



MARKET GPS

# FIXED INCOME PERSPECTIVES

APRIL 2021

FEATURING THE LATEST QUARTERLY INSIGHTS FROM OUR INVESTMENT TEAMS:

- ▶ Rising bond yields - a validation of recovery or a challenge?
- ▶ Don't fight the wave of rising rates, surf it
- ▶ Harvesting higher yields in today's bond markets
- ▶ ESG in credit investing: themes, considerations and implementation

# OUR FIXED INCOME CAPABILITIES

Janus Henderson Fixed Income provides active asset management solutions to help clients meet their investment objectives. Over the past four decades, our global investment teams have developed a wide range of product solutions to address clients' varied and evolving needs. From core and multi-sector investing to more focused mandates, we offer innovative and differentiated techniques expressly designed to support our clients as they navigate each unique economic cycle. The capabilities of these teams are available through individual strategies or combined in custom-blended solutions.

While shared knowledge across teams and regions encourages collaboration and the debate of investment ideas, each team retains a defined level of flexibility within a disciplined construct. Environmental, Social and Governance (ESG) considerations, for example, are a key element of our credit research process and integrated within each team's investment approach. Our portfolio construction processes are governed by a rigorous risk management framework with the intent of delivering stronger risk-adjusted returns. Further, we believe transparency is the foundation of true client partnerships; we seek to earn and maintain our clients' confidence by delivering robust and repeatable investment processes and by providing firsthand insights from our investment professionals.

The Janus Henderson Fixed Income platform comprises 103 investment professionals situated in the UK, US and Australia. The teams are responsible for US\$81.5 billion\* in client assets.



\*As of 31 December 2020.



# RIISING BOND YIELDS – A VALIDATION OF RECOVERY OR A CHALLENGE?



Andrew Mulliner

The world is set for a strong cyclical recovery. Andrew Mulliner, Head of Global Aggregate Strategies, shares his thoughts on the divergence in economic fortunes that are beginning to appear and the likely impact on investment opportunities.

## Key takeaways

- » As global bond yields have moved higher, notable divergences begin to appear among regions and countries; central bank responses have also been diverse, in stark contrast to the unified response in 2020.
- » Disentangling what should be temporary growth uplifts from longer term structural dynamics will be somewhat challenging.
- » Recognising the dynamics at work is crucial to understanding whether today's higher yields represent an opportunity for bond investors or whether the 30 year bond bull market is over.

The world appears to be set for the strongest cyclical recovery since the aftermath of the 2008 Global Financial Crisis. Accompanying this rosy outlook has been a pickup in global bond yields, albeit from extremely low levels. That yields are rising should be of little surprise to investors. In the recovery phase of the economic cycle, we would expect yield curves to steepen. Yields on longer dated bonds rise as investors reassess the outlook for long term growth while those on shorter dated bonds remain low, as central banks hold rates at low levels, cementing the economic recovery and encouraging economic actors to borrow and invest.

However, while global bond yields have moved higher in the past six months, there are notable divergences among regions and countries, both in terms of the strength of the economic outlook and the degree to which the changes in bond yields represent a validation of recovery or a challenge. Figure 1 shows gross domestic product (GDP) levels relative to end 2019 for a number of countries over the next two years.

Understanding the divergences and their likely impact can have a significant effect on the investment opportunities we see evolving in global bonds.

## Diverse central bank responses to rising bond yields

In Europe, rising nominal bond yields, even when those yields remain negative, has resulted in strong verbal and actual intervention to limit and potentially even reverse the

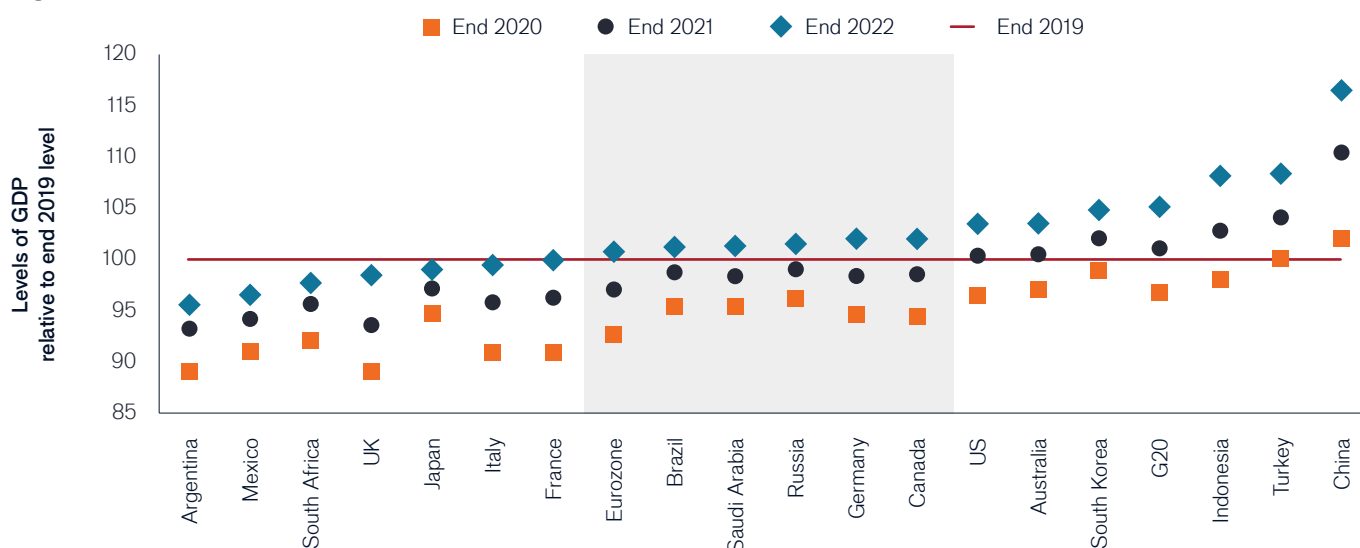
moves. In the US, the Federal Reserve (Fed) has reiterated its very dovish stance verbally but left its policy measures unchanged, and if anything, warmly welcomed the significant lift in bond yields as validation of the effectiveness of its policy measures. Other markets such as Australia, which was at the vanguard of the move to higher yields, have also pushed back on market pricing of yields but specifically around the timing at which the central bank is expected to lift rates, rather than the overall level of yields.

This diverse set of central bank responses to the move higher in yields stands in stark contrast to the unified responses of 2020 when rate cuts and quantitative easing programmes were common policy measures. The reasons for this are many but can be principally disentangled into the starting point for the different economies prior to the pandemic, how the economies weather the storm and the nature of the measures.

## First a look at Europe

When looking at economies through a more structural lens, the challenges of today's higher yields become more apparent. Taking Europe as a prime example, with anaemic growth and inflation already a chronic problem, the coronavirus pandemic has resulted in major falls in growth and significant increases in public debt loads, as governments have responded aggressively to avoid economic disaster.

Figure 1: Consensus GDP forecasts relative to 2019



Source: Bloomberg, Janus Henderson Investors, as of 11 February 2021. Note: chart depicts levels of gross domestic product (GDP) relative to end 2019 level, based on Bloomberg consensus forecasts.



Both the European Central Bank (ECB) and the European Union (EU) have taken significant steps to support the system, via bond purchases in the case of the ECB, and the launch of the next generation EU funds, which represent the first major foray into mutualised European debt issuance. The capital raised is to fund a combination of grants and low-cost loans to the hardest hit countries of the EU to assist in the recovery from the pandemic.

While the introduction of these schemes are significant for Europe, they are responses to a crisis and do little to solve the chronic issues that Europe continues to face. The baseline situation of weak growth and inflation continues to represent the biggest challenge to policymakers and although economic growth is expected to recover strongly, the ECB is all too aware that cyclical recovery is not enough, and that higher bond yields represent a tightening of conditions that Europe can ill afford.

## Australia next

Australia has weathered the coronavirus pandemic better than most developed economies. It acted swiftly to clamp down on the virus by shutting its borders on 20 March 2020 and strictly enforced its border security. This resulted in a domestic economy that bounced back quickly as internal restrictions were lifted relatively fast, even though sectors such as tourism remain significantly impacted. Also, as an exporter of raw materials such as iron ore and being economically sensitive to Asian and Chinese growth, Australia's chief export sector has been a beneficiary of the global shift away from services to goods.

Given the virus seems to have a seasonal element to it — colder temperatures correlating with higher transmission, the transition to the cooler winter period in Australia in the coming months could pose the risk of an increase in transmission. However, strong border protections and few if any cases in the country, should mitigate this risk.

All of this might leave us to expect that Australia's outlook is bright, and to some extent it is; however, with the winter season approaching, government support measures rolling off and vaccination a second half of 2021 event at best, the Australian economy faces arguably more headwinds to growth this year compared to the likes of the US.

It should also be remembered that prior to the pandemic, Australia was already in a slowing growth regime with low wage inflation and an economy still coming to terms with the tailing off of the massive investment boom in the mining sector that China's spectacular economic emergence prompted. In a world where relative rates of change matter,

Australia is likely to appear something of a laggard in 2021 and with plenty of the previous challenges still to be faced.

## It would be remiss to ignore the Chinese economy

China emerged from 2020 with a positive growth of 2.3% in spite of being the first country impacted by the virus and having some of the strictest lockdowns imposed around the world. After the first quarter of 2020, the economy reopened, albeit with a focus on the 'old style manufacturing' rather than service sectors. The country benefited from its key role in the global supply chain for medicines, personal protective items (PPI) and much of the manufactured goods that were increasingly demanded in western economies more traditionally focused on service sectors.

