In association with

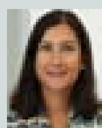
CHAIR

ROSS PAMPHILON
Chief Investment Officer and Senior Portfolio Manager, Head of Credit Europe, WFAM Global Fixed Income
Ross is the chief investment officer and senior portfolio manager for the Wells Fargo Asset Management (WFAM) Credit Europe team. Ross was a founding member of the investment team and the architect of the firm's investment process, with over 20 years of experience in trading and portfolio management.

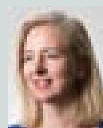
MARTIJN DE VREE
Senior Solutions Manager, Multi-Asset Solutions, WFAM
Martijn is a senior solutions manager for the Wells Fargo Asset Management (WFAM) Multi-Asset Solutions team in London. In this capacity, he designs and implements outcome-oriented investment portfolios. Prior to joining Wells Fargo in 2017, he served as a Senior Solutions Specialist at Insight Investment where he designed and delivered bespoke LDI pension solutions.

JENS VANBRABANT
Senior Portfolio Manager, Head of High Yield - Europe, WFAM Global Fixed Income
Jens is a senior portfolio manager and head of High Yield for the Wells Fargo Asset Management (WFAM) Credit Europe team. He has served as a portfolio manager responsible for team's corporate investment grade and high yield credit risk before becoming a lead portfolio manager of WFAM Credit Europe's Multi-Asset Credit portfolios.

PRASUN MATHUR
Head of Shareholder Investments, UK & Ireland, Aviva
Prasun joined Aviva in October 2016 where is responsible for leading on the development and execution og investment strategy for the UK life shareholder business - this includes the £57 billion (and growing) annuity bank. Prior to joining Aviva, he headed up ALM strategy for Phoenix and has also worked for HSBC.



SHAZIA AZIM
Partner – Risk and capital, insurance, PwC
Shazia leads Pwc's balance sheet optimisation proposition for financial services. She is a balance sheet optimisation expert who focuses upon capital and asset liability management across banks and insurance companies. Prior to Pwc, Shazia spent 16 years in senior capital markets roles in investment banking and 10 years for Goldman Sachs.



LUCINDA DOWNING
Senior Research Analyst, Aon Hewitt, Retirement & Investment (R&I)
Lucinda develops asset class views within Aon's Global Asset Allocation Team for investment advisory and delegated consulting clients. She was previously Director of Balanced Funds at Russell Investments where she structured and managed multi-asset, multi-manager funds. She has also been a Portfolio Manager at State Street Global Advisors.

INVESTING IN THE EUROPEAN LOANS SPACE

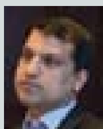
CHAIR: Where do we see the risks and the opportunities in the credit markets? Credit spreads generally widened last year in pretty much every sector. Valuations are now starting to look more attractive and offer a better cushion for default risk. Nevertheless, we are seeing increased risk dispersion and volatility, which can present opportunities but also certain risks.

At Wells Fargo Asset Management, we're expecting global growth to slow moderately as a result and we're seeing more risks to the downside, whether it's China, the impact of the US government shutdown or else political risk in Europe. With the ECB ceasing asset purchases, and looking to raise rates at some point later in 2019/2020, clearly we're in a different environment for risk assets. As a result we prefer to position more defensively, recognising that we are late cycle. So we're focusing on those credits and those companies that have strong access to capital, be it from their banks or a proven track record in the capital markets. We focus on those organisations that have strong balance sheets and stable cash flow generation.

DOWNING: As an asset allocator, we're also turning defensive, but at the asset class level, and clearly there are certain asset classes that perform better in this type of environment. I think a key question that everyone is asking is, when is the next recession? But we actually think that is the wrong question, because it's very difficult to tell, and a lot of the indicators, certainly on the credit sector side, can be coincidental, rather than forward-looking. The way we look at the market environment is that we think we're at the end of the up cycle, but not quite necessarily at the stage where we're going to see a big downturn. We call it a transition environment. You don't always have up cycles and down cycles. There is often a period where markets are just very choppy and broadly sideways, and we think we're in that type of environment, where volatility has picked up. That would mean generally taking opportunities to de-risk and move away from equities. Equities have been outperforming but we're moving towards a stage when bonds are going to outperform. Having some duration in your portfolio isn't necessarily looking such a bad thing over the next year or two.

