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Multi-asset credit focus:

A rising star

Jeff Boswell, strategy leader, Investec Asset Management

Why MAC strategies are relevant now

Many pension schemes are seeking to allocate investment to a credit solution as they search for more sustainable returns. Jeff Boswell of Investec Asset Management discusses how multi-asset credit strategies could meet these needs

Global growth remains lacklustre and the outlook for inflation highly uncertain. As a result, central banks are continuously looking at the efficacy of their monetary policy and how to sustain the economic recovery. This has resulted in government bonds losing their income generating qualities, with investors having no choice but to look elsewhere. Multi-asset credit (MAC) strategies typically offer a higher yield, while offering defensive qualities via risk management using several different credit asset classes. The strategy seeks to provide a strong income element on a consistent basis that few other assets can provide. An investor must also consider the security of that income. If, for example, income generation is reliant on equity dividends, there is a risk that these could be deferred in the case of a bad year or poor outlook for the firm, while the coupon of debt securities is pre-determined.

Core credit

A substantial allocation to credit is increasingly being recognised as part of the solution in solving the yield conundrum. This asset class substitution is coming from a variety of traditional asset classes, from de-risking core equity holdings to re-vamping vanilla credit portfolios, through to addressing low-yielding government bond portfolios. Not to mention those DB schemes that are facing the threat of becoming cash-flow negative and struggling to pay pensions without selling-down assets. The capture of this credit risk premium is, however, difficult to execute in practice, with the relative attractiveness of individual credit markets changing on a daily basis. MAC strategies seek to find the best risk-adjusted return within the credit markets, while also allowing the fund manager increased flexibility in managing portfolio risks. We regard this unconstrained, flexible approach to credit investment as ultimately replacing a large proportion of traditional segmented credit asset class investing.

Challenging rates and bond markets

With the US Federal Reserve embarking on its rate hiking cycle and the European Central Bank seeking to end its QE programme by the end of 2018, it has raised concerns for fixed income investors about the impact of higher rates. In our view, while the likelihood of a normalisation of rates to long-run averages (eg 6 per cent for 5-year US Treasury) from today's levels seems low, any movement in that direction will have a significant impact on bond markets. As we know, not all fixed income instruments, or fixed income strategies, are created equal. Unconstrained MAC strategies, which have the flexibility to derive returns from a broad opportunity set, have typically delivered robust performance through recent interest rate volatility. A key element of this performance is a focus on generating returns principally from credit spreads, rather than any significant duration views.

Volatility is on the rise

Volatility spikes have been much more common in recent years. In our view, such volatility is likely to remain in these uncertain financial markets. Macroeconomics (low growth), monetary factors (low central bank rates, low dealer liquidity) and politics (antiglobalisation, terrorism, and divisive campaigning) are all contributing to the increasing spikes in volatility. In this environment, we believe a flexible and reactive investment strategy will be far better placed to navigate this array of risks with the potential to perform well in both up and down markets.

MAC well positioned for a challenging interest rate environment

In our view, the likelihood of a true normalisation of rates from today's level may seem low, but any movement in that direction would have a significant impact on government bonds and other rate-sensitive instruments. Even if full normalisation is not a near-term phenomenon, interest rate markets are bound to go through periods of volatility in reaction to rate-raising rhetoric or action.

Not only do MAC strategies have a variety of tools at their disposal in managing their portfolios through challenging interest rate environments, but their focus on generating returns principally from credit spreads provides an effective counter to interest rate volatility. The short duration profile of MAC means there should be no need to predict interest rate moves in the same way as for a typical credit strategy.

The unconstrained MAC approach

to investment, across a variety of on and off benchmark instruments, provides the opportunity to not only construct an attractive portfolio diversified across a variety of sources of returns, but one which is capable of negotiating an uncertain interest rate environment. This versatility, coupled with appealing income generation, will prove helpful in negotiating the yield challenged environment facing many investors.

Capturing the right asset mix is essential

Each credit asset class has its own idiosyncrasies, the understanding of which are critical when constructing a broad based credit portfolio. While a siloed credit investing approach may capture the beta of a variety of markets, capturing the right asset mix, and getting the timing right from an asset allocation perspective is exceptionally difficult. This is one of the key drivers that sparked the evolution of MAC strategies, whereby rather than attempting to thread the needle in terms of this top-down timing, MAC strategies principally construct their portfolio through bottom-up credit selection, looking for the best value across the credit markets for a given level of risk.

This approach ensures that rather than relying upon market timing, a MAC manager would typically look for opportunities that are attractively valued within one market over the other. Although a robust top-down process is still critical in terms of establishing a broader portfolio risk bias, as well as any preference for a particular region or sector, MAC portfolios are typically driven by the aggregation of the bottom-up driven best ideas across the credit spectrum.

"Rather than attempting to thread the needle in terms of this top-down timing, MAC strategies principally construct their portfolio through bottom-up credit selection, looking for the best value across the credit markets for a given level of risk"

By its very nature, credit as an asset class also has an asymmetrical payoff profile. A poor investment in credit, which results in a significant capital loss, is unlikely to be compensated for by another credit investment, given the inherent cap in its upside. Hence the idiosyncratic risk of one position can have a disproportionate impact on the expected return of the portfolio as a whole. This is why bottom-up credit selection, even in the implementation of a top-down bias or thematic, is essential.