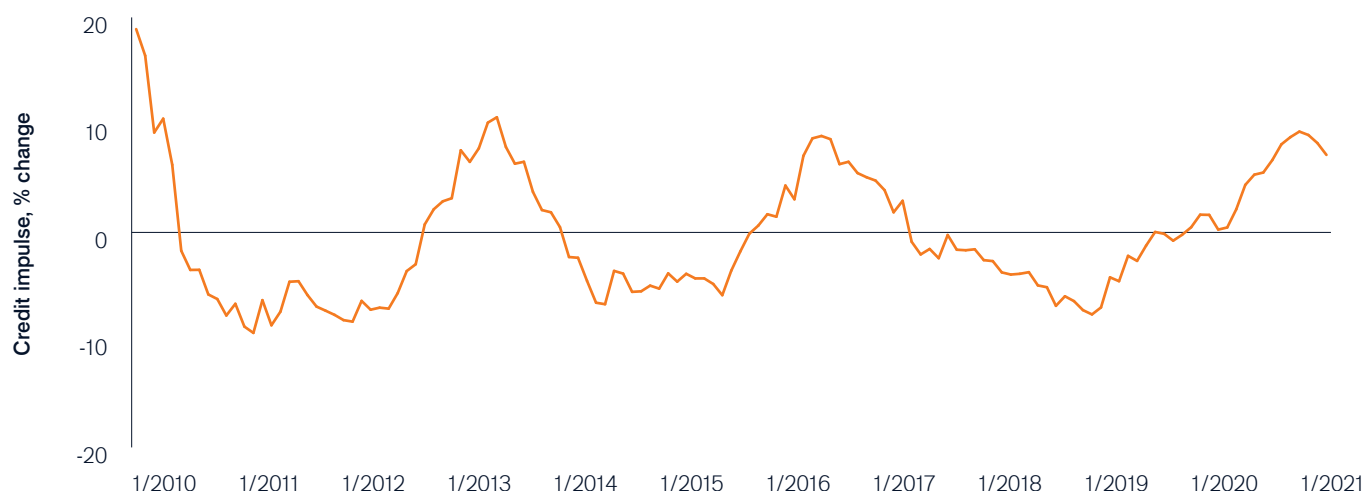
China is also noteworthy for its moderate monetary policy response, with the authorities focusing their attention on fiscal measures for specific elements of the economy. As other economies took interest rates down to zero and engaged in massive quantitative easing, the People's Bank of China cut its 1-year loan prime rate by only 35 basis points from 4.15% to 3.85% while managing liquidity actively in the system, as they sought to contain the crisis and at the same time avoid a speculative boom in housing — something they have been keenly focused on for some years.

## Do not look to China to reflate the world

Hopes of a repeat of the post 2008 China investment boom, which drove much of the global recovery after the financial crisis, are likely misplaced this time around. China has no intention of reflating the world and the recent growth target of over 6% for 2022 (announced at the recent National People's Congress) was lower than many anticipated, especially given the low growth rate of the previous year.

Looking further ahead, macroeconomic indicators such as China's credit impulse (a gauge of the flow of credit), which has been a good leading indicator of the global economic outlook (by around 12 months), deserves attention (Figure 2). We see the credit impulse as rolling over, suggesting tougher times ahead for the global economy coming into 2022, where a negative base effect from this year's fiscal stimulus will act as a brake on growth.

Figure 2: China's credit impulse is rolling over



Source: Bloomberg, Janus Henderson Investors, as of 31 January 2021. Note: 12-month percentage change in the China credit impulse, measured as growth in new lending/credit divided by nominal GDP, monthly data.

## Challenges and opportunities ahead

This multi polar world represents significant challenges as well as opportunities for investors. Historically, cyclical recoveries have been accompanied by booming stock markets, tightening credit spreads and a weaker US dollar, as central banks provided accommodative policies, corporates repaired their balance sheets and earnings improved.

Already, the expectation for a weaker US dollar has begun to falter with an uncertain outlook ahead, as unprecedented US fiscal stimulus looks likely to drive US growth to the very top of the pile for 2021. US exceptionalism once again appears to be back, but with it comes a challenge to the weak dollar playbook that has so often been a boon to emerging market (EM) countries who often finance in this currency. For emerging market economies who are well behind in the vaccine rollout, a stronger US dollar potentially spells trouble for the durability of their recovery.

The true challenge for investors is working out whether the secular trends of the last decade — low inflation and moderate growth, will be overturned by the massive response to the pandemic. Both in terms of the accelerated embrace in technology and the billions poured into revolutionary vaccine programmes, but also the massive accumulation of debt on both public and corporate balance sheets.

## A millstone around the neck of the bond markets?

History suggests that such massive debt burdens and the diminishing marginal productivity of debt will hang like a millstone around the neck of the bond markets, keeping yields low. There are also indications that the trend of lower fertility rates in wealthy countries has been significantly exacerbated by the coronavirus pandemic. This accelerates the trend of ageing populations and with it the questions as to whether ageing populations are inflationary or deflationary. While arguments are made in both directions, we find that evidence from Japan shows demographic decline correlates with lower yields and low inflation.

Against this, are expectations that massive fiscal responses in the western world and particularly in the US could finally see economies reach 'escape velocity' with growth and inflation rates back into the realms last seen in the 1990s. However, while stimulus has been large, so far only limited amounts seem destined for the sort of investment that could truly increase the productive capacity of these economies allowing for a sustained rise in yields through time. This suggests that once the sugar high of stimulus charged cyclical recovery has past, the global economy will look less different than one might have expected.

## Investing in a turbulent world

How does one invest in a world of such turbulence with yields moving higher and the outlook beyond the next 12 months so shrouded in uncertainty? A nuanced approach to the traditional cyclical strategies seems appropriate.

There are areas that could offer value such as higher yielding corporate debt and emerging markets, though we are cautious about treating the latter as a monolithic entity and only see value in select local markets and hard currency corporate bonds.

In government markets, we see increasing value as yields have risen. Beyond the US, there are significantly different opportunities for investors. In Europe we anticipate a continuation of the low yield, low volatility world that bond investors have become accustomed to and expect that strategies that benefit from stable rates to perform well.

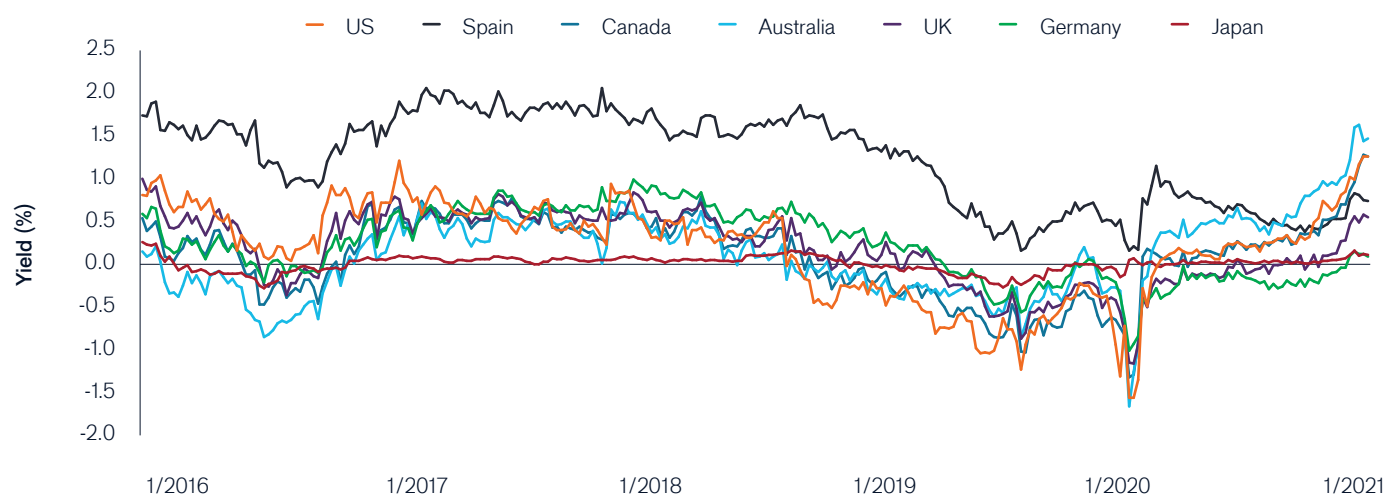
Among countries that have experienced a significant rise in yields, there may be opportunities as market expectations have run increasingly ahead of central bank guidance in the normalisation of rates. This is particularly the case in Australia, which faces a more challenging environment in the coming ten years relative to the previous decade.

Additionally, many of these markets (the US included) now offer much higher yields (after currency hedging), compared to what is available in Japan and Europe, encouraging greater demand from overseas buyers (Figure 3).

## Conclusion

The coronavirus shock to the global economy, a true exogenous shock that would have been hard to predict, represents one of the most significant economic disruptions in the history of the global economy, akin to a global natural disaster. The extreme nature of the economic drawdown and recovery, as well as the rapid progression through recession to recovery, makes disentangling what should be temporary growth uplifts from longer term structural dynamics somewhat challenging. However, recognising these dynamics is crucial to understanding whether today's higher yields represent an opportunity for bond investors or whether the 30 year bond bull market is over.

**Figure 3: 10-year hedged yields for a Japan-based investor**



Source: Bloomberg, Janus Henderson Investors, as of 16 March 2021. Note: 10-year government bond yields hedged to Japanese yen using 3-month forward cross currency rates, annualised.

## Glossary

**Credit impulse:** A measure of the change in the growth rate of aggregate credit as a percentage of gross domestic product.

**Currency hedge:** A transaction that aims to protect the value of a position from unwanted moves in foreign exchange rates. This is done by using derivatives.

