The case for multi-sector credit

With current yields low, the prospects for total returns from core fixed income appear subdued in the near term, and investors are seeking ways to achieve greater returns from their bond allocations.

In an environment where global growth has been improving and investors are focused on the risk of higher interest rates, we believe a multi-sector credit (MSC) approach can play several valuable roles in investors' portfolios.

For example, it can:

- Complement a core bond allocation by providing greater yield with less interest-rate risk;
- Provide potentially better risk-adjusted returns and opportunities to add value through active sector rotation, in comparison with an allocation to a single high-yielding sector; and
- Serve as an alternative to equities, potentially providing upside participation in growth environments yet with less downside when equities perform poorly.

Less rate risk – with more income

Despite recent increases in interest rates, yields on high-quality fixed income investments such as government bonds and investment-grade credit continue to languish at near-record lows. These low yields have left investors frustrated by the dearth of income from their core bond portfolios and justifiably concerned about the prospect that eventual increases in rates will erode total returns from these investments.

Higher-yielding, more credit-sensitive sectors of the fixed-income markets, such as bank loans, high-yield bonds and residential mortgage-backed securities (RMBS), can help address these concerns by providing a complementary return profile to core allocations by generating additional income and reducing the impact of rising rates.

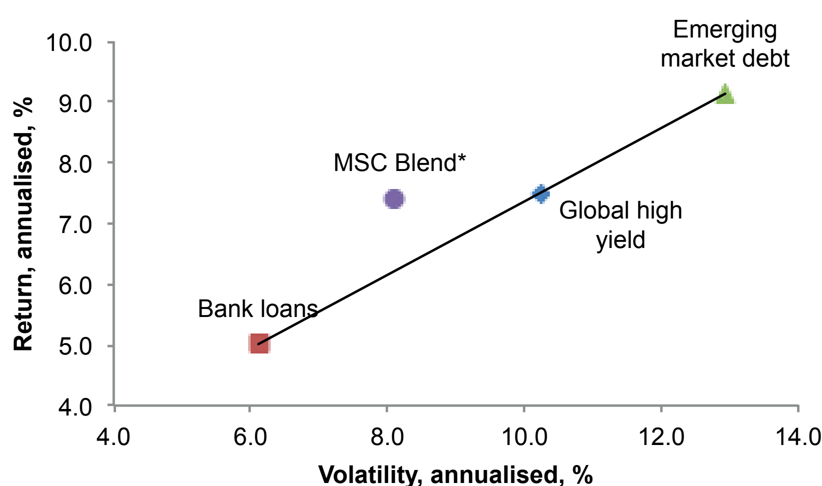
These credit sectors tend to be less sensitive to rising interest rates because their higher coupons, and the spread compression that typically accompanies economic growth, can help offset the negative impact of rate increases. In fact, the observed durations of credit sectors have actually been negative over the past 10 years – meaning that these assets have appreciated as yields have risen. They are therefore potentially well placed to outperform high-quality bonds in a rising-rate environment.

Of course, these sectors bear other risks: they typically have greater credit and liquidity risk than higher-quality sectors. Furthermore, although their returns have historically been negatively correlated with government bond returns, this relationship could change in the future.

Investors with strong concerns about rising rates sometimes ask about the possibility of reducing duration risk still further in a multi-sector credit approach, typically by employing interest-rate derivatives or by investing primarily in bank loans. While these approaches can indeed help in an environment of sharply rising rates, we believe there are benefits to maintaining a degree of positive duration. Positive rate sensitivity can be a good diversifier to the credit risk inherent in multi-sector credit.

Additionally, reducing the interest-rate duration of a portfolio through hedging or investing in floating-rate securities reduces the important cushioning effects of yield and income. Today's historically steep yield curves make lowering duration particularly costly in this respect. In the long term, we believe a multi-sector credit approach with positive duration should outperform the zero-duration alternative.

