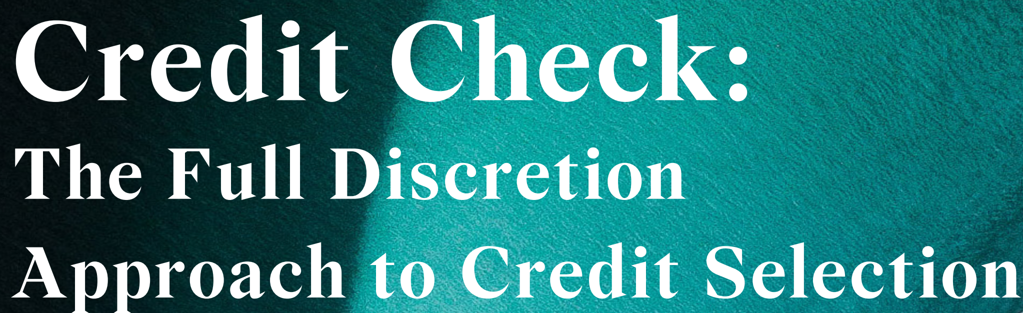
LOOMIS | SAYLES

WRITTEN BY
THE LOOMIS SAYLES FULL DISCRETION TEAM



Credit Check:
The Full Discretion Approach to Credit Selection

Credit markets are frequently moving. During our decades as bond investors, we've seen them frozen during times of crisis, frothy when investors have seemed desperate for yield, and everything in between.

Throughout these environments, we have consistently observed that the market is inefficient at pricing specific risk. Mispricings tend to occur when the market is short-term focused, illiquid or irrational because of fear and greed. Our full discretion investment style follows two core philosophies to help capitalize on this persistent inefficiency in corporate credit and drive excess return potential.

JANUARY 2025

KEY TAKEAWAYS

- We follow two core philosophies (Determine Enterprise Value and Build in Convexity) to help capitalize on persistent inefficiency in corporate credit and drive excess return potential.
- Through fundamental research and active management, we seek to capture risk premiums that other investors may be unable or unwilling to access.
- We consistently use six security selection strategies to help identify and capitalize on mispricings throughout market cycles.

Core Philosophies

1. **DETERMINE ENTERPRISE VALUE:** We believe fundamental research paints a clearer picture of intrinsic value. We take an equity-like view of company valuations by focusing on long-term enterprise value and identifying risks to that value. This foundation gives us the conviction to buy in illiquid markets and take contrarian positions.
2. **BUILD IN CONVEXITY:** We seek deeply discounted bonds that we believe offer call protection and price appreciation potential. Discount bonds tend to have positive convexity, which can help maximize yield and total return potential while minimizing downside risks.

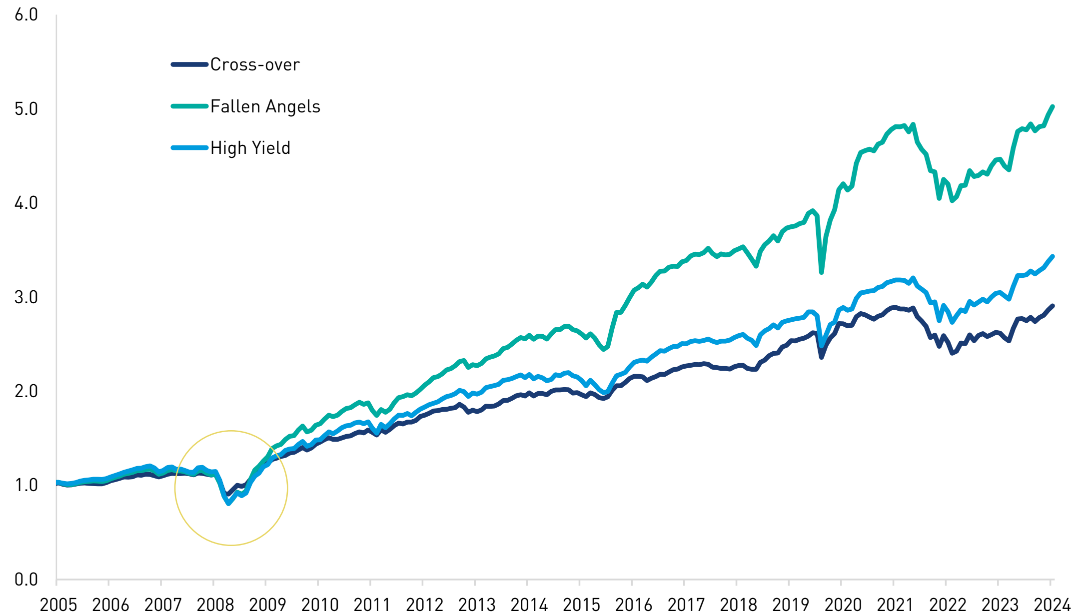
This paper zeros in on our six key corporate credit selection strategies, each rooted in these core philosophies and executed using Loomis Sayles' bottom-up fundamental research expertise. We also discuss how we integrate a top-down macro view with our security-specific strategies to evaluate what's driving the credit cycle and anticipate broad sector mispricings.

