Chapter 23

Investing Issues: Portfolio Management Interaction

What's in this chapter:

- portfolio types and styles
- trading liquidity and portfolios
- the basics of portfolio performance analysis

CREDIT ANALYSIS IS not done in isolation. It may be done in the context of an investment banking project or in an examination of risks on a broker-dealer trading desk. In many cases, credit analysis will be done as part of a decision on what goes into an investment portfolio. Understanding how the analysis, the relative value recommendations, and the decision-making process interact with the concept of portfolio management can improve credit analysis and make it more goal directed. It can also give insight into how the leveraged finance market works.

Portfolio Types and Styles

Any investment in the leveraged finance market is often a relatively small allocation of a very diversified pool of investment money that may have equities, government bonds, municipal bonds, and investment-grade debt investments alongside public and private leveraged finance investments. The ultimate capital for these portfolios may come from insurance companies, pension plans and other retirement savings programs, endowments, and individuals' savings. The individuals who manage these programs will decide how much they want to allocate to the leveraged debt markets and will also usually decide how they want the money managed.

The assets allocated to leveraged finance debt may be managed in-house by these organizations or they may allocate the money to unaffiliated money managers. The money could go into commingled funds where the assets are combined with the money of other investors. These could be in the form of mutual funds, ETFs, or a separate, limited-partnership-type of private structure. If the amount they are allocating to a money manager is large enough, it may be in a separately managed account.

The money could be in a dedicated asset class—for example, the allocation could be just for US dollar leveraged loans—or it could be a broad, corporate, fixed-income mandate where the manager decides how much is allocated to each asset class and in which currencies. More flexible mandates, such as hedge funds, may make periodic opportunistic investments in the leveraged debt markets, even though they do not have an allocation dedicated to the asset class. Understanding the type of money that is being invested in the marketplace can help an analyst understand some of the supply and demand dynamics in the market and also understand there will be different investing strategies, making up a diversified universe of buyers and sellers with different goals.

Usually, money allocated to the leveraged finance asset classes is put under the management of specialists who construct these investments to achieve client goals, or the stated goals of the commingled pool of money. Portfolio strategies can vary significantly. Some passive strategies just want to get exposure to one part of the leveraged debt markets and closely mimic some mandated index. Other strategies may be focused on maximizing interest income and minimizing realized losses. There can also be strategies that are willing to take more risk and

are focused on total returns, and those that may want to minimize volatility. Analysts will do better at their job if they understand the strategic style of the portfolio or portfolios that they are working with. One investment idea may work well for one style, but not another.

One of the common concepts in portfolio construction is diversification. Portfolios can create diversification in many ways, including by geographic region, currency, rating category or levels of risk, duration, and industry. Portfolio managers in credit markets will often manage their diversity and exposures across a number of these categories simultaneously. Within the leveraged finance markets, industry diversity is a factor of considerable focus. Diversification helps guard against a sudden turn of fortune in one industry or another. This will lead portfolio managers to often think of an investment as a percentage of the portfolio, and they will analyze what the weighting should be in the portfolio. This will typically lead portfolio managers and credit analysts to set up ranking systems of recommendations.

As portfolio managers think about the construction of the overall portfolio, they may also look to add or sell certain investments with certain characteristics and may look for relative value recommendations with selected characteristics, such as short duration or higher-yielding recommendations. Analysts should compare their recommendations to comparable credits and indexes, and also to the statistics of the portfolio for which they are recommending the investment.

Trading Liquidity and Portfolios

The leveraged finance markets have historically not been as liquid from a trading perspective as some other capital markets, such as government bond and equity markets. In some cases, bonds and loans may not have any trading liquidity for a month or more. This can create several issues for credit analysis and portfolio management. One issue is the quality of pricing data: an investment may look very attractive, based on a given price, but a purchase of that investment cannot actually be executed at that price in the markets. Another issue can be a mismatch of liquidity. A portfolio, such as a mutual fund, may see daily flows of cash in and out of it. However, many of the investments in the fund's opportunity set may not have daily trading liquidity. For this reason, the liquidity of the investment will impact its attractiveness as a portfolio component. Some investors actually prefer illiquid issues because

their prices tend to change less often, giving the impression of less volatility and therefore less implied risk. This can prove to be cold comfort if the credit starts to deteriorate and the portfolio looks for a bid and is suddenly down sharply from where it had previously been priced.

