equity and strong diversification versus other asset classes, including government bonds.

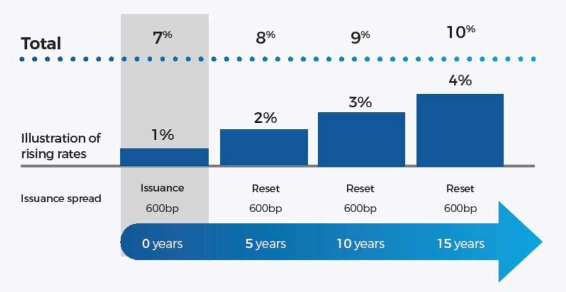
Premier Miton Financials Capital Securities Fund

7.6% Distribution yield1
6.8% Underlying yield1
14.0% Yield to call2

The bonds are perpetual, but have regular call dates. At the call date, if the bond is not called, the bond coupon resets to its issue spread above the current level of reference interest rate. In this way they offer, at least partially, a hedge against rising rates. Their diversification credentials against other assets are shown in the table below:

CoCos: yield, low volatility & diversification

As interest rates rise, fundamentals for banks improve (they reprice loans faster than deposits). CoCos are more correlated to equities than government bonds.



The chart above is for illustrative purposes, to show the effect of a hypothesized rising rate scenario.

Source: 1Premier Miton, as at 30.04.2023. Class C accumulation shares. The Distribution Yield reflects distributions amounts that may be expected to be distributed over the next 12 months as a percentage of the fund price as at the date shown. The Underlying Yield reflects the annualised income net of expenses of the fund (calculated in accordance with relevant accounting standards) as a percentage of the fund price as at the date shown. It is based on a snapshot of the portfolio on that date. Investors may be subject to tax on distributions. The Distribution Yield is higher than the Underlying Yield because a portion of the funds expenses are charged to capital. This has the effect of increasing the distribution(s) for the year and constraining the fund's capital performance to an equivalent extent 2Bloomberg, data as at 30.04.2023. Yield to call is the return received if the bond is held until the call date, which occurs sometime before it reaches maturity. This is calculated as the compound interest rate at which the present value of a bond's future coupon payments and call price is equal to the current market price of the bond. Past performance is not a reliable indicator of future returns. The yield is not guaranteed and will fluctuate

Correlation of CoCos to other key asset classes

	ICE BofA Contingent Capital Index	ICE BofA US High Yield Index	S&P 500 Total Return Index	FTSE Eurofirst 300 Banks Index	ICE BoA US 5-7 Treasuries Index
ICE BofA Contingent Capital Index	1				
ICE BofA US High Yield index	0.53	1			
S&P 500 Total Return Index	0.24	0.58	1		
FTSE Eurofirst 300 Banks Index	0.51	0.45	0.41	1	
ICE BoA US 5-7 Treasuries Index	0.05	0.32	0.10	-0.19	1

Source: Bloomberg, data from 30.04.2021 to 30.04.2023. ICE Data Indices, LLC is used with permission.

Premier Miton's fixed income managers have combined experience in analysing banks of over 40 years, spanning several economic cycles and more than one crisis. This gives them the perspective to see how changing rate and economic environments will affect bank and insurer profitability.