Pillars of Security Selection

Many investors react to short-term news. Others may emphasize beta, want to replicate a benchmark or have inflexible guidelines, so they may take a less discriminating approach to portfolio holdings. Because we invest for the long term, these behaviors create entry points for us. Through fundamental research and active management, we seek to capture risk premiums that other investors may be unable or unwilling to access. We consistently use six security selection strategies to help identify and capitalize on mispricings throughout market cycles.

1. **FALLEN ANGELS:** Many investors must sell downgraded bonds when they fall out of investment grade indices. This reflex can push bonds below fair value and inflate their yield. It has also helped fallen angels' return profile over time. Over roughly the past 15 years, fallen angels have outpaced high yield and crossover credits on a total return basis and bested high yield for return per unit of risk. Their return per unit of risk is roughly in line with that of crossover credits but with higher total return potential and volatility.

FALLEN ANGELS HAVE BEEN A HIGHER-REWARD POTENTIAL, HIGHER-RISK SEGMENT OF THE MARKET



1/1/2005 – 08/31/2024	CROSSOVER INDEX	FALLEN ANGELS INDEX	HIGH YIELD INDEX
Total Return	5.6%	8.6%	6.5%
Ann. Risk	7.1%	10.1%	9.2%
Ratio	0.79	0.85	0.70
Max. Drawdown	19.9%	31.2%	33.3%

Source: Bloomberg Barclays, Intercontinental Exchange Inc. (ICE) and Loomis Sayles analysis January 2005 - August 2024.

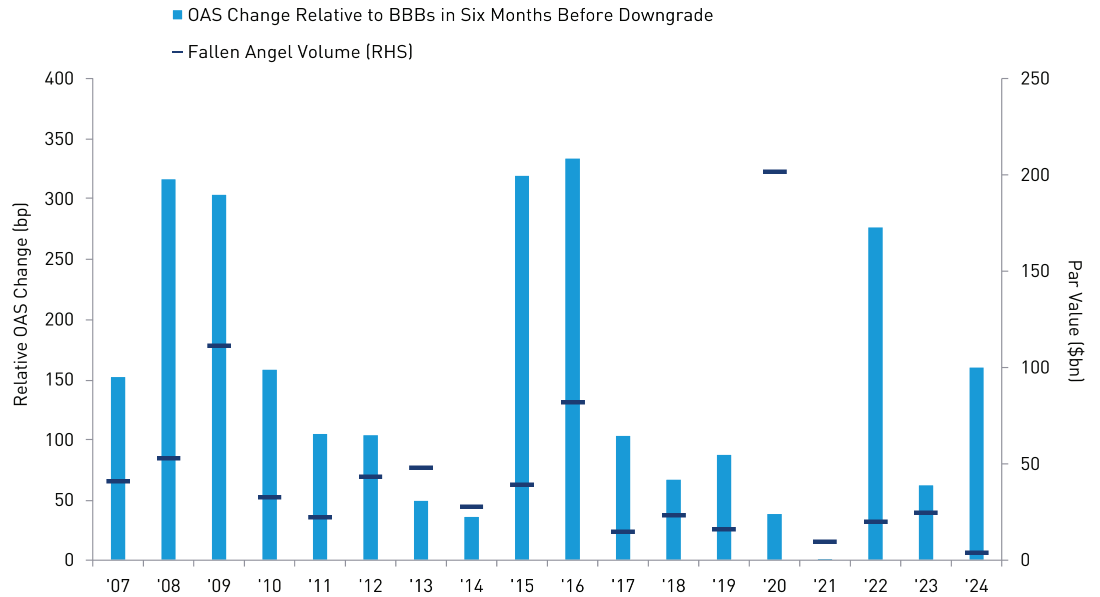
Index description: Cross-over: ICE BofA US Diversified Crossover Corporate Index, Fallen Angel: Bloomberg 3% Constrained Fallen Angel Index, High Yield: Bloomberg US Corporate High Yield Index.

