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Systematic Credit: A Q&A with Scott Richardson

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Scott Richardson, Senior Vice President and Director of Systematic Credit, recently sat down with Acadian's lead writer, John Turner,[1] to share his thoughts on the growth and development of systematic investing in credit markets. The Q&A below summarizes their conversation.

JT: Credit can be a vague term. How do you define it?
SR: You're right, credit isn't necessarily well-defined. So let me share what we mean by Acadian's Systematic Credit initiative. The systematic part should sound familiar to most folks who know Acadian. We are fundamental investors at heart, looking to systematically translate our understanding of fundamental drivers of returns and risks into our portfolios.

The credit piece is what's new for this firm. In its broadest sense, credit refers to fixed-income securities that embody credit risk, where there is a risk of non-payment of the fixed cash flows, whether coupons or principal, that are linked to that security. Our focus is on a strict subset of credit securities—corporate bonds and derivatives linked to them, i.e., credit default swaps.

JT: Is credit a distinct asset class?
SR: Yes, corporate bonds are a distinct asset class within the fixed-income universe. The market capitalization of investment grade and high yield corporate bond indexes for developed markets is around 13 trillion USD. Corporate bonds are a very large market, offering asset owners a potential diversifying source of both beta and alpha.

JT: Is there a risk premium associated with corporate credit?
SR: Yes, and it is material. In a journal article that I co-authored a few years ago, we estimated that corporate bonds paid a 137 basis point credit risk premium over Treasuries from the Great Depression through 2014.[2] This was a novel finding. While previous academic studies had questioned the very existence of a credit risk premium, they hadn't adequately controlled for differences in corporate and government bond characteristics, namely duration. The long-run evidence suggests that risk-adjusted returns for corporate credit are similar in magnitude to both government bonds and equities.

JT: Is the credit risk premium distinct from those offered by other asset classes?
SR: Yes. The long-run evidence suggests that an investor is better off allocating capital to government bonds, corporate bonds, and equities rather than to any one individual asset class or pairwise combination. This is worth re-iterating: corporate bonds are deserving of a strategic asset allocation. While positive, the correlation between stocks and corporate bonds—both classes of securities issued by companies—is far from perfect. That's because

BIOGRAPHY

Scott Richardson, Ph.D.

SVP, DIRECTOR, SYSTEMATIC CREDIT

Scott Richardson leads the systematic credit effort at Acadian. Scott previously worked as a researcher and portfolio manager at AQR, with a focus on credit and fixed income markets, and has held senior positions at BlackRock (Barclays Global Investors), including head of Europe equity research and head of global credit research. He is also affiliated with London Business School, serves as an editor of the Review of Accounting Studies, and has published extensively in leading academic and practitioner journals. In 2009, he won the Notable Contribution to Accounting award for his work on earnings quality and accruals. Scott earned a B.Ec. with first-class honors from the University of Sydney and a Ph.D. in Business Administration from the University of Michigan.

[1] John is Lead Writer and Editor, Client Advisory, Acadian Asset Management.

[2] Attakrit Asvanunt and Scott Richardson, "The Credit Risk Premium," *Journal of Fixed Income* 26, no. 3, (Winter 2017) 6-24.

different firms issue stocks and bonds, and the two types of instruments have different cash flow payoff profiles. Credit beta should be in most asset owners' portfolios.

JT: Within the credit space, how should one choose between active and passive?
SR: Passive is challenging in credit because credit instruments don't trade as frequently as equities. And while sponsors of purportedly passive products, including ETFs, use many methods to create credit-index proxies, the resulting portfolios tend to suffer from adverse selection, especially in high yield, leading to underperformance. Fortunately, most sophisticated credit investors understand this and appreciate the importance of active management where both beta—the credit risk premium—and alpha may be generated from well-crafted portfolios.

> ***[C]orporate bonds are deserving of a strategic asset allocation.***

JT: Within active credit, how would one choose between systematic and traditional fundamental strategies?
SR: It might surprise you, but I recommend holding both. Systematic credit and fundamental—or, as I call it, discretionary—credit can work well together within an investment portfolio. I make that further distinction between fundamental and discretionary because, after all, we as systematic credit investors are fundamental investors! Extensive research has shown that systematic and non-systematic approaches can help to diversify one another. They generally have low correlation in terms of both positioning and returns.

JT: Why systematic credit now?
SR: Data accessibility and culture. To support systematic investing, credit markets needed more time to mature, relative to equity, especially for market liquidity and data related to secondary markets. Developments in primary and secondary credit market trading, improvements in pre- and post-trade price transparency, and enhancements to relevant datasets have made it easier to implement systematic credit strategies. Culture has a role to play as well; inertia has meant that traditional discretionary approaches have dominated discussions by both asset managers and asset owners in credit markets. Times are changing, though, and there is an increased awareness and acceptance of systematic credit approaches coupled with favorable track records. As a result, systematic credit has taken its place alongside systematic equity as a well-recognized alpha-seeking investment approach.