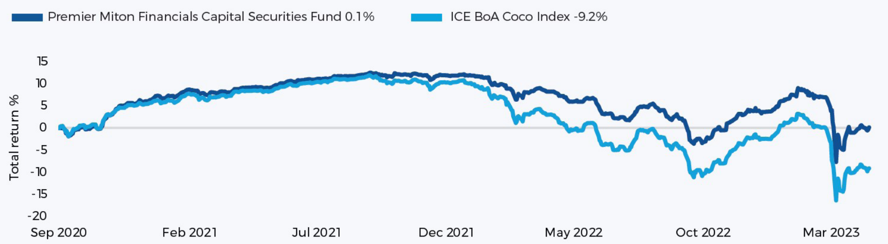
The CoCo opportunity

In our opinion, recent price falls in markets reflect an out of date view of bank fundamentals. In the past, a looming recession would come after a period of excess, with high loan growth at low levels of credit scrutiny, leaving the banks with low levels of liquidity and stretched capital ratios. A wave of bad debts would topple weaker banks and seriously wound others. This scenario is not the current situation. There has been little lending growth for several years. Indeed, over the pandemic period, thanks to furlough schemes, consumer balance sheets have been strengthened, with large unsecured debt repayment. Weaker corporates did borrow, butthrough government guaranteed schemes, leaving the banks with little risk. As shown earlier, capital levels have not been stronger, and the first line of protection, profit, is growing. We feel that the price falls in bank shares and bonds belong more in the past than the present, and so offer a significant opportunity for the investor.

The Premier Miton edge

Our competitive advantage lies in the combination of our ability to identify quality and the security of coupon streams, overlaid with tactical positioning. Banks and insurers must have high levels of capital above minima, and strong distributable reserves. Positioning on the credit curve is altered depending on macro economic and market conditions. For example, most recently given the change in the interest rate environment and subsequent credit spread volatility, duration to call on the portfolio has been shortened, thus helping to reduce the impact to investors of price volatility.

Premier Miton Financials Capital Securities Fund performance since launch 14.09.2020

