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APRIL 2023

GENERATING HIGH YIELD LIQUIDITY
CREDIT PORTFOLIO TRADING DEMYSTIFIED

INVESTORS ARE INCREASINGLY CONSIDERING HIGH YIELD, BUT TYPICALLY HAVE TO ACCEPT THAT POOR LIQUIDITY AND HIGH TRANSACTION COSTS WILL ERODE RETURNS.

HOWEVER, FOR SOME, HIGH YIELD LIQUIDITY HAS NEVER BEEN BETTER, VIA THE ETF ECOSYSTEM THROUGH CREDIT PORTFOLIO TRADING.

SUMMARY: LIQUIDITY HAS NEVER BEEN BETTER IN HIGH YIELD FOR SOME

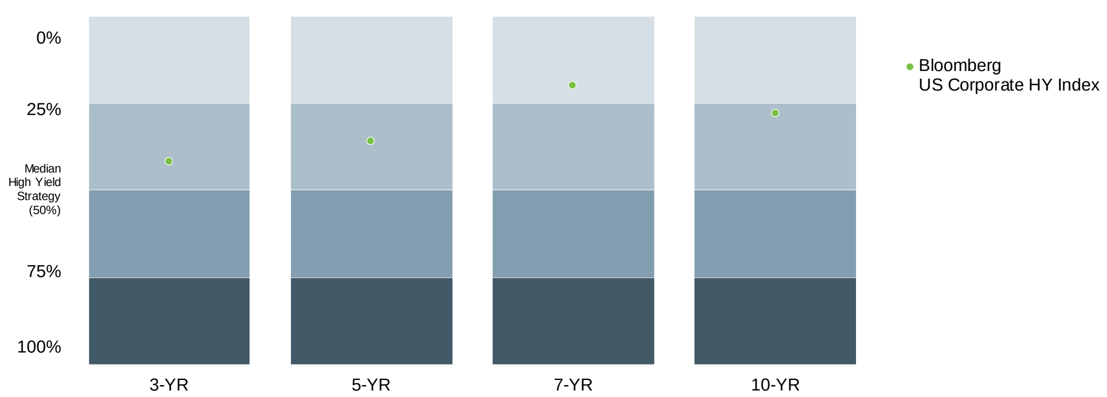
- Credit portfolio trading is a more liquid and innovative way to trade high yield bonds than over-the-counter (OTC) trading for portfolio implementation. It aims to extract the full potential from less liquid markets such as high yield
- With the right technology, tools and relationships, managers can trade custom baskets of up to 1000 bonds, within minutes, through the ETF ecosystem
- Credit portfolio trading can help investors source diversified beta, alpha opportunities that can be otherwise difficult to target. A highly diversified and liquid portfolio could also potentially act as a liquidity sleeve within a multi-manager allocation.

LIQUIDITY CHALLENGES MAKE IT TOUGH TO EXTRACT THE FULL POTENTIAL OF HIGH YIELD

High yield has become increasingly attractive for income generation and as an equity substitute, given a higher yield environment.

However, it is difficult to fully extract higher headline yields in practice. Bid-ask spreads are typically 60bp to 80bp per bond, so most active and passive strategies have underperformed the index over the medium and long term (Figure 1).

Figure 1: Most high yield strategies struggle to extract the potential of high yield[1]

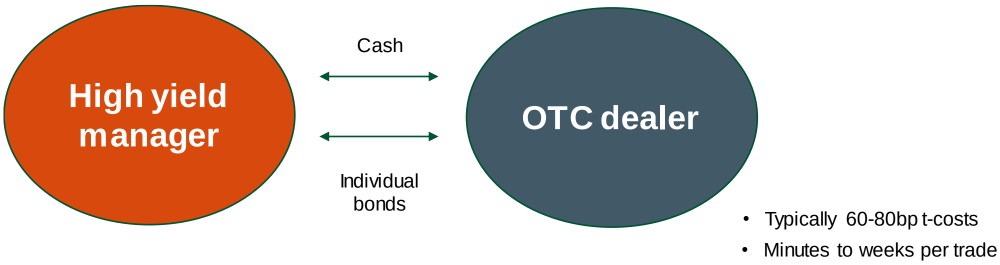


Traditional approaches to HY bond trading results in lower liquidity

Investment managers traditionally trade bonds over-the-counter (OTC). This means trading one bond at a time, line item by line item, typically by calling brokers or through electronic trading.