For each issuer amount outstanding is calculated as a maximum value of the amount outstanding of all its issues.

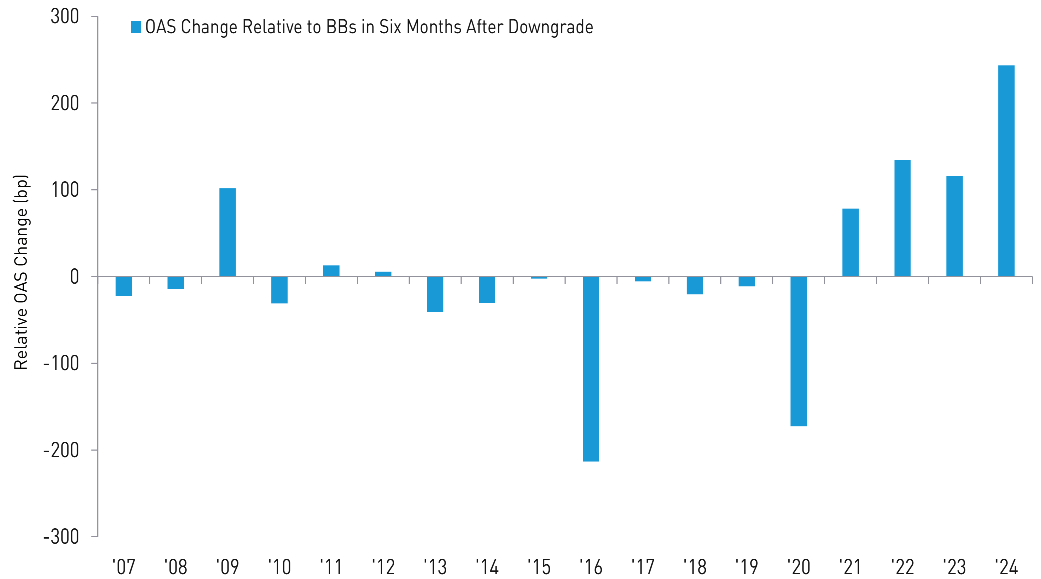
Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.
Past performance is no guarantee of future results.

Because fallen angels have been a higher-reward potential, higher-risk segment of the market historically, we believe fundamental research and valuation analysis are crucial for investing in this space. During the last two fallen angel cycles (2015-2016 and 2020), the analysis on the following page from Barclays Research highlights the importance of identifying potential fallen angels more than six months before downgrade while simultaneously having the flexibility to purchase them once they are downgraded to high yield. But, investments carry the risk of loss as well as profits.

FALLEN ANGELS HAVE UNDERPERFORMED AHEAD OF DOWNGRADE...



...BUT OFTEN HAVE A LARGE REBOUND IN PERFORMANCE AFTER



Source: Barclays Research, Bloomberg. Bradley Rogoff, CFA; Scott Schachter, Jeff Darfus, "Not All Fallen Angels Are Getting Wings," April 17, 2020. OAS change in six months before downgrade: data July 31, 2006 - August 2024. OAS change in six months after downgrade: data January 31, 2007 - August 2024.

