INVESTMENT | STAR MANAGER

MARK REDFEARN

Yield-hungry investors are piling money into US corporates, but are the tourists about to get a nasty surprise? PPM America fund manager **Mark Redfearn** gives **Michelle Abrego** the inside track on how the 'new normal' is leading investors astray

Age
46

Company
PPM America

Location
Chicago

Sector
US corporate debt

Funds
Eastspring Investments US Corporate Bond and Eastspring Investments US Investment Grade Bond

Investment style
Fundamental, bottom-up security selection with a macroeconomic overlay and emphasis on credit research picking rather than benchmark strategies or macroeconomic policies

By his own admission, portfolio manager Mark Redfearn was somewhat naïve when he started his career, but there's nothing like a few years in the market to rectify that.

As a US corporate and investment grade bond manager for PPM America, the Chicago-based subsidiary of UK insurance giant Prudential, Redfearn has made a career of diligently picking paper that will deliver irrespective of what rates or markets are doing.

'In my younger days as a professional I put myself in the "overly naïve" club at times. I came to the markets with an understanding of a textbook example that markets are efficient – the University of Chicago theory that all the information is priced in,' says Redfearn.

'What markets show me year in and year out is that they are highly inefficient. Markets are an amalgamation of individual investors, and they have all the trappings and flaws of individuals. With this in mind, opportunities abound.'

The present bond market is no exception. With trillions of dollars in negative yielding debt globally, and long-term interest rates in many developed economies at or below 1%, investors from Europe and Asia are turning to the US for yield.

According to Lipper data, investment grade corporate debt funds have taken in $90 billion so far this year.

Citywire AA-rated Redfearn runs the $5.2 billion **US Corporate Bond** and $481.1 million **US Investment Grade Bond** for fellow Prudential subsidiary Eastspring Investments, and has seen the appetite for the asset class grow first-hand.

Combined, Redfearn's two funds have returned 19.7% over two years in contrast to the average of 39 US corporate debt managers in Citywire's database, which returned 11.6% over the same period.

While his universe of US dollar corporate bondholders has increasingly become more global, Redfearn highlights his concerns about how a potential mismatch in investor expectations might cause issues down the line.

'Many of these investors may be more absolute return investors rather than relative value credit investors,' Redfearn says.

'I'm focused on excess returns, as it is my belief that interest rate investing is fraught with pitfalls that have befallen the most sophisticated investors. If absolute returns disappoint, selling may ensue independent of the attractiveness of spreads.'

In addition, Redfearn believes liquidity is currently undervalued. 'We're grinding tighter now because of the perception that there's not enough bonds is back in vogue. February and March were defined by gaps in liquidity where investors could not get fair value on the way down. No one was talking about too few bonds then.'

When speaking to foreign investors, he has tried to put this simply.

'I like to use the analogy of the children's game of musical chairs – the good news is that it's a game played internationally.

'The bad news is, I don't think there are as many chairs as people think around the table, so when the investment momentum shifts it's not simply about beating the person to the left or the right of you. It will be about finding a seat, and that will be much more difficult than people are assuming.'

BREAKING THE CYCLE

At the forefront of many investors' minds is the anticipated rate hike from the US Federal Reserve. The market has priced a rate hike for December this year, the first since last December.

The domino effect that such increases usually inspire should be limited this time around, Redfearn says. 'If and when the Fed tightens monetary policy, I have real doubts that it will be perceived as the beginning of a cycle. The Fed predicted in December 2015 that they would raise four times in 2016. It is now October and they have not raised it once.

'I think the market is obsessed with this story and I struggle to see the cycle of hikes scenario playing out,' he says.

Redfearn quickly points out that he is not dismissing the Fed's influence on the market.

'But why are equity investors discussing the Fed moves when all we're talking about is 25 basis points and then they will likely pause another nine to 12 months?'

In both of his bond funds, Redfearn has more than a third of the portfolio allocated to credit maturing in 10 years or more, a challenging position considering that a rate hike is approaching and there's usually a long-dated debt rally in such situations.

'[I'm] very interested to see where long-dated credit trades going forward. You wouldn't have anticipated, in a high-beta year defined by positive excess returns, that 10-year and 30-year credit spreads would have steepened out as much as they have.

'Market data appears to show that investor duration reach is now focusing all the way out the credit curve to find higher yields. We are long 30-year credit where curves are attractive.'

