

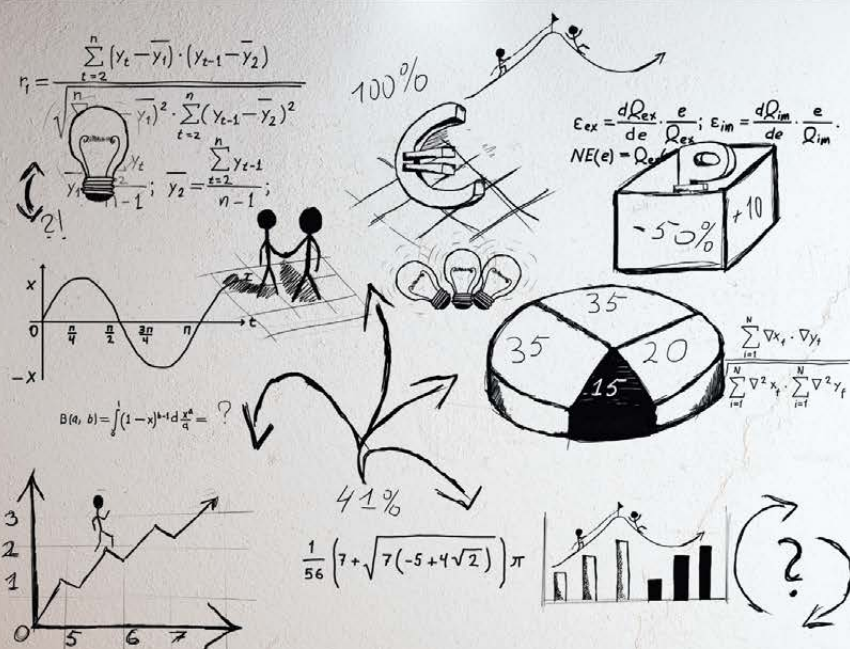
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Multi-asset credit focus: A comprehensive view



► **Craig Scordellis**, head of long-only multi-asset credit, CQS



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A delicate balance

► **Craig Scordellis reveals how to capture opportunities, including income, and minimise volatility among diverging markets**

In the prevailing macroeconomic environment, with low interest rates, potentially higher inflation, central bank activity and sporadically high asset price volatility, it is a challenge to maintain reasonable expected returns while moderating volatility. Alternative credit enables portfolios to reduce volatility, i.e. de-risk, relative to equities, while maintaining attractive risk-adjusted expected returns relative to government and investment grade bond markets. It also enables portfolios to generate income, reducing the requirement to fund liability cashflows from capital. Furthermore, a lower growth for longer environment should be generally attractive for credit, certainly relative to equities.

Over the past seven years, the size of credit markets and the number and breadth of credit securities traded has grown significantly, increasing the credit investment opportunity set. Meanwhile, challenges to liquidity driven by regulatory change are increasing relative value opportunities, while increased dispersion between individual credits is adding to opportunities for idiosyncratic returns from fundamental research.

MAC investing offers access to a broad investment opportunity set within credit. With exposure to the full spectrum of issuers and asset types, a manager can select investment opportunities across different credit asset classes and regions and be nimble in rotating between them. Flexible MAC investing can profit from cyclical volatility and help to manage credit, liquidity and interest rate duration risks.

MAC strategies can also be tailored to different risk and return profiles depending upon investor considerations. There is a need therefore to find asset

solutions through partnerships that offer the portfolio management flexibility to position portfolios appropriately.

Broader opportunity set

MAC offers a broader opportunity set than traditional single strategy vanilla credit, with access to a wider range of issuers and asset sectors and can maximise bottom-up driven fundamental credit research to mitigate risks associated with single strategy credit portfolios, capturing opportunities that present themselves.

With the flexibility to invest in multiple sectors and not tracking a broad index but targeting an absolute return, a MAC portfolio has ability to avoid a substantial portion of an individual sector, such as Energy. It can therefore potentially avoid such a drawdown or the volatility associated with its price correction and ultimate rise in defaults.

