

A long/short credit with a long bias

60 seconds with the
fund manager



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This marketing communication is aimed at non-professional investors.





Philippe Noyard



Patrick Zeenni



Nicolas Jullien

We continue to discover interesting opportunities in the corporate bond universe. Philippe Noyard, Global Head of Fixed Income at Candriam, Patrick Zeenni, CFA, Head of Investment Grade & Credit Arbitrage, and Nicolas Jullien, CFA, Head of High Yield & Credit Arbitrage, explain how their approach aims to optimise the credit market’s potential with the objective of generating returns.

Why invest in a long/short credit strategy?

This strategy aims to enable investors to take advantage of potential opportunities in the corporate investment grade⁽¹⁾ and high yield⁽²⁾ (HY) credit markets in Europe and North America. The strategy takes a long/short approach⁽³⁾ with a long bias, using active and flexible management based on strong convictions and disciplined risk management.

This approach aims to meet the needs of investors seeking steady performance and controlled volatility over the medium to long term. To capture the best opportunities in the credit markets, particularly in HY corporate credit, the strategy may invest in a variety of instruments (fixed and variable bonds, hybrid corporates, TRS⁽⁴⁾, CDS⁽⁵⁾, and options). It also relies on two complementary performance drivers: a conservative “Low duration⁽⁶⁾ bucket”, employing a low-beta⁽⁷⁾ philosophy, and an opportunistic «long/short» pocket” with no duration constraints, designed to capture alpha⁽⁸⁾. Risks inherent to the universe (systemic, sovereign, volatility, liquidity, interest-rate and credit) tend to be managed dynamically using derivatives. The optimization of these two complementary strategies, which on average should contribute equally to the strategy’s performance, makes this strategy a genuine alternative to traditional short duration strategies, offering a similar risk profile but, in our view, a potential return potential.

What current opportunities do you see for a long/short credit strategy?

Although credit markets overall are usually correctly valued on the basis of expected default rates, they are characterized by spreads⁽⁹⁾ that can differ widely from issue to issue, particularly within the high yield segment. This dispersion can be the result of disparate economic conditions such as inflation and growth. Company profiles will differ based on their ability to benefit or suffer from elements such as inflation, growth, and technological breakthroughs.

60 SECONDS WITH THE FUND MANAGER

(1) Bonds issued by borrowers who are rated AAA to BBB- by the rating agencies, according to the Standard & Poor’s scale.
(2) High-yield or speculative bonds refer to a lower-quality credit rating when assessing the likelihood of default by an issuer. The ‘high-yield’ designation is granted by a credit rating agency.

(3) Traditional management simply involves purchasing financial products, betting on market increases (Long Only), whereas the alternative approach takes both long and short positions (Long/Short).

(4) Total Return Swap: a swap agreement in which party A pays fees to party B in exchange for the income or return generated by an asset owned by party B.

(5) Contract Default Swap: a derivative product which serves as a form of insurance against the default of an underlying borrower or debt instrument.

(6) Duration is expressed in years and corresponds to the weighted average maturity of a bond or a bond portfolio.

(7) Beta is a measure of the market risk of the portfolio, where the market is represented by financial indices (such as the MSCI World) consistent with the portfolio’s guidelines. It measures the portfolio’s sensitivity to market performance. For instance, a beta of 1.5 means that the portfolio will typically move 1.5% for every 1% movement in the market. In mathematical terms, beta measures the correlation between the portfolio and the market, multiplied by their volatility ratio.

(8) Alpha is a metric used to measure the added value of an active portfolio manager compared to passive exposure to a benchmark index. A positive alpha reflects outperformance, while a negative alpha indicates underperformance.

(9) The spread of a bond represents the yield differential between a bond and the yield of a risk-free bond for the same duration.



Furthermore, market expectations of the speed at which key interest rates will change may be called into question by central banks.

The impact on the expected performance of benchmarked funds could be significant, given the sharp inversion of yield curves in Europe and the United States.

With such uncertainties acting as a source of dispersion, performance reflects, above all, the alpha of the security. This tends to generate numerous arbitrage opportunities. The strategy aims to use these to build an optimal configuration for our long/short credit strategy.

Can you explain how a flexible approach can help generate outperformance?

The management process of our strategy is based on a bottom-up approach, supplemented by a macroeconomic filter.

Security selection is based on three pillars: ESG-integrated⁽¹⁰⁾ analysis of issuers' business activities, analysis of their financial profile, and analysis of the legal clauses of each issue.

This triple analysis enables us to determine the most attractive credit instrument for a given issuer (e.g. cash bond vs. CDS, USD vs. EUR issue, or where in the capital structure to invest).

It also help us to try to anticipate potential risks (technological, operational, tax, etc.) and thus to be able to adapt positions very quickly if necessary. This fundamental analysis is augmented by a quantitative analysis. Relying on proprietary tools for assessing credit risk and thus spread risk, our quantitative approach is used to support and optimize the investment decision.

