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A 'better place' for sovereign risk

A paper from three Lxyor Asset Management looks at how managing sovereign credit risk in bond portfolios has changed since the financial crisis. Caroline Allen reports

Scan here to read the full paper:

In August 2011, Standard and Poor's downgraded the credit rating of US government debt from AAA for the first time. Even five years ago, such an event would have seemed very unlikely.

Historically, the debt of major developed countries has been considered almost free of credit risk. But the 2008 financial crisis and the resulting global recession has played havoc with this conception.

Sovereign issuers' credit-worthiness is now under increasing scrutiny, especially in Europe, while bond investors now face a significant new challenge: one that is especially important for those using a passive, index-based approach. The impact of the European debt crisis may be huge. From an economic point of view, economic growth, inflation and foreign exchanges are – and will be – very much affected for a long time.

There is a lot of uncertainty about the economic and fiscal policies that Europe and the rest of the world will adopt. Some risk scenarios are more plausible than others, but nobody knows what the final outcome will be.

EFFECTS OF EUROZONE CRISIS

From a financial investment point of view, the European crisis questions investment policies of pension funds, institutions and even retail investors.

For example, there is a big issue on strategic asset allocation and long-term investment policy because the allocation between asset classes depends on two economic pillars: the output and the inflation (Eychenne et al, 2011). A stagnation risk scenario will then not produce the same results as an inflation risk scenario in terms of the equity/bond asset mix decision.

Another consequence of the European crisis is its impact on bond portfolio management. Indeed, pension funds and institutions are massively invested in bonds – in particular, sovereign bonds. For a long time, sovereign bonds of developed countries have been considered a safe asset. Especially true, since the creation of the eurozone and European investors have largely diversified their portfolios by investing in non-domestic bonds since 2000.

The stability of the eurozone over the past decade explains this phenomenon: a European investor could prefer Italian bonds to German bonds because they offered a better return for a risk increment that was considered to be negligible. Until recently, bond management in the eurozone was then principally explained by the search of spread. This style of active management has been encouraged by the industry of passive management, with benchmarks and indexes based on debt weightings.

But the eurozone crisis and the rediscovery of the sovereign credit risk leads to a rethink of the management of bond portfolios by giving a better place to risk management.Traditional index bond management has been severely called into question.

This research focuses on the risk issues raised by classic market-capitalisation weighting. It proposes an approach to properly measure sovereign credit risk in a fixed-income portfolio. For that, it assumes that credit default swaps (CDS) spreads follow an SABR process and it derives a sovereign credit risk measure based on CDS spreads and duration of portfolio bonds.

INDEXATION METHODS

The authors consider two alternative weighting methods: fundamental indexation and risk-based indexation. The former is based on GDP indexation, while the latter uses a risk budgeting approach based on our sovereign credit risk measure.

They then compare these methods in terms of risk, diversification and performance. They show that risk budgeting is the appropriate scheme to manage sovereign credit risk in bond portfolios and gives appealing results with respect to active management of bond portfolios.

The paper then defines precisely the sovereign risk and explains why country risk is so specific with respect to other risks. It later gives some insight about the properties of a good sovereign credit risk measure, thus allowing the authors to define a risk measure consistent from a theoretical point of view and which could be used in practice for bond portfolios. They apply this risk measure to analyse market-cap weighted bond indexes.

The study then considers how both fundamental and risk-based indexation could correct the drawbacks of market-capitalisation indexation with regard to the sovereign credit risk measure.

The authors later present a comparative analysis between the three indexation schemes (debt-capitalisation, fundamental and risk-based indexations), before offering concluding remarks. ■

This paper is an extended version of the article *Managing Sovereign Credit Risk* published in *Journal of Indexes Europe*

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