[1] eVestment Alliance, as of March 31, 2023. **Past performance is no assurance of future returns. Investment in any of these strategies involves a risk of loss.** The quoted benchmark does not reflect deductions for fees, expenses or taxes. The benchmark is unmanaged and does not reflect actual trading. between the index shown and the strategy. Investors cannot invest directly in any index. Performance is shown in US dollars.

Figure 2: OTC trading is line item by line item[2]



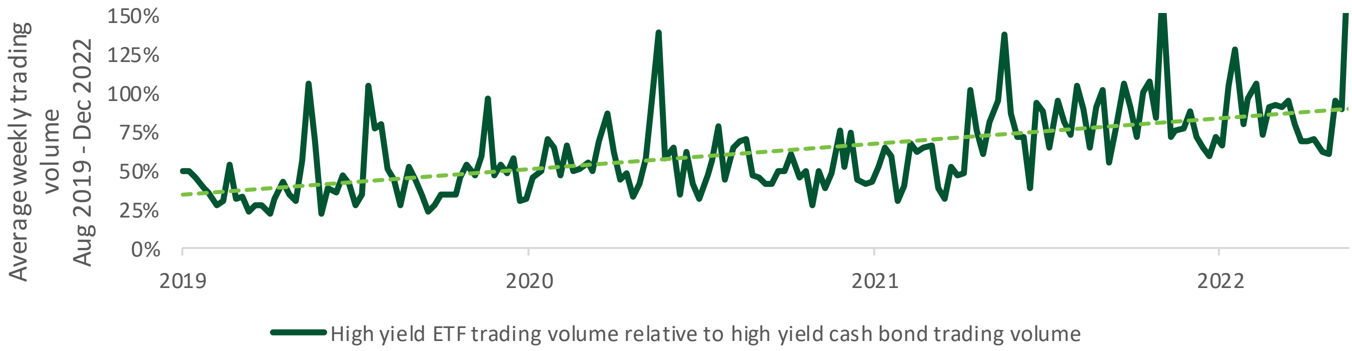
In the high yield market, it can take days or even weeks to complete an order. 2008-era banking regulations harmed liquidity by making it costlier for dealers to hold large bond inventories. Dealers can struggle to find the other side of a trade and have the challenging task of hedging idiosyncratic risk they hold. During stressed markets, two-way liquidity typically evaporates.

WE HAVE HELPED INVESTORS UNLOCK 'HIDDEN LIQUIDITY' WITHIN THE ETF ECOSYSTEM

The fixed income ETF ecosystem has developed rapidly over the last few years

The fixed income ETF market has grown substantially in recent years, accounting for an ever-rising share of fixed income trading, particularly during stressed markets (Figure 3). This has resulted in an increasingly deep and robust ETF 'ecosystem'.

Figure 3: The share of high yield ETF trading is rising, particularly during stressed markets[3]



The ETF ecosystem briefly explained

ETF issuers work with 'authorised participants' (APs – designated speciality brokers for ETFs) that act as middlemen between investors and the ETF issuers to transfer bonds in or out of the ETF (Figure 3).

For example, when investors buy shares in an ETF, all else equal:

1) An investor purchases fixed income ETF shares in the equity market.
2) The AP uses the cash to construct a basket of bonds that resembles the underlying fixed income index or strategy[4] and then exchanges that basket to the ETF issuer in-kind for newly-created ETF shares.
3) The AP hands the ETF shares to the investor[5].

When investors sell ETF shares, the reverse happens. The AP takes the ETF shares from the investor and gives them back to the ETF issuer – which then redeems them for a bond basket. The AP liquidates the basket and returns the cash to the investor[6].

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[2] For illustrative purposes only

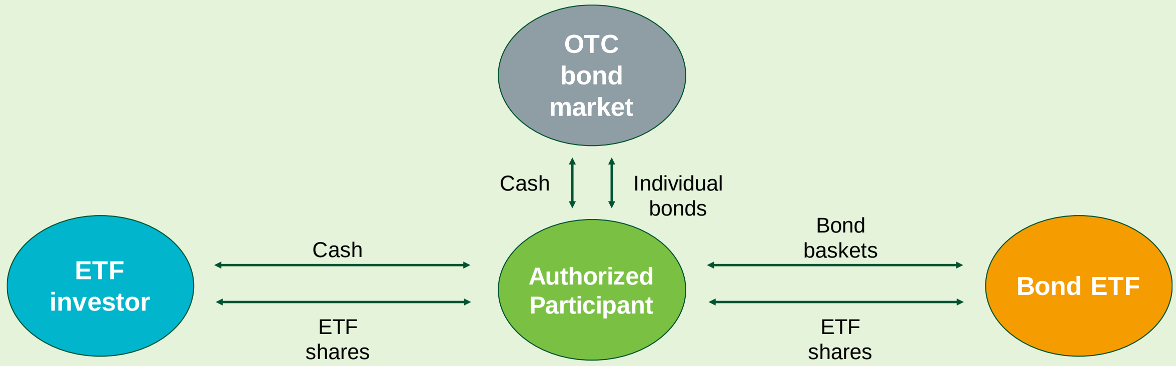
[3] Goldman Sachs, March 2023.