In addition, the ability to opportunistically select and trade assets within a certain sector can provide the ability to outperform indices whilst taking less fundamental credit and drawdown risk. An example of this is in the Senior Secured Loan Market between December 2014 and August 2017, where investing in fundamentally safer (lower default rate, higher recovery) BB rated US Loans

over higher risk B rated Loans returned more to investors, contrary to traditional returns implied from taking on a higher amount of risk.

Relative value between sectors

Credit market sectors are cyclical in nature, with this cyclical volatility driven by variations in fundamentals, supply and demand dynamics, liquidity and regulation. MAC investing can help to both mitigate risk from this cyclical volatility and profit from it. MAC portfolios can be highly selective and focus on being in the most opportune asset classes at the appropriate time. For example, as illustrated by Figures 1 and 2, relative European and US High Yield and Senior Secured Loan spreads have moved significantly in recent years, with Loans periodically yielding more than High Yield even though they sit higher in a firm's capital structure.

This shifting relative value has presented an opportunity for MAC portfolios to effectively earn more in spread and yet take less fundamental and technical risk. This is because High Yield bonds are traditionally riskier instruments than Senior Secured Loans; bonds have exhibited higher default rates, lower recoveries and more price volatility. Such market conditions can present themselves because of technicals (supply and demand factors) in alternative credit asset classes. In capturing higher spreads in Loans, for a select period of time, investors have been rewarded for avoiding the incremental risks associated with investing in bonds.

Relative value across geographic regions

Figure 1: Euro High Yield Spreads¹ vs. Euro Loans Spreads²

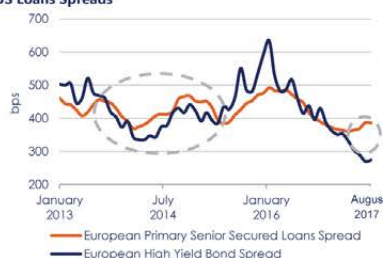


Figure 2: US High Yield Spreads³ vs.



The relative value between geographic regions can also increase and decrease in relative attractiveness. Global MAC managers are able to take advantage of such opportunities. These can be driven by shifts in fundamentals or by different supply and demand conditions for an asset class between geographies.

For example, Figure 3 highlights that US and European loan spreads have diverged greatly in recent years, with the spread on US Loans shifting from below to above that available on European Loans. The incremental spread in US Loans presented MAC portfolios with an opportunity to earn more spread while fundamentally de-risking the portfolios; US Loans have traditionally exhibited lower default rates and higher recoveries than their European counterparts.

Liquidity

As the increase in global financial market regulation and pressures on bank capital have been reducing liquidity in markets, MAC managers are able to take advantage of opportunities created when individual credits or credit asset classes become mispriced due to market technicals. The multi-billion retail fund outflows, and associated selling of a broad range of assets across a sector, presented an opportunity for MAC portfolios to access quality product at wider spreads when US Loan spreads were materially affected by retail flows into the asset class in 2013 and subsequent outflows from Q2 2014 onwards.

In the event there is limited liquidity in certain sectors, MAC can also help to mitigate liquidity risk as a multi-asset portfolio can opportunistically access the best pockets of liquidity at any time.

Relative value within the capital structure

Within an individual issuer, greater value may be available in selected parts of the capital structure. In order to select the most appropriate part of a capital structure both fundamental research

and technical analysis is required. For example, bottom-up research may uncover fundamental concerns about a business therefore a safer investment

in the senior secured instruments might be selected. Similarly, if a business is performing well the MAC portfolio can maximise returns by investing in subordinated debt instruments.

Duration management

Importantly in the current macro environment, MAC investing can help to manage interest rate duration risk by selecting appropriate duration instruments at differing points in the credit cycle. At certain points, asset allocation can favour shorter interest rate duration instruments, for example Convertible Bonds, Senior Secured Loans and ABS, the latter two of which are typically floating rate. Duration management is therefore a central tenet to MAC investing: Figure 4 highlights that a volatile rate environment can create potential problems for all forms of credit while as Figure 5 shows, higher 3 month Libor rates benefit floating rate credit as maximum floors are surpassed.

