CQS

How Can Investors Generate Income from Credit?

As history is a poor guide for understanding forward-looking income for investors, traditional credit markets are far from a safe haven. The question our investors ask is "how will we find income from credit markets?"

The Challenges

- Limited income from traditional Fixed Income
- Investment Grade bonds heavily exposed to rate risk

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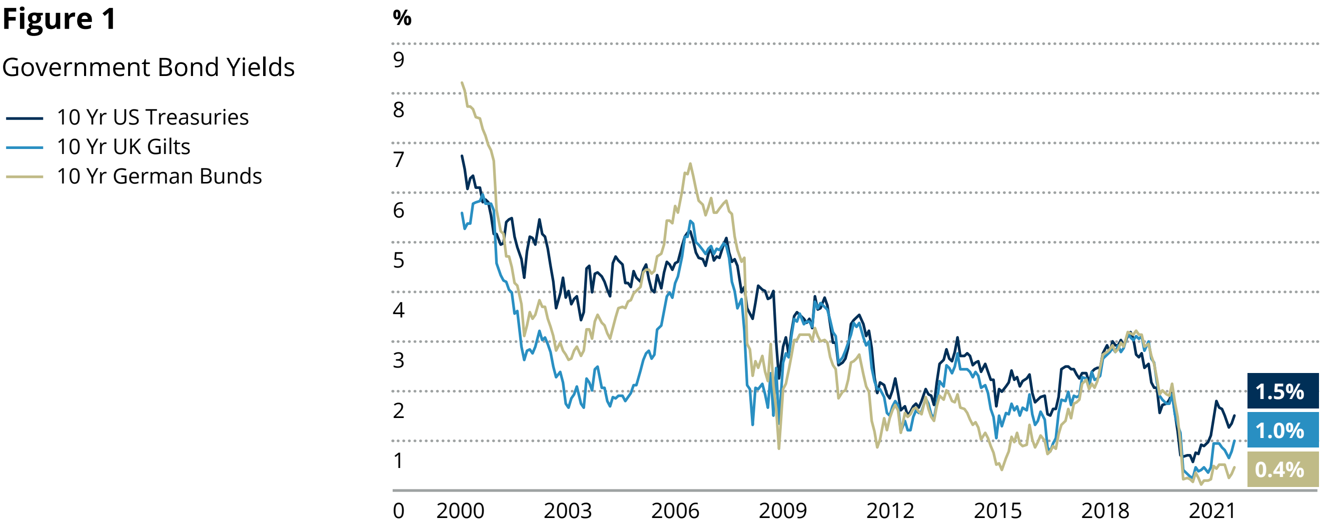
Limited Income From Traditional Fixed Income

While fixed income has benefited from a capitulation in government bond yields, this began to reverse at the beginning of this year, thereby dampening returns.

Figure 1

Government Bond Yields



Source: Bloomberg as at 24 September 2021.

As Figure 1 above shows, yields are near-record low levels (having lost upwards of 85%). Government bonds have been in high supply and there is a prospect of returning inflation. The level of income expected from traditional sources, such as US Treasuries or Investment Grade (IG) Credit is therefore expected to continue to remain at historically low levels.

The uncertain and potential increase in inflation is a challenge for real yields and low income

The recent broad-based rises in core inflation across a range of advanced economies has reopened the debate as to whether this year's rise in inflation really is a purely transitory phenomenon. The latest Consumer Price Index (CPI) inflation figures show that underlying inflation pressures in most advanced economies continue to build or remain at high levels relative to the past decade. For example, core US CPI inflation might have fallen back from its peak, but the 4% outturn is still high and a thirty-year high. The pick-up in inflation expectations has been amplified by surging gas and electricity prices To this end, recent (impartial forecasts) from the OECD significantly upgraded inflation in the Euro Area and the US to 2% and 3%, respectively for 2022.

