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A new deal for bond investors

Shalin Shah – Senior Fund Manager

Shalin Shah, fund manager at Royal London Asset Management, on the outlook for BBB in times of crisis, mitigating risks in fixed income and potential pitfalls of green bonds

1 What is the outlook for the BBB bonds you favour if market conditions deteriorate?

The BBB area is most at risk from widening spreads if we see a second wave of Covid-19. If a bond gets downgraded from BBB to sub-investment grade, then you lose about 10-20% straight off in performance because of its fallen-angel nature.

We are much more targeted in our BBB investments and focus on strongly covenanted issuers with low downgrade risk. This includes, for example, secured debt. We are mainly senior in the lending structure, so first in the pecking order if there is a default.

We also like the utility sector, as it is strongly regulated and requires investment grade credit ratings. If a company allows its balance sheet to deteriorate, it will lose its license to operate. As a result, companies are committed to their investment grade ratings.

We also prefer selected financial debt as the sector is healthier than in the 2008 crisis. For example, from a sustainable perspective, insurance provides financial resilience. It also has high solvency ratios, thereby reducing the probability of downgrades. We also favour banks with a community-funding approach, meaning those with a larger exposure to retail and SME lending but with strong capital backing.

2 How do you make sure you mitigate risks in the portfolio while having a strong high conviction?

The sterling credit market is comprised of over 80% in senior unsecured debt, while our portfolio has over half invested in secured debt, with a bias to senior bonds. That is excellent for downside protection. This includes bonds secured on Tesco supermarkets and on private finance initiatives such as hospitals.

When a company deteriorates, it seeks cash to get through the crisis. This could come from bondholders and banks. New bondholders will require security over assets, which means they tend to subordinate the existing unsecured bond holders. By investing in a senior secured bond format, we can avoid this subordination through legal language that can obstruct such an outcome. Cash injections then need to be junior to our lending position, thereby protecting us. Crucially, we can include such bonds without sacrificing yield on the portfolio.

3 Why is responsible investing less established in fixed income and what is your approach to it?

We select bonds that offer a 'positive choice', which means companies need to provide a net benefit to the society or show ESG leadership. Around 75% of the Sustainable Managed Income Fund sits in five key themes: social housing, the decarbonised economy, infrastructure, community funding (banks and not-for-profit building societies focused on SME and retail lending) and financial resilience. But we are not wedded to those five themes alone.

As debt holders, we do not have as much control as shareholders. In the credit market, only 40% of the debt is issued by companies that have a listing. A lot of our competitors focus on easily-accessible data from listed companies so there is a gap where we can add value through bespoke research.

4 What is behind the boom of green bonds and why do you think they are overrated?

Green bonds have grown exponentially, mainly because pricing is attractive for issuers. They are very accessible and convenient, but flawed. Anglian Water, for example, has 2029 green bonds and a similar maturity in non-labelled bonds. You get 0.2% less in yield in green bonds than for the non-labelled bonds. But in a default you get the same recovery proceeds. The company is an ESG leader, but the bond proceeds are not ring-fenced in a default.

Companies that have received huge environmental fines have been able to issue sustainability-related bonds. They may be making improvements, but it shows that 'greenwashing' is prevalent. Our less convenient but more credible approach is to find unlabelled green gems that offer wider credit spreads.

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