Global Investment-Grade Corporate Bond: Targeting Consistent Returns

Portfolio Manager Steven Boothe explains his philosophy and market insights.

March 2019

Steven Boothe
Portfolio Manager, Global Investment-Grade Corporate Bond Strategy

KEY INSIGHTS

- The Global Investment-Grade Corporate Bond Strategy is focused on delivering consistent alpha generation and downside risk management.
- The strategy's strong results since its inception in 2015 have come from finding attractive risk-adjusted returns across a global opportunity set.
- Despite global growth concerns, investment-grade corporate markets hold many idiosyncratic opportunities to deliver consistent income for investors.

The Global Investment-Grade Corporate Bond Strategy reached its three-year anniversary last year, having outperformed since its inception. Portfolio Manager Steven Boothe discusses the strategy and reflects on how the markets have evolved over his career.

Q. Can you describe the investment strategy and core philosophy of the Global Investment-Grade Corporate Bond Strategy?

To achieve our goal of alpha generation, our Global Investment-Grade Corporate Bond Strategy utilizes three broad components: First, we run a concentrated portfolio focused on issuers, sectors, and investment themes that reflect our team's best thinking; second, we target idiosyncratic names with strong fundamentals—in other words, we don't structurally overweight lower-quality credits or subordinated financials just to capture their "risk on" beta potential; and third, we seek to consistently hit our alpha target over a full market cycle. Building in a strong downside risk management component limits the potential for drastic swings in performance.

Portfolio positioning relative to our conviction is a defining element of our philosophy. I have a lot of confidence in our global research platform, and I aim to build a concentrated portfolio that emphasizes the high-conviction ideas produced by our team and resources.

Q. How do you think about risk in the strategy, and how do you manage it?

We identify two primary types of risk: rating downgrades and volatility. Given that default risk is minimal in investment-grade credit, much of our time and research focuses on avoiding potential rating downgrades and mitigating the risk of rating actions, which can drag on portfolio performance.

(Fig. 1) The Strategy Outperformed Since Its Inception

Total return since June 30, 2015, versus index.

As of January 31, 2019, figures are calculated in U.S. dollar.

			Annualized	
	Three Months	One Year	Three Years	Since Inception
Global Investment-Grade Corporate Bond Composite (Gross)	2.86%	1.06%	4.99%	4.66%
Global Investment-Grade Corporate Bond Composite (Net—Separate Account)	1.06	0.76	4.68	4.35
Bloomberg Barclays Global Aggregate Corporate Bond USD Hedged	2.90	1.62	4.10	3.69
Value Add (Gross)	-0.04	-0.56	0.89	0.97

Past performance is not a reliable indicator of future performance.
Net of fees performance reflects the deduction of the highest applicable management fee ("Model Net Fee") that would be charged based on the fee schedule appropriate to you for this mandate, without the benefit of breakpoints. Please be advised that the composite may include other investment products that are subject to management fees that are inapplicable to you but are in excess of the Model Net Fee. Therefore, the actual performance of all the portfolios in the composite on a net fee basis will be different, and may be lower, than the Model Net Fee performance. However, such Model Net Fee performance is intended to provide the most appropriate example of the impact management fees would have by applying management fees relevant to you to the gross performance of the composite. Supplemental information. Please see the GIPS® Disclosure page for additional information on the composite. Monthly composite performance is available upon request.
Sources: T. Rowe Price and Bloomberg Index Services Limited. See important information.

Volatility encompasses a wide range of risks, but in general, we focus on managing carry relative to volatility. We do this at the sector, region, and individual security levels. Our approach involves analyzing our positioning on credit curves, often prioritizing the steepest part of the curve to maximize carry and rolldown relative to volatility. It demands a comprehensive understanding of history as volatility is very much momentum driven and tends to follow identifiable historical trends. It is also important that we consider forward-looking fundamental analysis to get ahead of potential volatility regime shifts.

Q. What are the main changes you've observed in the market over the course of your career?

I've seen many, but I'd like to highlight three in particular: the role of central banks, the technical dynamics of credit markets, and credit quality deterioration.

In the years since the financial crisis, central bank actions have taken on a bigger role in determining how markets price credit and risk assets generally. Consequently, investors need to spend more time than they did in the past considering macro influences and the risks associated with changes in central bank behavior. Events such as the taper tantrum in 2013 are examples of where central bank action or messaging triggered a sharp change in market pricing. The unwinding of accommodative policies over the past year contributed to several bouts of volatility and have the potential to continue to do so further in the year ahead. We therefore believe that it is essential to complement a bottom-up idiosyncratic focus with a macro top-down lens.