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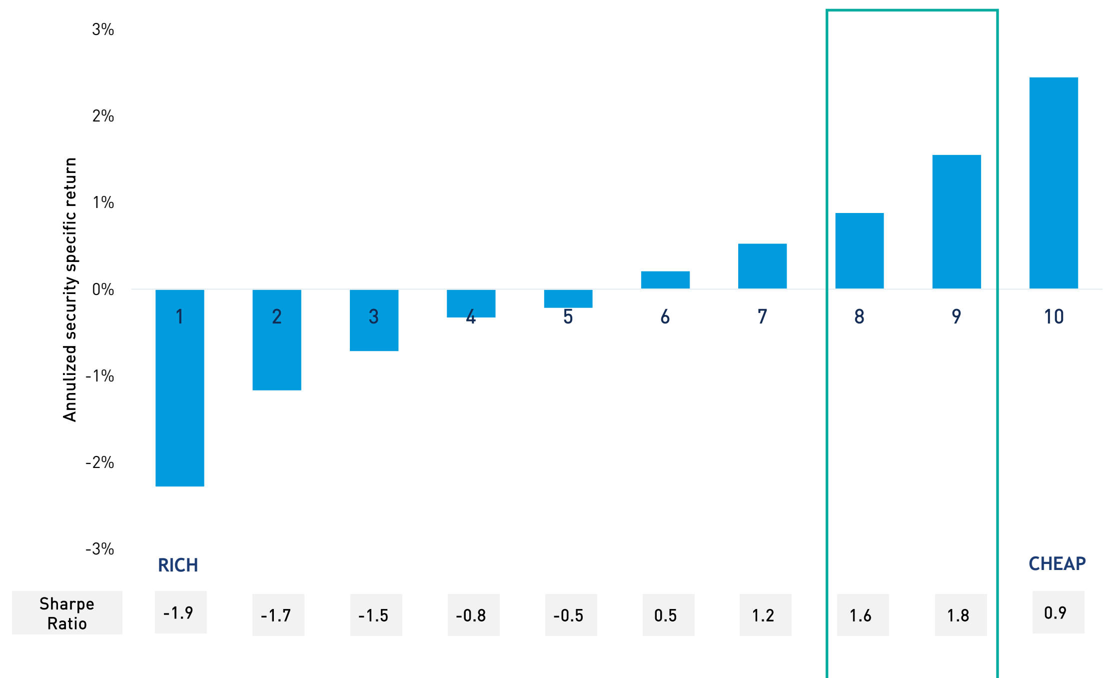
2. **CHEAP FOR RATING:** Bonds trading cheap—or at a wide spread—relative to their financial risk typically have strong appreciation potential. A Barclays study showed that from 1993 to 2016, portfolios with an above-median spread-for-financial risk outperformed those with below-median spread-for-financial risk by an average of 178 basis points (bps) per year.[1] Furthermore, by owning only the credits that were trading wider than the median spread given financial risk, a portfolio manager could have expected to beat the market by on average 118bps per year. Loomis Sayles conducted an internal analysis of securities trading cheap relative to our analysts' proprietary fundamental credit ratings. The results, illustrated below, showed that bonds trading wide for their rating earned higher security-specific return. In our view, indiscriminately buying wide spread bonds is not an effective strategy, as the Sharpe ratios below show. It takes credit research expertise and skill to help identify those credits that are truly trading at a discount to a company's fundamental value.

[1]Source: Barclays Research, Bloomberg. Albert Desclée, Anando Maitra, Simon Polbennikov, "Relative Value Investing in Credit," May 9, 2016. Barclays estimated Relative Value in Spread (RVS) scores of individual bonds on a monthly basis and constructed 10 portfolios that correspond to deciles of RVS. Analysis was based on Bloomberg US Corporate Bond Index filtered to retain non-callable, senior bonds. For each bond RVS score was produced by measuring its excess spread over its rating-industry-duration peers while also controlling for financial leverage.

SECURITIES TRADING CHEAP TO LOOMIS SAYLES ANALYST RATING HAVE OUTPERFORMED ON A RISK-ADJUSTED BASIS



Source: Bloomberg, Barclays and Loomis Sayles analysis. Analysis for the time period starting January 2001 - August 2024.

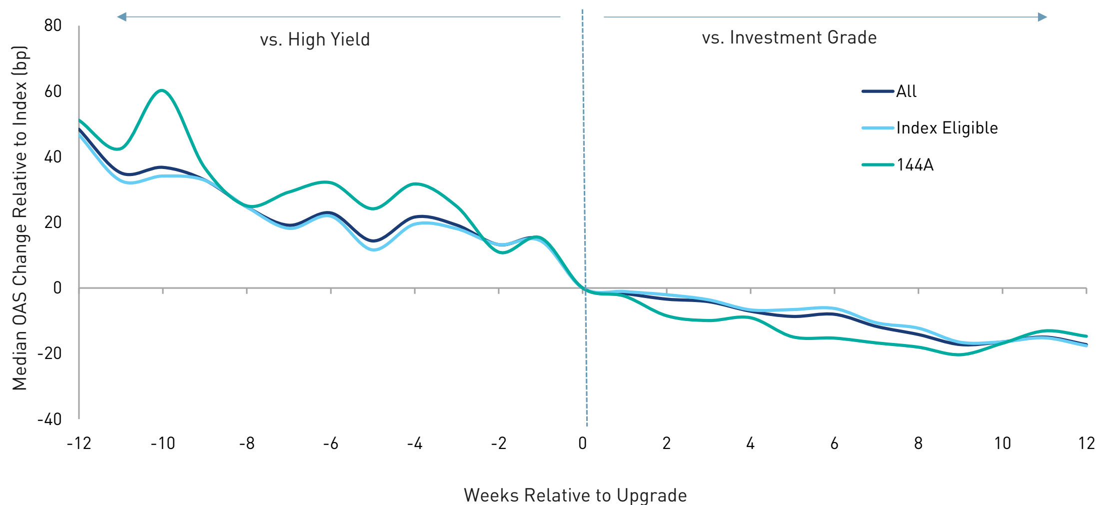
Calculation methodology: Each month all securities in Bloomberg US Corporate Bond Index are divided into deciles based on the value signal derived from Loomis Sayles fundamental rating. An average security specific return is calculated for all securities in each decile every month. An average of the decile time series multiplied by 12 represent the annualized security specific return. Security specific return of each security is the residual return after adjusting for three factors, namely, treasury, credit market and credit industry.