[4] These baskets are in line with the ETF's desired holdings. ETF providers communicate holdings it desires to incorporate or offload.

[5] In practice, given the largest high yield ETFs see $1bn to $2bn of secondary trading per day, APs will generally only need to submit "creates" or "redeems" for particularly large orders, in our estimation in the region of $500m.

[6] Its "redemption basket"

Figure 4: The basic ETF 'create and redeem' ecosystem[7]



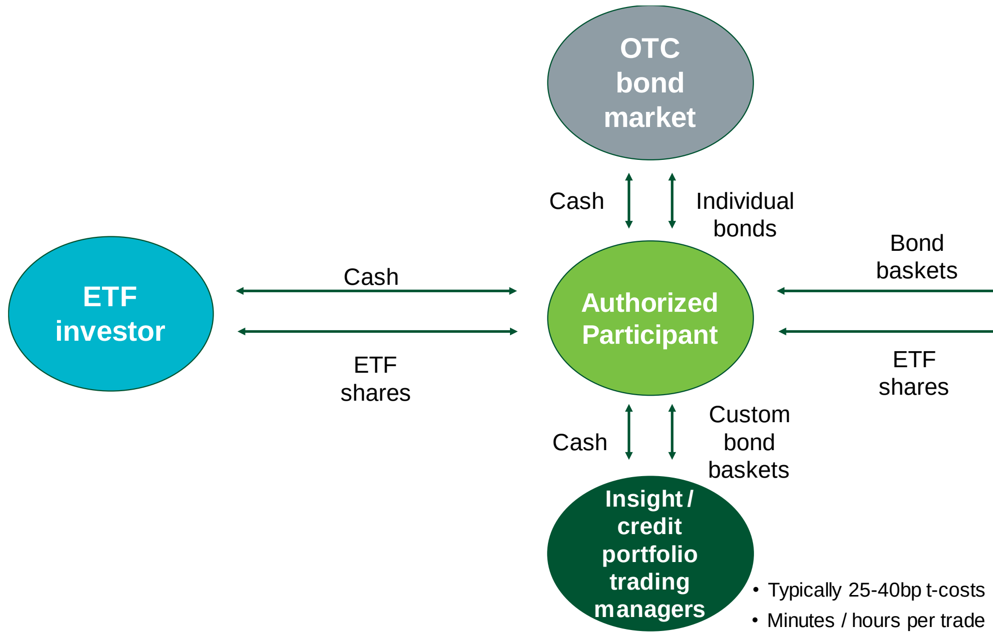
The process ensure liquidity as ETF shares can be created or redeemed in line with investor demand and APs compete away arbitrage opportunities if ETF prices deviate from the fair value of the underlying bonds.

We pioneered credit portfolio trading as a more liquid way to trade high yield bonds

The ETF ecosystem provides a source of 'hidden liquidity' for managers with the expertise and know-how. We noticed this and pioneered 'credit portfolio trading' in fixed income to tap into it. APs are increasingly trafficking in bond baskets to meet growing ETF demand and to manage day-to-day flows. This is challenging them when trading OTC, as larger sized single bond line items that can take much longer to trade, may have idiosyncratic risk and may not have a natural buyer/seller.

Investors therefore can trade custom bond baskets (or credit portfolios) with APs instead of single bonds one at a time. In our experience, transaction costs for well-structured credit portfolio trades in the high yield market tend to be 50-75% lower than OTC trades[8] (Figure 5).

Figure 5: Credit portfolio trading through the ETF ecosystem[9]



This better suits APs' requirements for trading with ETFs, collecting commissions, chasing arbitrage opportunities, hedging (as hedging bond portfolios is easier than hedging single bonds), and managing inventories.

Our investment process allows us to trade up to 1000 high yield bonds within hours if not minutes, even during stressed markets. Managers can customise these baskets, tilting them towards desired overweights and underweights.