In credit markets, the larger size of some modern issuers, specifically some of the mega-cap BBB rated issuers, means that investors will need to devote more attention to technical conditions when making positioning decisions. For example, we are more mindful now of our position sizes in mega-cap issuers as spikes in volatility can make trading more difficult.

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>
> **— Steven Boothe**
> *Portfolio Manager, Global Investment-Grade Corporate Bond Strategy*

In terms of credit quality, the BBB rating bracket has quadrupled in size since the early 2000s and now makes up roughly 50% of the investment-grade market. While I don't see this as a systemic risk, investors will need to delve deeper into idiosyncratic balance sheet fundamentals of specific sectors and credits to determine if they are getting fairly compensated to the level of risk. Most companies that have seen their leverage levels increase due to merger and acquisition activity still have the ability to stabilize, but the willingness to focus on reducing leverage and improving balance needs to be there as well. As more issuers start to focus on improving and maintaining healthy balance sheets by cutting dividends or selling assets, we believe credit quality will stabilize too.

Q. What aspects of the strategy have worked best over the past three years?

The portfolio generated the most alpha when we developed a contrarian view to the market consensus. Our global research platform is integral to what we do—when we generate a strong conviction in an individual name or a market theme that runs contrary to the current market pricing, we have been able to capitalize on these dislocations or inefficiencies. We saw this in 2015–2016 as oil prices fluctuated. In early 2015, we adopted a defensive position in the energy sector before oil prices collapsed but then shifted to a long position and benefited when prices recovered in 2016.

Generally speaking, patience when deploying risk has been a key to our success. We believe that sticking to fundamental credit convictions rather than chasing beta rallies will help performance in the long run, even if it can sometimes result in short-term drags. This approach helped us over the course of 2018 after volatility surfaced late in the year, rewarding our defensive positioning.

With bouts of volatility likely to return in the year ahead, we continue to believe that a disciplined, long-term approach remains the most prudent strategy.

Q. Has the recent market volatility created opportunities?

We have identified several new opportunities in the wake last year's volatility. For example, the insights generated by our combined equity and credit platform helped us hold conviction in some names that experienced price swings in the late-2018 volatility. This patience resulted in a significant performance boost when some of these securities recovered at the end of the year and into 2019.

Looking ahead, the auto sector appears to offer pockets of opportunity. Overall, the sector is facing end-of-cycle headwinds and could see increased selling pressure, especially as U.S. growth slows. However, we believe some of the larger, more fundamentally strong names should weather a cyclical downturn relatively well and remain attractive over the long term. This means that the periods following risk-off volatility could be a good time to enter or increase positions on an idiosyncratic basis.

However, with the likelihood of further market swings and growth concerns, it remains imperative for investors to do their homework to identify the best opportunities rather than buy solely based on cheaper valuations.

Q. What is your outlook for the coming year, and where are the biggest risks?

I would characterize our outlook as balanced. On one hand, we are more cautious than we were a year ago due to the growth concerns and potential for further volatility as liquidity is likely to continue to unwind. While I believe that the global economy will avoid recession, any further easing of growth momentum could weigh on risk assets.

In terms of the primary risks, the U.S. credit cycle appears to be very mature. A noticeable decrease in earnings growth with current cycle-high leverage levels would potentially see a degree of repricing in the investment-grade credit market. Investors also need to keep a close eye on European bank valuations as a further slowdown in the eurozone's economy could impact this sector. Consequently, we are keeping overall risk levels below that of the market as a whole for the time being.

The upside is that valuations improved on the back of last year's volatility spikes, creating opportunities to take on risk in specific credits where we think prices are dislocated and fundamentals are favorable. We believe that when investors show patience in their high-conviction names, they will benefit from strong performance over the longer term.

Q. In the current environment, what role do investment-grade bonds play in an investor's portfolio?

Investment-grade credit can offer investors the twin benefits of active risk management and income, and although volatility may return, we are confident that the asset class will continue to deliver both. We believe that disciplined credit selection can uncover how to attain these benefits over the longer term at more reasonable prices than in the recent past.

The concerns about growth also highlight the benefits of a global opportunity set. Not only does this larger universe contain potentially more positive idiosyncratic stories, but it gives investors the chance to diversify away from regions that are in late cycle, such as the U.S., and prioritize regions and sectors that are showing better growth outlooks or relative immunity to the wider concerns. Identifying regions and sectors that historically offer higher Sharpe ratios helps us to achieve our aim of generating both safety and income in investment-grade credit.

