MAC and absolute return fixed income: Better together?

Multi-asset credit (MAC) and absolute return fixed income strategies have long competed for investor attention. But does choosing one over the other make sense?

At a time when interest rates are either ultra-low or even negative, positive inflation-adjusted returns are in short supply. To achieve them, bond investors have turned to strategies that have the flexibility to invest in different types of fixed income, the most popular of which are multi-asset credit (MAC) and absolute return fixed income (ARFI).

Both have plenty to commend them. But they should not necessarily compete for investors' capital. We would argue that it doesn't have to be a case of one or the other. In fact, combining the two can improve a bond portfolio's diversification and increase its overall risk-adjusted returns over the long run. That's because MAC strategies tend to do particularly well when interest rates and bond spreads are stable, while ARFI portfolios outperform during periods of credit stress or when interest rates are volatile.

Universe and diversification

For a start, MAC strategies tend to have a tilt towards high yield rather than investment-grade bonds. This helps them perform especially well when market volatility is low and yield spreads between corporate and government bonds are narrowing. Their overall credit investment remit, however, can be very broad. This means MAC strategies traditionally offer greater diversification than a direct allocation to high-yield credit.

By comparison, the ARFI universe tends to be, by design, much broader, embracing the full fixed income toolkit; the investment styles and the sources of excess return or 'alpha' are more diverse than for MAC strategies. In many cases such portfolios also invest in credit, but often do so alongside currencies, interest rate products and derivatives. Probably the most common feature of ARFI strategies is the incorporation of capital protection/risk mitigation trades. The aim here is to improve risk-adjusted returns, but it also means that absolute return strategies tend to lag during bull markets in credit spreads.

ARFI strategies also use all the investment tools available, including derivatives, to manage risk – keeping the desired exposure while hedging out unwanted risk – across the full spectrum of fixed income sectors. This makes ARFI strategies less sensitive than MAC strategies to the overall direction of the credit market. For example, an ARFI strategy can protect against the risk of inflation and rising rates by taking a negative duration position.

The differences between the two strategies mean that correlation of the returns generated by ARFI and MAC strategies tends to be relatively low, and certainly much lower than between the returns of the different funds within the MAC universe. Combining the two strategies could thus offer diversification benefits compared to investing in just one.

Liquidity versus returns

As a rule of thumb, credit investments and emerging market bonds tend to be less liquid than developed market sovereign debt and currencies. Thus, MAC strategies – which invest heavily in such assets – are usually less liquid than their ARFI counterparts. This makes the risk of a sharp drawdown – or a sizeable peak to trough capital loss – more significant for the MAC strategies.

On the flip side, by capturing this liquidity premia, MAC strategies tend to deliver higher returns, on average, than their ARFI peers over the course of a market cycle.

The source of return also tends to be different, with MAC taking a more bottom-up approach and ARFI tending to place more emphasis on top-down, macroeconomic factors in portfolio construction.

Best of both worlds?

Despite their differences, MAC and ARFI vie for the same type of investor – one who is looking for a flexible approach that generates returns even in the current climate of low yields and low credit spreads. Yet, there are enough differences for the two types of strategies to be complementary. MAC can offer access to more exotic and less liquid securities that offer the prospect of higher yield. A well-balanced ARFI strategy, meanwhile, can harness strong macroeconomic trends while reducing risk and yet still delivering positive real returns.

By combining the two and selecting the managers that play to each strategy's strengths, investors can thus achieve better risk-adjusted returns than by focusing on either one in isolation.

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