**Deflation:** A decrease in the price of goods and services across the economy, usually indicating that the economy is weakening. The opposite of inflation.

**Fiscal policy/stimulus:** Government policy relating to setting tax rates and spending levels. It is separate from monetary policy, which is typically set by a central bank. Fiscal expansion (or 'stimulus') refers to an increase in government spending and/or a reduction in taxes. Fiscal austerity refers to raising taxes and/or cutting spending in an attempt to reduce government debt.

**Inflation:** The rate at which the prices of goods and services are rising in an economy. The CPI and RPI are two common measures. The opposite of deflation.

**Monetary policy/stimulus:** The policies of a central bank, aimed at influencing the level of inflation and growth in an economy. It includes controlling interest rates and the supply of money. Monetary stimulus refers to a central bank increasing the supply of money and lowering borrowing costs. Monetary tightening refers to central bank activity aimed at curbing inflation and slowing down growth in the economy by raising interest rates and reducing the supply of money. See also fiscal policy.

**Nominal value:** A value which has not been adjusted for inflation. Within fixed income investing it refers to a bond's par value rather than its current ('market') value.

**Quantitative easing:** Monetary policy used by central banks to stimulate the economy by boosting the amount of overall money in the banking system.

**Reflation:** Government policies intended to stimulate an economy and promote inflation.

**Spread/Credit Spread:** The difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

**Volatility:** The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

**Yield:** The level of income on a security, typically expressed as a percentage rate.

**Yield curve:** A graph that plots the yields of similar quality bonds against their maturities. In a normal/upward sloping yield curve, longer maturity bond yields are higher than short-term bond yields. A yield curve can signal market expectations about a country's economic direction.





# DON'T FIGHT THE WAVE OF RISING RATES, SURF IT



Greg Wilensky

Greg Wilensky, Head of U.S. Fixed Income, discusses the outlook for U.S. interest rates and the tools and investments available to navigate their rise.

## Key takeaways

- » Rising yields does not mean investors should avoid core bond allocations. We expect the rise will remain orderly, and long-term inflation expectations will remain contained.
- » Treasury exposure can be a key diversifier when equities markets are weak, while corporate bonds, securitized assets and floating-rate investments can add yield and diversification.
- » An active manager should dynamically adjust exposures as conditions evolve while maintaining a core focus on finding the appropriate balance of risk and reward to meet investors' goals.

U.S. bond yields have risen quickly in recent months and, given current expectations for an economic recovery, we expect they will rise further over time. Simply put, yields were too low given the improving economic outlook, and a normalization of interest rates should be expected. However, many factors will impact the speed of the rise, and their ultimate level, and we believe U.S. Treasury bonds continue to act as an important hedge to an investor's overall portfolio, especially their equities. Bond investors, in our view, should focus on the benefits of duration (a measure of sensitivity to interest rate moves) as a hedge against unexpected volatility in the riskier parts of their portfolio, while aiming to outperform cash. The question for a bond investor today is not whether to have or avoid bond exposure, but how to find the right balance of bond exposures. While there is no guarantee that bonds will provide insurance against falling equity markets, we think the expected outcomes of a balanced portfolio are likely to be better for most investors.

## Rates have risen before. What is different this time?

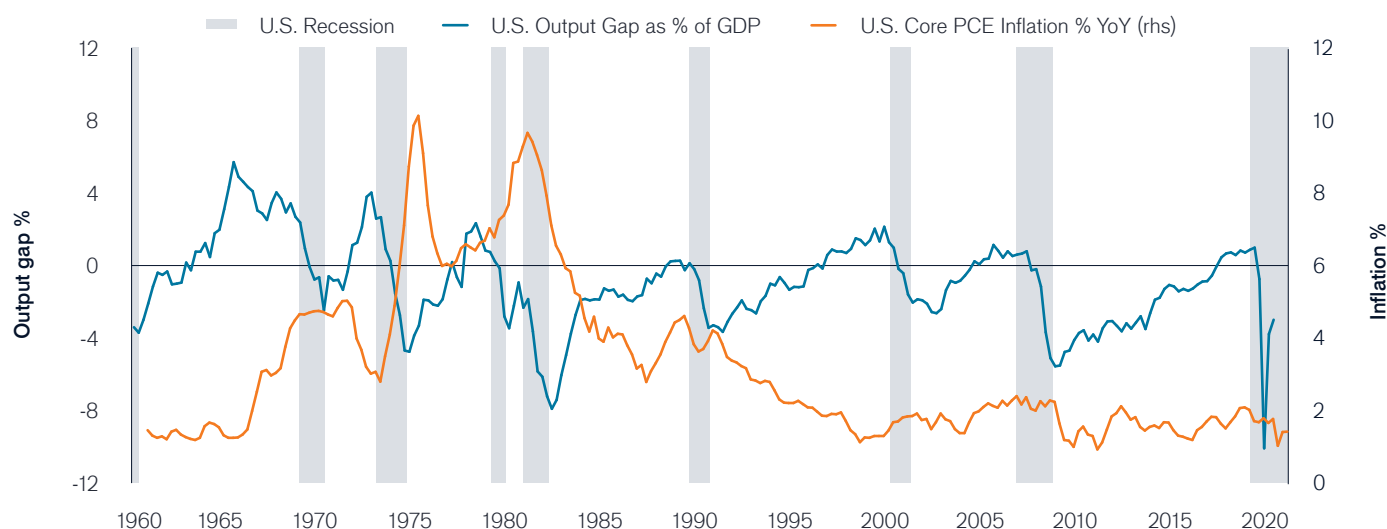
Since the mid-1990s, there have been five periods of rising interest rates, which we define as a period lasting at least 12 months. Interestingly, each period saw a progressively lower change in yields, with 10-year Treasury yields rising 2.24% in 1998-2000, and only 0.85% in 2017-18. The average rise was 1.47%. While one could argue that the approximately 1.0% rise we have seen since the lows of August last year would suggest the bulk of the rise may be completed, there are always mitigating factors. In the current case, the swift drop in yields as the pandemic took hold early last year skews the figures. Despite the recent rapid rise, 10-year bond yields are still below the 1.79% level at which they started 2020.<sup>1</sup> But the most significant difference in the current cycle is that the U.S. Federal Reserve (Fed) is

both tolerating government bond yields rising, while actively buying them in order to keep interest rates "low." This apparent contradiction can be explained by the view that the Fed wants to see interest rates normalize, but in an orderly way.

On the Fed's side is the relative value of U.S. Treasuries compared to the rest of the developed world. All else being equal, if you wanted to hold government bonds to guard against equity volatility, would you rather own 10-year U.S. Treasuries yielding 1.75%, or 10-year German Bunds at -0.3%? In fact, even after accounting for the cost to hedge the currency exposure, a German investor can realize an approximately 1.3% gain in yield by choosing U.S. Treasury bonds<sup>2</sup>. And it is not just foreign demand that may mitigate the speed of rising interest rates, but also domestic demand. Yield rises can be, in a sense, self-correcting insofar as the increasingly higher yields may attract buyers such as domestic pension funds.

Turning to more fundamental factors, the consensus forecast may be for a strong recovery; this can pressure yields higher because of the expectation that too much growth leads to inflation. Which, in turn, leads to the need for the Fed to raise official policy interest rates. But it is possible to have growth without a significant rise in inflation, and today's conditions could prove to be a model of such a recovery. Unemployment is high. Savings rates are high. The "output gap" – the difference between what the economy can produce and is producing – is currently at -4% (Figure 1), suggestive of a reasonably high amount of slack in the economy. The U.S. economy may, relative to history, grow hotter for longer before reaching the same risk of rising inflation. Indeed, many of the same factors present today, including large fiscal deficits and significant Fed balance sheet expansion, have failed to get inflation to the Fed's target over the last decade.

**Figure 1: Positive output gaps need not trigger higher inflation**



Source: Bloomberg, U.S. Real Output Gap as a % of GDP (CBO), U.S. Core Personal Consumption Expenditure year on year, NBER recession periods, quarterly, 31 December 1960 to 31 December 2020.

Nevertheless, there is risk of a surge in pent-up demand, and the recent \$1.9 trillion Biden administration fiscal stimulus could see the output gap disappear entirely. Through excess demand, this could lead to the output gap turning positive to the tune of 2%, according to Deutsche Bank, the highest it has been since 2000. As demonstrated in Figure 1, history shows that a positive output gap in the region of 2% is unlikely to trigger a sustained break higher in inflation.

Were the fiscal multipliers (the ratio of change in national income that arises from a change in government spending) to be particularly strong, the economy could run very hot and exceed potential output by as much as 3% to 4%, which would place it in territory not seen since the mid-1960s and early 1970s – the beginning of a period known as the Great Inflation of 1965-1980 – and likely increasing the chances of a sustained inflation breakout.

### Could history repeat itself?

The causes of inflation in the 1960s and 1970s are legion. Putting aside the oil price shocks of the 1970s, (the result of specific wars in the Middle East, which we hope are not to be repeated), the blame for rising prices lay primarily at the door of poor policy – both monetary and fiscal. It is

perhaps the specter of this being repeated that unsettled rates markets so abruptly in February and March this year.

While there are perhaps parallels between Biden's fiscal stimulus package and the inflated deficit spending to finance the Vietnam War or Nixon's attempts to stimulate the economy ahead of his re-election in 1972, the output gap is considerably wider today and unemployment higher, offering a stronger justification for pump-priming. Moreover, the fiscal stimulus today will result in a fiscal cliff (assuming it is not repeated) in 2022 as the rate of change of government spending turns negative.

Turning to monetary policy, we think the Fed today is a far more experienced organization, not just because of the benefit of the passage of time and the lessons of hindsight but because the increased wealth of data available today allows it to make more informed decisions. While the move to flexible average inflation targeting creates some opacity around how much inflation the Fed will tolerate, we think it has a stronger grasp of inflation expectations.