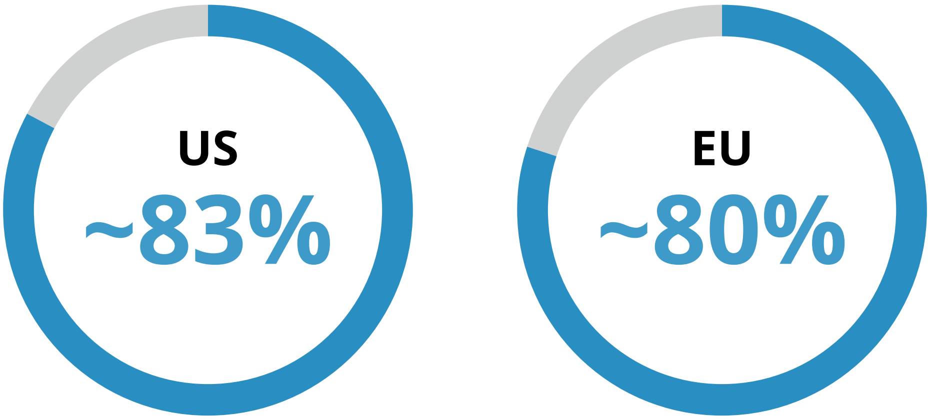
IG Bonds Heavily Exposed to Rate Risk

Although a historically low risk, high return asset class, IG bonds are highly sensitive to rates. Figure 2 is illustrating the annualised returns of US and European IG indices over the past 20 years. These figures imply that over 80% of historic IG returns have been due to government bonds. There is therefore substantial risk associated with their reliance on rates, and investors should tread with caution.

Figure 2

Historic IG Returns

Over the last 20 years, 80% of IG returns have come from government bonds.



Annualised 2000-2021

	US IG (%)	EU IG (%)
Total Return	6.01	5.30
Excess Return	0.92	1.01
Implied Returns due to Rates	**4.95**	**4.22**

Source: ICE BofA Indices (C0A0 & EN00). Returns are in USD hedged. Historic IG returns since 1 January 2000 to 24 September 2021. Please see the end of this document for information relating to the indices.

Where Can Investors Find Income?

The answer is a combination of lending selectively to the right businesses, and by being in the right asset classes and right geography at the right time, plus doing so responsibly.

A Multi Asset Credit, or 'MAC', approach is well placed to capture income and also generate capital gains from credit markets.

A MAC strategy has the ability to rise to the challenge of finding income. Having a broad investment universe enables MAC managers to be selective, and navigate credit markets, uncertainty and ongoing volatility to find the best risk-adjusted returns for investors.

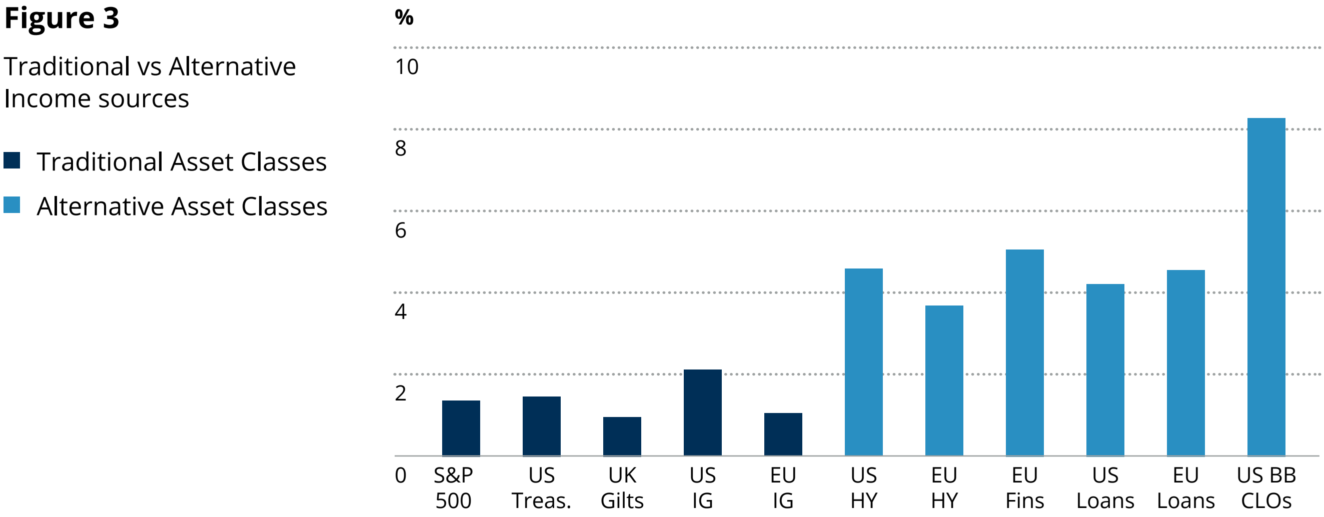
With exposure to the full spectrum of issuers and asset types, a MAC manager can select investment opportunities across different credit asset classes and regions, and be nimble in rotating between them.

