FINDING YIELD BY BEING NIMBLE IN MULTI-ASSET CREDIT

The lack of yield is one of the top concerns among pension funds and many other investors today. Central banks continue to intervene in the capital markets and expand their balance sheets. And this trend shows no signs of slowing, with the Federal Reserve cautious approach toward policy rate hikes, interest rates in Europe and Japan in negative territory, and some of the longest duration exposure in fixed income we've seen in a long time.

To adapt to this new environment, pension funds are seeking to supplement traditional approaches to be able to generate incremental returns in the future. The European Central Bank's asset purchase program also means that fewer high quality assets are available for institutional investors to hold. As a result, many investors are looking for ways to enhance their portfolios on a risk-adjusted basis. We think multi-asset credit (MAC) strategies present a compelling opportunity for pension funds in an environment of shifting markets and, eventually, rising interest rates.

However, there is a catch: Investors must be both nimble and cautious when employing these strategies. We think MAC strategies can be an effective tool, but as markets have seen with some unconstrained and other more flexible strategies, they can also result in underperformance if executed incorrectly. So investors should be cautious, and take the time to choose the right manager with the requisite skills and expertise.

CHOOSING PORTFOLIO ALLOCATIONS

To be able to harness strategies such as MAC, investors will need to be selective in choosing their portfolio allocations. While relative values across fixed income shift over time, we prefer credit spread risk over duration exposure and currently see value in components of investment grade, high yield, leveraged loans, and emerging market debt.

In investment grade, we continue to see value in banking sector debt throughout the capital structure. We prefer the risk/reward tradeoff of subordinated risk in a bank with strong fundamentals over sectors that are currently more susceptible to credit deterioration via corporate event risk.

In high yield, most companies outside of the commodities segment are well positioned to service their debts. Overall, high yield valuations in some sectors appear to be pricing more downside risk than we believe is necessary, a dynamic that is presenting select opportunities although the recent rally has resulted in a broadly fair-valued asset class.

Leveraged loans remain attractive due to their potential to perform well in all market cycles. Loans rank at the top of the capital structure, so recoveries are generally higher than those for high yield bonds. They can also act as a hedge against rising interest rates.

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Finally, emerging market debt continues to provide excess yield opportunities relative to comparably rated developed market debt and the divergence across segments of the asset class results in relative value opportunities across regions, countries, sectors, and issuers.

The key factors for all investors to determine – including pension funds – are their objectives and risk tolerance in constructing the optimal approach for their portfolios. For example, if your view is that equity returns will be lower in the future with expectations of mid-single-digit returns, by shifting the equity exposure toward leveraged finance components of credit, you may be able to more efficiently replicate expected equity returns with lower risk. But if you are considering a shift of a portion of core into a multi-asset approach, then you may prefer to target more investment-grade credit within your allocation options.

CHOOSING MANAGERS

The asset classes used in a MAC strategy can be more illiquid, inefficient, and complex than in other classes, giving active managers greater opportunities to create value. Active tactical allocation and security selection when investing in the fixed income markets is crucial. Skilled active management can analyse both bottom-up and top-down credit factors over the course of business and credit cycles to seek opportunities and avoid overpriced issues.

To optimise outcomes, investors should consider shifting opportunities and risks across both asset classes and geographies. MAC managers who are solely focused on domestic markets are unable to take advantage of global market opportunities in both the developed and emerging markets.

Manager size can also affect the implementation of a MAC strategy. Large managers may find it difficult to maneuver sufficiently or add security selection alpha. So investors need to evaluate whether their manager is nimble in what they manage and how they manage it to successfully execute.

BE PREPARED FOR VOLATILITY

Regulation has forced dealers to reduce exposure, draining liquidity from fixed income markets. This new liquidity environment has resulted in less diversity in bond ownership and trading, which means we can expect more frequent and severe bouts of short term volatility. But these periods of technically driven volatility results in investment opportunities for those who are able to take advantage of value dislocations. In order to have the ability to capture these alpha opportunities, it is necessary to be of nimble size to effectively maneuver in this market.

If investors can dynamically identify the relatively undervalued assets on a consistent basis, they can capture incremental returns by using a multi-asset strategy and tilting their portfolios toward areas that provide the best opportunities.