CHANDRA: I think you're right to focus on the more secure parts of the capital structure at this stage in the cycle. But of course, many managers are looking in the same space, and yields are often not attractive in an absolute sense. It's important to look beyond the general matrix of asset class vs yield and seek out particular pockets of value. For example, within real estate finance, core properties outside Germany might provide a spread of 100 bps. But if you are willing to take a measured, calculated risk on asset quality – i.e. a fantastically located property that's been recently vacated, you can get a yield of, say, 200 basis points, as long as you have done the work to be confident that the property will be re-let. Finding those pockets of value is the key to generating attractive returns without chasing yield.

AZIM: From an advisory side, we sit across a variety of asset classes.



NIKHIL CHANDRA
Investment Strategist, Alternative Income Solutions, Aviva Investors
Nikhil is responsible for designing and delivering investment strategies to meet investors' specific objectives. In particular, he focuses on alternative income solutions. He works closely with colleagues across a wide range of functions including business development and client service, portfolio management, operations and legal.

We largely focus on risk and capital impacts. We do not advise on portfolio shifts per se. We are currently observing two main trends. One is definitely defensiveness - whether it's a late cycle, whether it's transition, it is not quite what you would call a robust and an up cycle. We are generally seeing clients shorten duration. It is tough to call the rate cycle, and it is very difficult to see what is going to happen with the continued, or discontinued unwinding of QE, so from our perspective, duration is definitely something we are asking our clients to look at. The second is to cherry-pick low volatility asset classes. Diversification is important, both at an overall allocation and individual asset perspective. If you take private credit, for instance, covenant-lite - this is not the time to be invested in this. So our views are coming from a holistic perspective.

MATHUR: We are long-term investors, so we invest for the cycle. We would carry on investing in every asset class. I think relative value becomes essential to the thinking here, when it comes to where you want to deploy your next fund of capital. That's where we spend a lot more time, because we expect that our asset managers will be assessing on an active basis, the through cycle risk of the individual credit, and as a consequence, some sectors will automatically be screened out and some sectors wouldn't.

CHAIR: Martijn, what about you, from your solutions perspective, how do you see the relative value across the asset classes?

DE VREE: We invest for the long term on behalf of our investors and position portfolios tactically to take into account current market conditions. Looking at the current environment, in the late stage expansion of the economy, we are carefully balancing global recessionary risks, on the back of slowing global growth, with increasing dynamism of the Fed with respect to their interest rate policy in the nearer term. There is a lot of focus on US policy and we also take a more global picture into account, for example Europe is in quite a different stage of the cycle and the yield curve is very different - portfolio positioning reflects that.

> In Europe we favour European loans compared to high yield. Across markets we like high quality securitised fixed income assets

More specifically in our multi-asset portfolios we favour high yield over loans in the US markets, with a particular focus on shorter dated high yield. We are generally short on duration in the US. In Europe we favour European loans compared to high yield. Across markets we like high quality securitised fixed income assets, as long as securities are selected by a skilful team.

US loan market

CHAIR: There's been a lot of press around the fact that the leveraged loan market in the US has grown significantly, over the last six years or so, to $1.2 trillion, and the CLO market accounts for about 50% of the investor base, so $600 billion. It's tempting to draw analogies to the CDO market and the subprime loan market, which grew to a similar size by 2007. How do we feel about the US loan market? Do we really see it as being a source of potential financial Armageddon? Or do we think that's going to play out differently? How is that going to impact global demand for credit risk?

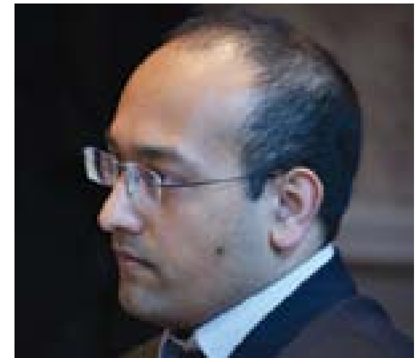
VANBRABANT: There have indeed been a lot of warnings about the state of the US loan market from central banks and news agencies, in particular with respect to its increasing leverage and its weaker documentation. We also know that when the US sneezes, Europe typically catches a cold so we are monitoring developments on the other side of the pond closely.

But it is also worth pointing out that some major differences exist between the US and European syndicated loan markets. Importantly, Europe is at an earlier stage of its economic cycle than the US with the first rate hike currently only priced in by markets for the end of 2019 versus the US which has already seen 9 hikes. Loans are assets that perform well during the latter stages of a cycle as they benefit from rising rates. Also, European loans on average offer stronger credit quality than US loans as they benefit from lower leverage, higher cash coverage and larger equity commitments from financial sponsors.

