COUNTERPOINT
ASSET MANAGEMENT

Thought Piece

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Carefully picking our poison

No single investment philosophy will outperform in all market conditions. However, at Counterpoint we believe that over the long-term, an optimal fixed income strategy must, at a minimum, include measures to:

1. **Comfortably accommodate liquidity shocks;**
2. **Minimise default risks; and**
3. **Diversify the risk of being wrong.**

These criteria serve as the fundamental guiding principles in the management of all Counterpoint's fixed income exposures. We illustrate how each of the principles is derived and applied below, with specific reference to the Counterpoint SCI Enhanced Income Fund (the Fund).

Comfortably accommodating two-way liquidity shocks

Unlike retail bank deposits, collective investment scheme (CIS) funds do not benefit from an explicit government guarantee. It is therefore incumbent on portfolio managers to ensure that the liquidity of underlying investment holdings is appropriately matched to that of the CIS. In practice, however, it can be tempting for portfolio managers to sacrifice investment liquidity in pursuit of a higher return.

In the fixed income universe, ostensibly wide yield-spreads sometimes entice investment in sub-investment grade or speculative credit instruments. But the South African credit markets are not very actively traded (compared to government bonds or equities) and often lack comparable secondary-market transparency. Thus, when general market volatility is high and returns are down, 'high-yield' credit instruments can become notoriously difficult to liquidate at carrying value. The portfolio manager may lose the ability to comfortably provide liquidity in the event of large fund redemptions and may even have to sell the illiquid investments at a significant loss. Similarly, when sizable inflows are received, the manager may find it difficult to deploy the surplus cash profitably and in proportion to existing holdings, as secondary market opportunities sometimes need to be induced by offering inflated prices.

For these reasons, Counterpoint's Enhanced Income Fund is managed with an explicit focus on liquidity and is predominantly invested in government and bank-issued notes as a by-product (where liquidity is relatively ample). Investment in high-yield, junior, or speculative corporate paper is naturally limited, as these instruments often cannot be comfortably liquidated in periods of market turmoil.

Being intolerant of existential or default risks

Liquidity concerns are not the only factor preventing Counterpoint's wholesale investment in speculative credit. Successful fixed income investing requires a fundamentally different mindset to equities. Most debt investment opportunities offer a contractual yield to maturity, which is invariable to any improvement in the value of the underlying borrower's assets. By contrast, equity returns enjoy theoretically unlimited upside potential (while downside is capped at 100%). This positively skewed distribution of returns means that, in stocks, it pays handsomely to take diversified risks and embrace uncertainty over the long-term. The value of a call option, after all, increases as expected volatility rises.

By contrast, the capped upside potential of fixed income investment returns can be easily outweighed by the emergence of any meaningful default risks, where they do occur from time to time. Debt investors therefore need to be extremely vigilant of credit risk and properly consider the impact of extreme events (both upside and downside) on the expected return profile of the instrument.

Junior corporate credit instruments often provide a spread (in the order of 300 to 500 basis points) over the yield on senior debt. However, in extremely positive scenarios, it is the equity investors who are entitled to most of the investment spoils. In a similar vein, junior creditors do not benefit from the same protection as senior and secured debt investors in extremely negative scenarios. Junior credit is clearly neither robust (like senior debt) nor anti-fragile (like equities), and we believe that human biases limit the ability of investors to properly calibrate the likelihood of these kinds of extreme shocks. As a result, speculative credit spreads are often quite severely mispriced relative to the other levels of the capital structure.

Within Counterpoint's Enhanced Income Fund, we are taking several measures to minimise the existence of meaningful default risk in the portfolio. We are passively reducing the Fund's exposure to state-owned enterprises (by re-investing maturing debt elsewhere in the market) and actively lowering the Fund's exposure to certain categories of commercial property, in an orderly fashion.

Diversifying the risk of being wrong

The fluctuation of global interest rates is commonly the most important determinant of short-term fixed income returns. However, consistently forecasting macro-market outcomes (like future interest rates) with any useful accuracy is impossible due to the complexity of the global economic and market system. Counterpoint's fixed income team therefore always considers several scenarios in conducting our top-down interest rate analysis, with due regard for a wide range of possible outcomes. Acknowledging what we cannot know constrains how concentrated our strategic positioning can be, as significant probability weights are always applied to very different potential outcomes.

Nevertheless, where our analysis suggests that excess returns are available at specific points along the yield curve (on a probability-weighted basis), we will incorporate bias in the Enhanced Income Fund's positioning. This active positioning will, however, be tempered by some investment in instruments which outperform in different macroeconomic situations, limiting the extent of possible capital downside which the Fund is exposed to in any scenario.

Picking our poison

In an efficient market, there cannot be excess returns without risk, and our aversion to liquidity and credit risks clearly does not preclude the Fund from taking measured exposures to other types of risk. Active yield curve positioning has resulted in a significant investment in very long-dated South African government bonds, which has introduced some capital volatility (duration risk) to the portfolio. As interest rate gyrations reverberate through the global system, the Fund has, as a result, experienced some capital fluctuations in the year to date. However, in the absence of default, there are no permanent unexpected capital losses in fixed income.

We believe that in the fullness of time, South African government bond yields, which are exceptionally high by global standards, will likely decline, The resultant capital gains would benefit our position greatly. So, rather than taking unseen liquidity risks in lightly traded and speculative credit, we take comfort in the view that the Counterpoint SCI Enhanced Income Fund's disclosed NAV is always a fair reflection of its realisable liquidation value.

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