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Absalon Capital - Investment Philosophy

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Executive Summary

- Grounded in common sense, endorsed by academic research
- Distinct focus on Value and Size factors developed over the past 15 years
- Focused on opportunity, not index weights
- Employs an active, unconstrained, conviction-based approach

Introduction

The team has developed a unique approach to credit investing which is active, unconstrained and conviction orientated. The origins of the team's approach date back to 2006 when the Global High Yield strategy was first launched. The foundation of our approach is based on research carried out in 1992 by Farma & French and subsequently enhanced by Elton, Gruber, Agrawal & Mann 2001. Elton, Gruber, Agrawal & Mann's research paper "Explaining the Rate Spread on Corporate Bonds" was the first to show that credit spreads were both a compensation for default and taxes but also included a reward for bearing systematic risk. Since those early days, the team has continued to develop the approach using both internal and external research. In recent years, a growing body of practitioner/academic research has highlighted the benefits of an approach which focuses on the underlying systematic drivers of returns, rather than one based simply on index weightings.

Unlike value investing in equities where value can remain trapped for a long time, credit investors benefit from a defined maturity date, where value can be unlocked; assuming the bond does not default.

At Absalon Capital we believe in active bottom-up issuer selection. We have been working with the Value and Size factors for the past 15 years. Our experience tells us that returns from disciplined bottom-up credit selection, over a 3-5-year investment horizon has a high likelihood of outperforming a passive or index aware approach.

To ensure that we continue to deliver long term outperformance, we have imposed capacity constraints on the assets we will manage on behalf of our clients. By limiting overall capacity, we ensure that we can access opportunities which remain off limits to passive funds and many large index orientated credit managers.

[1] Alpha based on gross return versus ICE BAML Global High Yield . EUR Hedged
[2] Important contributions include Houweling (2018, 2019), Parker & Rosenberg (2019), Kauf mann, Messow, Fang-Klingler (2020)

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The foundation of our philosophy
To understand the underlying factors, we first categorize bonds into four broad factors. A growing body of research shows that these factors can enhance returns over and above a purely index orientated approach. Our own internal research also supports these findings and shows that these factors all outperform the overall market (see below). Our focus is on the two most rewarded factors - Value and Size.

Table 1. The Four Factors – A Summary of Factors used in our Study

Size	Smaller companies tend to be under-researched and are less liquid. The Size factor contains bonds of small companies based on the market value of their outstanding bonds. Size effect at company level.
Low Risk	The Low Risk Factor contains shorter-dated bonds with a high credit rating. For the High Yield segment, it implies ratings from BB+ to B-
Value	The Value Factor contains bonds with a higher credit spread than a model implied 'fair' spread, hence comparing the required compensation for the bond's riskiness to fundamental risk measures*.
Momentum	Securities with recent outperformance tend to continue to outperform. The Momentum Factor contains bonds with high past returns**.

**Cross-sectional regression of credit spreads on Maturity, Rating and 3-months Spread Change.*
***Based on past 6-months return with 1-month implementation lag.*

Table 2. Results from our recent Factor Study

Return Statistics

	Market	Size	Low Risk	Value	Momentum
Mean	3.18%	7.68%	4.02%	6.91%	5.95%
Volatility	10.45%	11.77%	6.55%	15.11%	11.22%
Sharpe Ratio	0.30	0.65	0.61	0.46	0.53

Outperformance Statistics

	Market	Size	Low Risk	Value	Momentum
Mean		4.49%**	0.83%	3.72%*	2.77%**
Tracking Error		7.38%	5.52%	7.15%	3.86%
Information Ratio		0.61	0.15	0.52	0.72
t-Value		2.85	0.71	2.43	3.35

*Note: * Significant at level 5%, ** at level 1%*
Return Statistics based on Excess Returns (versus duration matched Treasuries) of Long-only Factor Portfolios from January 1999 to November 2020.
The results are annualized.
No transaction costs.

Size (TMKT): Total Market Value. Sum of all bond's Market Value for each Company. Represents issuer size.

