LA FRANÇAISE
INVESTMENT SOLUTIONS

CAPTURING THE CURRENT OPPORTUNITY SET FOR CREDIT

Now is no time to be complacently long credit. Spreads are tight, especially for corporate bonds, and late-cycle indicators abound. Factor in upcoming monetary policy normalization, resurgent geo-political risk and the increasing likelihood for a U.S. equity correction, and the landscape looks complicated.

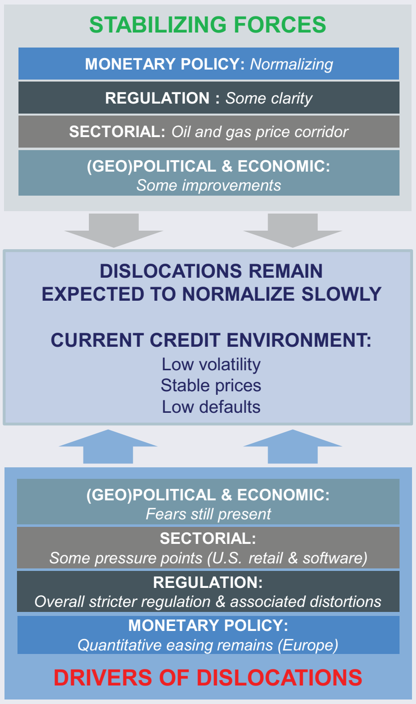
However, not all indicators are flashing red. The overall credit environment is characterized by low volatility and stable prices. Global macro indicators continue to strengthen, high yield default rates to edge down, and credit expansion and leverage are lower than during the previous cycle. Therefore, it is too soon to be outright bearish. For investors with the expertise to look beneath the surface, the landscape is rich with opportunities.

As detailed in Figure 1, regulatory and economic dislocations persist and multiple opposing forces will drive a slow normalization, creating opportunities.

A PRUDENT APPROACH IS WARRANTED

Informed risk taking is the order of the day. For investors with the right mix of credit, derivatives and quantitative expertise, the current opportunity set lends itself to relative value trades and smart hedging strategies. These can be implemented using liquid instruments and stand to deliver diversifying returns with limited duration and directional risk. Below, a few examples:

FIGURE 1: OPPOSING FORCES ARE CREATING OPPORTUNITIES



Monetizing Monetary Policy Dislocations - Cash versus CDS Basis

Strategy: Capture outperformance of credit default swaps ("CDS") versus corresponding European corporate bonds.

Implementation: Long CDS / short investment grade ("IG") bonds.

Rationale: IG corporate bonds are currently 30 to 40 basis points tight to CDS (positive basis) thanks to distortions in bond spreads driven by QE by the European Central Bank ("ECB"). This should reverse with ECB tapering. Significant spread widening should have the same effect, as in 2008-09, when the basis moved to -150 basis points. The corporate bond market is currently three times larger and most bonds are in ETFs and daily liquidity funds, making a repeat possible. Furthermore, regulation has made holding bonds unattractive for banks, removing a traditional dampener of major market moves.

Advantages: Preserves cash, avoids positions in over-inflated bond markets, relative value implementation for limited directional exposure, insurance policy against major moves wider.

Monetizing Regulatory Dislocations: Capital Structure Arbitrage

Strategy: Long and short positions on tranches of the iTraxx Main (the "Main"), a pool of 125 IG names with different seniorities, to capture the spread differential.

Rationale: Historically, main super senior tranches have seen only one default over a five-year horizon. Yet, they currently comprise roughly 50% of the Main's value. Under Basel III and Solvency II, capital charges are now punitive for insurers and banks that hold the super senior. Remaining investors can find it difficult to leverage the investment to a profitable degree. The super senior tranche is now relatively cheap versus the mezzanine.

Implementation: Long super senior / short mezzanine.

Advantages: A market neutral, carry positive trade (the super senior has a high roll-down given its low default probability). Jump-to-default positive, as an isolated credit event would have a stronger impact on junior tranches.

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Other examples abound to pair interesting long positions in one credit segment with prudent shorts in another. European CLO capital structure curves have flattened such that senior tranches show significant relative value versus mezzanine tranches. As it is difficult to short mezzanine tranches of CLOs, an efficient short would be the iTraxx Crossover index (of 75 most liquid European sub-investment grade entities). Returning to the regulatory landscape, certain bank tier 1 legacy instruments no longer qualify as regulatory capital under Basel III, making them likely to be called. Technically squeezed lower tier 2 debt, which is out of favor with investors, makes a good complimentary short.

EXPERTISE REQUIRED

Over more than four years, La Francaise Investment Solutions' ("LFIS") diversified credit strategy has established an award-winning track record of successfully navigating complex credit markets. Our credit team has 20 years of experience across credit markets allowing for a comprehensive approach.

As the above examples illustrate, there are segments of credit markets that offer tremendous value vs. overbought vanilla corporate bonds. These examples are just the tip of the iceberg. Investors have unduly deserted many segments, whether due to regulatory pressures or because of the structural complexity of the trades. Successful credit investing today requires going beyond the traditional long-short cash credit strategies to access all dimensions of credit markets. This, in turn, requires the expertise and ability to invest across cash, derivatives and structured credit instruments and markets.