For Investment Professionals only

M&G INSTITUTIONAL

Focus on Multi-asset credit

Accessing a broader opportunity set

March 2019

- Seek to provide long-term returns above a cash rate, while reducing volatility and downside risk, even in times of credit market stress
- Focus is usually on the attraction of benefitting from taking credit risk while minimising unwanted interest rate and currency risk
- **Richard Ryan** explains why adopting a multi-asset credit approach offers attractions to long-term investors

Richard Ryan, Fund manager

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

The evolution of multi-asset credit strategies

Multi-asset credit (MAC) strategies emerged more than a decade ago, as the needs of institutional fixed income investors became more sophisticated. Traditional corporate bond, or credit, benchmarks, often referred to as indices, were introduced during the mid-1990s. They were originally created to provide investors with a way of measuring the risk and returns of their portfolios, relative to the market and competition.

These indices are typically a market-weighted composition of all the corporate bond issues that satisfy the index provider's rules for inclusion. Each index can be thought of as representing a passively-managed portfolio of bonds, which the active manager then seeks to outperform.

Investing in credit can be attractive to pension funds and similar institutional investors for two primary reasons. First, it offers the ability to capture the credit risk premium, or additional return available for accepting corporate risk. Second, it offers exposure to changes in interest rates, or duration, so that, though the values of bond assets rise and fall, they do so in much the same way that the value of the pension fund's liabilities.

However, as the needs of institutional investors have become more complex, so have the tools available to them. Strategies that are designed to hedge against unwanted interest rate risk and fluctuations in the currency markets, typically using derivatives, are now commonly found within an institutional investor's portfolio.

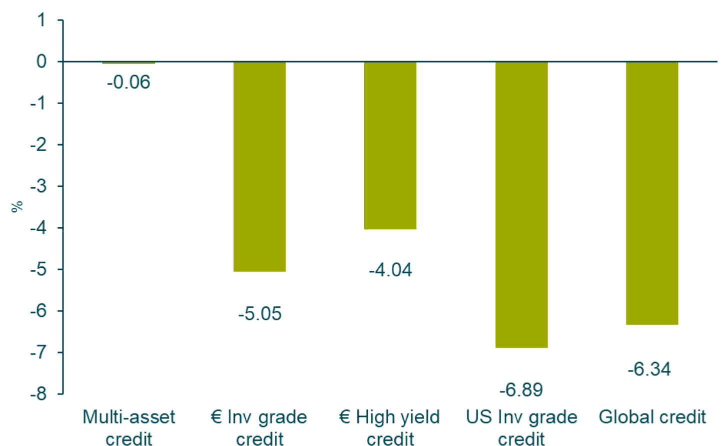
A MAC strategy will typically offer investors three key features:

- Limited, or even no, exposure to interest rates or currency movements,
- A broad, and highly diversified, exposure across the spectrum of credit asset classes, in contrast to focusing the strategy on a typical corporate bond benchmark,
- An objective of achieving a long-term return above a cash rate benchmark such as LIBOR or EURIBOR, while reducing volatility and the risk of significant downside, even in times of credit market stress.

Minimising interest rate and currency risk

Figure 1 shows how the inverse relationship between interest rates and bond prices means that a 1% increase in the respective underlying government bond yield, would negatively impact credit indices by more than 6% in some cases. This is due to the interest rate sensitivity of corporate bonds. A MAC strategy will typically use investment techniques to remove almost all interest rate sensitivity so the risk of losses arising from higher interest rates, is significantly reduced.

Figure 1: Potential impact of a 1% increase in government bond yields



Source: M&G multi-asset credit strategy, ICE BAML indices (Euro IG, ER00; Euro HY, HPIC; US IG, C0A0 and Global credit, G0BC) indices as at 31 January 2019.

Currency risk is typically reduced, or removed, by using forward foreign exchange contracts, which can hedge any unwanted currency exposure.

Loosening the confines of traditional bond benchmarks

Fixed rate bonds were predominant when the credit market first emerged but there has been significant growth and development in credit markets in recent years. MAC strategies evolved from the desire of investors to move away from being tied to traditional bond benchmarks. Today, investors can select between a range

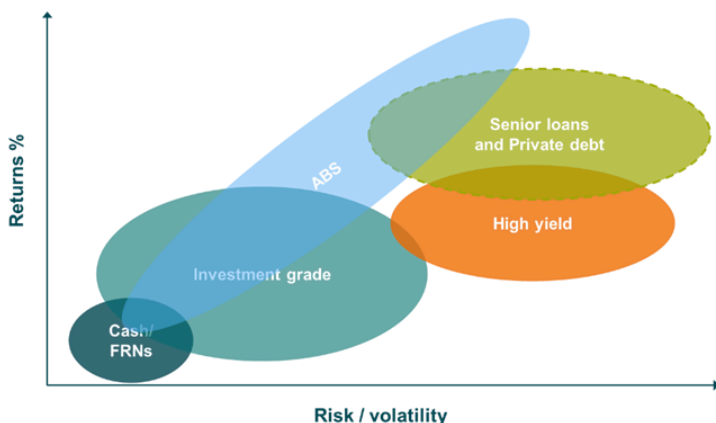
of different investments with differing levels of seniority, security, liquidity and credit rating. They are also not confined to public debt markets as there is also now greater access to private debt.