WHAT WE'RE WATCHING NEXT

While we are very aware of the growth softness and trade uncertainties in China, we continue to see strong opportunities in high-quality emerging market investment-grade credits. Specifically, Asia credit displays defensive qualities and is a good risk management tool during market downturns. We are finding the best risk-adjusted returns globally in the region as it boasts some of the highest Sharpe ratios.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material: Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default which may affect the value of an investment.

GIPS® Disclosure

Global Investment-Grade Corporate Bond Composite

Period Ended December 31, 2018
Figures Are Shown in U.S. Dollars

	2015[2]	2016	2017	2018
Gross Annual Returns (%)	1.12	8.01	6.92	-0.76
Net Annual Returns (%)[1]	0.97	7.69	6.60	-1.06
Bloomberg Barclays Global Aggregate Corporates Bond USD Hedged Index (%)	0.50	6.22	5.70	-1.00
Composite 3-Yr. St. Dev.	N/A	N/A	N/A	3.21
Bloomberg Barclays Global Aggregate Corporates Bond USD Hedged Index 3-Yr St. Dev.	3.47	3.43	3.28	2.92
Composite Dispersion	N/A	N/A	N/A	N/A
Comp. Assets (Millions)	20.0	21.7	170.3	185.2
# of Accts. in Comp.	1	1	3	3
Total Firm Assets (Billions)	772.4	817.2	1,000.2	972.7

[1]Reflects deduction of highest applicable fee schedule without benefit of breakpoints. Investment return and principal value will vary. Past performance is not a reliable indicator of future performance. Monthly composite performance is available upon request. **See below for further information related to net of fee calculations.**
[2]June 30, 2015 through December 31, 2015

T. Rowe Price (TRP) has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). TRP has been independently verified for the 22-year period ended June 30, 2018 by KPMG LLP. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. TRP is a U.S. investment management firm with various investment advisers registered with the U.S. Securities and Exchange Commission, the U.K. Financial Conduct Authority, and other regulatory bodies in various countries and holds itself out as such to potential clients for GIPS purposes. TRP further defines itself under GIPS as a discretionary investment manager providing services primarily to institutional clients with regard to various mandates, which include U.S., international, and global strategies but excluding the services of the Private Asset Management group. The minimum asset level for equity portfolios to be included in composites is $5 million and prior to January 2002 the minimum was $1 million. The minimum asset level for fixed income and asset allocation portfolios to be included in composites is $10 million; prior to October 2004 the minimum was $5 million; and prior to January 2002 the minimum was $1 million. Valuations are computed and performance reported in U.S. dollars. Gross performance returns are presented before management and all other fees, where applicable, but after trading expenses. Net of fees performance reflects the deduction of the highest applicable management fee that would be charged based on the fee schedule appropriate to you for this mandate, without the benefit of breakpoints. Gross and net performance returns are net of nonreclaimable withholding taxes on dividends, interest income, and capital gains. Effective June 30, 2013, portfolio valuation and assets under management are calculated based on the closing price of the security in its respective market. Previously portfolios holding international securities may have been adjusted for after-market events. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Dispersion is measured by the standard deviation across asset-weighted portfolio returns represented within a composite for the full year. Dispersion is not calculated for the composites in which there are five or fewer portfolios.

The strategy utilizes on a regular basis a variety of derivative instruments such as (but not limited to) currency forwards, fixed income futures, interest rate swaps, credit default swaps, synthetic indices, and options on all mentioned instruments, primarily to hedge certain market risks associated with the strategy's objective, to express directional opportunities on specific markets and to facilitate liquidity management. Benchmarks are taken from published sources and may have different calculation methodologies, pricing times, and foreign exchange sources from the composite. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow greater than or equal to 15% of portfolio assets. The temporary removal of such an account occurs at the beginning of the measurement period in which the significant cash flow occurs and the account re-enters the composite on the last day of the current month after the cash flow. Additional information regarding the treatment of significant cash flows is available upon request.

The firm's list of composite descriptions and/or a presentation that adheres to the GIPS® standards are available upon request.

Fee Schedule

Global Investment Grade Corporate Bond Composite. The Global Investment Grade Corporate Bond Composite seeks capital appreciation primarily through investment in fixed income securities, floating rate bank loans and floating rate debt securities rated below investment grade (BB or below) by S&P, Moody's or another nationally recognized securities rating organization (NRSRO). (Created May 2014)

First 50 million (USD)	30 basis points
Next 50 million (USD)	25 basis points
Above 100 million (USD)	22.5 basis points on all assets[1]
Above 250 million (USD)	20 basis points on all assets[1]
Minimum separate account size	50 million (USD)

[1]A transitional credit is applied to the fee schedule as assets approach or fall below the breakpoint.

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ID0002013 (03/2019)
201902-756084