While any MAC manager should undoubtedly be aware of macroeconomic drivers, socio-political events, and secular trends, we believe the essence of the MAC proposition is to apply a balanced approach, whereby even in implementing any top-down view, it should be executed with the objective of finding the best individual investments to reflect that view.

We believe a structure of disparate regional teams, siloed into different asset classes, has the potential to result in structural biases which goes against the grain of what MAC is trying to exploit. As such, a robust decision making structure, with strong alignment of interest from stakeholders, is essential in efficiently executing a best ideas bottom-up driven strategy.

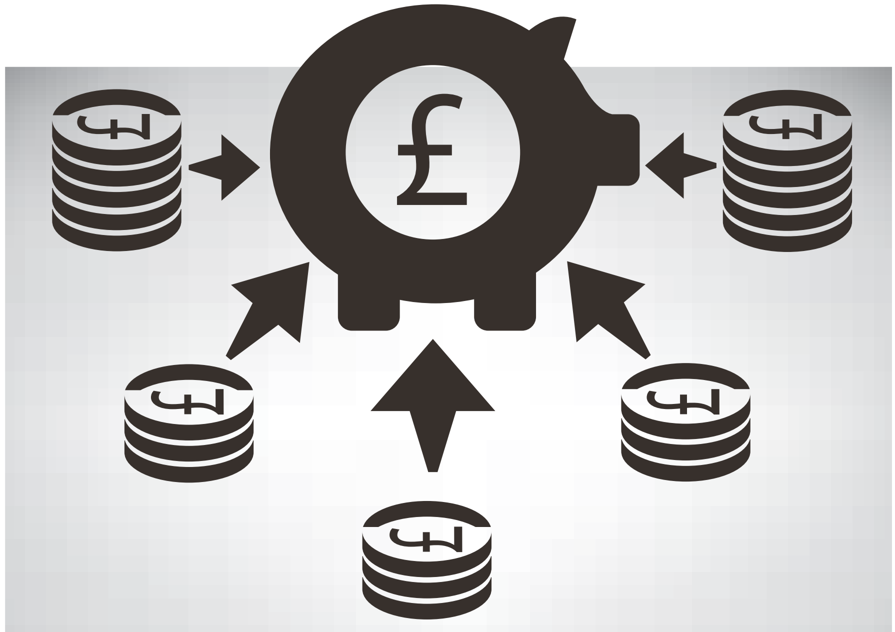
The future of MAC

The current yield challenges facing many investors undoubtedly require a new way of thinking in terms of asset allocation. While credit has long been a core income generating component of many traditional asset allocation models, the evolution of financial markets, coupled with the complexities of investing in the current environment, have cultivated a different way of credit investing. We believe the breadth of opportunity set and flexibility afforded to the MAC manager in seeking its target return should not only result in a better investment outcome, but also one that is better than the sum of the underlying constituent parts.

Written by Jeff Boswell, strategy leader, Investec Asset Management

In association with Investec Asset Management

Investments carry the risk of capital loss.



Summary
• MAC funds continue to gain momentum as investors look for better risk-adjusted returns with lower volatility, especially in a rising rate environment.
• As the asset class develops, the breadth and depth of instruments being included has broadened but investors need to look underneath the bonnet to see what is included.
• The challenge is that because construction of portfolios can widely differ, comparisons between different offerings can be difficult.

The maturation of MAC funds

Lynn Strongin Dodds explores how MAC funds have come of age

Over the past year, there has been a steady march of UK pension funds going down the multi-asset credit (MAC) route. They range from the £1.1 billion Enfield Pension Fund's £50 million allocation to the £23 billion Greater Manchester Pension Fund's (GMPF) £1 billion allotment. The investment case is compelling – superior risk-adjusted returns with low volatility – but performance can be patchy, which is why schemes have to carefully choose their managers and the assets they slot in.

Looking at the US where MACs have been an embedded feature on the investment scene for a longer time period than Europe and the UK, a study by Bfinance shows only 23 of the 58 institutional MAC funds with a track record of more than three years (at October 2017) analysed generated a better three-year Sharpe ratio.

As for gross annualised performance, slightly over half of the group outperformed global corporate bonds, while only a handful beat the Bank of America Merrill Lynch Global High Yield Index. Moreover, the studies found that some investors have been disappointed by the slow sector rotation, particularly during the energy price collapse and high-yield debt crisis when a tweaking of the asset allocation might have enhanced returns.

Why invest

However, this has not dampened the appetite for MAC funds, perhaps because performance is not the only motivating factor. "There are several reasons why pension funds invest in MAC funds," says Mercer senior fixed income consultant Noel Collins. "Many schemes did not have exposure to high-yielding, sub-investment grade asset classes because they were seen as riskier. One of the advantages of a MAC is that it gives them, especially those without an effective governance approach, access to a number of different credit investments and the managers make the decisions when to move between them."