Accessing High Income from Sub-IG or Alternative Credit

MAC strategies have the ability to access income in alternative credit asset classes such as high yield bonds, senior secured loans, asset backed securities and convertible bonds. As we can see in Figure 3, while traditional sources of income are currently yielding approximately 1%, alternative income sources are yielding upwards of approximately 4%.

Figure 3

Traditional vs Alternative Income sources



Source: CQS as at 24 September 2021.

We like opportunities where investors are paid well in excess of the fundamental risks. The credit spread (or the excess spread offered over and above an equivalent government bond) in some asset classes remains attractive in this yield-challenged environment.

Being in the right asset classes and the right geography at the right time relies on thoughtful top down asset allocation. Allocating to asset classes such a senior secured loans and asset backed securities, which are floating rate securities, also serves to mitigate the impact of interest rate risk. For medium and longer-term investors, the low duration, floating rate bias of these asset classes will benefit investor returns versus higher duration credit strategies.

With MAC, it is therefore possible to construct a portfolio with a much lower duration than would be possible in IG credit markets, and therefore reduce exposure to the impact of future interest rate moves.

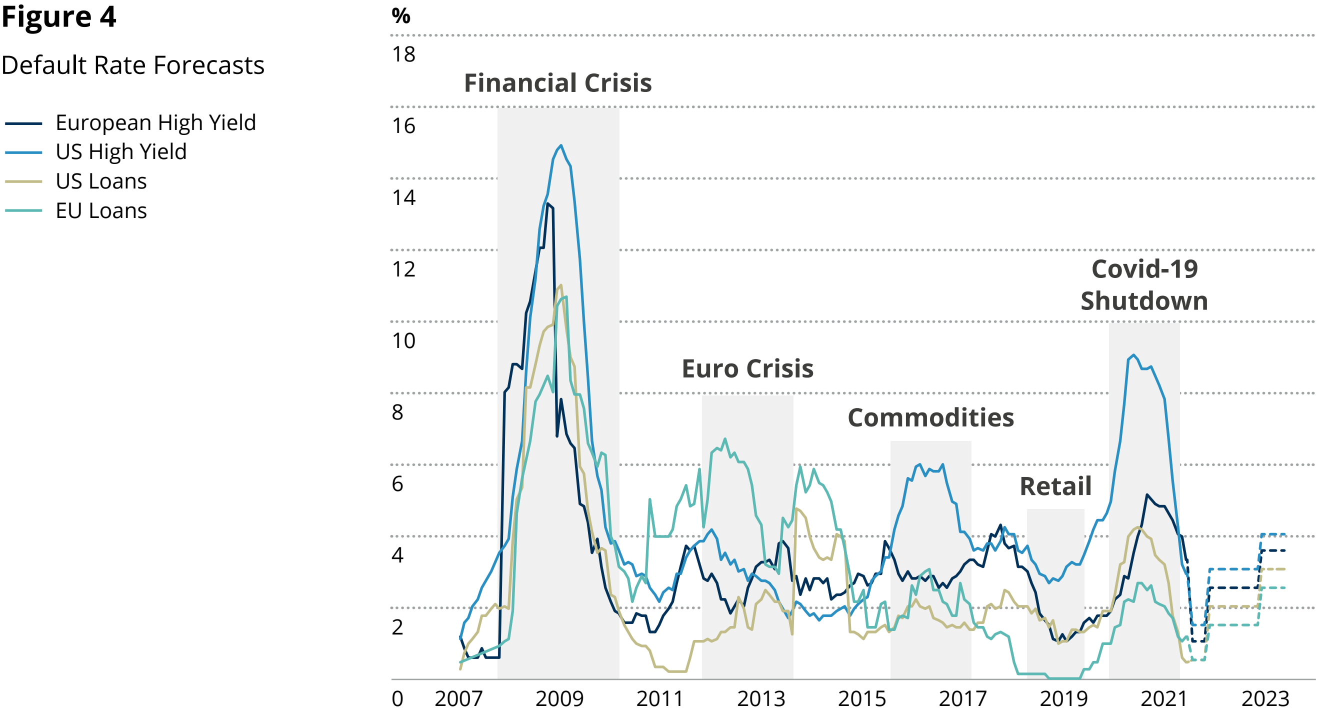
Credit Picking Helps Avoid Defaults

As with any credit portfolio, the biggest risk is defaults. After recent unprecedented rating agency downgrades, the agencies themselves are acknowledging the resilient fundamentals of many sub-IG businesses. The performance of certain businesses and sectors during the pandemic has been stronger than anticipated by rating agencies, highlighting the rapid adaptability of certain business models and excellent management.

Lending to the right businesses, through detailed fundamental analysis, not buying the market and not being afraid to say "no", are all imperative to mitigating credit default risk.

Figure 4

Default Rate Forecasts



	EU HY %	US HY %	EU Loans %	US Loans %
Current	3.87	3.11	1.00	0.58
2021 (Full Year)	1.00	1.50	0.50	0.50
