



Accessing opportunities in leveraged credit

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Leveraged credit markets continue to offer pockets of opportunity for selective investors at this juncture. On a longer term view, these markets retain a strategic appeal for asset allocators. Relative to most other income generating assets, the shorter duration characteristics and often higher yields of floating-rate loans and high-yield bonds mean that they can add value not only in today's environment of low and negative yields, but also when interest rates eventually turn up. Investors looking to add strategically to this area may wish to consider standalone floating-rate and high-yield strategies, which can be especially attractive as complements to portfolios designed to substantially mirror major fixed-income benchmarks. Alternatively, they may wish to opt for a multi-asset credit (MAC) strategy, a one-stop solution that effectively delegates cross-asset allocation decisions to a single investment manager.



Leveraged credit is likely to continue to find support in a low-growth environment where the sum of negative-yielding global government bonds is now around US\$13 trillion (Source: Bank of America Merrill Lynch calculations in July). Even factoring in an expected pickup in corporate default rates (and lower recovery rates) at this point in the credit cycle, we believe investors are being adequately compensated for risk.

That said, US high yield and leveraged loan markets have, thanks to a strong rally since mid-February, moved closer to fair value. Investment in this area of the market requires a highly active, selective approach – targeting the pockets of opportunity that exist.

On a longer term view, leveraged credit retains a strategic appeal for asset allocators. Its two sectors – floating-rate loans and high-yield bonds – occupy a special capital market niche. Relative to other income generating assets, their shorter duration characteristics and often higher yields mean that they can add value not only in today's environment of low and negative yields, but also when interest rates eventually turn up.

Investors looking to add strategically to this area may wish to consider standalone floating-rate and high-yield

strategies – which can be especially attractive as complements to portfolios designed to substantially mirror major fixed-income benchmarks – or via a multi-asset credit (MAC) strategy. The low correlation of loans and high-yield bonds with traditional fixed-income debt also means that a MAC strategy having a substantial allocation to leveraged credit can serve as a convenient cornerstone for diversifying a traditional fixed-income portfolio.

Investors and their advisers who are considering either standalone credit asset class strategies or MAC options need, as part of their due diligence process, to ascertain whether the investment manager offering the strategy has the requisite expertise in the underlying asset class or classes. Eaton Vance's credentials in this regard are very strong. Few income-oriented managers can match the experience, expertise and professional continuity of our dedicated income sector investment teams. Our investment professionals helped shape the historic growth in the US of the floating-rate loans and high-yield bond sectors, and our high yield and floating rate loan strategies have demonstrated unequivocally that they can add value over different cycles. Our investment approach combines bottom-up, fundamental credit research — employing quantitative and qualitative tools to generate proprietary

Exhibit A Correlations of different credit asset classes (January 2007 to June 2016).

	1	2	3	4	5	6	7	8
1. Global Aggregate - Corporates (USD Hedged)	1.00							
2. Global Aggregate - Securitized (USD Hedged)	0.62	1.00						
3. Global High Yield Corporate (USD Hedged)	0.66	0.17	1.00					
4. J.P Morgan EMBI Global Diversified	0.77	0.52	0.78	1.00				
5. JPM CEMBI Broad Diversified	0.78	0.45	0.80	0.93	1.00			
6. S&P/LSTA Leveraged Loan Index	0.46	-0.05	0.88	0.56	0.65	1.00		
7. 50% Barclays Global HY Corp (USD Hdgd) 50% S&P LSTA	0.59	0.07	0.98	0.71	0.76	0.96	1.00	
8. Global Aggregate - Treasuries (USD Hedged)	0.43	0.77	-0.22	0.19	0.06	-0.40	-0.31	1.00

Source: Barclays, JP Morgan, S&P and Zephyr as at 30 June 2016. Investment grade corporates are represented by the Barclays Global Aggregate – Corporates Index. High yield is represented by the Barclays Global High Yield Corporate Index. Securitized is represented by the Barclays Global Aggregate Securitized Index. Emerging markets is represented by the JP Morgan CEMBI Broad Diversified Index. Bank loans are represented by the S&P/LSTA Leveraged Loan Index.



views on value – with systematic risk-weighted portfolio construction. Our investment time horizon, given our contrarian approach, is typically longer term, but we can also be nimble when shorter term, potentially high return opportunities arise.

Our US high-yield portfolios employ rigorous fundamental credit research and market-factor analysis to capitalise on inefficiencies in the high yield bond market. Via an opportunistic, value-driven approach, we seek to deliver consistent risk-adjusted performance with high information ratios and a favourably skewed up/down market capture. According to eVestment Alliance Peer Group Rankings as at 30 June 2016, our US high-yield composite ranks in the top quartile over 3, 5, 7, and 10 years.

Our global high yield strategy, incepted in July 2015, has also been faring relatively well. As at 30 June 2016, it had delivered 5.02% gross (4.5% net) since inception, ahead of the 2.25% USD hedged return for the BofA Merrill Lynch Developed Markets High-Yield ex-Subordinated Financial Index over the same period (Source: Eaton Vance).

Our loan portfolios are conservatively managed. We endeavour to outperform the market on a risk-adjusted basis over full cycles, but with a strong emphasis on limiting downside risk. To this end, our portfolios have a bias towards higher quality credits (we believe there is an asymmetrical relationship between credit risk and return potential in this asset class) and are broadly diversified in

terms of industry exposure and number of positions (450-550 positions).

Our floating rate loan strategy is designed for investors who want a high, steady return – higher than that offered by investment grade bonds – but who also want to sleep at night. Performance will typically tend slightly to lag risk-seeking peers whose portfolios have a bigger emphasis on less liquid, more exotic credits. However, it is worth noting that whereas our strategy has survived many cycles, previous downturns have claimed the scalps of a number of opportunistic, risk-seeking strategies. The performance of our senior loan composite highlights our conservative approach. Over the year to 31 March 2016 – a generally difficult period for risk assets globally – the strategy held up well, returning -0.26% (gross of fees) versus -1.26% loss for the in S&P/LSTA Leveraged Loan Index. In the second quarter of 2016, a strong rally in lower quality areas of the index (second-lien loans and loans rated CCC and D) saw the strategy gaining 2.69% gross of fees, slightly less than the overall index (+2.92%).

With financial market stability risks having risen and more volatility in risk assets likely, we believe Eaton Vance's tried-and-tested approach should continue serve investors well in a world where central bank-dispensed medicine continues to fall short of stimulating real economic growth.



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