There are many factors that can impact the liquidity of an investment. Issue and issuer size are often a factor in trading liquidity. Information flow is also a factor—a company with public financials will often have better liquidity than one with private financials. If a credit has many comparables, it will often have greater liquidity as well, because relative value can more easily be determined than the debt of an issuer in a unique one-off business line. Credit quality can also impact liquidity. Stronger credits and issues with less volatility (e.g., short duration) tend to have better trading liquidity than those of weaker quality.

Analyst recommendations that are very hard to execute can prove to be less valuable to portfolio managers even if they look good on paper. Portfolio managers also are cognizant of overtrading a portfolio. So, quick buy-and-sell recommendations for minute changes can prove less valuable in a less liquid market. There is a cost for each transaction as there is a spread between the bid (price to sell) and offer (price to buy) prices in the market. An experienced analyst usually factors this into any recommendations.

Basics of Portfolio Performance Analysis

Understanding the basic concepts of how a portfolio's success is judged can give analysts insight into what types of investment might work best for a portfolio. There are numerous tools for analyzing performance, including detailed formulas for attribution of returns. Some basics are outlined below. Allocators of capital will look at various analysis tools to judge not just returns, but how much risk is being taken to achieve those returns, and they will compare these results to peer groups and benchmarks.

One measure of risk and return is to analyze a portfolio's return divided by the return of a broad market index in periods of positive and negative returns, referred to as upside capture and downside capture. As an example, if the benchmark index is down -5%, and the portfolio is down only -4%, it has achieved 80% downside capture. Comparing upside and downside capture will

give those who allocated money to the portfolio a sense of how much risk they are getting for their returns.

In risk-versus-reward analysis, volatility of returns is often viewed as risk. One of the common and long-standing tools that uses this concept to measure risk versus reward is the Sharpe ratio.[20] There are three components to the ratio:

1. the return on the portfolio = RP
2. the return on a risk-free asset, usually a government bond = RF
3. the standard deviation of the portfolios returns over this risk-free rate, which is a measure of the volatility of the portfolio's returns = VP

Volatility is viewed as a measure of risk. The Sharpe ratio formula below is effectively showing the excess return per unit of risk:

$$\text{Sharpe Ratio} = (RP\text{-}FR)/\ VP$$

This type of ratio is commonly used to compare the risk-reward of different asset classes and different portfolios competing in the same asset class. As with many portfolio analysis tools, it was originally developed for the equity market. The ratio has many shortcomings, especially when applied to the leveraged debt markets. Some of the shortcomings are: 1) the formula treats both upside and downside volatility equally as a risk; 2) with interest income such an important part of the return in leveraged finance, volatility can get distorted when comparing asset classes; 3) the risk from volatility may be short lived; and 4) in a market where some securities only trade once a month, volatility measures may be misleading. Despite the shortcomings, measuring returns relative to the risk by means of volatility is common in portfolio analysis. Many similar analysis tools can be studied—such as the Sortino ratio, which uses the volatility of downside returns as a measure of risk.

20 This ratio is named after its developer, William F. Sharpe.

Indexes and Benchmarks

Portfolios are typically measured against other portfolios with similar strategies but also are measured against a benchmark, which could be a government rate plus a certain percent, such as a three-year German government bond rate plus 4% return. More commonly, the benchmark is an index designed by a third party. These indexes are used to compare and analyze a portfolio's performance. Many portfolio managers will focus primarily on issues that are in the assigned benchmark as their opportunity set. Other managers will actively look to add out-of-benchmark investments. If working with a portfolio measured by a benchmark, it is always helpful to understand what is included and excluded in the benchmark and have access to data about the benchmark. Benchmarks change over time and will even change their inclusion rules. Portfolio performance ratios, such as the Sharpe or Sortino ratio, are typically run in comparison to a portfolio's benchmark.

Portfolios often have specific rules about what they can and cannot buy. These could be based on ratings or a socially responsible restriction. It is also typical to have concentration restrictions, such as permitting no more than 5% of the debt of one issuer. Many regulated entities, such as insurance companies, may place restrictions on taking gains and losses for various reasons. These are all factors that analysts should be aware of as they analyze and interact with portfolio managers.

Closing Comment

The more analysts, traders, salespeople, and capital markets personnel understand how portfolios are designed and managed, the more insight they can have into relative value and how the markets act. This knowledge can help analysts tailor and manage their recommendations to meet the portfolio's needs and make the investment process more efficient. Even if analysts are not working directly with a portfolio, an understanding of how portfolios operate can be very helpful in developing a better view of the workings of the leveraged debt markets. When working with a portfolio management team, how each individual investment impacts the holistic characteristics of the portfolio must be considered.