For example, investors who do not want exposure to interest rates (duration) in their portfolios can consider floating rate notes (FRNs), or asset-backed securities (ABS), where the bond's cashflows are effectively secured, frequently on property.

MAC strategies have gained popularity partly because they allow the pursuit of a broader, less-constrained investment approach, with freedom to select from a wider range of credit asset classes. These may include such things as leveraged loans (private debt), and senior mortgages (debt secured on long-term property loans). Importantly, this flexibility brings access to opportunities that carry different risk and reward characteristics.

Figure 2 illustrates the breadth of corporate debt instruments that a multi-asset credit investor might consider.

Figure 2: Asset classes across debt markets can offer an array of risk / return outcomes



Source: M&G, illustrative as at 28 February 2019

Fixed rate corporate bonds principally consist of interest rate risk and credit risk. A bond's value fluctuates in response to changes in either underlying government bond yields (interest rates) or credit spreads (the credit risk premium that a corporate borrower needs to pay in excess of what a government pays). An investor may feel that only one of those risks is being adequately compensated at a particular time and worth accepting in their portfolio. A MAC approach can provide that investor with the capacity to capture that granular opinion.

Derivatives can be used to remove the effects of changes in interest rates (also known as hedging the duration risk), thereby allowing an investor to isolate and capture the credit risk premium. An investor can also compare fixed and floating rate corporate bond issues from the same or similar issuer, on a like-for-like basis and take exposure where the returns are most attractive and the risk appropriately compensated. These features, of enabling more precise selection of the risks within a portfolio, are at the core of multi-asset credit investing.

This means that it is now possible to make direct comparisons between different securities to identify compelling value across and between credit asset classes. For example, having removed the interest rate component of the risk we can compare long-dated fixed commercial mortgage-backed securities (CMBS) issues such as Tesco Property Finance, which is fixed rate, with floating rate CMBS issues such as ESTON (which is a Sainsbury's store securitisation issue), on a like-for-like basis. It also facilitates comparison between credit asset classes, for example high yield corporate bond debt with leveraged loans (senior secured private floating rate debt).

One universe of individual bonds

We believe that applying big-picture, 'top-down' macro views to allocate within a portfolio and then populating those views with 'bottom-up' stock and sector selections presents two challenges. First, the 'top down' opportunities are unlikely to be consistent or provide repeatable sources of return, and may also introduce additional volatility to returns. Second, that by excluding certain markets or geographies due to top-down views, many attractive opportunities at stock level may be over-looked.

Genuine asset allocation opportunities are likely to be infrequent because, historically, high levels of correlation exist between credit asset classes. For example, Euro investment grade and Euro high yield markets may move in close step with each other, just to differing degrees. There may also be a high correlation of the returns from the investment grade credit markets in Europe, UK and US at any given time.

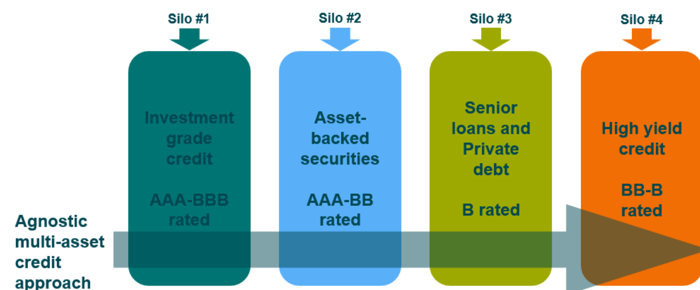
To compound the possibility that attractive stock-level opportunities become inaccessible because a top-down view excludes a market, the same view may effectively force an investor into marginal stock selection opportunities. A top-down view needs to be filled regardless of the availability of attractive bottom-up opportunities to populate it. These may be made at the expense of more attractive opportunities apparent in other, unallocated, markets.

However, we believe that constructing a portfolio populated with securities that are compensating the investor for the risk being taken will tilt the portfolio towards the cheapest assets, and that high-level asset allocation decisions are only warranted when there are compelling opportunities.