For example, Treasury Inflation Protected Securities (TIPS) were only launched in 1997, so there was a less visible representation of market views on future inflation. Therein lay the problem: the Fed had a weaker grip on

inflation expectations which allowed inflation to become entrenched. It would take a shift in public and political attitudes together with Fed Chair Volcker's tightening medicine from 1979 before the U.S. would embark on the long disinflationary road.

## Opening the floodgates

The uncharted territory this time round is the impact that pent-up demand will have on the economy. Household savings have risen, partly a cautionary response to uneconomic uncertainty, but also reflecting forced savings as households have been legally unable to spend on activities that they took for granted, from having a restaurant meal to travelling on holiday. Buoyant asset markets from housing to equities have also led to wealth accumulation. Yet Figures 2 and 3 reveal that most of the increase in savings and wealth has occurred among the upper income brackets. Checkable deposits among U.S. households may have risen by \$2 trillion over the course of 2020, but only \$92 billion of this rise was among the bottom 40% of households, who have a higher propensity to consume than wealthier households.

A large part of the improvement in the balance sheet of lower income groups is the result of government transfer programs, which may not be repeated beyond this year.

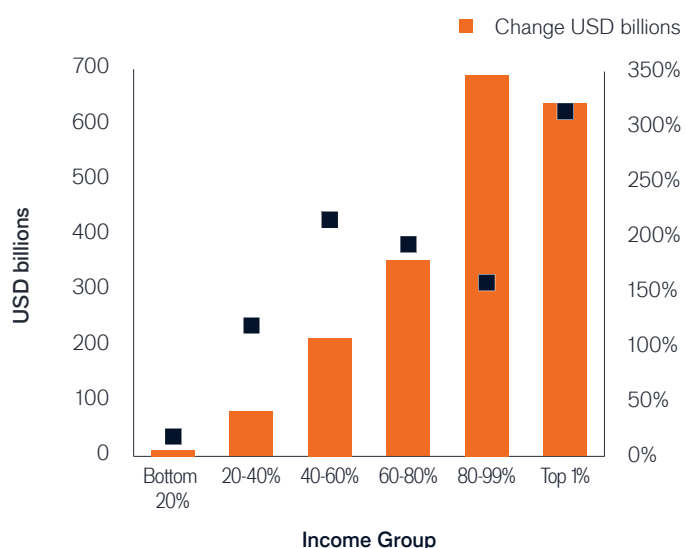
Regardless, we can expect a "sugar high" as the huge fiscal stimulus coincides with excitement around reopening, which will push up inflation in the short term, but this will likely fade.

We think the surge in consumption is unlikely to lead to a permanent shift higher in inflation without being accompanied by a meaningful expansion in household borrowing. Evidence here is mixed. Banks are in better shape than post the Global Financial Crisis (GFC) so the transmission mechanism of accommodative monetary policy ought to percolate through the banking system unhindered. Credit demand, however, seems to be the issue. As with the proverbial horse, it can be led to water but not forced to drink. There still seems to be resistance from households to take on additional borrowing. This is most acute in Europe, which seems to have followed Japan in moving towards a low-growth, low-yield environment, but even in the U.S., households have been more conservative with their borrowing since the GFC.

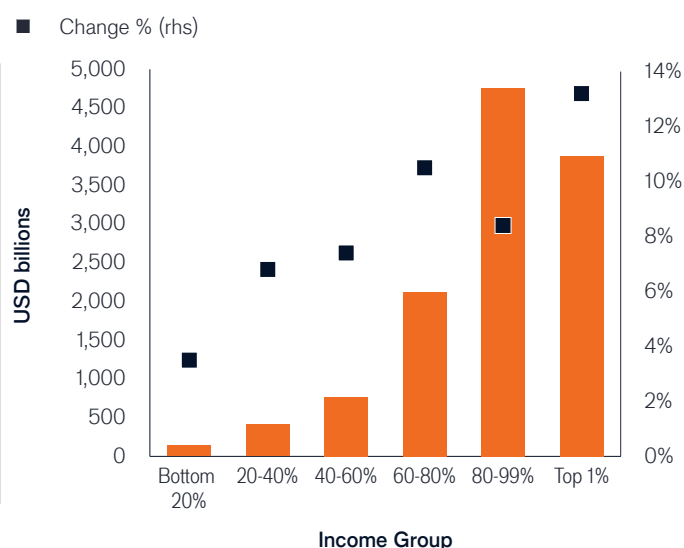
A potent question is whether the COVID crisis (and its disruptive long-term impact on the economy) has nudged the U.S. onto the same path as Japan and Europe. In which case, while yields may rise in 2021, their upper bound may be considerably lower than average.

## Growth in savings and assets is skewed towards higher income groups

**Figure 2: Change in U.S. checkable deposits, Q4 2019 to Q4 2020**



**Figure 3: Change in U.S. total assets, Q4 2019 to Q4 2020**



Source: Federal Reserve Board, Distributional Financial Accounts Overview, income levels detail, Q4 2019 to Q4 2020.

## Bond yields may be low, but so are cash yields

Rising yields do detract from performance, but you are also earning something during the time you hold the bond, providing a cushion against losses from rising rates. The bigger the yield spread a bond has over cash, the more “carry” (the incremental yield benefit from holding, or carrying, the bond instead of cash) you get. And, everything else being equal, when the yield curve is steep – as it is now – bonds should benefit from seeing yields “roll down” the curve. As the security’s time to maturity shortens, bond yields tend to fall in order to match the lower yields of the shorter bonds. Both the carry and roll down provide some cushion, permitting bonds to outperform cash even if yields rise, and the size of this cushion has substantially increased as the curve has steepened.

Figure 4 shows the history of the amount 5- and 10-year Treasury yields can rise (in basis points) over the next six months while still outperforming cash over the period. In both maturities, the levels have increased substantially in the last year, reaching levels not seen in four years. Thanks to low cash rates and a steep yield curve, the cushion provided for sitting on U.S. Treasuries has gotten bigger.

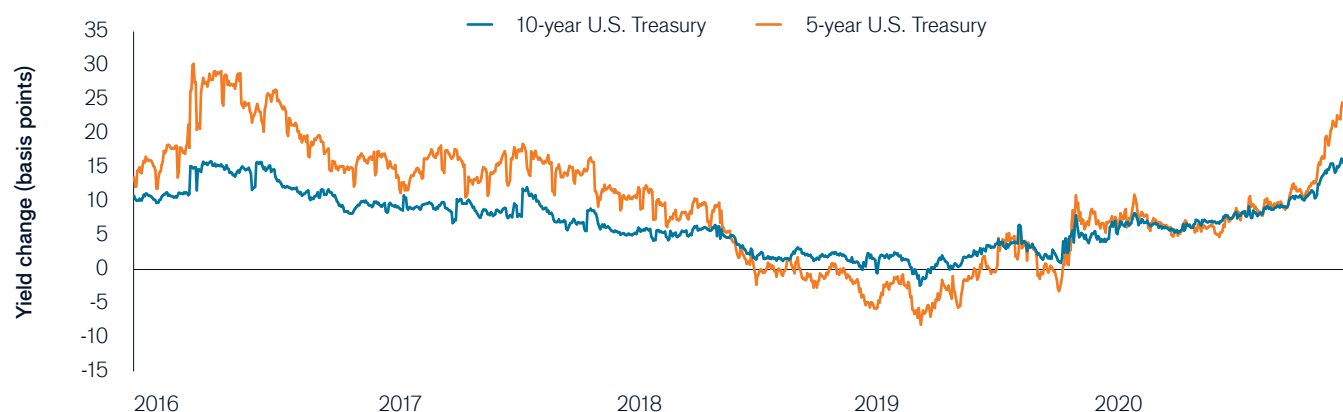
## The importance of being earnest about diversity

Every investor has different goals, different time horizons, and different risk tolerances. For investors that want a balanced portfolio that will perform (that is, generate a reasonable risk-adjusted return) across different environments, “core” allocations to bonds have generally delivered. Even as interest declined towards – and in some cases through – zero, core bond benchmarks like the Bloomberg Barclays U.S. Aggregate Bond Index proved they could still rally when equities sold off. We don’t believe the current environment is so fundamentally different that this history should be ignored. Equity markets are (as of this writing) at all-time highs, and the risks of unknown or unexpected events are as prevalent as ever.

In the meantime, the Fed has a specific goal for inflation of 2.0% over time and with 10-year bond yields near 1.75%, real yields (the yield paid after taking into account expected inflation) are negative. This can make holding equities look relatively attractive. But we believe most investors would not be comfortable with the volatility – the risk – of a 100% equity portfolio.

When Treasury rates are expected to rise, it makes sense to have less exposure to them. But however strongly this view may be held, Treasury exposure can be a key diversifier when equities markets are weak.

**Figure 4: Rise in interest rates required for the holding to perform the same as cash over 6 months**



Source: JPMorgan, Janus Henderson, as of 25 March 2021.



Additionally, fixed-rate corporate bonds and securitized assets, which typically provide higher yields/returns but a little less insurance against weak equity markets, add diversification. TIPS, and floating rate investments like many commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs), can provide even more diverse profiles of interest rate risk, income and defense. All of them provide some spread over Treasuries and thus provide an additional yield cushion which can help shield capital against rising interest rates.

An active manager can use all of these instruments to dynamically adjust exposures as conditions evolve, while maintaining throughout a core focus on finding the appropriate balance of risk and reward to meet investors' goals. However inevitable it may seem that bond yields will rise, we believe bond portfolios have a core role to play in investors' diversified portfolios, and the challenge is on the manager to surf the wave, not fight it.