Regarding the CLO market, it is important to distinguish its performance from that of its cousin, the CDO. S&P did a study of CLO performance during the Great Financial Crisis. By 2008, S&P had rated over 4,300 CLO tranches. Of all those tranches, less than 1% defaulted in 2008 – 2009. CLO's are essentially quite robust structures. Since then, CLO structures have actually become even more robust because S&P has tightened its rating methodology: they've reduced the recovery rate assumptions for loans and increased the amount of losses a structure would have to suffer before AAA tranches would lose. So I don't think that the CLO market will be that source of volatility or systemic risk that maybe the CDO market was 10 years ago.

If we look at the 2018 returns on CLO equity tranches in the US, it was -11%, which is painful but not so bad as to cause holders to be forced to sell, particularly as these tranches are typically held by strong hands capable of dealing with a modicum of volatility. AAA tranches on the other hand, which represent two-thirds of a typical CLO cap structure, were up 2.5%. Not bad, when the overall US loans market was down -2.5% in 2018.

What will happen in the CLO market



this year? Well, the default rate in the US is expected to remain low 3.5% from a realised 2.8% in 2018, so with that level of defaults and with the threat of higher US interest rates off the table, I don't think that the US loan market will necessarily sell off as much particularly because right now spreads are higher than they were at the start of last year. So the US CLO market will generate positive returns in my view in 2019.

European loans

CHAIR: Do people think there are any reasons that Europe might be different, with respect to lending standards in the liquid loan market?

VANBRABANT: Specifically from a regulatory point of view, there have been two developments in the US that did not occur in Europe. One was the removal of the leveraged lending guidelines by the Trump administration. Trump sent out a clear message that those guidelines would not be

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enforced, and those guidelines were essentially aimed at making sure that banks did not put too much debts on the balance sheet of borrowers. So with that cap removed in US, of course there's going to naturally be an incentive for borrowers to take on more leverage, for the private equity owners to put more leverage on their businesses. Inherently that makes investing in US loans slightly riskier.

Secondly, if you look at the CLO market the 5% risk retention requirement has been removed in the US. What that means in practice is that there is more freedom for CLO

managers to maybe put some riskier assets into their structures.

In Europe unlike in the US, we still have those two pieces of legislation in place, so the market is structurally more regulated and therefore safer here than stateside.

MATHUR: Do you see the interpretation of leverage loan lending guidelines in Europe as being different, depending on whether it's German loans, Italian loans, or Spanish loans?

VANBRABANT: I haven't seen differences. I mean I think the way the legislation works is that there is an onus on the banks to report to their regulator, when they are putting a certain amount of leverage - in practice six times - on a company. They have to report that, and they have to also indicate to the regulator how they think the company will be able to deliver to half the original levels of leverage within a 3 year time period.

CHAIR: How does your market, which is more liquid in the spectrum compete with the private credit markets, with respect to overlap, lending to larger SMEs? Do you see a similar lack of discipline, with respect to direct lending, regarding leverage levels and covenants?

VANBRABANT: Traditionally the cut-off between the private debt markets and the syndicated loan markets, the publicly-traded loan markets was EUR 50 million EBITDA. If your business generates EUR50 million EBITDA, you can take on 5 times leverage and issue a €250 million deal to the loan market. At that level, it's big enough for a number of banks to offer liquidity in it in the secondary markets.

One consequence of the leverage lending guidelines that I referred to earlier, has been that banks and financial sponsors looking for ways around this restriction have turned to the private debt market, where that requirement does not exist. So the European private debt market's growth can at least partially be explained by the leveraged lending guidelines. Direct lending funds have been more willing to offer these higher levels of leverage, often using unitranche deals, as they have been competing desperately for lending opportunities given the strong inflows into their asset class and the resulting need to get invested.

CHAIR: Does the private debt market sufficiently compensate you for illiquidity?

CHANDRA: I think it's important to look at this on a pan asset class basis. The key is relative value—different asset classes exhibit different illiquidity premia at different times. They don't all move in tandem. Hence a multi-asset approach to private credit allows an investor to take advantage of the best relative value opportunities. Historically

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we've seen illiquidity premiums go between 50 bps to 100 bps. The other point to be aware of is that not all managers define the illiquidity premium in the same manner.

