Pulling levers

Investec Asset Management's head of developed market credit, Jeff Boswell, speaks to *Pensions Age* about the benefits of a dynamic multi-asset credit investment strategy in a changing fixed-income market

Please could you provide an overview of the current fixed income market situation? What are the current trends you are seeing?
It's been a very strong year generally for fixed income markets, fuelled by a very strong rates-based rally.

What's been unusual about the rally since the start of the year is that it certainly hasn't been uniform. An interesting observation in that regard is US high yield, which has had a very strong returning year so far. US high yield as a whole is up around 12 per cent. Never in the history of US high yield before have you had returns of north of 10 per cent, with the BBs outperforming CCCs.

What does that tell us? It tells you that there's a little bit of apprehension from investors in terms of reaching for risk. So, it's been a very defensively orientated rally, certainly in parts of the market.

Following this rally, parts of the market are starting to look increasingly expensive, with certain credit subsets edging back towards post-crisis tight spread levels.

There are certain parts of the market that we feel are starting to look a little bit more vulnerable or susceptible. It's this divergence in performance which then lends itself to a multi-asset credit (MAC) strategy.

MAC investment has increased in popularity with pension funds in recent years. Can you explain why? What benefits does it provide in today's FI markets for this to be the case?
There is a spectrum of MAC strategies. You've got some higher-octane strategies where they're looking for higher returns (and take more risk) and you've got some super-defensive strategies. But I'd say the majority of MAC managers fit into the middle ground and that is where we sit as well.

That middle ground I'd consider to be around cash plus 4-5 per cent in terms of return objectives with MAC seen as a means of generating an attractive yield in a world that is certainly yield challenged.

Historically, if you look at any investor's portfolio, the core building block of that portfolio was government bonds, which generated attractive yield, but then also had a defensive element to it in terms of acting as a defensive anchor in choppy markets. That has been whittled away given the long rally in bond markets.

The MAC solution has come about as a means of trying to plug that gap by providing defensive yield, but also in a non-interest rate sensitive manner.

That's the core reason why people are interested in MAC. But there's also a supplemental reason around where we are in the cycle.

A MAC approach, where the manager has a lot more levers to manage through those different environments, is potentially going to lead to better outcomes, not just from a returns perspective in terms of the opportunity that's provided by having divergent performance across different credit asset classes, but also in terms of managing the downside.

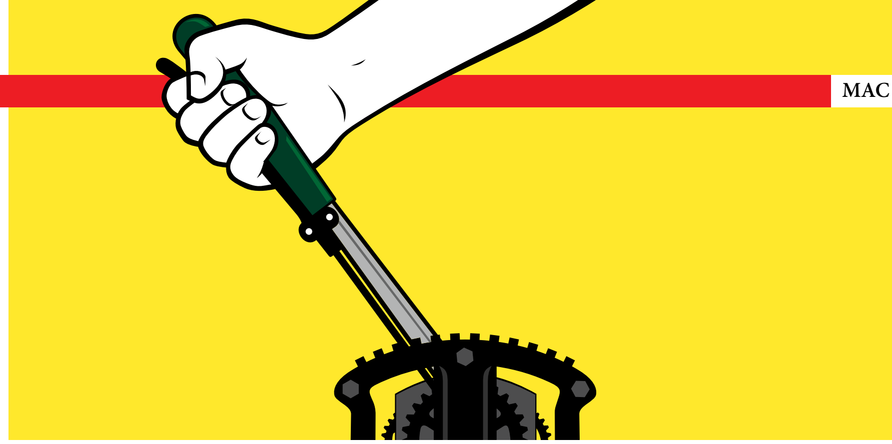
What is Investec's particular approach to MAC investing? How does it differ to others on the market? And how is it particularly suitable to today's fixed income environment?
There are different camps in terms of how managers approach MAC. Some are very top-down driven with their asset allocation calls. Then there's also very bottom-up driven approaches, which is where managers are really driven by where they see value. That's very much the camp we fall into.

