HEALTH WEALTH CAREER

MULTI-ASSET CREDIT (MAC)
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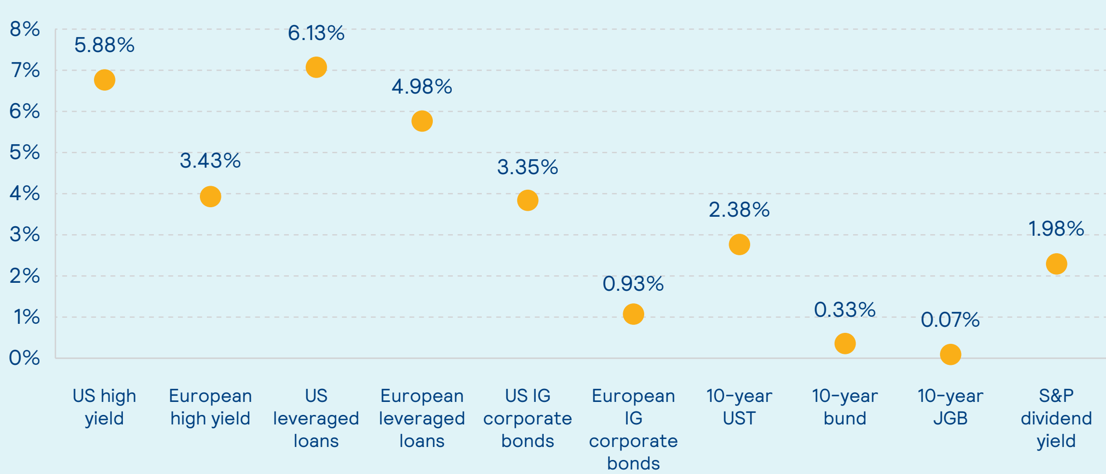
WHAT DO WE MEAN BY MULTI-ASSET CREDIT?

Although various forms of investing in broad credit portfolios have been around for many years, the more specific concept of multi-asset credit (MAC) strategies was developed significantly in 2013/2014.

With the perspective of hindsight, we now see this was a period when some degree of normalization had returned to higher-yielding fixed-income markets after the disruptions and turmoil of the global financial crisis (GFC) five or six years earlier. But this period also coincided with a stark compression of developed market sovereign bond yields across the globe as policymakers pursued unorthodox monetary policies to stimulate economic growth (as shown on the right side of Figure 1). This situation led to the well-documented "search for yield" by investors, and for many investors, higher-yielding fixed-income markets provided a large part of the answer. But many other investors were not so familiar with such markets, and they also had to grapple with the risk and reputational issues that go hand in hand with higher-yielding assets — for weren't high-yield bonds also known as "junk bonds"? And hadn't some structured credits been among the most toxic excesses of the GFC?

FIGURE 1. ASSET CLASS YIELDS



Source: BlueBay Asset Management, data accurate as at 31 March 2017

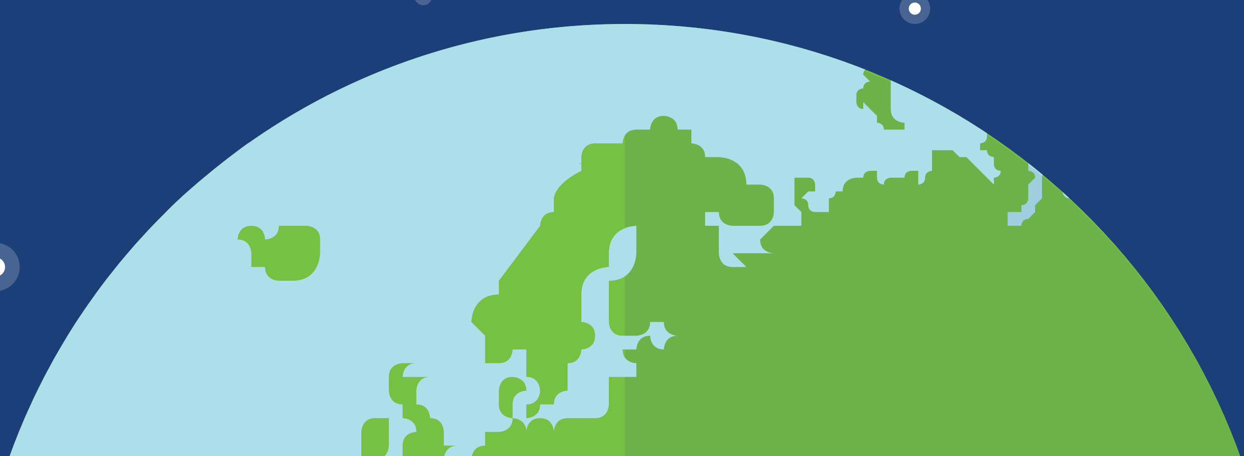
MAC strategies typically invest in a mix of bank loans, high-yield bonds and securitized credit (such as mortgage- and asset-backed securities), with some strategies also investing in emerging market debt, distressed debt and convertibles. Portfolios are generally managed in an opportunistic and unconstrained manner, with little or no reference to traditional benchmarks, thereby mitigating the drawbacks associated with benchmark-driven investing.

