RBC BlueBay
Asset Management

A fresh opportunity from dispersion?

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> "The turbulence in bond and credit markets has driven a wider range of potential returns in investment grade credit."

Andrzej Skiba, Head of US Fixed Income, RBC BlueBay Asset Management, says rising issuer dispersion in investment grade corporate fixed income creates a fertile hunting ground for active managers.

The turbulence in bond and credit markets has driven a wider range of potential returns in investment grade credit. This dispersion is providing active managers with a compelling entry point to capture opportunities across sectors. Elevated dispersion is associated with a turning point in the economic cycle and particularly when macroeconomic conditions take a turn for the worse. Rather than just focusing on valuations and market conditions, investors consider the risk of rating downgrades and a pickup in defaults to guide their views.

This year's recent market volatility has created divergent views among investors, particularly when they start to see signs of meaningful differentiation in the performance of individual sectors or rating groups. So, sometimes, rising dispersion is a symptom of what is already obvious within our investible universe, and sometimes, it's a harbinger of what could happen, although there is no assurance.

Not a time to stay passive

Climbing dispersion in fixed income poses problems for those investors looking to 'buy the market.' Dispersion is a source of alpha for an active manager looking to identify mispricing and opportunities in sector underperformance where it is not justified. This is true at the individual issuer level and often even at the individual security level, and when compared to the rest of the universe. For the bottom-up investor, this is one of the core ways to outperform a benchmark over time.

We generally find that pure bets on market directionality, when you put your crystal ball and decide whether spreads go wider or tighter, the information ratio of those kinds of bets is lower than of issuer-specific, catalyst-driven opportunities where we find those have a much better rate of success over time. Yet many managers cannot take advantage of dispersion successfully, due to the inability to source the securities in a size that makes a difference. If you are running hundreds of billions of assets within your investment portfolio, it's much more difficult to source issuers or sectors where you want to reflect on that dispersion or mispricing. In that case, you're more reliant on beta drivers of the market.

Some sectors offer select pickings

Within sectors, in the spring of this year, when markets saw the blow-up of regional banks in the US, there had been a dramatic difference in their performance versus the global systemically important banks (G-SIBs). That created an opportunity for investors because they came from a point where regional banks before the Silicon Valley Bank (SVB) crisis were trading at spreads tighter than those of the 'money center' banks, that raise most of their funds from the domestic and international money markets, relying less on depositors for funds. In the aftermath of SVB and First Republic collapse, G-SIBs were trading around 200 basis points spread at the 10-year maturity point. In contrast, regional banks traded anywhere between 300 to 400 basis points. That dramatic increase in dispersion created an opportunity for investors to bet on the normalisation of trends in that space.

Another sector for opportunity is in the technology space. Here, the market has been assessing equity-related factors yet showing disagreement about their validity from a credit investor's perspective. Earlier in the year, there was significant pressure on names in the semiconductor space. To shift away from Asia, companies had to spend significant capital on building up the production capacity in the US, which led to unwelcome dividend cuts for equity holders. However, credit investors realised the companies cut dividends to benefit credit holders. They want to defend their ratings, and spend money on CapEx rather than share buybacks or dividends. Well, that's good from a credit perspective.

Finally, commercial real estate is one growth-sensitive area that should not come as a surprise, particularly in the segments of the Real Estate Investment Trust (REIT) universe that are office-related. Compared to last year, we have seen dramatic underperformance of those names, given the shift in the secular themes for office real estate. However, at the overall market level, it is almost not noticeable because office real estate names dominate a small portion of the REIT universe. Amidst the wreckage, some issuers have been unfairly penalized, creating investment opportunities ahead.

Will dispersion continue to climb?

Dispersion could pick up further down the line if the US economy takes a turn for the worse. What we saw earlier this year with regional banks versus money center banks would be magnified to a greater number of sectors, a greater weight of our investment universe, and more noticeable in dispersion statistics. There is no assurance that inflation will continue to moderate at the pace central banks require in the quarters ahead, and while the US economy has been relatively resilient, deteriorating conditions could continue to favour active managers. We must be vigilant because there is a big difference in the performance of our asset class between the more benign and the more negative scenarios.

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