<sup>1</sup> Source: St. Louis Federal Reserve

<sup>2</sup> Bloomberg as of 22 March 2021, Janus Henderson

## Glossary

**Asset-Backed Security (ABS):** A financial security which is 'backed' with assets such as loans, credit card debts or leases. They give investors the opportunity to invest in a wide variety of income-generating assets.

**Basis point:** A Basis point is 1/100th of 1%

**Collateralized Loan Obligations (CLOs):** Debt securities issued in different tranches, with varying degrees of risk, and backed by an underlying portfolio consisting primarily of below investment grade corporate loans.

**Commercial Mortgage-Backed Security (CMBS):** These are fixed income investment products backed by mortgages on commercial properties rather than residential real estate.

**Duration:** A fixed income security or portfolio's sensitivity to a change in interest rates, measured in terms of the weighted average of all the security/portfolio's remaining cash flows (both coupons and principal). It is expressed as a number of years. The larger the figure, the more sensitive it is to a movement in interest rates. 'Going short duration' refers to reducing the average duration of a portfolio. Alternatively, 'going long duration' refers to extending a portfolio's average duration.

**Fiscal stimulus:** Fiscal policy is government policy relating to setting tax rates and spending levels. It is separate from monetary policy, which is typically set by a central bank. Fiscal expansion (or 'stimulus') refers to an increase in government spending and/or a reduction in taxes.

**Floating rate loans or Leveraged loans:** These are typically loans arranged by banks on behalf of businesses and sold to investors. They are called floating rate because the regular coupon paid to investors adjusts in response to changes in interest rates. The loans are senior within the borrowing firm's capital structure, which means they are among the first to be paid back in the event the company defaults.

**High yield:** A bond that has a lower credit rating than an investment grade bond. Sometimes known as a sub-investment grade bond. These bonds carry a higher risk of the issuer defaulting on their payments, so they are typically issued with a higher coupon to compensate for the additional risk.

**Inflation:** The rate at which the prices of goods and services are rising in an economy. The CPI and RPI are two common measures. The opposite of deflation.

**Monetary stimulus:** Monetary stimulus refers to a central bank increasing the supply of money and lowering borrowing costs.

**Pump-priming:** This is the action taken to stimulate an economy, usually during a recessionary period, through government spending and interest rate and tax reductions.

**Quantitative easing (QE):** An unconventional monetary policy used by central banks to stimulate the economy by boosting the amount of overall money in the banking system.

**Real yield:** The nominal yield of a bond minus the rate of expected inflation.

**Securitized:** Securitized products are fixed income securities that pool financial assets together to create new securities that can be marketed and sold to investors.

**Spread:** The difference in the yield of a corporate bond over that of an equivalent government bond.

**Treasury Inflation-Protected Security (TIPS):** A type of Treasury security issued by the U.S. government that is indexed to inflation in order to protect investors from a decline in the purchasing power of their money.

**Volatility:** The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

**Yield:** The level of income on a security, typically expressed as a percentage rate.

**Yield spread:** A measure of how much additional yield an issuer offers over comparable "risk-free" U.S. Treasuries. In general, widening spreads indicate deteriorating creditworthiness of corporate borrowers, tightening spreads are a sign of improving creditworthiness.



# HARVESTING HIGHER YIELDS IN TODAY'S BOND MARKETS



John Kerschner



Seth Meyer

Head of U.S. Securitized Products John Kerschner and Portfolio Manager Seth Meyer discuss the opportunities available in bond markets, despite rising interest rates.

## Key takeaways

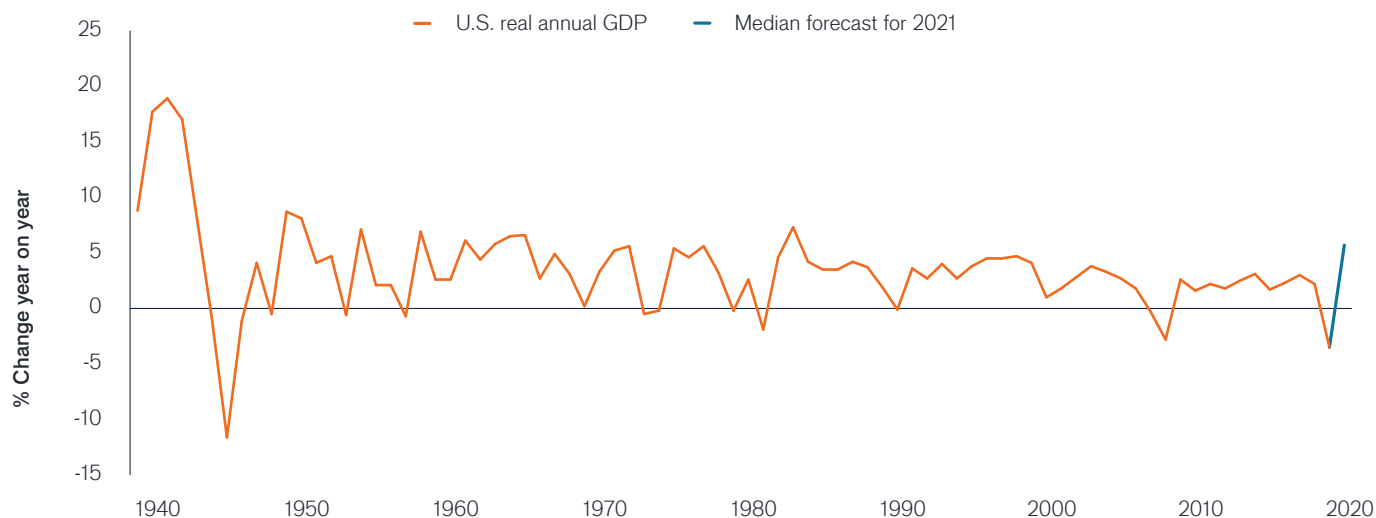
- » Bond yields are rising because the market thinks economic growth will be strong.
- » Strong economic growth is positive for many individual companies and securities across the securitized and high-yield markets.
- » We believe there are numerous opportunities to harvest higher yields with lower durations.

Rising interest rates raise justifiable concerns about the future returns of bond portfolios. But it is important to not let fear of higher rates dragging on returns keep investors from capitalizing on the potential opportunities in the current environment.

Bond yields are rising because the market thinks economic growth will be strong, and the expectation that the Federal Reserve (Fed) will ultimately have to raise interest rates to cool the economy. But the degree of growth in the meantime could be substantial. The to-date fiscal stimulus in response to the COVID-19 pandemic is around 25% of U.S. gross domestic product (GDP)<sup>1</sup>. We haven't seen fiscal support like that since World War II. The median projection for 2021 growth in the U.S. is currently 5.7%, higher than any year since 1984 when annual growth was 7.3% (Figure 1).

A rapidly growing economy may fan the fears of inflation, but it is also a significant positive for many individual companies and securities. Indeed, in the past six months, corporate credit and securitized bond markets have rallied broadly as investors (literally) bought into the idea that maybe the worst of the COVID-19 crisis was behind us. But we have generally observed that as spreads tighten, the correlation between industries and sectors tends to decline and the dispersion of future performance tends to rise. In our view, the opportunities have shifted from timing the direction of an entire asset class to more careful industry, company and security selection. The key question being, which industries and companies are most likely to benefit from a rebounding economy?

**Figure 1: U.S. annual GDP growth and 2021 median forecast**



Source: Bloomberg, as of 25 March 2021.

## Opportunities for yield exist

### CMBS in a changing world

Each recovery is different. COVID-19 accelerated many transitions in the U.S. economy, including the shift to a more digital economy, which has sparked some surprisingly niche opportunities. The rise of e-commerce enabled a fast-tracking of remote work capabilities, cloud services, and on-demand grocery and goods delivery. As online ordering has gained popularity, the call for speedy delivery has grown. This is driving increasing demand for industrial space – particularly warehousing – close to large urban areas, builders are scrambling to add it, and the commercial mortgage-backed securities (CMBS) market is funding it.

Mortgage-backed securities (MBS) are fixed income investments secured (or 'backed') by a collection of mortgages. Investors receive periodic payments derived from the underlying mortgages, similar to coupons. CMBS are backed by mortgages on commercial properties rather than residential real estate.

Similarly, we are seeing a rise in demand for biomedical office space. Occupancy rates for these spaces are likely to stay high because it is a niche industry that – unlike many other sectors of the economy – does not lend itself to working from home. (It is rather difficult to do cutting-edge biomedical research from your spare bedroom.) Likewise, it is not easy to retrofit existing industrial spaces to suit medical research – the requirements are too specific, with highly regulated health and safety requirements. Current occupancy rates of biomedical facilities are near 100% and rents are high per square foot, and CMBS is funding new facilities.

Finally, multi-family homes fall within the commercial mortgage sector, and demand for housing remains strong. Multi-family mortgages performed well relative to expectations throughout the COVID crisis, and successive stimulus payments have helped. Ultimately, demand exceeds supply for homes in the U.S., and the more affordable multi-family home sector is no exception.

### Investing in the U.S. consumer

Despite the historic recession, consumer bankruptcies and auto delinquencies are both near all-time lows. Home price appreciation and used car sale values are near all-time highs. Aggregate consumer savings have surged, with over \$2 trillion in excess savings accumulated since the pandemic hit. This environment creates, in our view, attractive risk-adjusted return opportunities in consumer-

related sectors, such as asset-backed securities (ABS) which are 'backed' with assets such as car loans or credit card debt.

Market-placed lending (MPL) securities – which consist primarily of direct-to-consumer loans – have grown, taking share from the credit card market. In our view, the trend towards MPL is likely to accelerate, and may well be the future of unsecured consumer lending. Like many newer markets, this provides opportunities for experienced investors to identify attractive pools of loans offering higher yields and/or lower credit risk than similarly rated counterparts in the ABS market.