See the disclosure statement for important information. Past performance is no guarantee of future results.

3. **UPGRADE CANDIDATES:** The market is often slow to price potential upgrades for companies with improving credit fundamentals. Short time horizons and distortions created by passive investing may be two reasons for the lag. But as the exhibit below shows, risk premium tends to disappear quickly before an upgrade.

   Our investment philosophy takes a long-term view, so we naturally seek improving credit stories in their infancy. We look for high yield companies with the willingness and the ability to become investment grade. Willingness takes a sustained commitment from corporate management teams. It's easy to talk about wanting investment grade status when that goal is many years off. Our credit analysts typically have long tenure covering their industries, which can help them decipher which managements may have a sincere commitment to investment grade. We assess ability through in-house financial projections. Loomis Sayles credit analysts forecast financials over a three- to five-year time horizon. This helps us identify companies that can meet the ratings agencies' minimum investment grade requirements for things like size and diversification of revenue streams, leverage and cash flow before the market starts to price it in.

SPREAD TIGHTENING BEGINS BEFORE UPGRADE



Source: Barclays Research, Bloomberg. Bradley Rogoff, CFA; Scott Schachter, Jeff Darfus, "Tracking a Thousand Stars," February 7, 2020. Data updated from original study through August 2024. Barclays evaluated the performance of more than 1,000 rising star bonds dating back to 2006 relative to their respective indices (US High Yield Index before upgrade and US Credit Corporate or US 144A Index following upgrade). Across all rising stars, the study found bonds tend to tighten by approximately 50bps relative to the high yield index in the 12 weeks leading into the upgrade. In the 12 weeks following the upgrade there is modest outperformance relative to the investment grade index of approximately 20bps. This material is for informational purposes only and should not be construed as investment advice. Information obtained from outside sources is believed to be correct, but Loomis Sayles cannot guarantee its accuracy. This material cannot be copied, reproduced or redistributed without authorization.

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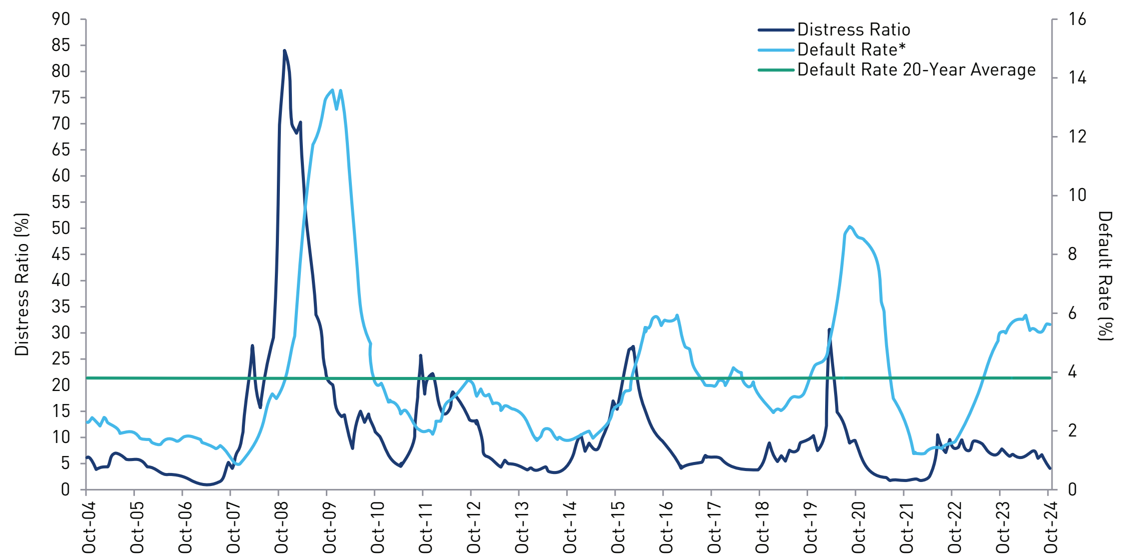
4. **STRESSED/DISTRESSED:** As the chart below shows, the market has tended to overestimate default risk in times of stress. During downturns, the lowest-quality bonds (rated CCC and lower) often trade at or even below their recovery values. Ironically, this tendency can be a competitive advantage relative to other securities in risk-off markets. Because bonds have a senior recovery position in the capital structure, they may have little additional downside as their price approaches recovery value. So while bonds rated CCC and below have historically underperformed BB-rated bonds, they can potentially offer meaningful upside convexity with asymmetric downside risk during severe selloffs.