Collins says one of the main drivers has been the long journey of de-risking, which has seen UK pension schemes slash their equity allocations from 68 per cent to 25 per cent over the past 15 years. "If you move away from equities and traditional government bond returns are too low, then MAC funds are in the middle ground," he says. "They offer a reasonable return profile – not as high as equities – but better than traditional bods."

M&G Investments director, global institutional distribution, Annabel Gillard, also believes there has been a change in mindset brought about by liability-driven investments. She notes that credit is no longer seen as a quasi-liability hedge in an LDI context but part of the growth bucket in its own right. "I do not believe MACs are a flash in the pan because they are targeted for investors who want better risk-adjusted returns but also want to manage volatility. Many MAC funds target Libor plus 3-5 per cent cash but have much less volatility than equities and diversified growth funds, which first appeared in the late 1990s."

According to Gillard, an indicative

range (based on M&G MAC funds versus MSCI equities) is that volatility can be as low as a third to a half of the volatility of equities, while in diversified-growth fund world, the general consensus in the industry is that they typically exhibit two-thirds of the volatility of equities.

Another equally important trend influencing demand for MACs is the rising interest rate environment in the US and to a lesser extent the UK. Within MAC strategies, credit spreads are significantly more important than duration in determining performance, according to Investec strategy leader, multi-asset, Jeff Boswell. Credit spreads are negatively correlated to interest rates, helping to dampen any rate sensitivity. "At the moment the MAC story is particularly strong given where we are in the credit cycle," he adds. "They offer greater diversification and source of returns and give managers the flexibility of an unconstrained universe to build portfolios that perform well through different market cycles and events such as geopolitical risk."

Approaches

However, as with any investment strategy, investors are advised to take a good look under the proverbial bonnet in terms of the asset classes and research skills being deployed. There are a plethora of different funds and analysis being deployed, which makes comparisons between the various offerings difficult. For example, some fund managers deploy a bottom-up selection approach as opposed to top-down and a certain segment of the MAC population avoids overly complicated or heavy derivative use. There are also different benchmarks used, although a Libor plus index seems to be the most common.

"The first MAC funds typically focused in the sub-investment grade space investing across leveraged loans and high yield," says Boswell. "However, as the asset class has matured, there has been an evolution and a broadening of the assets to also include structured credit, investment grade and emerging market credit. You may have two funds with the same name but from an investment perspective, there is a whole range of outcomes that can be achieved."

CQS partner and head of long-only multi-asset credit Craig Scordellis believes MAC strategies should reflect a real partnership between asset manager and owner to establish risk, return and liquidity targets. "There are different MAC approaches but it is important to understand the risk/reward and liquidity profiles. We focus on strong returns, low volatility and rate risk mitigation. We are in the privileged position to be able to invest across a wide geographic span of alternative credit classes which include senior secured loans, high yield, asset backed securities and convertibles."

Currently, around 70-80 per cent of the CQS long-only strategy is in floating-rate instruments in order to seek to immunise investors from interest rate hikes. Although it employs a bottom-up credit analysis, it is avoiding particular sectors, such as retail groups and energy companies in the high yield sub-sector, according to Scordellis.

Opinions are more divided over emerging markets that have lost their lustre this year due to interest rate hikes in the US and the negative impact of the country's ongoing trade war with China. This has led to a widespread weakening of currencies with for example, Turkey's lira falling more than 40 per cent, Argentina's peso more than halving, India's rupee reaching record lows, and South Africa's rand, Russia's rouble, and Brazil's real each losing between 15-20 per cent so far this year. The dollar strength has also raised credit risk since dollar-denominated debts have become more expensive to service in local currencies.

However, some analysts believe that the strong fundamentals and long-term growth prospects in major emerging economies will outweigh the short-term jitters the markets are currently experiencing. As BlueBay Asset Management's head of UK and Ireland Anthony Pickering says: "Although not all investors opt for this approach, we believe that offering a balance of largely investment-grade, emerging-market debt and sub-investment grade developed market debt in a MAC construct can offer both an attractive yield due to the combination of the emerging market and credit risk premia, as well as a balanced risk profile."

There is also some debate about whether MAC funds should invest in illiquid assets. Advocates contend that the illiquidity premia can enhance the returns and dampen the volatility while others such as Royal London Asset Management head of institutional John Burke believe it can make it difficult to dynamically allocate. "We invest in an intermediate level of illiquidity, to include loans, secured and unsecured high yield debt, leveraged loans, asset backed securities and emerging market debt. We don't invest in distressed debt because you have to go through a restructuring process and you may lose flexibility in redeploying assets," he adds. "If, for example, something extraordinary happens you want the opportunity to reinvest but won't be able to do if you are in an illiquid asset."

Looking ahead, MAC funds will continue to develop and widen their appeal. Pickering also sees the higher coupon bond universe being viewed as part of the income, as well the growth portion of a portfolio.

"As defined benefit schemes go cashflow negative, they do not want to be forced sellers in order to meet their liability payment needs, preferring to seek sources of income instead," he says. "The high fixed-coupon rates of these bonds represent an attractive level of income that can be used for this purpose by both corporate and public DB pension funds."

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