2022	2.50	3.00	1.50	2.00
2023	3.50	4.00	2.50	3.00

Source: CQS Macro and Fundamental Research, Moody's Default Report and LCD, estimated as at 31 August 2021.

While a systemic default crisis is not expected, businesses in certain sectors (e.g. travel, leisure, hospitality, retail) face continued substantial monthly and annual cash burn. This, combined with additional re-opening related capex and working capital outflows, will likely result in default rates rising into 2022 and beyond (as illustrated in Figure 4).

In our view, an approach that buys the market is therefore more than likely to materially dampen returns from losses associated with defaults. Conversely, returns from sub-IG credit markets can be substantially enhanced through fundamentally-driven, active management.

Spreads Compensate Investors for Loss Risk... Just

	EU Loans %	US Loans %	EU HY %	US HY %
Market Spread-to-Maturity	4.60	4.23	3.13	3.21
Historical Average Default Rate	2.28	2.11	2.83	3.93
CQS Estimated Loss Given Default	50	50	60	60
Net Loss to a Portfolio	1.14	1.06	1.70	2.36
Return Post Defaults	**3.46**	**3.18**	**1.43**	**0.85**
CQS MAC Historical Default Rate	0.44	0.44	0.44	0.44
CQS MAC Return Post Defaults	**4.38**	**4.01**	**2.86**	**2.94**
Market Priced-in Default Rate	9.20	8.46	5.22	5.35

Source: CQS as at 31 August 2021. For the time period January 2013 to August 2021. Please see the end of this document for information relating to the index description.

It should also be remembered that as secured assets, loans and asset backed securities are typically at the top of a company's capital structure, first to be repaid in the event of default and well placed for recovery. At the same time, there is no room for complacency, and managers of MAC strategies must constantly adapt for potential shifts in fundamentals, technicals and sentiment.

SIZE IS IMPORTANT

As a manager, it is also important not to be too big. If a MAC manager is to be successful, they need to be selective and nimble. In our experience, a more boutique approach to credit investing opens up opportunities and gives more flexibility from a geographic perspective. This may be a challenge for the very largest managers, who may as a result be essentially buying their 'home' market.