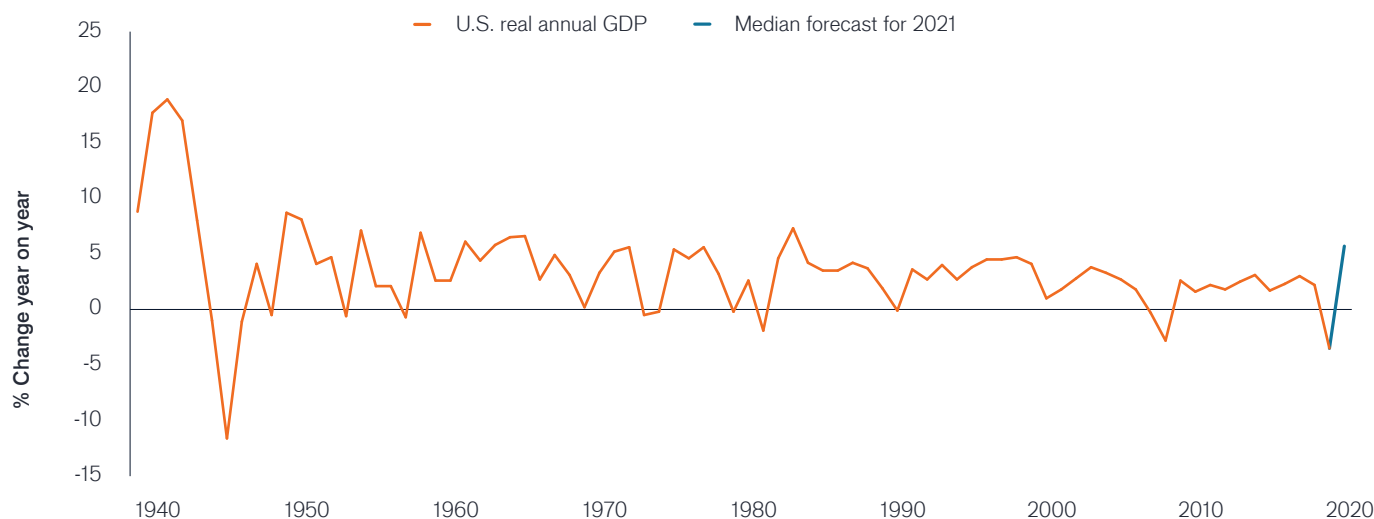
Credit-Risk Transfers (CRTs) are another opportunity where performance is more directly tied to the outlook for the consumer. When the U.S. housing Agencies (such as Fannie Mae or Freddie Mac) issue mortgages, they issue MBS securities, which are guaranteed by the issuing agency, and CRTs, which transfer the credit risk of the mortgage to the buyer. Having a positive outlook on CRTs is predicated on having a positive view on the creditworthiness of homeowners. In addition to the already mentioned strengths of the aggregate consumer, there is more demand for homes as a result of COVID-19 and a shortage of supply. While mortgage rates have risen in recent months, they are still relatively low, and home price appreciation was strong in 2020 at near 10%<sup>2</sup>. We expect home price appreciation will remain positive, significantly mitigating foreclosure risk.

Meanwhile, we see numerous consumer- and business-related opportunities within the ABS market. For example, air travel has been picking up, with leisure demand particularly robust<sup>3</sup>. With the vaccine distribution moving faster than many expected, we think pent-up demand for travel will see bookings rise further and we foresee a sharp rebound in airline travel in the quarters ahead. This travel includes the even more niche sectors such as cargo plane leases and business jets – both investable via the ABS market.

Sometimes the opportunities are more technical in nature. Take securities backed by timeshares (vacation homes that are purchased for limited use). Many of these securities were considered part of the hospitality sector and were thus assumed to have a cloudy outlook. However, in our view, Americans' desire for a holiday hasn't diminished, and it is generally a higher-quality borrower that opts to purchase a timeshare.

The list goes on: Technology ABS backed by cell towers, fiber-optic cable and data centers are all more likely to see increased demand as the digitization of the economy

**Figure 2: 2-year average yield spreads of CLOs and corporate bonds**



Source: Janus Henderson Investors, JPMorgan, Bloomberg, as of 30 December 2020.

progresses. It takes time to identify viable prospects and evaluate the specific credits, but, in our view, there is no shortage of opportunities.

### **CLOs that float, as rates rise**

Collateralized loan obligations (CLOs) are made up of floating-rate bank loans (also known as leveraged loans) issued to corporations that normally have a below investment-grade credit rating. But when the loans are pooled into portfolios, the offerings to investors range across the rating spectrum, including AAA. Yields at the AAA level are high compared to similarly rated corporate bonds and other securitized AAA assets. And the “credit curve” in CLOs is currently quite steep: The amount of additional yield paid for securities with lower credit ratings is increasingly higher as credit-quality diminishes. The result is yield spreads that are increasingly attractive relative to similarly rated corporate bonds, as can be seen in Figure 2.

Like many other corporate and securitized markets, the projected losses in leveraged loans (the building blocks of CLOs) have been trending lower as economic forecasts have trended higher. CLOs deserve a closer look in a low yield, rising rate environment.

### **Monetary stimulus supports high-yield corporates**

Monetary stimulus has been as historic as the fiscal stimulus provided since the pandemic began. Not only did the Fed lower policy rates to zero, it also bought bonds directly in the open market, including – for the first time – high-yield bonds. The aim was clear and twofold: to ensure companies could access funding, and to lower companies’ funding costs to buttress their profitability. Such was the signaling strength of the Fed, that the corporate bond-buying programs were only lightly tapped, with market participants eagerly supporting new issues, allowing the Fed to cease further purchases at the end of 2020. While broader monetary accommodation must end at some point, it is difficult to argue against the mathematics of low default rates in short-maturity securities given the current support. Unsurprisingly, the forecast default rate has fallen. During the height of the COVID-19 induced uncertainty, defaults were predicted to be as high as 15% this year. In reality, the default rate over the past 12 months – both in the U.S. and globally – was in the single digits, and declining<sup>4</sup>.

In our view, the Fed’s generous accommodation will last until it is no longer needed. We do not believe the Fed engaged in the most massive balance sheet expansion since World War II only to pull the plug too soon. While high-yield bonds are rated below investment grade and



thus carry more risk, we think we are in the part of the recovery cycle where lower-credit quality securities returns are probably more skewed to positive than at other times. And with current yields in the Bloomberg Barclays U.S. High Yield Index near 4.4%, the absolute income is nearly two times the yield of the Bloomberg Barclays U.S. Corporate Bond Index (currently at 2.3%) and nearing three times the yield of the Bloomberg Barclays U.S. Aggregate Bond Index (currently at 1.6%)<sup>5</sup>.

While the high-yield asset class has more duration (a measure of its sensitivity to changes in interest rates) than many of the securitized sectors we have discussed, it is low relative to investment-grade corporate bonds. High yield also has the highest correlation to U.S. equities among the major bond markets. As such, high yield can be thought of as an attractive hybrid asset in a diversified portfolio, providing returns more in line with the direction of equities, while also offering a relatively high income.

Our more positive outlook on the asset class as a whole does not discount the attractive risk-adjusted return opportunities within particular sectors, and companies. CCC rated securities have outperformed (up 4.9%) the rest of the high-yield market year-to-date<sup>6</sup> as the market reprices the higher, but more rapidly diminishing, default risk in the lowest-rated securities. Understanding divergences between the rating sub-sectors of the market can provide active managers opportunities to add value. The same is true at the sector level, where themes like rising e-commerce or a strong consumer can also be applied.

## Balancing yield and duration

We believe interest rates are likely to rise in the quarters ahead as the recovering economy forces them to levels more appropriately aligned with “normal” economic growth. This poses risks to bond portfolios. But if an individual bond’s duration is a risk in a rising rate cycle, the key question in our view is, are you being sufficiently compensated for that risk?

Broad corporate credit benchmarks such as the Bloomberg Barclays U.S. Corporate Bond Index have rallied significantly in recent quarters, and currently yield 2.3% with a duration of 8.4 years<sup>7</sup>. With 8.4 years of duration, the index would – assuming spreads stay unchanged – fall 8.4% if the comparable-maturity Treasury bond yield were to rise a further 1.0% in the next year. With a yield of 2.3%, investors would lose a net 6.1%<sup>8</sup>. The benchmark’s duration risk should not be underestimated.

But not all bond portfolios need to be constructed the same as the benchmark. First, an individual investor’s goals and risk tolerance are key factors in finding the right balance of duration and income. Second, we do not believe that rising rates mean “bonds” (generally) are inappropriate in a diversified portfolio. On the contrary, we believe there are numerous opportunities to harvest higher yields with lower durations. And because the path to higher rates is unclear and surprises happen, owning some duration is prudent.

In our view, adjusting and actively managing the balance of income and duration will be the key to total returns in 2021. Investors can also opt to take on additional credit risk and lower correlation to interest rates by extending into the high-yield market. Or they could diversify their exposure into securitized products where yields often exceed those paid for corporate bonds, the durations are lower and – as in the case of CLOs and many CMBS – the coupons are floating rate, offering a natural hedge against potentially rising interest rates.

Sector selection is only part of the process, however. Ultimately, we believe the value in active bond asset management comes from security analysis within sectors that are identified as offering attractive risk/reward. Characteristics of individual securities can vary widely, and it is the role of the manager to pick securities and combine them into a portfolio that meets the yield and risk targets investors seek.