Seeing through the artificial partitioning of markets provides opportunities

The other, often unspoken, criticism of benchmark investing is the extent to which partitioning the market by asset class, rating or sector, may inhibit seizing opportunities. The construction of traditional corporate bond benchmarks has historically relied on ratings agencies (e.g. Standard & Poor's, Moody's, Fitch) opining publicly on an issuer's credit quality. Whatever rating is articulated, it may create an artificial picture of issuers / sectors that can differ or lag the conditions in the real world. Consequently, breaking down investment allocations into 'silos', based on the characteristics of an asset class, can also lead to mispricing of risks that are examined in isolation rather than across boundaries.

Figure 3: Benchmark-driven focus on discrete 'silos' creates barriers that lead to mispricing of risks



Source: M&G, illustrative as at 28 February 2019

Confining investments to these artificial, and sometimes seemingly arbitrary, partitions or 'silos' may mask opportunities when a company issues debt across multiple asset classes. For example, the UK building society Nationwide issues covered bonds, mortgage-backed securities, investment grade corporate debt and high yield debt. If the company was to be viewed as an attractive credit from a purely top-down perspective, this could

lead to an investor's portfolio managers all independently selecting Nationwide for their particular asset class – leading to an overexposure in the name at a total portfolio level. By removing the traditional asset class barriers and taking an agnostic approach to market sectors, a MAC strategy can purchase a Nationwide security in the sector considered to offer the best relative value. It can also help avoid the concentration risk that may arise from a top-down approach.

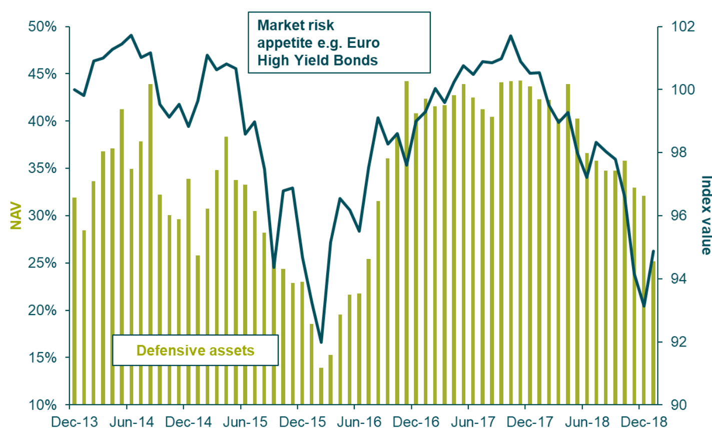
The difficulty of comparing issuers is further compounded by the differing levels of seniority of bonds issued by the same issuer. Issues from the same issuer may sit at different levels in that company's capital structure and therefore enjoy different degrees of protection, or seniority, in the event of impairment or default. This may be most prevalent in the financial sector where the fragmentation of the market has been used by issuers to fund at their preferred levels – playing one set of investors off against another. Banks are an obvious example, with asset-backed, covered (secured), senior unsecured and subordinated junior debt all issued by or from a single bank's balance sheet. Some of the bonds may be included in benchmarks and others may not. A MAC strategy may be free to look through the various labels attached to a bank's borrowing across its capital structure, while a benchmark-driven approach may be constrained, seemingly arbitrarily, by the rating or asset class of an issue.

One benefit, to a multi-asset credit investor, from the artificial partitioning and fragmentation of debt markets, is that the changing tides of supply and demand can create a steady stream of opportunities. These typically arise from the bonds or issuers whose risk is mispriced relative to the credit market and / or to the fundamental valuation of the business. These mispricings can be incorporated to create a preferred risk and return profile in a portfolio – less risk at the same price or the same risk at a lower price. MAC strategies enable the wider investment community to access a broader opportunity set across credit asset classes.

Preserving capital when opportunities are not compelling

Capital preservation should not be forgotten as an important objective of many investors, when there is otherwise a focus on maximising returns. Managers can often lose sight of the need to have assets available to use in the event of unexpected opportunities, which may arise from market volatility and illiquidity. We believe that building a defensive allocation to help preserve capital is a key tool in a multi-asset credit approach.

Figure 4: Defensive allocations increases with the market risk appetite

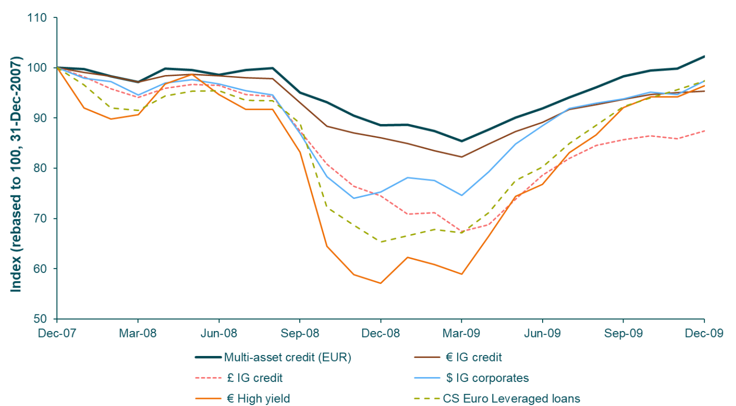


Source: ICE BAML: Price return index of Euro Non-Financial 2% Constrained index (Ref. HPIC) rebased to 100 as of 31 December 2013. Defensive assets include Cash, T-Bills, short dated government bonds, AAA ABS, AAA Floating Rate RMBS and AAA Quasi and Foreign Govt held in M&G Alpha Opportunities Fund. As at 31 January 2019.