Transactions that may not be sufficient in scale for larger managers, tend to attract higher levels of spread and income. To give an example, in the search for relative value, high yield bond and financial issuers that have smaller capital structures can often be the most attractive. Their asset values have not been distorted by central bank intervention or passive fund flows. Medium-sized transactions are also less likely to be influenced by ETF-related volatility.

The CQS Approach
Sustainable Credit Investing

We believe the diverse investment universe and the attractive level of yield available in an environment where income is increasingly hard to find makes MAC investing an attractive proposition.

For us, the key to finding income from credit markets, and indeed MAC investing overall, is sustainability. In today's markets, stability of returns and responsible credit investing go hand in hand, and allows us to be a market-leader in fixed income. Our focus remains on maintaining discipline in our investment process, and rigour in our fundamental research to achieve the best risk-adjusted returns for investors and avoid the risks of defaults, and loss given defaults. To achieve a solid core of sustainable income, it is important to focus on good quality companies. Increasingly, these are businesses that demonstrate strong Environmental, Social and Governance ("ESG") characteristics, as well as adaptability and resilience in the transition to a low carbon economy.

As our approach primarily invests in sub-IG debt, we work hard to ensure that the companies to whom we lend have sufficient cash flow generation and liquidity to pay the interest and principal on their debt. These issuers are more likely to be companies who are working to improve their ESG factors, including sustainability characteristics, or who are already solid in these areas. Given our size, we are able to engage with a large number of these businesses to help drive sustainability and long-term ESG improvement. How a company behaves from an ESG perspective can have direct implications for their long-term future, affecting the cost of financing, valuation and performance. In our experience, ESG issues themselves are a credit risk; poor governance and E, S, and G controversies are leading indicators for a probability of default and loss given default.

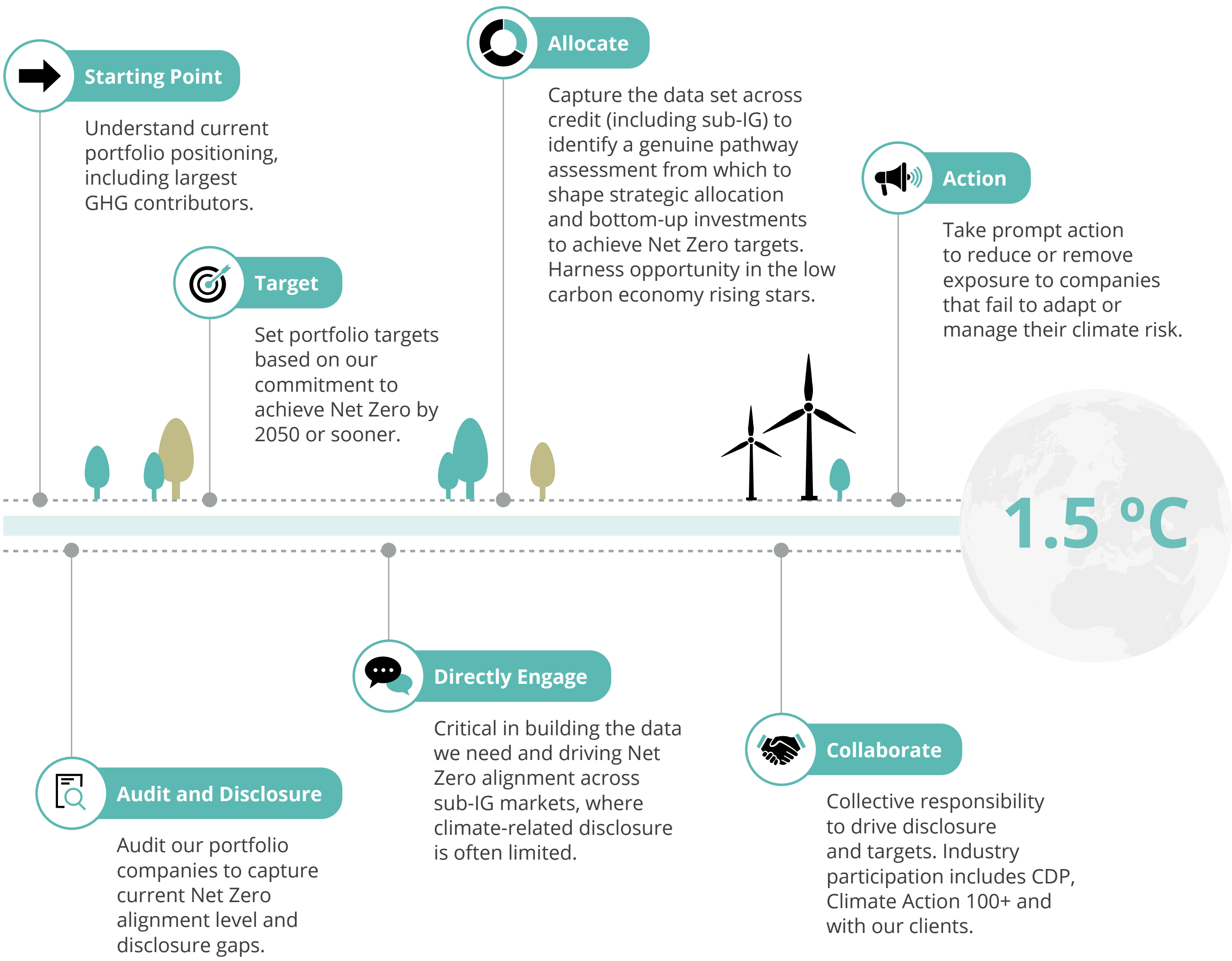
We are a boutique manager, with an investment team located between London and New York. Our MAC portfolios reflect the extensive experience of our team, and in particular access to deal flow in markets in which we operate.