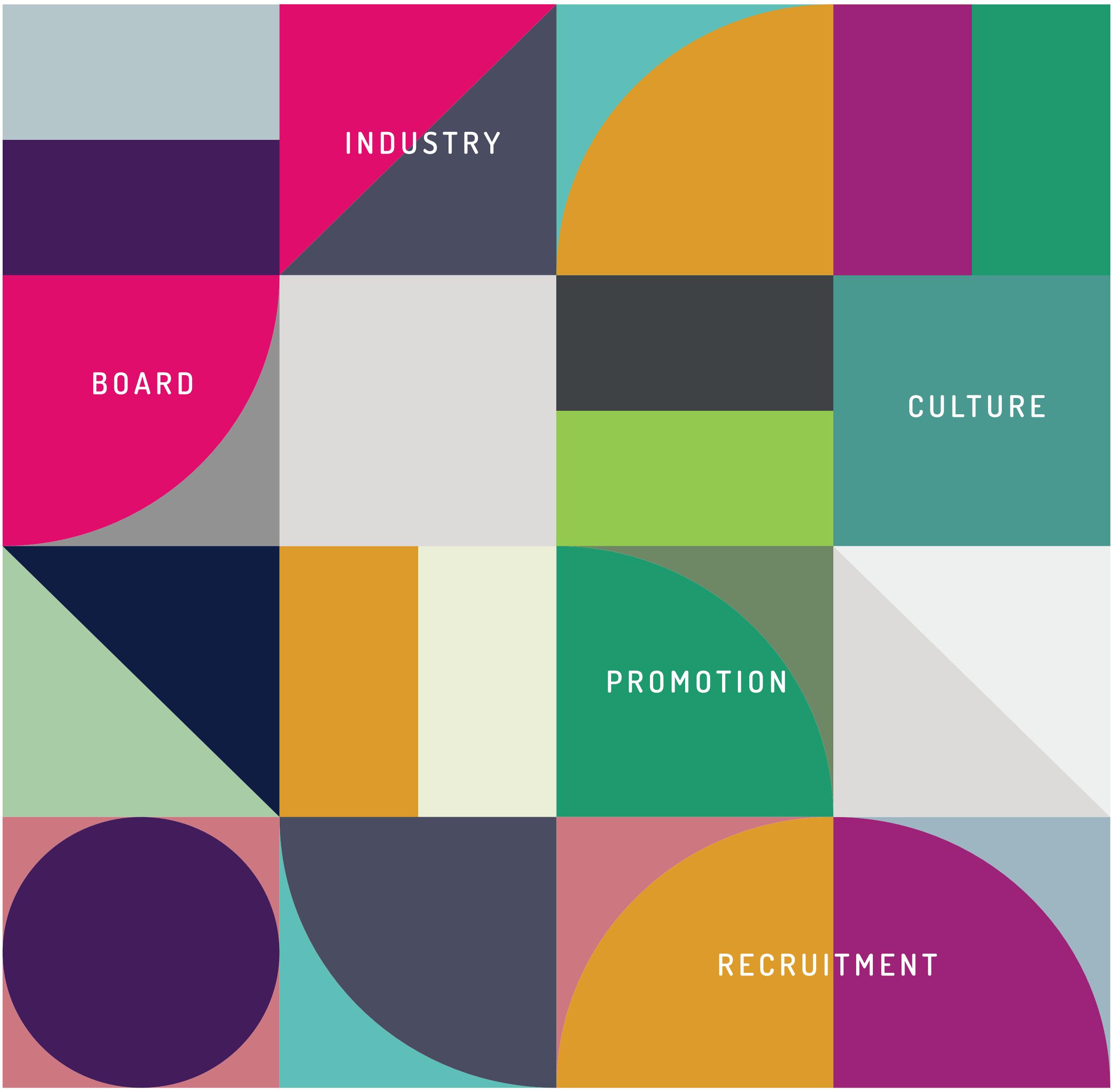


Calendar year performance (%)	Since launch 2020 [1]	2021	2022	2023 YTD[2]
Premier Miton Financials Capital Securities Fund	6.4	5.3	-7.4	-3.5
ICE BofA Contingent Capital Hedged GBP	5.7	4.7	-11.9	-6.8

Performance source: FE Analytics. Based on UK Sterling, class C accumulation shares, on a total return basis to 30.04.2023. Performance is shown net of fees with income reinvested. 1Data from 14.09.2020 to 31.12.2020. 2Data to 30.04.2023. Please note that the full five years of performance is not available as the fund launched on 14.09.2020. This fund is priced on swing pricing basis, which is where the price can swing to either a bid or an offer basis depending on the investment and redemption activity in the fund. Past performance is not an indication of future returns.

Risks

This fund may experience high volatility due to the composition of the portfolio or the portfolio management techniques used. The value of stock market investments will fluctuate, which will cause fund prices to fall as well as rise and investors may not get back the original amount invested. Funds that have a strong focus on the financial services sector can carry a higher risk than funds with a more diversified portfolio. Securities with loss-absorbing features may be subject to regulatory intervention and / or specific trigger events relative to regulatory capital levels falling to a pre-specified point. This may result in their conversion to company shares, or a partial or total loss of value.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What factors are generating a surge in special situations opportunities?

"Corporates are facing a range of challenges that are very much to the benefit of special situations investors because the scale of the opportunity set is growing dramatically"

Author:

Adam Phillips
Partner, Head of DM Special Situations

High levels of leverage, rising interest rates, changing consumer behaviours and the geopolitical situation have created a perfect storm for corporates. We spoke to Adam Phillips, Head of BlueBay DM Special Situations, about how these factors are generating a surge in special situations opportunities.

Q: How is today's macro environment impacting corporates?