MATHUR: I think we're not sure what illiquidity premium is right now. I think it has very different interpretations. That view keeps on evolving as the market changes.

AZIM: First, if you look at Solvency II, one of the things that it has done is it's crystallised the way of thinking about illiquidity premium. It is not about illiquidity, it is actually about thinking through the cycle, through the curve, about essentially what I would call credit fundamentals analysis. Clearly, if it's not publicly traded or publicly rated, at the end of the day it is still a credit, so how do you understand the major risk drivers, and then how do you price? How do you put a basis point price on those risk drivers and then understand their relative impact on spread. An interesting example on illiquidity premium is the private placement market. Pure credit analysis based on balance sheet fundamentals and business metrics can sometimes price private placements through traditional rated corporate credit.

CHAIR: How do insurers approach illiquid assets from a skill set perspective? Is it a case of building up internal teams with relevant expertise, or is it more a case of relying upon external consultants, advisers and asset managers?

AZIM: I don't see very many insurers relying completely internally on this. Due to its novelty, it is receiving increased public scrutiny, from regulators, internal first –second and third- line, analysts etc. This entails a focus on obtaining the right expertise and input. Whether that means having light internal teams, which are fully focused from a number of different aspects - i.e. manager selection, due diligence for different types of assets, strategic asset allocation, to different types of assets and then also understanding the quantitative illiquidity premium of those type of assets and relative value of those assets. Then thinking about how to rate these assets, how to monitor these assets.

It is quite a complex chain and I think that there are insurers who do it all internally, but there are a lot of other insurers who seek specific help.

DOWNING: At Aon, we have a big manager research team. We have a team that focuses on private credit, and obviously, we rely on manager insights as well. At this particular time in the cycle, we are stressing to our clients that you have to pick a good manager to get your good returns.

CHAIR: What do you look for in a good manager?

DOWNING: I think there's a few things that you can look at - strong deal-sourcing expertise and experience of past cycles and distressed credits.

MATHUR: The credit rating process is quite a big differentiator between different asset managers, and not every credit rating process stands up to scrutiny. That's especially true for private assets. So we definitely put a lot of focus on the ability of the investor to assess that.

AZIM: I think if it's private assets, the complexity of the investment and capital decision making process would make me question if insurers have the entirety of the skills needed to get all of that right. With private assets, credit and ratings is only one thing. A lot of these assets are structured or collateralised, hence a need to understand the cash flows, tax implications of putting one structure versus another structure. To do all of that internally needs a lot of different skills. I think that you'd be smart in making sure that you're reaching out to your advisers – asset managers or consultants.

DE VREE: Insurance companies make their own cost-benefit analysis in our experience, based on ability to attract talent, size of allocation and complexity. Private credit is one of those type of assets that more generally ends up being oursourced.

VANBRABANT: It depends on the insurer as well, because so many insurers are at different stages with

respect to their expertise in terms of investing in credit markets to start with. I would say generally, insurers are comfortable doing investment grade in-house but when it gets to high yields, loans and private debt, they will typically use external managers.

Solvency II

CHAIR: What are the challenges insurers face when looking to incorporate credit into their portfolios, from a Solvency II perspective?

CHANDRA: Pre-Solvency II, an insurer would focus on asset selection and management and it tried to make that match with its liabilities. With the advent of Solvency II insurers focus much more on the liabilities side in terms of risk and duration. In the UK insurers are constrained by matching-adjustment eligibility criteria: prepayment protection, fixed vs. floating, investment grade, etc. In the Eurozone, it's much more driven by their underlying business model. Some insurers have shorter-dated liabilities, so they can't do longer-tenor deals. Most will have fixed liabilities, so will pursue fixed rate deals, unless they tactically prefer floating. It's also driven by whether they use an internal model, when they'll seek attractive assets on a capital basis as defined by them, or standard formula, in which case unrated investment grade loans become quite attractive.

MATHUR: The PRA is certainly pushing most of the insurers down the internal model route, rather than the standard formula route. This means that insurers can actually understand the risk, and this is very encouraging. Second, it means that different insurers, depending on their ability to understand that risk, will have different uptakes for them, from a capital perspective.