Don’t give up on bonds. Instead, find a manager that understands your goals and has the ability to harvest opportunities that help you realize them.

“You can’t always get what you want. But if you try sometime, well you just might find you get what you need.”

THE ROLLING STONES

<sup>1</sup> International Monetary Fund, as of 11 March 2021.

<sup>2</sup> Bloomberg, as of 29 March 2021.

<sup>3</sup> Bank of America, as of 29 March 2021.

<sup>4</sup> Source: Moody's, US speculative-grade trailing 12-month default rate, global speculative-grade trailing 12-month default rate, at 28 February 2021.

<sup>5</sup> Source: Bloomberg, as of 22 March 2021.

<sup>6</sup> Bank of America, as of 24 March 2021.

<sup>7</sup> Bloomberg, as of 22 March 2021.

<sup>8</sup> Janus Henderson, as of 22 March 2021.

## Glossary

**Asset-backed Security (ABS):** A financial security which is 'backed' with assets such as loans, credit card debts or leases. They give investors the opportunity to invest in a wide variety of income-generating assets.

**Basis point:** A Basis point is 1/100th of 1%. 1 bp = 0.01%, 100 bps = 1%.

**Bloomberg Barclays U.S. High Yield Index:** The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the US dollar-denominated, high yield, fixed-rate corporate bond market.

**Bloomberg Barclays U.S. Corporate Bond Index:** The Bloomberg Barclays U.S. Corporate Bond Index measures the US dollar-denominated fixed-rate corporate bond market.

**Bloomberg Barclays U.S. Aggregate Bond Index:** The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

**Collateralized Loan Obligations (CLOs):** Debt securities issued in different tranches, with varying degrees of risk, and backed by an underlying portfolio consisting primarily of below investment grade corporate loans.

**Commercial Mortgage-Backed Security (CMBS):** These are fixed income investment products backed by mortgages on commercial properties rather than residential real estate.

**Correlation:** How far the price movements of two variables (e.g., equity or fund returns) match each other in their direction. If variables have a correlation of +1, then they move in the same direction. If they have a correlation of -1, they move in opposite directions. A figure near zero suggests a weak or non-existent relationship between the two variables.

**Credit ratings:** A score assigned to a borrower, based on their creditworthiness. It may apply to a government or company, or to one of their individual debts or financial obligations. An entity issuing investment-grade bonds would typically have a higher credit rating than one issuing high-yield bonds. The rating is usually given by credit rating agencies, such as Standard & Poor's or Fitch, which use standardized scores such as 'AAA' (a high credit rating) or 'B-' (a low credit rating). Moody's, another well-known credit rating agency, uses a slightly different format with Aaa (a high credit rating) and B3 (a low credit rating).

**Credit Risk Transfer Securities (CRT):** Pioneered by Freddie Mac in 2013, Credit Risk Transfer programs structure mortgage credit risk into securities and insurance offerings, allowing the transfer of mortgage credit risk exposure to investors.

**Duration:** A fixed income security or portfolio's sensitivity to a change in interest rates, measured in terms of the weighted average of all the security/portfolio's remaining cash flows (both coupons and principal). It is expressed as a number of years. The larger the figure, the more sensitive it is to a movement in interest rates. 'Going short duration' refers to reducing the average duration of a portfolio. Alternatively, 'going long duration' refers to extending a portfolio's average duration.

**Fiscal stimulus:** Fiscal policy is government policy relating to setting tax rates and spending levels. It is separate from monetary policy, which is typically set by a central bank. Fiscal expansion (or 'stimulus') refers to an increase in government spending and/or a reduction in taxes.

**Floating rate loans/leveraged loans:** These are typically loans arranged by banks on behalf of businesses and sold to investors. They are called floating rate because the regular coupon paid to investors adjusts in response to changes in interest rates. The loans are senior within the borrowing firm's capital structure, which means they are among the first to be paid back in the event the company defaults.

**High yield:** A bond that has a lower credit rating than an investment grade bond. Sometimes known as a sub-investment grade bond. These bonds carry a higher risk of the issuer defaulting on their payments, so they are typically issued with a higher coupon to compensate for the additional risk.

**Inflation:** The rate at which the prices of goods and services are rising in an economy. The CPI and RPI are two common measures. The opposite of deflation.

**Investment grade:** A bond typically issued by governments or companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default, such as high-yield bonds.

**Market-place Lending (MPL):** Marketplace lending is a nonbank lending industry that uses innovative financial technology (fintech) to make loans to consumers and small businesses.

**Monetary stimulus:** Monetary stimulus refers to a central bank increasing the supply of money and lowering borrowing costs.

**Securitized:** Securitized products are fixed income securities that pool financial assets together to create new securities that can be marketed and sold to investors.

**Spread:** The difference in the yield of a corporate bond over that of an equivalent government bond.

**Yields:** The level of income on a security, typically expressed as a percentage rate. For equities, a common measure is the dividend yield, which divides recent dividend payments for each share by the share price. For a bond, this is calculated as the coupon payment divided by the current bond price.

**Yield spread:** A measure of how much additional yield an issuer offers over comparable "risk-free" U.S. Treasuries. In general, widening spreads indicate deteriorating creditworthiness of corporate borrowers, tightening spreads are a sign of improving creditworthiness.



# ESG IN CREDIT INVESTING: THEMES, CONSIDERATIONS AND IMPLEMENTATION



Adrienn Sarandi

As the focus on Environmental, Social and Governance (ESG) investing globally continues to sharpen, Adrienn Sarandi, Director of Fixed Income ESG, answers some of the most frequently asked questions, including whether COVID-19 has altered the evolution of ESG.

## Key takeaways

- » ESG investing has markedly matured in recent times, forcing a shift in focus from 'why' asset owners and investment managers should integrate ESG factors into their investment processes to 'how'.
- » Janus Henderson's corporate credit strategies integrate ESG as a core component, aiming to identify the most material ESG considerations for each issuer we invest in, reduce risks and uncover 'ESG alpha' opportunities.
- » To accomplish this, we are proponents of integrated, forward-looking analysis, and strong advocates of both active company engagement and industry-wide collaboration on disclosure standardisation.
- » While emphasis on climate change lost momentum amid the pandemic, the spotlight shifted to 'S' and 'G' issues. We think 2020 proved that ESG analysis is not just a bull market luxury but very much a bear market necessity, and its importance will only grow.

## Why is ESG a vital part of the value proposition in all of Janus Henderson's credit portfolios?

The Global Corporate Credit Team at Janus Henderson seeks to enhance value for clients through active management, and ESG considerations are key elements of our approach. We believe that excelling at ESG research and actively engaging with investee companies will lead to better-informed investment decisions by reducing risks and uncovering 'ESG alpha' opportunities.

At the heart of ESG is the simple idea that companies are more likely to succeed and deliver strong returns if they create value for all their stakeholders – employees, customers and suppliers – as well as society more widely and the environment. Consequently, ESG analysis focuses on how companies are serving stakeholders, the strength of their 'social licence' to operate and how this impacts their current and future performance. Hence ESG analysis is a key ingredient in our analysis that seeks to identify companies with business models that are 'future proofed' and able to deliver sustainable cash flows. At the same time, it helps us seek to avoid borrowers that cannot or will not mitigate their material ESG risks, which may ultimately lead to meaningful underperformance or capital impairment.

In the past, asset owners and investment managers focused on 'why' they should integrate ESG factors into their investment processes more systematically. ESG investing has markedly matured in recent times and now the conversation has moved to the 'how'. How is it best to leverage ESG insights to enhance risk-adjusted returns? How can disclosure standards be improved? How can ESG performance and outcomes be measured? In terms of the why, we believe the question is comprehensively answered and there is no trade-off between performance and ESG integration\*. We believe that integrating ESG considerations into investment decisions can improve performance. It is now the 'how' questions that are pertinent.

## Is ESG now an inseparable part of credit investing?

Absolutely. In our view, a process that fails to integrate ESG factors properly, misses some important dimensions in investment decision-making. Bond investors have always been focused on governance factors, but in recent years broader ESG considerations have become a more systematic and formalised part of the investment process. Environmental and social considerations therefore now vie

for importance. Many of the environmental and social risks have also been increasing and some are now prominent across industries and regions.

More recently, it was consensus to expect the 2020s to be the decade of transition and transformation from an E, S and G perspective. While the heavy focus on climate change lost some momentum in 2020 due to the pandemic, there has been an uptick in focus on other 'S' and 'G' issues, with companies taking a greater interest in employee wellness and workplace equality, as well as supply chain management. Crises also typically expose governance issues and COVID is no exception with several scandals erupting last year that left some corporates paying a heavy price.

It is therefore clear to us that investors ignore material ESG factors at their peril.

## ESG investing is a broad concept. How do you apply ESG?

ESG is integrated in all of Janus Henderson's corporate credit strategies as a core component. We aim to identify and evaluate the most material ESG risks of each issuer we invest in and use these insights to improve returns.

In terms of strategy implementation, it is important to differentiate between 'integrated' ESG strategies – which apply responsible investing principles – compared to 'values'- and 'impact'-based strategies that apply Socially Responsible Investing (SRI) principles.

In our 'integrated' ESG strategies, the primary purpose of the ESG lens is to maximise risk-adjusted returns. Since there are no specific ESG performance objectives within these strategies, in the vast majority of cases, we do not have blanket sector exclusions. The integrated ESG approach looks at credit markets holistically and aims to evaluate on a case-by-case basis how relevant factors may lead to credit improvement or deterioration, and the resultant impact on credit spreads and the issuer's cost of capital.

For clients in our 'values'-based strategies, we apply the same approach but with the addition of a negative screening overlay to remove controversial sectors/issuers in accordance with clients' beliefs.

