MAC: Delivering income

Craig Scordellis reveals how multi-asset credit can be a managed income solution to the problem of low-yielding traditional credit

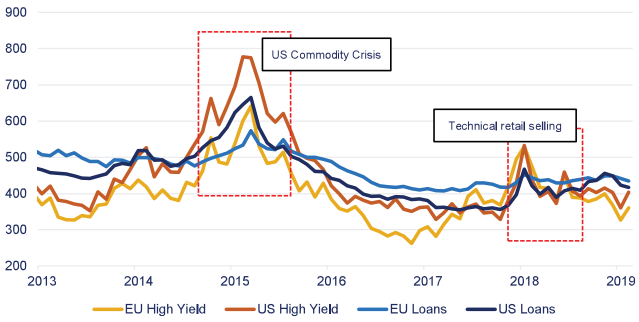
It's no secret that pension funds continue to face long-term challenges. Strong investment returns are needed to close the gap between assets and liabilities, and keep it closed, as assessments of future liabilities change. Income is an increasingly important component of these returns as schemes mature or experience lower contributions and go cashflow negative, while the ability to protect capital and manage volatility is critical if markets are to be navigated safely.

Yet the usual asset allocation solutions are challenged by the economic and geopolitical backdrop. The rapid spread of the coronavirus has complicated an already sensitive global macroeconomic picture for 2020, most likely leading to heightened volatility and a need to diversify away from high-beta equities. At the same time, traditional credit markets are far from a safe haven for pension funds. With sensitivity to interest-rate moves comes potentially high volatility across government and investment-grade bonds, and this volatility is likely to be exacerbated without the buffer that higher yields would offer.

The low growth, low rate environment means that it is not easy to find acceptable levels of income in these markets in any case. The extent to which yields have compressed in recent years is significant, with the investment-grade markets in the US, UK and Europe yielding just 2.90%, 2.16% and 0.51% respectively at the end of January, but carrying a relatively high effective duration – or sensitivity to interest-rate moves – of 7.65, 8.64 and 5.22 years respectively.

For us, a potential solution is multi-asset credit, or MAC, which has the potential to deliver income for pension funds while limiting the volatility associated with short-term interest rates and partially mitigating market risks.

Global loan and high yield market spreads



Source: CQS, ICE BofAML EU High Yield (H9PC), ICE BofAML US High Yield (H0A0), LCD Leveraged Loan Indices, all as at 31 January 2020.

Rather than investing exclusively in traditional credit markets, MAC strategies have the ability to access income in alternative credit asset classes such as high yield bonds, senior secured loans, asset backed securities and convertible bonds. As the chart shows, while yields have declined here too, the credit spread – or additional yield offered over and above an equivalent government bond – remains at an attractive level, more than compensating in our view for the probability of default and loss given default.

At the same time, since senior secured loans and asset-backed securities are mainly floating rate securities with very low levels of interest-rate risk, it is possible to construct a portfolio with a much lower duration than possible in investment-grade credit markets, and therefore reduced exposure to the impact of future interest-rate moves.

As with any credit portfolio, the biggest risk is defaults. Geopolitical uncertainty could lead to a material economic slowdown, a loss of corporate earnings and pick up in defaults. This risk can, however, be mitigated through fundamental research, and active management at the security and the asset class level.

As secured assets, loans and asset-backed securities are typically at the top of a company's capital structure, first to be repaid in the event of default and well placed for recovery. At the same time, there is no room for complacency, and managers of MAC strategies must constantly adapt for potential shifts in fundamentals, technicals and sentiment.

We anticipate further volatility and increased dispersion in the performance of individual investments in 2020. We believe it is likely that we will see further financial stimulus from China in response to the coronavirus. While in the short-term, concerns over the global economy have resulted in government bonds trading to even lower yields, the stimulus packages could well further extend the economic cycle, potentially pushing government bond yields higher – and investment grade bond prices lower – in the second half of 2020 as economies bounce back.

Against this context, we believe a multi asset credit portfolio built around a core of stable, secured income-generating assets such as loans and asset backed securities supported by an actively traded portfolio of investments in more volatile asset classes such as high yield and convertibles has the potential to generate the investment returns and income pension funds are looking for, without sacrificing the ability to protect capital and manage volatility.

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

In association with