Our Pathway to Net Zero in Credit

As part of CQS' Firm-wide process to drive sustainability, we focus on companies which demonstrate strong ESG characteristics as well as adaptability and resilience in the transition to a low carbon economy.

CQS has pledged to become a signatory to the Net Zero Asset Managers Initiative. In doing so, we will be part of the collective goal to engage and, through investment, achieve net zero greenhouse gas emissions by 2050 or sooner.

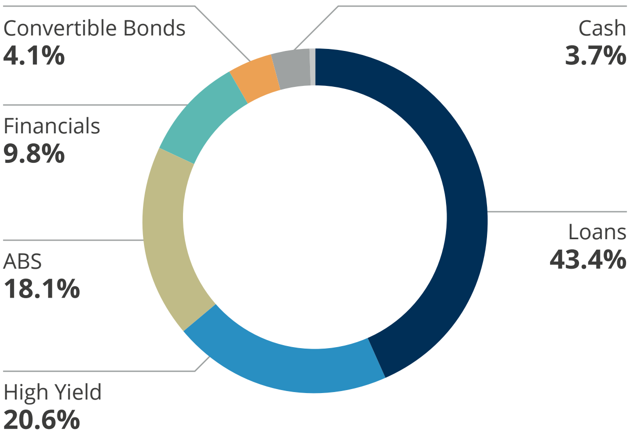
Managing the impact of the transition to a low-carbon economy is essential to deliver the returns and outcomes sought by our investors, as well as playing our part to deliver the goals of the Paris Agreement. Indeed, addressing decarbonisation is now critical to ensure we mitigate risk and deliver opportunities for our clients.



Source: CQS as at September 2021.

Current Asset Class Views

Flagship MAC Strategy Asset Allocation



Source: CQS indicative as at 31 August 2021.

Loans

We remain positive on Loans and believe the credit risk premium is attractive. Loans benefit the portfolio from strong security packages, demonstrable excess (non-rate dependent) returns, lower forward-looking defaults and higher recoveries than alternative sub-IG asset classes.

The European Loan market has been particularly dynamic, with buoyant levels of new issuance led by an active private equity market absorbed with relative ease. The volume of loans supporting buy-outs is currently at the highest level seen since 2007. The US Loan market has also seen high levels of issuance this year which has been met with strong demand.