Conclusion

Global pension funds and other

Figure 3: US Loan Spreads vs. Euro Loan Spreads⁴



institutional investors face material challenges in the current macroeconomic environment, with lower interest rates, potentially high inflation, central bank activity and sporadically high asset price volatility. We believe that for many investors, alternative credit in multi-sector format is an attractive solution to de-risking from equities and maintaining reasonable expected returns with dampened volatility. MAC investing can also be fully flexible so that solutions can be tailored to sit alongside and complement existing investment allocations. It is however vital that a nimble and active multi-sector portfolio management approach, with skill in fundamental credit selection and robust risk management, is adopted to take advantage of opportunities, mitigate risks and secure solid through-the-cycle returns and provide downside protection.



Written by Craig Scordellis, head of long-only multi-asset credit, CQS

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Figure 4: US Ten Year Treasuries¹¹



Figure 5: 3 Month Libor¹¹



Source: 1Bloomberg, BofA Merrill Lynch Index HEC0 as at 31 August 2017. 2S&P LCD European Leveraged Lending Review, as at 31 August 2017. 3Barclays US High Yield ex-Energy Index. 4S&P LCD as at 31 August 2017. 5Bloomberg as at 31 August 2017.

Summary

- As MAC strategies become more popular, the marketplace becomes more crowded, squeezing returns.
- MAC strategies remain attractive in the current low-yield environment, as it allows investors to capture opportunities and mitigate risks across a diverse set of investments.
- It is important to conduct rigorous due diligence of MAC strategies.
- MAC can be used to capitalise on interest rate changes, along with accessing EMD opportunities.

A closer look

Lynn Strongin Dodds considers why pension fund investors should explore the differences between different MAC strategies

While multi-asset credit (MAC) remains a favourite in institutional portfolios, increasingly-stretched valuations means some strategies are losing their lustre. This has led to a narrowing of opportunity sets, which is why investors are advised to closely inspect the risk and return characteristics of the underlying constituents.

The MAC label is all-encompassing and can cover a multitude of investments ranging from asset-backed securities (ABS) to emerging-market debt (EMD). Although the blend of assets can vary, most promise to deliver superior risk adjusted returns with low volatility. They have steadily gained a following over the years as their trusted fixed investment universe, most notably investment-grade corporates and sovereigns, failed to deliver the returns pension funds needed to meet their liabilities.

Squeeze

However, as with many fashionable

investments, the marketplace became more crowded, squeezing returns. This has certainly been the case with high-yield bonds where spreads relative to comparably-dated US Treasuries are as tight as they have been throughout the post-crisis period. They have slid to around half a percentage point this year to levels not seen since 2007, according to Bloomberg Barclays bond indexes.

Investors though do not have to look at the charts to realise there are cracks. The recent bankruptcy filing of Toys R Us serves as a reminder of the perils of piling on mountains of leverage. The company's \$5.3 billion in debt included a large number of leveraged loans and high-yield bonds.

Despite the pitfalls, MAC's place in a pension funds investment armoury seems secure. "The credit market is less attractive and there are some fund managers who not being as aggressive as in the past," says Amundi's head of global corporate credit Grégoire Pesquès. "In our case we have slightly reduced our exposure to the market but continue to

have a long bias towards credit because of the fundamentals and the fact that the unwinding of quantitative easing that has been announced in the US and Europe will be done at a slow pace."

CQS head of long-only multi-asset credit Craig Scordellis also expects MAC's appeal to be long lasting. "Globally pension funds are facing a challenging low-yield environment that may make it challenging to meet liabilities," he adds. "Multi-asset credit strategies allow them to capture the opportunities and mitigate the risks across a diversified set of investments such as investment-grade bonds, high-yield bonds, senior-secured loans and asset-backed securities."

Russell Investments head of client strategy and research David Rae sees two, seemingly contradictory drivers of demand for these funds. On the one hand, pension funds are looking to compensate for the paltry returns on offer from government bonds by moving into extended segments of the fixed income universe. On the other hand, and conversely, "some schemes are keen to reduce risk and the over-reliance on equity exposure as the primary source of return", he adds.

