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# Right time to Invest in Credit?

## EXECUTIVE SUMMARY

Credit with its negligible drawdowns, low volatility, and low correlation with other asset classes is ideally suited for wealth preservation and steady yield. In a world starved of yield, Indian credit spreads are at decadal highs in-spite of a strong economic recovery. Thinning of competition is the reason for such attractive credit spreads and is a harbinger of lucrative risk adjusted potential returns in the coming years.

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Actually, strike that question. The question should be that whether we can afford to ignore an asset class which is 3-4x the size of equities globally. Credit is mid-way in terms of risk between equities and treasuries, and **ideally suited for Investors looking for capital preservation and a steady source of portfolio yield**. The spectrum of performing credit ranges from high quality AAA securities to investment grade ones rated BBB, much like how equities are classified as large cap and mid/small caps.

When businesses do well, equities do great. Credit shines even when they falter. If one were to analyse NAVs of the 3 largest private AMCs offering both credit risk and flexi cap funds since 2018, the worst monthly drawdown of credit risk funds was less than 4% compared to ~35% for equity funds. Over the past 42 months, average volatility of credit risk funds has been less than 3% compared to ~20% for equity funds, and the correlation of their daily returns is a measly 0.05. **Statistics don't lie – credit allocation does improve portfolio returns meaningfully** when adjusted for risk.

Moreover, we should be greedy when others are being fearful. In a world where negative yields have become the norm, and BBB yields in the US are barely a percent or two above treasuries, India high yield spreads (securities with A rating) are at decadal highs of 6-7% as per the CRISIL yearbook. Such elevated spreads are typically indicative of stress in the system. However, economy has consistently displayed green shoots since last 6 months. Upgrade-downgrade rating ratios have improved from a decadal low of 0.54 in the first half of FY21 to 1.33 by year end, and ~2.5 as of July end as per CRISIL. **With an expansionary fiscal and monetary stance, worries of a widespread credit crisis should be behind us.**

If the macro is supportive, micro isn't far behind. **Scarce capital conditions have made the businesses battle hardened**. They have reduced expenses, controlled their working capital, and curbed their expansionary desires simply because the financing environment has been tough. This is reflected in generally lower leverage across industries today. Business profitability has also held surprisingly well in a pandemic year and the ensuing IPO boom has further reduced implicit leverage in system.

In the backdrop of such supportive macro and micro conditions, what explains these unreasonably attractive spreads? We need to appreciate how the structure of Indian credit markets has orphaned relatively lower rated issuers. Credit risk mutual funds, which were mandated to lend primarily to AA and below rated securities, have seen their AUMs contract from around INR 85,000 Cr in 2018 to INR 30,000 Cr currently. Most NBFCs have pivoted to retail lending. PSU bank lending to companies rated lower than AA has de-grown by ~5% in FY21 as per RBI's latest Financial Stability Report. If asset liability mismatches dissuaded NBFCs and Credit risk MFs, PSU banks have been beset with past NPA challenges. **Thinning of competition is the reason for such attractive credit spreads and is a harbinger of potential lucrative risk adjusted returns in the coming years.**

But how do we judge whether this spread is sufficient? CRISIL publishes an Annual Default Study where research over multiple decades shows that A rated securities have a 1.6% default rate over a 3-year span. That research includes not just all CRISIL rated bond issuers, but bank loans as well. Similar work done by Care Ratings concludes that A rated securities have 2.9% default rate over 3-year span. So, **a 6-7% additional return with a 0.5-1% credit cost per year remains a very good deal.**

It's not just us who are bullish on wholesale credit. HDFC Bank, which has been an epitome of conservatism and was largely retail focused has become aggressive in wholesale lending. Between June 2017 and June 2021, the wholesale loan book has grown at a CAGR of ~23% while retail loan book growth has been much slower at ~15%. The wholesale book is now 53% of the bank's total loan book.

Despite the fact that credit spreads are great and other marquee participants are going long, a lot can still go wrong between investing and exit. To cross that Agnipath, seasoned managers employ "Kavach" in the form of good structure, covenants, credit enhancements and collateral. **Credit situations rarely unfold quickly**; balance sheet crisis is a slow grind. Constant monitoring and disciplined enforcement can be life saviours in such situations. Good promoters have tremendous will and ingenuity to succeed even in face of odds. **Smart credit investing may produce asymmetric returns**; as Mohnish Pabrai puts it - heads I win; tails I don't lose much type of scenarios.

Having said that, investors have had tumultuous experience with credit over the last 2years. Among large fund houses with credit risk fund AUMs of INR 500+ Cr, the returns have been in the range of 6.5-9.0% with the worst returns being in the range of 3-4%. Returns haven't been disastrous even in a very tough environment, but we agree that being able to sleep comfortably is also priceless. The best features of structured credit - its flexibility and its bespoke nature - were its Achilles heel. Complex structured trades didn't have easy liquidity. As an investor, it's your decision whether liquidity is more important to you, or risk adjusted returns.

Rest assured that whole Government machinery is working behind the scenes to make sure credit is safer, more liquid and investors can participate without hitches. IBC, debenture trustee regulations, improved accounting standards, multiple regulations on disclosures, on independent directors and others are aimed at making credit investing a smooth process. While these evolve, the opportunity to scale up exposure to the private credit markets is a great way to improve your portfolio's asset allocation.

***Sources: Value Research, RBI Financial Stability Reports, CRISIL-Yearbook, Internal estimates***

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