For those clients who want to go a step further with 'impact' investing – an approach that seeks to deliver a measurable positive impact for society and the environment alongside positive returns – we are currently building out capabilities that allow us to design tailored solutions with measurable positive outcomes.



## Why do you include some 'sin' sectors in your strategies that integrate ESG within their investment approach?

Excluding some controversial sectors outright makes sense for 'values'-based ethical investors. In 'integrated' ESG strategies we do not apply blanket exclusions based on industry classifications alone because we do not believe this is the best way to enhance risk-adjusted returns.

This does not, however, mean we invest in challenged sectors and issuers. When approaching areas of the market that have an inherent material ESG risk profile, we take each sub-sector and issuer on its own merit and actively engage to better understand whether and how ESG risks are addressed. In keeping with this approach, we avoid investing in companies – in any sector – where the materiality of the ESG risk and deteriorating trajectory of that risk lead us to believe we could see a marked worsening in credit strength or capital impairment. Examples include structurally challenged businesses (such as certain coal miners where the risk of stranded assets – which are now worth less than expected due to the transition to cleaner energy – are high) or those that are negligent in terms of their conduct towards workers, customer safety and the communities they operate in, or those with other serious governance issues.

Conversely, we aim to reward those – and benefit from – issuers that may not have a very strong ESG profile but are taking meaningful initiatives to make improvements. This is dependent on the associated risks not being material enough to pose a serious risk of capital impairment. For example, Volkswagen faced the fallout from its emissions scandal, but management change led to serious steps being taken to redeem itself and significantly improve its ESG profile. Another example is an issuer in a high-emission industry that has a credible strategy to transition to a low-carbon economy and can evidence its progress. We want to benefit from ESG-led credit improvements that translate into tighter credit spreads. Ultimately, we believe improving ESG profiles will benefit society as well as increase the potential for bondholder gains.

## How do you integrate ESG considerations into your credit research?

Our credit analysts aim to identify the most material ESG considerations for each issuer we invest in, to make sure we can understand and price the risks and then aim to detect credit improvement or deterioration before the market prices in this change. To do this, we need to conduct our own forward-looking ESG analysis rather than using external ESG data providers, which tend to base their scores on backward-looking disclosures.

We do not have dedicated ESG analysts in the credit research team because we consider ESG analysis a core part of credit analysis. We believe no one is more qualified to integrate the most material ESG considerations into our credit recommendations than our credit analysts who are experts in their sectors. To authentically integrate ESG, we consider credit analysts to be best placed to incorporate it within the research, rather than have a small number of ESG analysts providing an 'overlay' and engaging on their behalf. We do, however, leverage our centralised specialist ESG resources to support us with research and engagement.

## What are the benefits to having proprietary ESG ratings as well as using external ESG data providers?

We believe both add value – but in different ways. While we subscribe to several third party ESG data providers, we believe it is imperative to carry out our own analysis, in line with the reasons noted previously, and set a proprietary ESG rating for every issuer we hold.

The biggest difference between external providers and our own ESG ratings is the focus on what we consider most material for each issuer. We also put a greater emphasis on the forward-looking factors and the direction of travel rather than just backward-looking historical data. We are also cognisant of some biases inherent in external ESG scores given that large companies from certain regions tend to provide better disclosures and score more highly. While we acknowledge there are data challenges, where we do

“Ultimately, we believe improving ESG profiles will benefit society as well as increase the potential for bondholder gains.”



make extensive use of external data providers is in relation to climate change. We use various sources of climate data to inform our assessments and measure and manage climate change risks in our portfolios.

## What are the biggest challenges currently in ESG investing?

The biggest challenges remain the lack of standardisation in disclosures as well as the depth and quality of the disclosures that we need for better visibility into how companies are run, particularly around some harder to quantify 'S' metrics. This is why we believe company engagement is so important. Whether it is encouraging companies to improve their carbon disclosures or trying to better understand their policies around supply chain management, diversity or financial inclusion, a proactive dialogue with companies is necessary until we have more standardised metrics and better reporting from companies. This is important because encouraging companies to improve in these areas should ultimately help drive stronger corporate sustainability and enhance investment returns.

Hence, we are strong advocates of active engagement and industry-wide collaboration with our peers to help steer improvement and make progress on corporate disclosure. Our efforts in this area include helping to frame questionnaires that seek to standardise minimum disclosure from issuers. We recognise they are

inundated with questions from investors and not always sure what they should be disclosing. We also take part in working groups and events that bring together issuers, asset managers and credit rating agencies, as well as being a Task Force on Climate Related Financial Disclosures (TCFD) supporter and actively engaging with issuers on their alignment with TCFD recommendations. In addition, we are a member of the SASB Alliance, that helps businesses around the world to identify, manage and report on the sustainability topics that matter most to investors.

## Why do you believe ESG is best implemented using an active strategy rather than passive?

In our view, it comes down to extracting the maximum benefit from identifying and driving change. ESG analysis is ultimately about being on the right side of change. As active managers our goal is to be proactive and spot improving trends in the economy, sectors and bond issuers that can boost returns and equally avoid deterioration that could damage returns. We believe there are clear benefits to accessing this larger toolbox that active management can offer to help mitigate risks, drive change by proactive company engagement and seek out stronger risk-adjusted returns.



## Do you think the importance of ESG will continue to grow?

Definitely. We think last year proved that ESG analysis is not just a bull market luxury but very much a bear market necessity, and its importance will only grow. In the past, ESG was integrated mostly on the back of client demand. Recently passed and upcoming regulations, however, especially in Europe, will require that ESG is systematically integrated within investment management. This momentum seems certain to increase globally as governments, policy makers and regulators push for meaningful progress on addressing climate change and social issues. In fact, the COVID-19 crisis has shown us what a global systemic emergency looks like and reinforces to us the importance of accelerating the fight against other globally relevant threats, such as global warming, loss of biodiversity and inequalities, while building a greener, resilient and more inclusive global economy in the interest of everyone, including investors and asset owners.

In terms of climate change, there is a pressing need to reallocate capital to speed up the transition to a low-carbon and circular economy if we are to limit global warming to well below two degrees. More public and private sector investments will need to be channelled into clean energy and new technologies as well as helping high-emission and hard to abate sectors, that are vital to economic growth, to decarbonise and align with the Paris Agreement. We as an asset management industry need to provide to our clients a range of investment options and solutions that align with their values and help achieve

their financial as well as ESG related objectives. We expect to see more innovative, well designed and purpose-led strategies to address real issues and achieve real outcomes. For example, in our view, Transition Finance will have a big role to play and recent developments around sustainability-linked instruments were well received by the market. Demand is rising for companies that are able to transition to a more sustainable world and they should provide better risk-adjusted returns over the long term.

We believe good ESG analysis will be key to identifying and supporting companies that are driving, and benefitting from, change and in turn allow us to deliver good quality and consistent risk-adjusted returns for the clients we serve.

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**Morningstar, Sustainable Investing Research Suggests No Performance Penalty:** A report by Morningstar in 2016 overviewed academic literature and conducted analysis to conclude that sustainable investing does not have a negative effect on investment performance. It found a focus on company-specific ESG factors led to better risk-adjusted returns at the portfolio level than an exclusionary screening approach.

**MSCI, Foundations of ESG Investing:** A paper from MSCI in November 2017 sought to test for causation by analysing three different ESG transmission channels – 1) good ESG leads to higher cash flow, 2) good ESG companies are better at managing company specific risk, 3) good ESG companies have lower exposure to systemic risk factors. The paper found a positive link for all three channels. MSCI, Foundations of ESG Investing – Part 1: How ESG Affects Equity Valuation, Risk and Performance.

**HSBC, ESG Playbook:** In Generating alpha across 19 sectors (October 2018) the strategy team re-weighted the components of the Refinitiv ESG score according to the topics that sector analysts considered most material. The report found this increased the performance of a portfolio with improving ESG scores. Ioannis Ioannou and George Serafeim, 2019: A study in 2019 focused on whether sustainability practices converge over time, and hence whether they can be a source of long-term competitive advantage. It is based on MSCI ESG ratings for 2012-17 for 3,802 companies.

**Harvard, Corporate Sustainability:** First Evidence on Materiality: This study acknowledges that the prior literature has been mixed, but finds that if one differentiates between what is material to each sector (based on the SASB materiality map) then sustainability data is meaningful for long-term performance. The paper uses MSCI KLD data for the US, which has 650 companies for 1991-2000 and 3,000 companies for 2003-2012. The paper finds that by constructing portfolios weighted to material sustainability issues 3-8% annualized outperformance can be achieved, while weighting to immaterial sustainability issues leads portfolios to underperform. Khan, Mozaffar N., George Serafeim, and Aaron Yoon, Corporate Sustainability: First Evidence on Materiality, Harvard Business School Working Paper, No. 15-073, March 2015.

**Gunnar Friede et al, 2015:** This was a meta-study aggregating more than 2,000 empirical studies on the link between ESG and company financial performance. Consequently, it looks beyond ESG scores to broader studies. It found 90% of studies identified a non-negative relationship between ESG and financial performance. Gunnar Friede, Timo Busch and Alexander Bassen, ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment, 15 Dec 2015.

## Other literature

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## Glossary

**Alpha:** The difference between a portfolio's return and its benchmark's return after adjusting for the level of risk taken. A positive alpha suggests that a portfolio has delivered a superior return given the risk taken.

**Bear market:** a financial market in which the prices of securities are falling. A generally accepted definition is a fall of 20% or more in an index over at least a two-month period. The opposite of a bull market.

**Bull market:** a financial market in which the prices of securities are rising, especially over a long time. The opposite of a bear market.

**Transition finance:** financial support that aids high-carbon companies in implementing long-term changes to reduce their overall climate impact.

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