

The tried and tested approach

Aviva Investors' Tim Jagger shares insights on the Asian high yield space and the near to medium-term outlook

INTEREST in high yield assets among Asian investors has been on the rise, thanks to their appetite for income. But this year, high yield assets have weathered a volatile patch, due to jitters over China and the Federal Reserve actions.

We speak to Tim Jagger, Aviva Investors Senior Vice-President and Portfolio Manager for fixed income – Asia. He is also the lead fund manager of Aviva Investors' Asian High Yield Bond Fund.

Q: Please share with us your outlook in the near to medium term for the Asian high yield asset class in terms of valuations and the sources of potential returns. Are investors adequately compensated for the risk they take?

Market valuations have improved over Q3 2015 given the broader “risk off” environment and they begin Q4 at their most attractive over the last three years based on benchmark spread levels. However, Asian high yield looks rich relative to both the US and other emerging high yield markets and this, coupled with a weaker technical environment, may well hold back a wholesale recovery in spreads.

In terms of sources of potential returns, there is some merit in reallocating towards some of the underperforming sectors and countries, although this needs to be done very selectively given a volatile risk environment. We do expect default rates to increase a little from currently extremely benign levels although they should remain below historic averages. We remain focused on our tried and tested investment process, particularly the avoidance of “special situations”.

Q: What sectors of the Asian high yield space are you positive about, and which sectors would you underweight or avoid and why?

The Asian High Yield Bond Fund is over-weighted in the China property sector. We believe many Chinese developers are taking advantage of the reopening of the onshore bond

market to issue securities at far lower yields than those prevailing on their US dollar (USD) debt. This has the positive impact of reducing exposure to a downward USD/CNY move and increases the technical attraction of its USD paper as it becomes more scarce and investors are able to buy both onshore and offshore to acquire the USD debt to lock in more attractive returns.

However, we also note that the developers are becoming increasingly risk averse by scaling back land acquisitions and focusing on clearing inventory. This has mostly met with success with many developers likely to meet sales targets for the year, which were set at around a 5-10 per cent improvement in renminbi terms on 2014.

The Fund is underweight the energy and metals and mining sectors given the ongoing weakness in selling prices, concerns over global growth and over-capacity problems. Over-capacity problems are particularly acute in coal mining and steel manufacturing, for example.

Q: How do you screen assets for inclusion into your portfolios?

Aviva Investors has an established and robust investment process and credit research to screen securities. Our research framework consists of qualitative and quantitative evaluations of four factors: Macro, Fundamentals, Valuations and Technicals (MFVT). Within credit research, analysts will develop an Original Investment Thesis and Exit Strategy for every investment idea put forth. The Original Investment Thesis is defined as the catalyst for why a bond will add alpha.

Our analysts monitor holdings by reading official financial statements, monitoring relevant security and industry news and events, maintaining robust financial models, and keeping dialogue with management teams to continuously monitor portfolio holdings. This helps us stay dynamic with our investment recommendations and ensures the portfolio incorporates the securities with the optimal risk/return profile at all times. The portfolio managers and credit analysts travel regularly throughout the region to meet with company management, visit sites and discuss local market conditions with independent authorities.

We apply this MFVT framework consistently across asset classes, sectors, industries and securities, resulting in disciplined decision making, discrete identification of performance drivers and a clear interpretation of actionable ideas in client portfolios.

From the MFVT process we assign an internal credit rating: R score. Next, each issuer's total return expectations are delineated within our recommendation scale, with a range of [-2 ; 2]. This enables our analysts to rank securities relative to the expectations set forth in the Original Investment Thesis. The weighting of the position takes into consideration the expected return and risk to determine the appropriate risk position for the security/issuer. The ultimate weighting of each security in the portfolio is directly related to the corresponding recommendation and

is based on portfolio positions that accurately reflect return expectations which are consistent with expected risk taken.

An analyst's ranking with associated total return scenarios will provide the assessment relative to industry, and a recommended portfolio position will tie the recommendation to total portfolio construction. Recommendations are framed as a percentage of the credit portion of the portfolio and as a portion of the total portfolio contribution to duration. All recommended holdings (+2, +1 and 0) are expected to provide positive excess return. All weighting recommendations from the analysts fall within the designated range for each category with rare exceptions. The maximum weightings correspond to the designated ranges [-2 ; 2].

Q: What risks are you most mindful of in this asset class, and how do you mitigate those risks?

Our philosophy regarding risk is based on the key principles of effective risk management, which include identifying, quantifying and managing risks such as credit risk, interest rate risk, currency risk and liquidity risk. Rigorous risk management is essential to our investment management process and Aviva Investors has developed tools and processes which demonstrate our strong understanding of risk.

Risk is also a key factor in our proprietary credit rating, driven by the firm's MFVT framework. We control security specific risk through our robust research process and through monitoring idiosyncratic risk reports. Our MFVT framework not only allows each investment professional to highlight factors that we expect to drive performance of a sector, security, or asset class, but it also keeps us vigilant in our exit strategy in terms of specific expectations relating to each of these factors. Our first line of defence is our investment team actively monitoring our original investment thesis.

Aviva Investors also has an independent risk management team that provides an important second line of defence check and balance from the front office portfolio management team. To assist portfolio managers in controlling risk, the team produces weekly quantitative portfolio risk reports, and performs scenario analysis to stress test our portfolios and assist the portfolio managers in controlling risk at the security and portfolio levels. The portfolio management team discusses intended risk in daily market calls, through monthly performance attribution analysis, in weekly credit research roundtables and in monthly strategy and economic reviews.

Portfolios are constructed utilising a risk budgeting process. We incorporate the client's risk and return objectives as well as guidelines and constraints to ensure proper risk exposures are followed. While we are benchmark aware, we do not let its composition dictate our portfolio construction. The fact that a particular credit is a large part of the benchmark does not influence our portfolio construction process. If we do not like a credit, we will not own it. **W**

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