Other factors, according to Rae,



include changes to the demographic profile of schemes, the impact of pension freedoms and the increasingly cashflow-negative position of schemes. “The access to the full spectrum of opportunities and the ability to dynamically switch between market segments is critical for investors to reap the full benefits of a multi-asset credit investment,” he adds. “Return opportunities and entry points can be fleeting. For example, the selloff in high yield bonds in early 2016 was a great buying opportunity.”

Insight Investment head of secured finance Shaheer Guirguis also believes more attention should be paid to returns and that league tables can be misleading indicators of success. “If you look at the performance of the entire range of MACs, it would be hard to know what to invest in,” he says. “While the top quartile and deciles look reasonable, there is a huge dispersion around the median. The question that needs to be asked is what approach do you take to reduce the volatility of the outlook?”

Due diligence

This only underscores the need to conduct rigorous due diligence. “Although the number and breadth of credit securities traded has grown significantly, it is important to conduct credit analysis in order to be in the right geography and asset class,” says Scordellis. “This means understanding the regulatory environment, the fundamentals and the technical aspects to properly assess the risks.”

M&G Investments director, global institutional distribution, Annabel Gillard, also stresses the importance of doing rigorous and “proper” homework and research in order to identify and establish the creditworthiness of the individual securities. “The main objective

is to find sensible companies to lend money to and get a clear source of return,” she adds. “We build portfolios that will deliver consistent returns with low volatility and it should not matter if interest rates go up or down.”

Opportunities

In the current environment, fund managers are changing the mix and adding more short duration securities and floating rate notes (FRNS), which as their names suggest do not have a fixed interest rate, but are pegged to a benchmark such as the US Treasury bill rate or Libor, allowing their coupon to be rebalanced at regular intervals. According to Scordellis, loans and parts of the asset-backed securities market are attractive because as they are typically floating rate, they can help immunise the portfolios from rising interest rates.

These investments are also a popular staple in the MAC funds of M&G Investments, which, like CQS builds portfolios using a bottom up, dynamic and active approach. “The main attraction of a floating rate MAC is that it avoids doubling up on duration for those clients who are matching their liabilities more directly via an LDI mandate,” says Gillard. “Unlike in the past, pension funds are managing duration through a liability-driven investment strategy while using a flexible MAC fund to move into a broader range of assets.”

The US is leading the charge, with the Federal Reserve on track to raise its benchmark fed funds rate three times in 2018. However, it only pegged two further rates in 2019 instead of three. Equally as important, the central bank flagged its intention to unwind its hefty quantitative easing programme, which stands at around \$4.2 trillion (£3.1 trillion) in US Treasury bonds and mortgage-backed securities bought in to bolster the economy after the collapse of Lehman Brothers.

Meanwhile, the Bank of England is considering pulling the QE plug but has made more definitive noises about increasing rates by 0.25 per cent before

the year end. This would reverse last August’s post-Brexit cut and lift base rates to 0.50 per cent. As for the Europe, the European Central Bank is expected to sit tight on the rate front but it has signalled its plans to end its €2 trillion economic stimulus programme.

Aside from the interest rate play, MAC are looking to capitalise on the rebound in emerging markets, especially as the debt, although by no means cheap relative to historical norms, is paying higher returns than other parts of the bond market. For example, the yield on J.P. Morgan’s Emerging Market Bond Index, which tracks hard currency debt, is around 5.5 per cent compared to roughly 6 per cent on the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified Traded Index. This outshines the UK 10-year gilt yield of about 1 per cent as well as the approximately 2 per cent generated by the 10-year US Treasury bond.

Other benefits of emerging-market debt are exposure to economies such as Russia and Brazil, where growth is returning after two years of recession. Moreover, local debt markets are becoming more alluring amid slowing inflation, relatively high interest rates and strengthening currencies.

Guirguis also points to structured credit as a good investment due to their risk-adjusted return profiles. “Their spreads are wider in Europe than fair value because regulation such as Solvency II does not allow insurance companies to invest in them,” he adds. “A related investment is secured finance loans where an illiquidity premium can be extracted because these are bilateral contractual agreements between a borrower and its lenders. Due to regulation such as Basel III, banks are playing less of a role.”

Written by Lynn Strongin Dodds, a freelance journalist

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