KEYNOTE INTERVIEW

Assessing credit opportunities through a quant lens

Combining data analytics with deep expertise is key to identifying the most attractive opportunities, including through the covid-19 dislocation, says Marianna Fassinotti, managing director at the D. E. Shaw group

Q What motivated the D. E. Shaw group's participation in the credit and structured credit markets? How does the group's quant expertise help you navigate these markets?

We have been active in credit markets since 1989, first through our participation in the convertible bond market and later in a broader mix of credit strategies across public and private markets. What has made the credit markets compelling for us is that although they are broad-based and global in nature, they often feature distinct local attributes, disparate sectors, and instruments with complex, esoteric structural features, and require an investor to assess and interpret many data inputs. Those elements combine to create real barriers to entry and fit well with our quantitative and highly analytical approach to investing.

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For example, in the structured credit markets, an investor needs access to a lot of data and proprietary modelling technology. Our Asset-Backed Strategies investment unit has a dedicated tech and data analysis group that aggregates and remediates data, but also synthesises and analyses it with our investment team. We believe this approach allows us to uncover opportunities that may not have been obvious to others, or to identify mispricings well before others.

Over the years, we have successfully applied this data-driven, technology-enabled investment approach to a wider menu of credit and credit-related assets, allowing us to pursue a multi-strategy credit approach that can be flexible as market conditions evolve and intra-market dynamics shift, and have built teams dedicated to specific areas of credit, such as asset-backed securities, convertible bonds and corporate credit.

Q How would you describe the general state of structured credit markets in the US and in Europe?

Generally speaking, at the moment we don't see widespread areas of opportunities in public credit markets, including in structured credit. That said, we are currently monitoring more niche and esoteric parts of the structured credit markets, particularly in Europe.

Traditional securitisation markets in Europe are significantly smaller and less mature than those in the United States. However, Europe has an active and growing synthetic securitisation market, which allows banks to transfer credit risk exposures and reduce associated regulatory capital requirements without actually selling the underlying assets. We believe this marketplace has room to mature in a number of areas, and that participation requires deep knowledge of underlying assets as well as structural expertise in understanding covenants, cashflow waterfalls and various triggers similar to those in the traditional securitisation markets.

In the US, opportunities in the structured credit markets have been and continue to be episodic or fleeting since the fall of last year. It's also worth noting that this is a very large market that can quickly produce idiosyncratic mispricings due to tactical withdrawals and/or broader rebalancing activities by asset managers, particularly mutual funds and REITs, whose participation has increased dramatically since the 2008 Global Financial Crisis. For this reason, we believe the current environment benefits managers with agile investment processes and efficient decision-making frameworks.

Q How do you evaluate the progress of the European banking system in cleaning itself up in the years since the global financial crisis?

Unlike in the US, where banks historically have securitised and/or transferred credit risk into the capital

Q How did you react to the initial market stress that resulted from the covid-19 crisis?

When presented with a large market correction, we often begin by thinking about the right risk benchmark. The temptation is to look at the last crisis and extrapolate from there. Because the catalyst of the 2020 crisis was a defined exogenous shock, we believed that observing how consumers and other market participants reacted to sudden disruptions caused by past natural disasters would provide more relevant insights than the experiences of the GFC.

For example, in March 2020, residential mortgage-backed securities, particularly government-sponsored enterprise credit risk transfer bonds, came under enormous pricing pressure, with most CRT bond prices falling well below par. Given the limited history available for CRT bonds, we used a proprietary database containing loan-level information on more than 50 million agency mortgages to mimic the credit profiles of existing CRT bonds.

In fundamental terms, the situation entering the 2020 crisis was also quite different than that of the GFC – home prices increased in recent years, suggesting that loan-to-value ratios for recently issued mortgages had actually decreased post-origination, and measures of the condition of the housing market and household health were strong entering 2020. As a result, in the current crisis, borrowers had options at their disposal other than default, including selling properties or modifying loans.