Corporates are facing a perfect storm. Most companies in the high-yield bond, leveraged loan and public credit markets went into covid with higher levels of debt than had been the norm for the preceding few decades. They then had to borrow more money to survive, which led to whole sectors emerging from the pandemic not only highly leveraged, but also with a decreased ability to make money because the world they were operating in had changed. Cinemas provide a great example. When cinemas closed due to lockdowns, people turned to streaming services and the rebound in attendance has been slow. Most cinema chains globally are only at around 65-70 percent of 2019 attendance levels. Some are doing a good job of making more money out of the people that are going by charging higher prices and selling more food and drink. Nonetheless, a number of major cinema companies are restructuring. In addition to higher leverage and a reduced ability to make profit, there have been extreme supply-chain disruptions, which have had a particularly acute effect on manufacturing companies. This disruption is abating but it has not gone away altogether. Then, of course, we are moving from a 30- year secular decline in interest rates into something that, in a long-term context, looks more normalised. The market is currently pricing US terminal rates at something like 5.5 percent. When you factor in higher leverage, increased interest rates can clearly cause issues. Finally, I would point to war on the edge of Europe, which is having both micro and macro effects. From a micro perspective, many companies had operations in Eastern Europe, Ukraine and even Russia, some of which had to be abandoned. From a macro perspective, the war has caused further supply disruptions to commodities and other goods. Disruption to gas supply has exacerbated energy price inflation. In summary, corporates are facing a range of challenges that are very much to the benefit of special situations investors because the scale of the opportunity set is growing dramatically.

RBC BlueBay Asset Management

Q: How are banks responding to this situation in terms of appetite and ability to lend?

It should be no surprise that lending standards are tightening, and the ECB has been very open in warning about anticipated increases in non-performing loans. Banks are in a fundamentally different place from previous downturns in that they have slimmed down their workout departments, and they are penalised in terms of capital for holding onto NPLs. Hence, the banks are more likely to sell troubled assets earlier than in the past and, anecdotally, this is exactly what we are seeing. This is clearly advantageous to special situation investors.

Q: Why do you feel that the European mid-market is particularly attractive?

We have chosen to focus our latest strategy on the European market precisely because we believe there will be more opportunities in that region. Europe is undoubtedly the epicentre of stress and distress this time around. There is something like €7 trillion of corporate bank lending in Europe today, so you really don't need that many percentage points of stress or distress to create a very substantial special situations market. Mid-market companies, meanwhile, are typically less diversified by geography and product and have less access to capital markets. Many large companies did a good job raising money at the back end of covid, but smaller companies just didn't have access to the capital markets. These are businesses that are reliant on banks and if the banks won't lend, then that can clearly cause huge disruption. In summary, we believe that there is only limited capital focusing on the European mid-market, meaning that we see more opportunities and less competition.

Q: Where are you seeing the most interesting opportunities by sector and by jurisdiction?

One of the biggest differences with this downturn is that it is so broad-based. The inflationary effects of war clearly affected base industries that use a lot of gas, but there has also been hyperinflation in commodities, and high levels of inflation in most other raw material inputs, that has affected lots of manufacturing
companies. Inflation expectations have already fed through to wage negotiations and many European nations are struggling to control wage inflation, particularly in the public sector. There is a cost-of living crisis, in parts of Europe, which is impacting consumer discretionary expenditure. If you are struggling to pay your heating bill you will not be buying a new car or washing machine or updating your wardrobe. Data suggests that consumers are trading down in terms of food shopping and F&B consumption. The downturn is affecting chemicals, paper and packaging, healthcare, autos/autoparts, cinemas, food, F&B, leisure, real estate, cruise shipping, manufacturing, travel, gyms, hotels, housebuilders and retail companies. Equally, the opportunity set is broad when it comes to geography. The UK is in a particularly difficult place, partly because of political
incompetence and partly due to Brexit, which reduced labour supply. We see opportunities right across Europe, although we are primarily focused on the UK, Germany, Spain, Netherlands, Scandinavia and Italy.

Q: Why is a special situations strategy the place to be for investors right now?

First and foremost, this is a big and growing opportunity. My watch list would have had 70 or 80 names on it a year ago, and that has increased to around 250 names in terms of the public markets alone. In an environment where equities and fixed income markets are down dramatically, the ability to make positive uncorrelated returns should be of real interest to many different types of investors.

RBC BlueBay Asset Management

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CAMRADATA
With Intelligence
One London Wall
London
EC2Y 5EA

+44 (0)20 7832 6500
camradata.com

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