Figure 1: Potentially stronger risk-adjusted returns through sector diversification



Summary statistics based on historical index data from January 1998 – February 2014. Sources: Barclays, Credit Suisse, JPMorgan, Wellington Management. Index names below.*
*The MSC Blend return series ("MSC Blend") was created by blending in equal thirds the historical returns of the BofA Merrill Lynch Global High Yield Constrained Index (unhedged in US dollars), the Credit Suisse Leveraged Loan Index, and the JPMorgan Emerging Markets Bond Index Plus, with monthly rebalancing from January 1998 to February 2014. The MSC Blend provided in this article is hypothetical, for illustrative purposes only and is not a representation of an actual investment. Actual results would and will vary, perhaps significantly. MSC correlations against the broad bond markets use the Barclays Global Aggregate Index for comparison.

Diversification benefits

Combining a multi-sector credit approach with a core bond portfolio can also improve diversification. To provide a long historical perspective, we have constructed

"Multi-sector credit may complement a core bond approach or serve as an appealing equity alternative"

By Campe Goodman, CFA

an equally weighted blend of high-yield bonds, bank loans and emerging market debt: the MSC Blend*. This hypothetical blend has exhibited a low correlation of just 0.31 with the global bond markets, illustrating the diversification benefit that is possible by including a multi-sector credit approach in a broader investment portfolio. Also, the sectors that make up the MSC Blend display relatively low correlation with each other. As illustrated in figure 1, diversification across sectors has produced better risk-adjusted returns for the hypothetical portfolio than one that focuses on any single high-yielding sector.

Figure 2: Upside growth participation with less volatility

	Annualised return	Annualised volatility	Sharpe ratio
MSC Blend hypothetical*	7.4	8.1	0.61
MSCI World index	6.0	16.3	0.22

Summary statistics based on historical index data from January 1998 – February 2014.
Sources: Barclays, Credit Suisse, JPMorgan, Wellington Management.

Pursuing alpha through sector rotation

Because different bonds and issuers may have disparate performance within each sector, one way to add value in the credit markets is through active security selection where the manager strives to pick the best-performing bonds in each segment of the credit markets.

Returns between sectors can exhibit an even greater degree of dispersion over time than returns within individual sectors. For example, high-yield bonds were strong performers in the "risk-on" years of 2003, 2009 and 2013, while agency mortgage-backed securities (MBS) fared much better during the challenging markets of 2007 and 2008. A significant potential source of alpha, therefore, is sector rotation: positioning the portfolio to own those sectors that the manager believes will provide the highest returns. A manager who is able to pick the best bonds in each sector but does not engage in sector rotation is missing a key source of potential alpha. We therefore believe an active approach to sector rotation in multi-sector credit can add significant value.

Multi-sector credit as an equity alternative with potentially lower volatility

Multi-sector credit has a return profile that exhibits a hybrid of bond and equity characteristics. In periods of strong equity returns, high-yielding credit assets have historically enjoyed strong equity-upside participation. In periods when equity markets have sold off, the fixed income attributes of these instruments (coupon income and senior placement in the capital structure) have limited their losses.

The performance of the MSC Blend during the last two recessions illustrates this attractive upside/downside return combination. In 2008 the MSC Blend lost far less ground than stocks, and it generated modest positive returns in the early 2000s when equities endured a multi-year slump. In the ensuing recoveries the MSC Blend rose along with stocks. As figure 2 shows, over the last 15 years the annualised volatility of the hypothetical MSC Blend has been less than half that of global equities, but with similar returns.

With historically lower risk than equities but potentially greater returns than high-quality bonds, multi-sector credit can serve as an appealing equity alternative for some investors. It is particularly interesting as an interim step for investors seeking to de-risk their portfolios and transition out of equities into fixed income.

Take a flexible approach pursuing returns in multi-sector credit

In summary, a flexible approach across credit segments allows for an emphasis on higher-beta sectors when the macroeconomic backdrop suggests pro-cyclical positioning. Conversely, when more defensive positioning is warranted, market beta can be reduced through allocations to higher-quality sectors, such as MBS and investment-grade credit. Broadening the opportunity set from higher-yielding sectors into better-quality fixed income can provide additional relative-value opportunities. We believe that this flexibility will potentially enable a multi-sector credit approach to generate returns across multiple markets.

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