   We believe rotating into lower-quality securities when the distressed ratio is high can offer a persistent source of potential alpha. We assess each opportunity individually, targeting investments that we believe have a margin of safety (trading at or below our fundamental recovery value estimate) and a low probability of bankruptcy (a sufficient cash position and ample time before upcoming debt maturities).

THE MARKET HAS OVERESTIMATED DEFAULT RISK IN TIMES OF STRESS



Source: Bloomberg, Merrill Lynch, Moody's, as of 31 October 2024.

**Percent of bonds in Merrill Lynch High Yield Master Index with Spreads 1000bps over Treasurys.*

Distress ratio is the percent of bonds in Merrill Lynch High Yield Master Index with Spreads 1000bps over Treasurys.

The chart presented above is shown for illustrative purposes only. Some or all of the information on this chart may be dated, and, therefore, should not be the basis to purchase or sell any securities. The information is not intended to represent any actual portfolio. Information obtained from outside sources is believed to be correct, but Loomis Sayles cannot guarantee its accuracy. This material cannot be copied, reproduced or redistributed without authorization.

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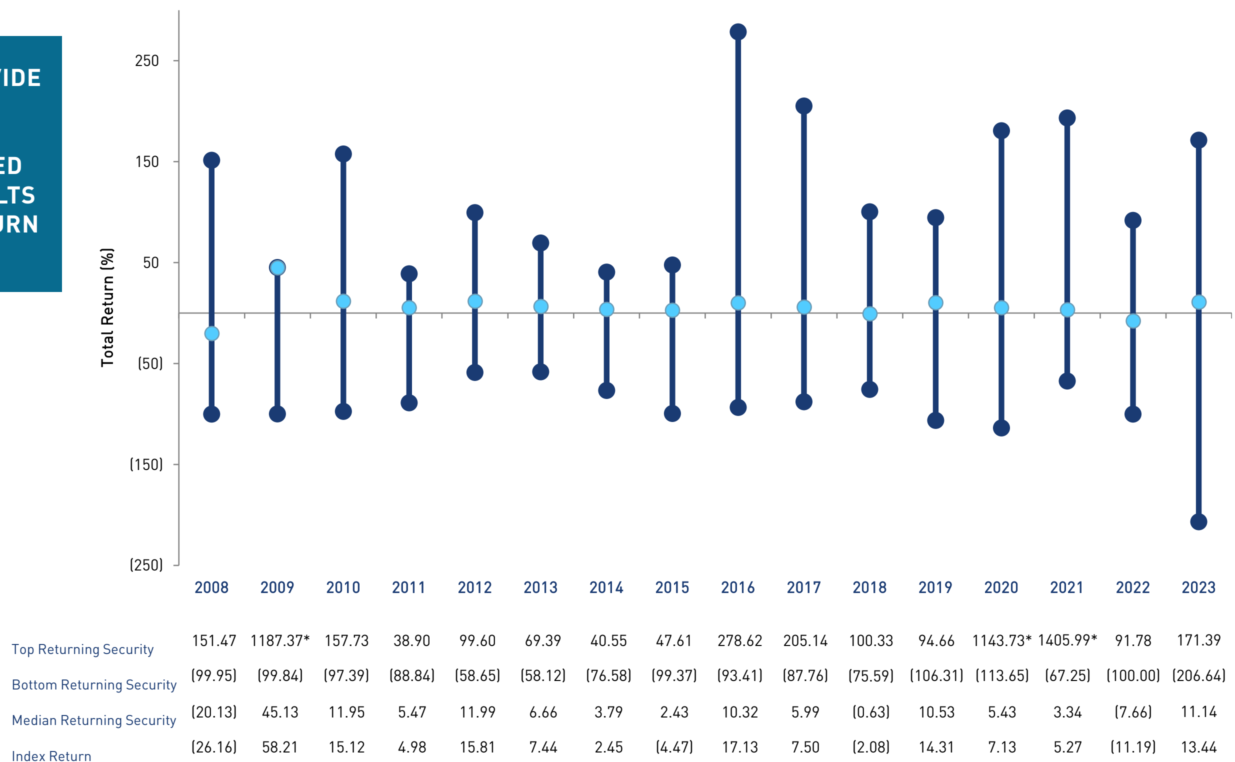
5. **AVOID LOSERS:** Not every bargain is worth it. Value traps tend to arise from distortions created by passive investing and the market's mispricing of enterprise value, especially in cases where there is no publicly available equity valuation. We use fundamental research and high-conviction estimates of enterprise value and risks to try to distinguish likely winners and losers. We also rely on trading expertise. Our trading desk has a pulse on what's likely motivating market players, and this insight can help explain how securities are priced. For instance, is a bond being bid because of a material development, or is it for a technical reason like short covering? These fundamental and trading insights help us limit permanent principal losses associated with value traps.