In Figure 4, the line represents the market's appetite for risk assets, depicted here by the price return of a mainstream European High Yield bond index. The bars represent the percentage holdings of defensive assets in one of the main MAC funds that M&G manages and includes cash, Treasury bills, short -dated government bonds and liquid AAA-rated floating rate RMBS. When the prices of riskier assets are high our MAC strategies will typically reduce allocation to these riskier securities and add more defensive assets. In any case, we will not invest in securities that we do not consider to offer sufficient compensation for the risk taken. Instead, where we perceive riskier parts of the market to be overvalued, we are content to preserve investors' capital and hold more in defensive securities.

Figures 5 and 6 can help illustrate the potential benefit of adopting such a cautious approach during periods of unexpected or high volatility. In Figure 5, during the period of the Global Financial Crisis (GFC) in 2008 / 9, M&G's MAC strategy (in € terms and gross of fees) experienced less volatility in the excess returns, generated over LIBOR, EURIBOR or swaps, than a number of alternative fixed income market sectors.

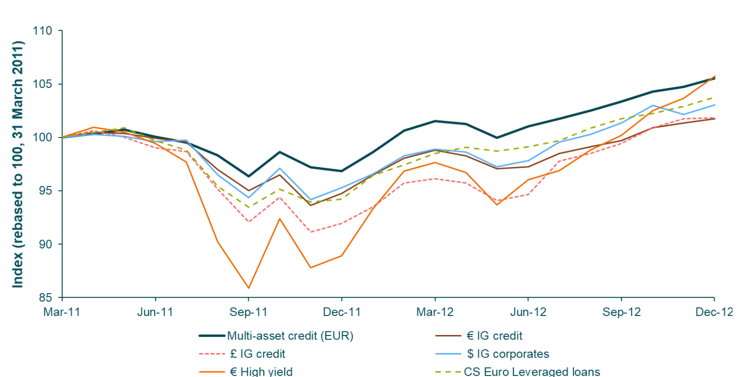
Figure 5: MAC strategy helped to temper drawdowns during the GFC



Source: M&G multi-asset credit strategy composite, ICE BAML indices (Euro investment grade credit, ER00; Euro high yield, HEAD; US corporate master, C0A0 and Sterling credit UC00), Credit Suisse, as at 31 January 2019.

Later, during the European sovereign debt crisis, when a number of peripheral nations, notably Greece, sought financial bail-outs, the M&G MAC strategy, again held up well compared to other mainstream fixed income sectors, through a volatile period (Figure 6).

Figure 6: Volatility of excess returns through the European Sovereign debt crisis (2011-2012)



Source: M&G multi-asset credit strategy composite, ICE BAML indices (Euro investment grade credit, ER00; Euro high yield, HEAD; US corporate master, C0A0 and Sterling credit UC00), Credit Suisse, as at 31 January 2019.

These two examples highlight how a MAC approach can offer the potential for generating returns that come with reduced experiences of downside risk, compared to focussing solely on a single fixed income sector.

M&G – Successfully managing multi-asset credit strategies since 2007

By using a combination of fundamental research and market insight, we aim to add value from identifying mispriced and under / over-valued securities. These opportunities are typically driven by a wide variety of factors, including company or sector-specific news, social or political unrest and episodes of market greed, fear and panic. We make investments only where we find a sound basis for believing that what we are purchasing offers appropriate compensation for that risk being assumed. We believe that top-down investment decisions such as interest rate and country allocations are best expressed only where valuations for markets as a whole have become significantly over-extended and the opportunity is compelling. Above all, we believe that patience and pragmatism are rewarded, and that this is reflected through our investment performance.

Contact

Andrew Swan
+44 (0)20 7548 2375
andrew.swan@mandg.co.uk

Henry Barstow
+44 (0)20 7548 3469
henry.barstow@mandg.co.uk

John Atkin
+44 (0)20 7548 3466
john.atkin@mandg.co.uk

Sunita Dey
+44 (0)20 7548 3393
sunita.dey@mandg.co.uk

www.mandg.co.uk/institutions
institutional.clients@mandg.co.uk

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