> MAC strategies can invest in a mix of bank loans, high-yield bonds, securitized credit, emerging market debt, distressed debt or convertibles, are managed in an opportunistic and unconstrained manner and are benchmark agnostic.

For many, MAC strategies were and continue to be an excellent way to access higher-yielding exposure in their portfolio, since these strategies invest across a range of higher-yield credit asset classes. Such strategies give investors a diversified portfolio with exposure to a number of different credit return drivers, to the opportunity to benefit from asset-class rotation between the different asset categories and to managers' ability to apply security-selection decisions across many different areas. Ultimately, MAC strategies evolved in order to give investors access to high-yield fixed income in a more diversified and better managed way than simply allocating directly to one particular area of high yield. In addition, the global "search for yield" also means that many fixed-income markets reached yield levels in recent years at which they were considered rich.[1] This heightens the potential for MAC managers to add value by successful asset rotation. Perhaps more importantly, it heightens the role for MAC managers to try and protect investors against excessive valuations potentially caused by indiscriminate investor demand for yield investments.

Reflecting these considerations, Some MAC strategies might also allocate to investment-grade credit and sovereign bonds when they want to adopt a more defensive position. MAC strategies are generally long-biased, but they may use hedging and shorting to try and reduce the volatility of returns.

[1] As of Q2 2017 Mercer's Dynamic Asset Allocation process currently rates a number of fixed-income asset classes as being unattractive.



MAC strategies are "best idea" portfolios that can limit interest rate sensitivity and credit-spread risk.

In today's market environment, two aspects of MAC strategies are particularly relevant for investors looking to protect accumulated wealth. First, by the nature of the credit asset classes involved (especially, for example, loans, which have low duration), a MAC strategy is likely to have limited interest-rate sensitivity. For investors concerned about rising interest rates, this may be an attractive feature. Second, with prevailing credit spreads being tight, an advantage of MAC is that managers have the freedom to invest in their "best return" ideas while having the flexibility to reduce risk to spread widening via asset allocation, or indeed by introducing some hedges into the portfolio.

MAC portfolios typically have outright return objectives that reflect market conditions over time.[2] Some strategies are more defensive in nature, with lower exposure to credit markets, and therefore should have reduced drawdowns in a stressed environment. Others may have a higher market exposure or a greater focus on riskier or more illiquid sectors. These strategies have higher return expectations and higher risk, but the diversified nature of the strategy should reduce the risk of being overexposed to any one individual credit asset class. So, although at one level the "MAC concept" is quite clear, in practice the universe of MAC strategies is quite heterogeneous, and, accordingly, investors have a diverse range of strategies available to them.

We see this in our research on managers and in the different types of managers we have rated; for example, a number of MAC managers are specialist credit houses and their strategies can focus on "deep credit" analysis that looks to exploit inefficiencies that can emerge from issuers in the lower-rated areas of the market. This can include issuers that are under credit pressure when some form of restructuring may be underway, and these specialist credit managers can often take an active involvement in such situations. Other MAC managers provide a strategy that can be quite broad in terms of the range of asset classes covered, and these strategies can have more formal asset allocation procedures. Many of the managers with such strategies tend to come from larger established investment houses. Another grouping of MAC managers can be those managers that include emerging market debt (EMD) in their portfolios, and this often (though not always) reflects the simple factor of whether the manager has an EMD team and franchise. From the viewpoints of the clients, the importance of the EMD allocation often depends on whether they already have EMD in their portfolio and whether they wish to use the MAC strategy as a means of building up their EMD exposure.