MARKETS CAN PROVIDE OPPORTUNITIES BUT FUNDAMENTAL RESEARCH IS NEEDED TO MINIMIZE DEFAULTS AND MAXIMIZE RETURN POTENTIAL



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Top Returning Security	151.47	1187.37*	157.73	38.90	99.60	69.39	40.55	47.61	278.62	205.14	100.33	94.66	1143.73*	1405.99*	91.78	171.39
Bottom Returning Security	(99.95)	(99.84)	(97.39)	(88.84)	(58.65)	(58.12)	(76.58)	(99.37)	(93.41)	(87.76)	(75.59)	(106.31)	(113.65)	(67.25)	(100.00)	(206.64)
Median Returning Security	(20.13)	45.13	11.95	5.47	11.99	6.66	3.79	2.43	10.32	5.99	(0.63)	10.53	5.43	3.34	(7.66)	11.14
Index Return	(26.16)	58.21	15.12	4.98	15.81	7.44	2.45	(4.47)	17.13	7.50	(2.08)	14.31	7.13	5.27	(11.19)	13.44

Source: Source: Bloomberg Barclays, as of 31 December 2023.
**Not shown on chart for presentation purposes.*
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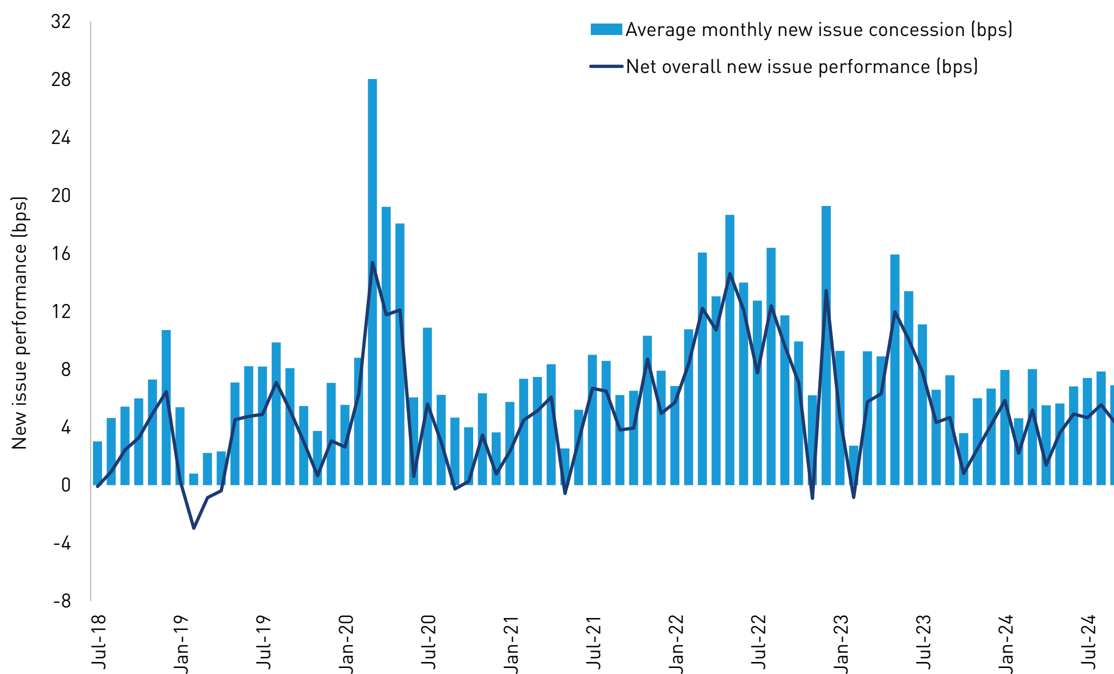
6. **NEW ISSUE PREMIUM:** The new issue market has been a steady source of sizable allocations that often offer a yield premium relative to the outstanding securities of an issuer. After they come to market, these bonds may move up in price to trade in line with the issuer's other outstanding debt. The premium varies depending on economic and market conditions and an issuer's circumstances. Our credit research analysts evaluate individual deals to determine when the new issue premium could offer compelling potential value.