[7] Insight, June 2023. For illustrative purposes only

[8] Insight, April 2023

[9] For illustrative purposes only

Credit portfolio trading case studies[10]

Credit portfolio trading has delivered benefits of relatively lower trading costs with two-way liquidity during stressed markets:

- In March 2020, the peak of pandemic-era market disruption, Insight transacted $1bn notional in 2-way flow across the high yield market. We paid an average bid-offer cost of 80bps, at a time OTC trading in high yield cost 200-300bps.
- During early 2022, when the Federal Reserve hiked rates sharply from the zero bound to over 1.5%, we traded $7.7bn notional in 2-way flow for an average bid-offer costs of 18bps, at a time OTC trading in high yield cost up to 100-150bps.
- November 2022 (UK liquidity crisis), we traded $135m notional in high yield for an average bid-offer costs of 31bps, at a time OTC trading in high yield cost 100-120bps.
- Year to date through May 2023, we traded $1.8bn notional for an average bid-offer cost of 15bps, at a time OTC trading in high yield cost 80-100bps

MAKING USE OF CREDIT PORTFOLIO TRADING IN HIGH YIELD ALLOCATIONS

We believe that credit portfolio trading can open the door to a highly diversified high yield strategy that efficiently captures beta more effectively than a traditional active or passive high yield strategy. Further, within a wider high yield allocation, a strategy that uses credit portfolio trading can double up as a 'liquidity sleeve' for the entire allocation.

Standalone liquid broad-based high yield strategy

Credit portfolio trading can allow investors to build diversified high yield strategies holding up to 2000 high yield bonds, 10 or 20 times more than typical in traditional active or passive portfolios.

Further, managers can tilt strategies to reflect precise overweights and underweights relative to the index with a quantitative portfolio construction and trading platform.

A 'liquidity sleeve' within a multi-manager high yield framework

Investors can potentially benefit from a liquid high yield strategy within the rest of their high yield allocation as a 'liquidity sleeve'. Consider an allocation comprised of three high strategies, one of which uses credit portfolio trading (Figure 6):

Figure 6: A liquid high yield portfolio within a multi-manager framework[11]

	Low Risk Satellite	High yield portfolio using credit portfolio trading	High Risk Satellite
	Concentrated Defensive	Core / Liquidity Sleeve	Concentrated High Risk
Allocation	30%	40%	30%
Holdings	200	1,700+	99
Tracking error	2%	< 0.50%	5%
CCC exposure	13%	12%	58%
Beta	0.85	1.00	1.05

The presence of the more liquid high yield strategy can enable other, less liquid, strategies to work as intended without the potential drag of forced selling to meet cash flow obligations, rebalancing or strategic or tactical reallocations. Instead, a more liquid high yield portfolio can take on the liquidity burden more cost-effectively and efficiently through stressed or normal market conditions.

Further, investors allocating to deeply illiquid credit markets may wish to initially allocate into a credit portfolio trading-based high yield portfolio, rather than cash, as they wait for cash to be drawn down over months or years.

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[10] Insight, June 2023. All transaction cost estimates based Insight trading team's credit portfolio trading and OTC cost estimates. Trading costs maybe lower or higher than the costs stated here.

[11] Insight, June 2023. For illustrative purposes only

MANAGERS NEED EXPERTISE WITHIN THE ETF ECOSYSTEM TO IMPLEMENT CREDIT PORTFOLIO TRADES

Our team at Insight has 15 years of experience managing and sub-advising ETFs, cultivating in-depth knowledge of their inner workings.

For over two decades, we have also invested in developing proprietary technology to assess thousands of bonds along multiple risk dimensions to quickly generate diversified custom trade baskets for portfolio construction and liquidity management.

Further, over the past 15 years we have fostered strong relationships with APs, which has allowed us to work side-by-side with them to iterate and innovate credit portfolio trading processes with the aim of delivering further benefits to our clients.

We believe using this framework even within just one strategy can dramatically enhance an entire high yield allocation, by ensuring liquidity, diversification and allowing investors to collect a 'free' illiquidity premium.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and certain charges, such as currency conversion charges may depend on the individual situation of each investor and are subject to change in future.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
- While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.
- The specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Also, many loans are not actively traded, which may impair the ability of the portfolio to realise full value in the event of the need to liquidate such assets.

- Property assets are inherently less liquid and more difficult to sell than other assets. The valuation of physical property is a matter of the valuer's judgement rather than fact.

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