DE VREE: Insurance companies usually appreciate working with asset managers that have people with sufficient actuarial and Solvency II knowledge to speak the same language. Interestingly, we see different insurance companies in quite different situations, with those insurance companies that are better capitalised having the luxury of focusing more on investment efficiency and being less strictly influenced by Solvency II. We work with insurance companies subject to Solvency II both in the UK and also across Europe and customisation of the solution is key to cater for varying needs across these markets.

> Insurers are comfortable doing investment grade in-house but when it gets to high yields, loans and private debt, they will typically use external managers

DOWNING: However, Solvency II does restrict which asset classes are attractive to insurance firms. This can be seen by comparison with the investments we are recommending on the pension side. We're advising pension schemes to gain access to certain asset-backed securities and more absolute return products, whether it's alternative risk premia or hedge fund type structures. The eligibility and capital requirements make some of these types of assets less appealing to insurance companies.

CHAIR: The US credit markets have always been much larger than European credit markets, particularly in sub investment grade. Do you expect that gap, over time, to narrow?

VANBRABANT: I'm sure it will. Right now sub-investment grade markets in Europe are about 20% the size of the US. Our markets will never be as big as in the US because Europe is a patchwork of different countries and legal regimes but they will grow versus the US as European banks continue their battle to become more capital efficient.

One very effective way of becoming more capital efficient is for banks to become originators as opposed to lenders. So whereas in the past they would lend directly, they now prefer to underwrite deals and immediately recycle them to the public HY bond or syndicated loan market, pocketing an underwriting an origination fee and relying on institutional investors

to carry that risk until maturity. That means banks' balance sheets become smaller and their return on assets and return on equity increases. European banks have an example in mind as they embark on this journey: their US counterparts, who have already succeeded in making this from lender to originator, which is exactly why the US HY bond and loan markets are so much larger than in Europe despite similarly sized levels of GDP being generated in the US and in Europe. The other benefit of having banks with smaller balance sheets and more capital is that it becomes much easier also for European governments and regulators to support their banks in case of difficulty.

ESG

CHAIR: Moving on to ESG, when I talk to the team internally, we refer to the three E's: exclusion, evaluation and engagement.

How do people feel about ESG? Firstly within private debt, the incorporation of ESG is more challenging, because you can't necessarily rely upon, for example, indices which can cover typically the more broad liquid credit markets. Do you see ESG as being necessary? One hundred per cent necessary? Relevant? Or a nice to have? With respect to the private credit markets?

CHANDRA: I think it's absolutely fundamental to what Aviva Investors does. On the one hand, it is imperative for us to be good corporate citizens. And on the other hand, this is increasingly important to clients. To your point about private credit, well thought out exclusion and engagement policies are absolutely feasible even in an illiquid context, and represents a good starting point for any asset manager in the space.

MATHUR: It's not an optional anymore. We've never considered it optional, but it's embedded in our investment beliefs. The regulator in the UK has put out a consultation paper on it - on how we expect to plan for it and demonstrate that we are thinking about it. We do look at ESG for every private or public credit that we do, whether it's investors or others.

We are much more familiar with the investors methodology than others.

The last I checked, it was the G that offered the maximum return on investment, but it's ever-evolving, that research, and I don't know what the latest is on it, but it does suggest a direction and an area of focus that maybe you can just be screening out the E and the S, but putting a lot more focus on the G.

> Integrating ESG will do no harm to performance, and therefore there's every reason why investors should look at it

DOWNING: I think the E and the S will come into their own in the longer-term. Our line is that, at the very least, integrating ESG will do no harm to performance, and therefore there's every reason why investors should look at it. We rely on managers to incorporate ESG into their processes and we rate them on how well they do integrate it.

For ourselves, we also give guidance to our clients. For example, we can run climate change scenarios on portfolios to demonstrate risks to long-term investment returns. This type of analysis is useful for our clients as it helps pin down potential outcomes.

CHAIR: How do you distil and separate out the good managers who take ESG seriously and adopt it as a philosophy, in their investment decision making, versus those that perhaps jump on the bandwagon to help them not being screened out? From an asset manager perspective, how do you perhaps balance those tough decisions between whether to invest and incorporate if you see a good opportunity to make a dollar, versus to not invest, based upon the ESG criteria?

DOWNING: I think you can tell if a manager is just writing an RFP as an ESG tick-box exercise. It's not that difficult to weed out those managers by asking for actual examples of how ESG concerns have affected past investment decisions. You really do need the thought process to be integrated into the whole investment process. Certainly we are seeing a lot of managers saying the right thing around ESG.