JT: What subsectors of the credit market are best suited to a systematic approach and why?
SR: For now, it's still a case of the larger and more liquid the better. For example, it's easier to implement a systematic credit strategy in developed markets than in emerging markets. Systematic approaches work well for both investment grade and high yield corporate bonds. While there are some differences in return drivers and hence opportunities across investment grade and high yield, there are more similarities than differences.

JT: Do themes that investors might know from bottom-up stock selection have relevance to credit? Key similarities and differences?
SR: Yes. When we focus on potential alpha within credit markets, there is significant overlap in the types of investment themes that generate outperformance for both stocks and corporate bonds. As a familiar example, my published research has shown the efficacy of credit signals based on value and momentum.[3] While the labels are similar, there are differences in measurement across stocks and bonds, especially for value. In equity, a value signal is typically constructed by comparing a market price to a measure of fundamental value derived from the income statement or balance sheet. In credit, a value signal would typically compare an observed credit spread to a model-derived default probability. Both measures anchor the respective market price to a relevant measure of fundamental value—but it's a different price and a different fundamental anchor.

I'd emphasize that while there are natural synergies across equities and credit in terms of the intuition, data, and analysis that we can use to identify mispricings, we nevertheless expect the active returns generated through systematic credit to be additive to those generated in equities. Just as we discussed earlier that credit and equity betas are diversifying, credit and equity alpha are also distinct.

> ***Extensive research has shown that systematic and non-systematic approaches can help to diversify one another.***

JT: In building Acadian's systematic credit investing capabilities, what are your initial priorities?
SR: Building out the data platform and getting the right people. Fortunately, the longstanding systematic equity effort at Acadian's core provides a natural foundation for systematic credit. For example, we already have

[3] Correia, M., S. Richardson, and I. Tuna, "Value Investing in Credit Markets," *Review of Accounting Studies* 17 no. 3, (2011) 572–609.

a world-class data and analysis platform for company security selection. We are integrating credit market data and reference data related to corporate bonds to form a complete view of the value of the corporate enterprise. We are also extending the research environment to handle unique aspects of credit markets, for example, multiple securities for a given issuer. In addition to the research platform, we are also adding credit-focused portfolio management and implementation infrastructure.

I'd emphasize that in systematic credit, implementation requires special care for trading and liquidity provision, more generally, in both primary and secondary markets. We are onboarding execution management systems that will handle all these idiosyncrasies. While credit securities do not yet trade like stocks on electronic markets, the increasing electronification of credit markets and the evolution of common trading protocols and platforms is a great tailwind for the development of systematic credit strategies.

[T]here is significant overlap in the types of investment themes that generate outperformance for both stocks and corporate bonds.

Of course, while Acadian's systematic focus makes systematic credit a natural fit, we will build this capability without taxing the existing equity team. To get this all to work, and to do so within a reasonable time frame, we need to hire experienced investment professionals. I've been focused on hiring the systematic credit investment team, and we have onboarded three individuals to date and expect to have around ten dedicated individuals by Q1 2023.

JT: How would you expect systematic credit strategies to perform across changing interest rate environments?

SR: Our objective is to provide asset owners with two things. First, we must provide the beta in their selected benchmark, for example, investment grade or high yield. Second, we must provide additional alpha via security selection. Our systematic approach to security selection means that the benchmark-relative active returns have low sensitivity to market risk premia and macroeconomic variables. My prior research has shown this to be the case.[4] On the other hand, the beta component of a systematic credit portfolio, or indeed any long credit portfolio, will have a positive exposure to economic growth.

We achieve the low correlation of active returns to macroeconomic variables by picking issuers and issues within peer groups. This tends to reduce incidental risk exposures that can creep in when making comparisons across very different companies or instruments. Moreover, in portfolio construction, we seek to balance portfolio-level interest rate and credit, further dampening any exposure of active returns to interest rates and other macroeconomic variables.

JT: Are institutional asset owners seeking systematic credit solutions?

SR: Absolutely. Institutional investors have significant interest in systematic credit. One of their main motivations is to find a source of benchmark-relative active returns that doesn't simply lever up on credit risk. Systematic credit strategies have been successful in delivering alpha. Not only that, but as I've mentioned, systematic methods tend to produce portfolios that look materially different than those that we see in the discretionary credit space. Of course, to become convinced of the potential additivity of systematic credit, institutional investors need to see implementation efficiency. In other words, managers must demonstrate that they can get desired positions into their portfolios in a cost-effective and liquidity-aware manner.

I expect continued interest from institutional investors for systematic credit strategies across the product spectrum, from benchmark-aware investment grade and high yield long-only portfolios to alternative long-short offerings. And I look forward to engaging with Acadian's investor base!

[4] See, for example, R. Israel, D. Palhares, and S. Richardson, "Common Factors in Corporate Bond Returns," *Journal of Investment Management* 16, no. 2, (2018): 17-46.

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