Based on our analysis, we believed that the underlying credit profiles of CRT bonds were more resilient than was assumed by many other marketplace participants, who may have over-relied on experiences from the GFC in their assessment of these securities.

markets, banks in Europe are both primary originators and holders of credit risk. Given many European banks' weaker capital positions at the outset of the GFC and limited options for generating capital in subsequent years, the banking system's 'clean up' remained incomplete when the pandemic hit.

The pandemic has effectively put a halt on the deleveraging activity of the European banking system, while also creating an environment conducive to problematic-asset formation; we believe non-core assets on bank balance sheets may track upwards again, effectively slowing, if not reversing, the deleveraging. At the same time, we expect the regulatory thrust towards shrinking exposure to non-core assets will resume, potentially creating new opportunities.

Q How would you assess the general risk environment in credit markets in recent years?

We believe that central bank intervention in the larger syndicated public credit markets for both corporates and structured credit has meaningfully reduced return opportunities in those areas; the more liquidity a specific market has received from a central bank, the less attractive it appears from an opportunistic credit perspective.

By contrast, private credit markets' access to capital and liquidity has not been as robust. In general, this tends to benefit those investors with broader credit mandates and the ability to pivot to attractive opportunities across both public and private credit markets.

Q In what ways are the GFC and the more recent covid-19 crisis similar? How do they differ?

The proximate cause of the current crisis was an exogenous shock, not something inherent to the financial system, as was the case with the GFC.

Another important distinction is that, unlike the GFC, which primarily involved banks and households, the most vulnerable sectors leading up to the current crisis were non-bank financials and corporates. In recent years, lower yields have compelled mutual funds, REITs, and other non-bank financials to invest in riskier and less liquid assets. As a result, these investors became a larger source of funding for non-financial firms, and often by means of very short duration capital structures, creating an asset-liability mismatch.

Typically, we would expect crisis-related liquidations initially to involve assets moving from leveraged investors to unleveraged, traditional asset managers (such as mutual funds or pensions), or to the Fed. In this case, while we did witness some forced selling by leveraged investors such as hedge funds and REITS, the more interesting early-stage activity stemmed primarily from mutual fund liquidations sparked by retail investor redemptions, which were acute in credit and structured credit markets.

That is not to say there were no similarities between the crises. Once again, we were reminded that highly leveraged financial systems are vulnerable to unexpected shocks, and that liquidity events can quickly become solvency events. We also observed that the areas most impacted by the initial liquidations appear to be those that may have benefited most from easy financial conditions and a 'risk-on' sentiment.

Q How do you see the private debt market evolving over the medium term?

In recent years, large monetary and fiscal stimulus programmes have contributed to reducing volatility and keeping credit spreads tight. Indeed, with credit spreads well below historical averages, most public credit segments ended Q1 2021 in their lowest decile of yields ever. As a result, we believe that the larger syndicated public credit markets currently offer very few attractive absolute or risk-adjusted return opportunities. This is not to suggest that the more esoteric public and private credit markets are completely immune to macro pressures, but in general the further out one looks in terms of liquidity and access to monetary or fiscal stimulus, the less resulting distortion one sees.

> *"In the structured credit markets, an investor needs access to a lot of data and proprietary modelling technology"*

We do believe opportunities exist in parts of the corporate debt market, particularly in the lower end of the mid-market and in small and medium-sized enterprises, as well as in certain segments of the real estate market. Potential mispricings exist either because stimulus did not reach these credits and assets, or because the recovery story is not easy and obvious. We view those areas as laggards in some sense, because the shape of their recovery curve has been more muted.

To tackle the issues faced by these parts of the market, we believe two things are needed. The first is flexible capital. Direct lending strategies have been a huge engine of growth in private credit, but this market hasn't historically provided flexible lending on bespoke terms of the type one would normally see from distressed debt or special situations players.

Second, we believe the market needs longer-duration capital. Regulatory pressure has reduced banks' appetite for concentrated exposure in the middle and smaller credit markets, where they are mostly interested in lending in very liquid forms. Combined, these can create compelling opportunities for agile players able to provide capital solutions with an appropriate duration and structure of capital. ■

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