We have maintained our tilt towards Europe owing to relative value and lower forward-looking defaults.

High Yield

Our theme of favouring Europe continues to be true for High Yield too. Historically, nearly 70% of US High Yield returns have been attributable to rates. In an environment of rising rates, European High Yield offers a more spread-driven return than US High Yield.

Recent market volatility has presented opportunities to lock in attractive credit spreads in Europe.

Asset Backed Securities

We see excellent opportunities from a relative value perspective within parts of the ABS market. We maintain a tilt towards CLOs, principally European CLO liabilities at the BB and B level, where spreads are materially higher than corporate equivalents, despite historic default rates being substantially below corporates.

We continue to see opportunities in Regulatory Capital trades, which provide high levels of income but can sustain a challenging economic environment and preserve capital.

Financials

We continue to believe the asset class presents excellent risk-adjusted returns. Fundamentals in the sector remain strong, with some headline risks being more relevant to equity.

From a sustainability perspective, Financials is particularly attractive; credit picking is critical.

Convertible Bonds

Convertibles have performed well in inflationary and rising rate environments relative to other asset classes. They are defensive to rising rates due to their short duration, and appear well priced relative to certain credit asset classes and uncertain equity valuations.

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Index Descriptions:

It is not possible to invest directly in an index

S&P/LSTA Leveraged Loan Indices are capitalisation-weighted syndicated loan indices based upon market weightings, spreads and interest payments.

S&P/LSTA Leveraged Loan Index (LLI) covers the US market back to 1997 and currently calculates on a daily basis.

S&P European Leveraged Loan Index (ELLI) covers the European market back to 2003 and currently calculates on a weekly basis.

ICE BofAML US High Yield Index (H0A0) tracks the performance of US dollar-denominated below investment grade corporate debt publicly issued in the US domestic market.

ICE BofAML European Currency Fixed & Floating Rate Non-Financial High Yield Constrained Index (H9PC) contains all non-financial securities in ICE BofAML European Currency Fixed & Floating Rate High Yield Index but caps issuer exposure at 3%.

ICE BofAML US Corporate Index (C0A0) tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

ICE BofA Euro Non-Financial Index (EN00) tracks the performance of non-financial EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

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S&P 500 Total Return Index (SPXT): The Standard & Poor’s 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

J.P. Morgan CLO (CLOIE): An index that holistically captures the USD-denominated CLO market by tracking floating-rate CLO securities in 2004–present vintages.

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Signatory of:

In our first year of reporting for the Principles for Responsible Investment, we are pleased to confirm CQS scored an A for the Strategy & Governance of our overall process, and across each of the three direct fixed income modules, we scored a B.

CQS is a public supporter of TCFD (Task Force on Climate-related Financial Disclosures), with climate disclosures a core component of our ESG Engagement Framework. TCFD reporting is available on our website.

CQS is a signatory to the UK Stewardship Code 2020 (the "Code"). Our Stewardship and Shareholders' Rights Report sets out how we have complied with the Code and have applied its principles in the context of our global credit investing.

As a participant of Climate Action 100+, CQS actively supports engagement with some of the largest carbon emitters globally, as we collectively seek strong accountability & oversight for climate risk, action on GHG emissions and proper company disclosure.

CDP (formerly the Carbon Disclosure Project) is a key collaboration amongst asset owners and asset managers in the drive for greater transparency on Climate Change, Forestry & Water Stress.

CQS is a founding signatory. We are pleased to have collaborated with the SBAI to produce the Review on Responsible Investment Regulatory Expectations.

CQS is a credit-specialist multi-strategy asset manager

CQS launched our first strategy in 2000 and today provide a range of investment solutions for investors globally, across a variety of return objectives and risk appetites.

We focus on our core credit asset classes, where we have built specialist expertise over our 20+ year history, and are committed to delivering performance and high levels of service for our investors. Our ambition is to continue to develop our market-leading expertise in responsible credit investing.

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