SOURCING YIELD PREMIUM FROM NEW ISSUES



Source: Bank of America. Data from January 2011 - September 2024.

Cycle-Based Approach to Top-Down Investment View

We believe security selection can be most effective when paired with a rigorous top-down analysis of the macro environment. Credit markets go through cycles, just like the economy. We use credit cycle analysis to evaluate the factors driving the cycle, anticipate broad sector mispricings and seek to take advantage of changes in risk premiums at every stage. The process helps us identify which risk drivers we want to emphasize or avoid in the portfolio, and it lays the foundation for our bottom-up credit work.

We break the cycle into four periods—downturn, credit repair, recovery and expansion to late cycle. Each has its own characteristics and investment implications.

CHARACTERISTICS OF CREDIT CYCLE STAGES

DOWNTURN	CREDIT REPAIR	RECOVERY	EXPANSION/ LATE CYCLE
Profit contraction	Debt contraction	Profit > Debt growth	Debt > Profit growth
Central bank is cutting rates	Easy monetary policy	Monetary policy is about neutral	Monetary policy is tight
Recession	Growth is rebounding	Growth near trend	Tight economic slack
Liquidity and risk appetites are low	High liquidity	Diminishing liquidity	Fading risk appetite
	Improving risk appetite	Improving risk	Liquidity tightening

- **DOWNTURN:** Credit spreads widen (sometimes dramatically), defaults escalate and profits and incomes collapse.
- **CREDIT REPAIR:** Surviving companies are forced to improve their balance sheets to fix the damage. This can create a sweet spot for selective investors to take advantage of an environment in which yields are high and bond prices are low.
- **RECOVERY:** Credit spreads tighten; investors who bought at elevated yields can realize capital gains.
- **EXPANSION/LATE CYCLE:** Spreads tend to be narrow and investors need to be selective particularly because many lower-quality securities may not compensate them for the level of risk. In this phase, it can often make sense to move into higher-quality names and build up cash reserves—dry powder that can be put to use later.

The Art of Research

The six security selection strategies we have laid out rely on in-depth research. It takes preparation and skill to translate market inefficiency into investment opportunity.

We use proprietary research every day to figure out when the markets may be sending the wrong signal. We take a deep-dive approach across each component of our research effort, which includes macro, sector and bottom-up security analysis. On the macro level, we work with the Loomis Sayles Macro Strategies Team and leverage their analysis of the global economy and the economic prospects of individual countries, as well as quantitative frameworks. We also draw on the firm's sector teams, made up of portfolio managers, strategists, analysts and traders with expertise in different asset classes, such as investment grade credit, high yield bonds, emerging market bonds, convertibles, securitized assets, bank loans and commodities. Our partnership with the firm's deep fundamental research resources, including credit and securitized, gives us the analysis and conviction we require to execute our contrarian, deep-value style.

Conclusion

Value investing is in our DNA. We follow the same mantra today as when Dan Fuss pioneered the full discretion style in the 1990s: "Same bonds, different prices." Price fluctuations are a given in investing, and they can be tough to take. But we seek to seize opportunities to buy deep-discount, call-protected, positive-convexity holdings that can roll up in price to par, not down. We prepare ahead of time, doing the deep fundamental research work to develop our assessment of enterprise value, including recovery scenarios. That fundamental foundation can give us the confidence to hold and buy when others are selling.

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Disclosure

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Past performance is no guarantee of future results.

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There is no guarantee that investment objective will be realized or that the strategy will generate positive or excess return.

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