In our strategy, we usually select only 40 to 60 names. These decisions are built around the two pockets, with between 50% and 100% of net assets positioned in the «low duration» pocket, and 0% to

50% in the “opportunistic pocket”; that is, the issues included for their more dynamic contribution potential. Our exposure to market beta reflects our macroeconomic views.

These economic forecasts define our net credit exposure and our exposure to interest rates within the framework of portfolio management constraints. The strategy is subject to daily risk monitoring by a dedicated independent risk team. It is actively managed, incorporating a strict sell discipline based on the macroeconomic and fundamental forecasts and changes. This constant monitoring aims to ensure that all our positions continue to offer attractive return potential.

What are your key strengths in executing your strategy?

The assessment of key performance drivers, along with precise risk management, are crucial with thorough risk control, particularly in uncertain times. While a disciplined strategy and strong technical skills are prerequisites, there is no substitute for experience.

Candriam is a pioneer in European high-yield management, with close to 25 years of innovation dating back to the creation of the euro. Our team is built around a complementary mix of experience and skills, ranging from proprietary desk trading, to long-short/equity, to leveraged finance.

Our credit market expertise is based on rigorous fundamental bottom-up research, develop a thorough understanding of the risks surrounding an issuer and to fully gauge a company's creditworthiness. We aim to assess the entity from all aspects, including the legal framework (bond contracts and documentation) as well as a sustainability profile. It is only after this disciplined study of individual issuers that we decide to invest in them. We believe that this scrutiny of idiosyncratic elements allows us to identify the winners and the losers within high yield markets.

⁽¹⁰⁾ Environmental, social & governance.

The main risks of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the sub-fund in question, and investors may not receive back the full amount invested.

• Interest rate risk:

A change in interest rates, resulting in particular from inflation, may cause a risk of losses and reduce the net asset value of the sub-fund (especially in the event of a rate increase if the sub-fund has a positive rate sensitivity and in the event of a rate reduction if the sub-fund has a negative rate sensitivity). Long term bonds (and related derivatives) are more sensitive to interest rate variations. A change in inflation, in other words a general rise or fall in the cost of living, is one of the factors potentially affecting interest rates and consequently the NAV.

• Credit risk:

Risk that an issuer or a counterparty will default. This risk includes the risk of changes in credit spreads and default risk. Some sub-funds may be exposed to the credit market and/or specific issuers in particular whose prices will change based on the expectations of the market as regards their ability to repay their debt. These sub-funds may also be exposed to the risk that a selected issuer will default, i.e. will be unable to honour its debt repayment, in the form of coupons and/or principal. Depending on whether the subfund is positively or negatively positioned on the credit market and/or some issuers in particular, an upward or downward movement respectively of the credit spreads, or a default, may negatively impact the net asset value. When evaluating the credit risk of a financial instrument, the Management Company will never rely solely on external ratings.

• Derivative risk:

Financial derivatives are instruments whose value depends on (or is derived from) one or more underlying financial assets (equities, interest rates, bonds, currencies, etc.). The use of derivatives therefore involves the risk associated with the underlying instruments. They may be used for purposes of exposure or hedging against the underlying assets. Depending on the strategies employed, the use of derivative financial instruments can also entail leverage risks (amplifying downward market movements). In a hedging

strategy, the derivative financial instruments may, under certain market conditions, not be perfectly correlated to the assets to be hedged. With options, an unfavourable fluctuation in the price of the underlying assets could cause the sub-fund to lose all of the premiums paid. OTC financial derivatives also entail a counterparty risk (though this may be attenuated by the assets received as collateral) and may involve a valuation risk or a liquidity risk (difficulty selling or closing open positions).

• Arbitrage risk:

Arbitrage is a technique which consists in benefiting from the differences in prices recorded (or anticipated) between markets and/or sectors and/or securities and/or currencies and/or instruments. If such arbitrage transactions perform unfavourably (a rise in sell transactions and/or fall in buy transactions), the SICAV's net asset value may fall.

• Sustainability Risk:

The sustainability risk refers to any environmental, social or governance-related event or situation that might affect the performance and/or reputation of issuers in the portfolio.

Sustainability risks may be subdivided into three categories:

- Environmental: environmental events may create physical risks for the companies in the portfolio.
- Social: refers to the risk factors linked to human capital, the supply chain and the way companies manage their impact on society.
- Governance: these aspects are linked to governance structures.

The sustainability risk may be specific to the issuer, depending on its activities and practices, but may also be due to external factors. If an unforeseen event occurs in a specific issuer such as a strike or more generally an environmental disaster, the event could have a negative impact on portfolio performance. In addition, issuers which adapt their activities and/or policies may be less exposed to the sustainability risk.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.

**Find out more about our funds
and their risk profiles:**

www.candriam.com

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