Note: Market data is ICE Global High Yield Index (HW00)
The Long Factor Portfolios is defined as the 12-months average of the top 10% equally weighted Factor Portfolios

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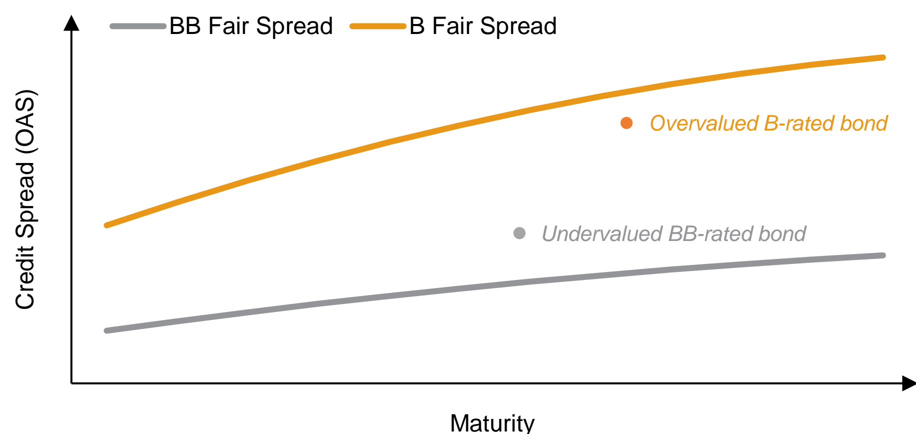
Investing in the "Value factor" does not entail simply choosing the highest spreading bonds in the universe. On the contrary, the most attractive Value factor portfolio might well be mispriced crossover credits often referred to as "Fallen Angels". Following a downgrade to high yield, investment grade funds become forced sellers of "Fallen Angels" and the bonds experience a spread widening which often overshoots their fundamental value.

The illustration below demonstrates an undervalued bond relative to its fair credit spread based on its credit rating and maturity, and an overvalued bond relative to its fair credit spread. Even though the B-rated bond has a relatively higher market spread than the BB-rated bond it is in fact the BB-rated bond, which is undervalued and hence a candidate for further research.

Chart 1: Understanding the value factor



The "Size factor" shares some similarities with the Value factor. Smaller companies often pay a higher interest rate because they are under-researched and unavailable to larger managers due to issue size constraints - rating agencies also penalize for size. Consequently, a small cap company might trade in line with its rating but be undervalued relative to its underlying financial strength – hence investors get a higher spread for a given level of leverage. Because of these market inefficiencies, small caps will tend to recover later following a selloff. In that sense, the Size factor becomes Value later in the cycle because spreads stay wide for longer. In that part of the cycle, small cap bonds also offer an opportunity to unlock hidden value through mergers and takeovers by larger competitors with higher ratings.

Due to our long experience with the Value and Size factors, we understand that bonds can trade "cheap" for a reason - so we emphasize bottom-up research to challenge and sanity-check potential investments. Company fundamentals are also a key part of our risk management philosophy - avoiding permanent loss of capital remains a primary focus. We prefer companies with tangible assets and leverage below the market average to keep flexibility in the portfolio during downturns - in addition, we exclude bonds rated below B- from our investment universe to exclude the most default prone candidates.

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Our high yield strategy has followed a factor-based investment process since 2006 and has always included exposure to emerging market bonds. In 2010, we launched our emerging market corporate debt fund which shares investment philosophy with our high yield strategy but reflects structural differences between the two investment universes.

Within Emerging Market Debt, mispricings are often the result of market dislocations which remain a common feature of the asset class. Recent examples include Argentina, Mexico, Russia and Turkey, where either government finances, the imposition of tariffs, or a government change has led investors to re price the risk premium in these markets. The opportunities such events present tend to cluster in regions and sectors as the credit cycle develops. Using an active, conviction-based approach, we aim to exploit opportunities irrespective of the country, rating, or size of the issuer.

When dislocations occur, there is often a significant and rapid depreciation in the local currency against the USD. This is then followed by the main rating agencies reacting to the macro change with either a negative outlook or rating downgrade. The "sovereign debt ceiling" often forces constrained investors to sell when sovereigns are downgraded, and the corporate ratings are adjusted down accordingly. This often occurs even if corporate fundamentals have not changed. During such periods, even the best quality export focused companies get repriced despite the fact that they will often be the main beneficiaries of a drop in the local currency. As a value manager much of our focus is on identifying these "undervalued" high quality opportunities in out of favor markets without being constrained by index considerations.

Conclusion
For the past 15 years the Corporate Credit team at Absalon Capital has focused on a unique approach to global credit investing which focuses on potential opportunity and not index positioning. Our emphasis on the systematic factors of Value and Size have been shown to deliver superior returns over the medium/longer term. To access these opportunities, we invest with conviction via a portfolio of 75 -125 positions and avoid low quality issuers that use excessive leverage. By limiting overall capacity, we ensure that we can access opportunities which remain out of reach to larger index-oriented managers.

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Document
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