Michael Murphy: Why discipline is the key to volatile markets

By Perpetual Asset Management
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Perpetual's proprietary credit scorecard helped position its funds defensively ahead of the current market dislocation, limiting downside and creating room to act on emerging opportunities. Michael Murphy explains.

- Credit scorecard flags deterioration
- Defensive positioning
- Find out about [Perpetual's credit and fixed income capabilities]

The biggest market shake-up in years on the back of an escalating global trade war underlines the need for investors to stay disciplined to limit downside and capture emerging opportunities, says Perpetual's Michael Murphy.

US President Donald Trump's sweeping global tariff regime – and the prospect of further reprisals from trade partners like China – has rocked markets, with credit spreads widening sharply as investors rapidly unwind exposures.

But Murphy says Perpetual entered this period defensively positioned, supported by its proprietary credit scorecard that had flagged deteriorating conditions for weeks ahead of the market downturn.

"We're not Nostradamus," says Murphy, a portfolio manager in Perpetual's credit and fixed income team.

"It's not that we picked that these things were going to happen. But the indicators on the scorecard have pretty consistently led us to be conservatively placed going into those periods of volatility."

Credit scorecard

Perpetual's credit scorecard generates a number ranging from +4 to -4 that reflects the probability of either widening or tightening in credit spreads over the next six months.

The scorecard is updated fortnightly and combines four key indicators: valuations, macro outlook, supply/demand dynamics, and technicals.

A strongly positive score indicates an expectation that spreads will tighten. A negative score suggests spreads are more likely to widen.

"It's not an exact science," says Murphy.

"But the more negative the score, the more we expect spread widening. Ahead of this current disruption, the scorecard registered -3 – a high expectation of spread widening.

"That was a signal to shorten credit duration."

Shortening duration

One of the key levers available to credit managers is duration – a measure of the average time to maturity across the portfolio. Duration determines how sensitive a portfolio is to changes in credit spreads.

“If you get 100 basis points of spread widening, and your credit matures in a year, that’s roughly a 1 per cent price impact,” says Murphy

“But if it matures in five years, that’s a 5 per cent hit.”

In periods of market stress, shortening duration can materially reduce downside risk, he says.

That’s exactly what Perpetual did in response to the scorecard’s -3 reading, moving out of longer-dated exposures and reducing the portfolio’s average credit duration.

Positioned for opportunities

Murphy says the discipline that led to conservative positioning going into the downturn cushions the funds and means there is now opportunity to take advantage of mispriced assets.

“I acknowledge that this is a stressful time for investors – but being defensively positioned going in means you can take advantage of the volatility. It gives you the opportunity to pick up good assets.

“For the funds, historically these have been the periods of best performance. If you’ve done the work, you protect your downside, and then you can generate some really good returns out the other side.”

He says the credit scorecard also led to defensive positioning ahead of the COVID-19 market shock and the last mining downturn, protecting funds and conserving capital for redeployment as conditions stabilised.

About Michael Murphy and Perpetual’s Credit and Fixed Income team

Michael is a portfolio manager and senior high-yield analyst with Perpetual’s credit and fixed income team.

Michael manages Perpetual Loan Fund – a portfolio of private and syndicated loans that forms a crucial component of the ASX-listed Perpetual Credit Income Trust (ASX: PCI) and Perpetual Pure Credit Alpha Fund.

Perpetual offers a range of cash, credit and fixed-income solutions.

Our credit and fixed income team are specialists in investing in quality debt.

They take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Learn more about [Perpetual's Credit and Fixed Income capabilities]

Questions? [Contact a Perpetual account manager]

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