Moving up the quality ladder has been his main defensive move, as well as an underweight to BBB and A-rated paper and an overweight to the AAA bucket.

He also leans heavily on PPM America's structured products team to ensure the fund has dibs on priority payments from the institutions it has lent money to. The fund allocates at least 7% to structured products.

'Our structured product staff is going through every loan, in every deal and we're looking at relative value among the tranches. I have great confidence that when we put a position on we are very comfortable with our long-term perspective. Then it becomes an issue of tracking and monitoring the relative value changes.'

Redfearn came into investment with a liberal arts education, having studied political science and economics, which very much influenced his qualitative perspective.

'Historical data tells us only where we've been. The power to think is the challenge.

'We all have access to the same data, it is how we value it that differentiates us. How do we look at markets, prices, volatility? It is often the qualitative overlay that distinguishes a new trend or opportunity.'

TECH BOOM

One bet that has been paying off this year for Redfearn has been Microsoft, a AAA asset with a low default outlook.

'Because lots of cash in the tech space is trapped offshore and repatriation does not look like it is close on the horizon, many tech companies have accessed the US dollar bond market in order to fund shareholder enrichment programs.

'Names such as Apple and Microsoft that were not in our markets 10 years ago at all are becoming prominent issuers with the frequency of their $10 billion-plus forays into the new issue market.'

Over the past seven years, since the financial crisis, banks have also earned a spot in Redfearn's portfolio because of their improving fundamentals.

'They're highly regulated and are actually deleveraging and building capital in excess of what their long-term needs are, so fundamentally we tend to like them.'

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'Interest rate investing is fraught with pitfalls'

Canadian banks, such as TD Bank, Bank of Montreal and Royal Bank of Canada, feature in both the funds' top 10 holdings, as he believes they have healthy excess capital at their disposal and are in a strong regulatory position.

He has, however, moved from a multi-year overweight to a more neutral position based on concerns over how banks might respond to incoming requirements from the Financial Stability Board to bolster global their capital and leverage ratios.

The final rules will be announced in early November and should result in technical pressure in the banking sector.

Not all investments in bank bonds look attractive though, Redfearn warns.

He's steering clear of the Additional Tier (AT1) and CoCo note markets because their conditions of liquidation are highly onerous and a challenge to the principal of capital preservation.

'Look no further than developments at Deutsche Bank, and the capital dialogue under way,' he says.

The German bank's AT1 bonds have been subject to a major selloff since mid-September when the US Department of Justice asked the bank to pay $14 billion to settle an investigation into its selling of mortgage-backed securities. The potential size of the fine triggered fears the bank would not be able to deliver on its debts.

'This bank has a challenged operational track record of performance and finds its debt under tremendous stress,' Redfearn says.

'Too many investors more highly valued the yield opportunity at the expense of risk adjusted total return, and now find themselves sitting on material losses.'

SIDESTEPPING INDUSTRIALS

Industrials currently account for about 67% of the Barclays Capital Credit Most Conservative 2% Issuer Cap Bond Index, which Redfearn's US corporate bond aims to beat.

The fund held about 38% of its assets in industrials as of the end of August, the underweight being because of idiosyncratic risks driven by industrial firms' focus on boosting dividend payments with leveraging activity.

One sector in particular that has experienced balance sheet deterioration is energy, according to Redfearn.

He is skeptical about oil production cartel Opec's ability to strike a deal that would see production curbed for the first time since 2008.

'I think the market has been complacent in terms of chasing potential returns, chasing yield, but I'm hard pressed from a macro standpoint to think the market is in the type of real balance that would merit $65 oil in the marketplace.'

TRICKY INVESTOR TRENDS

The hunt for yield has investors abandoning the rulebook, which could end badly for some.

'What you get when negative rates persist for a long period of time is the assumption that a new state of normal has been created,' Redfearn says. 'In this state investors deviate from their objectives and take on more risk than they should be taking on.

'Too many investors are undertaking ill-advised investments because they perceive to be investing along with central banks. Rarely does this play out well over a longer time horizon.'

Fund selectors and buyers could be inviting more risk by paying too much attention to what Redfearn believes is a new buzz metric: tracking error.

'As I travel, tracking error has becoming a big buzz phrase. It's backward-looking volatility,' he says.

'Today we find ourselves in a low volatility environment and tracking error is telling you to add volatility. It is telling you to add risk and to get a tracking error target level. I've learned over time these are the opposite outcomes you desire if you were thinking rationally over long periods of time.'