One of the beauties of credit markets is that there are significant inefficiencies in terms of the way credit risk is priced. That comes down to a variety of factors including local supply and demand dynamics, the construct of markets, and even the stickiness of the investor base.

What that means is when we're looking at a particular credit, often that credit will issue bonds or loans in multiple different markets, but the spread that you can earn on that credit will differ market by market because of those different dynamics, or technicals within those markets.

So, our approach is driven from the bottom up, assessing where we get best paid for a given level of risk.

It is the opportunity from certain markets, repricing relative to other markets and making them look more



compelling, that drives our asset allocation. We believe that allows us to far more consistently deliver on positive asset allocation, rather than taking big top-down calls where the error rate is exceptionally high.

The appeal of our MAC strategy is we have all these levers, all these different markets to invest in. Our asset allocation relative to a lot of our peers shows, we believe, a lot more dynamism.

We're not defined by specific hard boundaries in terms of just using the big credit blocks that are out there. We're unconstrained in terms of how we can find a type of risk in a range of different markets.

So, for example, rather than taking US high yield BB risk, we have seen far better value within bank capitals, which is also known as contingent convertibles (CoCo's). We think that there's good value in parts of that market as a substitute for traditional high yield. Corporate hybrids we also really like as an asset class because not only has it provided very similar upside to high quality high yield, but it has the appeal that, in sell-off scenarios, it has typically performed a lot better than high yield.

How can pension funds use MAC strategies?

For smaller pension funds, MAC can be a fixed income solution, whereby rather than them trying to figure out when to invest in investment grade or what their allocation to high yield should be, we're effectively an outsourced solution that will give the pension fund access to a variety of different markets.

MAC can fulfil a slightly different need with larger pension schemes. It might be that they still are looking for attractive returns but they're not willing to take too much incremental risk. Maybe they want to substitute some of their investment-grade bond allocation into a MAC solution, which plugs that gap for them.

For some, it might be that they've had a great run with high yield, but they're a little bit worried about where we are in the cycle. MAC can be that substitute in terms of giving them a similar type of upside yet better potential downside.

Or it can be for some pension funds who have had a great run from an equity standpoint but would like to take some risk off the table, without getting too defensive. That's where MAC comes in. Our flagship strategy targets returns in excess of cash +4 per cent, (typically cash +4-6 per cent). It's an attractive return profile. Certainly, seeking far more compelling drawdown characteristics than equity.

More specifically, for DB schemes aiming to get to a funding position suitable for a buyout, having seen their funding level increase over the past seven years, maybe to the 90 per cent range, they will want to maintain a funding level around this level, but even then, it is not quite where they need it to be. MAC provides the opportunity to still deliver attractive returns, but has equally the dynamism and the defensiveness to help protect the overall portfolio in more difficult times.

For DC, the member needs to be in a fund that has the opportunity to create an attractive yield and an attractive return, but has equally the dynamism and defensiveness to offer protection. Large falls in the value of pension savings puts people off saving into, or remaining in, a DC pension.

Because MAC is such a dynamic solution, it can fulfil very different needs.

How can Investec's approach help pension funds in a changing FI market, for instance, the bubble bursting?

No matter when/if the FI bubble bursts, the beauty of our MAC is it just gives us far more levers to pull in managing through such a scenario.

If that bubble does burst, there's going to be huge opportunity for us as a dynamic MAC manager, as you will see divergence in the performance of different asset classes. That's where we believe we can add a huge amount of value.

For instance, the levers we're pulling at the moment are still generating an attractive yield, but as markets tighten in, it typically is more about capital preservation and managing and protecting the downside. Then waiting for any sort of proper correction, and that's when the opportunities arise.

There is a risk that the issuers of fixed income investments may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. There may also be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated. All data as at 30 September 2019.

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