[2] As of Q2 2017, return targets in the region of 5% to 8% per annum are typical, with stated risk levels generally between 6% and 10% per annum.

HAVE MAC STRATEGIES WORKED?

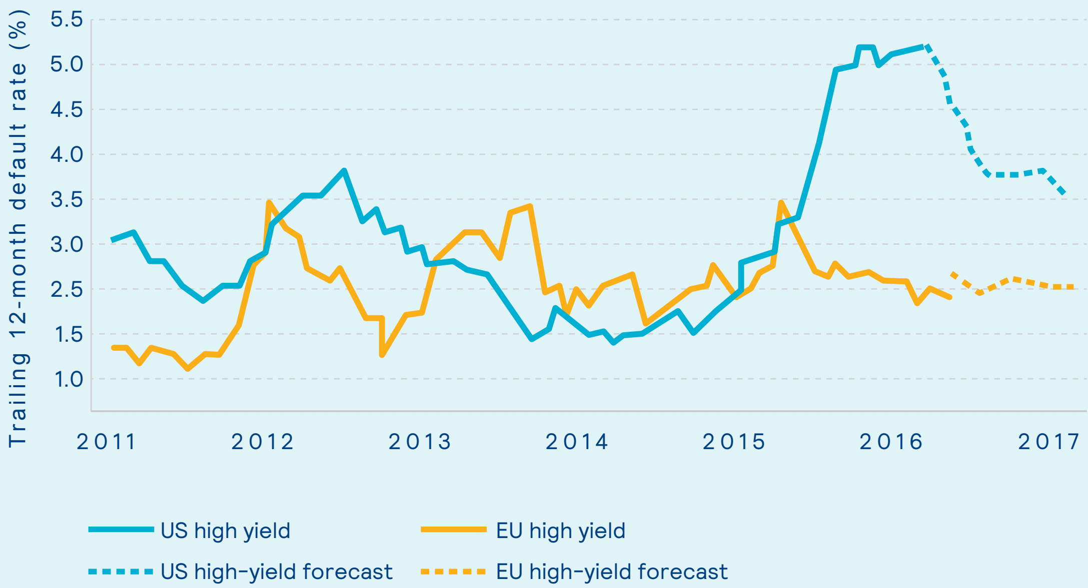
MAC strategies evolved in order to give investors access to high-yield fixed income in a more diversified and better managed way than simply allocating directly to one particular area of high yield. Has this been the case in practice? Given that the MAC concept evolved in 2013/2014, we now have 3-4 years' worth of track records, and in particular, we have a solid body of universe returns over three years. Over this period, the high-yield market environment has been quite eventful, with considerable volatility in late 2014 through 2015 as oil and commodity prices fell substantially. Markets steadied in late 2015 and then made some degree of a recovery in 2016, but further significant market events occurred during the year in the shape of the UK's Brexit vote and the US election of President Donald Trump.

Defaults picked up on the back of the 2015 slowdown, but not by as much as analysts feared, and, indeed, the default experience in high yield "ex-energy" has been reasonably robust. MAC managers that allocate to EMD also experienced substantial volatility in EMD markets over this period. Some of the drivers were common to wider high-yield markets (for example, the commodity slowdown), but there were also any number of country-specific stories (regarding Brazil, South Africa, Ukraine, Venezuela, and so on) that highlight the idiosyncratic nature of sovereign credit risk within EMD.

FIGURE 2. GLOBAL HIGH-YIELD BONDS - YIELD

Source: Datastream

FIGURE 3. GLOBAL HIGH-YIELD BONDS – DEFAULT RATES



Source: BlueBay Asset Management. Chart data to January 2017

In overall terms, high-yield markets have provided decent but not exuberant returns in recent years. Over the three-year period to the end of Q1 2017, global high yield returned 3.3% p.a., global loans returned 4.8% p.a. and a 50:50 blend of hard currency and local-currency sovereign EMD gave a return of 1.8% p.a. Thus, a broad brush sweep of the main higher-yield fixed-income markets gave returns in the region of 3%–4% p.a. over this three-year period. So, how did MAC managers do over this period? In the following charts and commentary, we answer this question by examining returns from the universe of MAC managers. As we do so, we must remain mindful that the universe is quite heterogeneous, and we should expect and, indeed, we should want to see different return and risk patterns emerge across the universe.

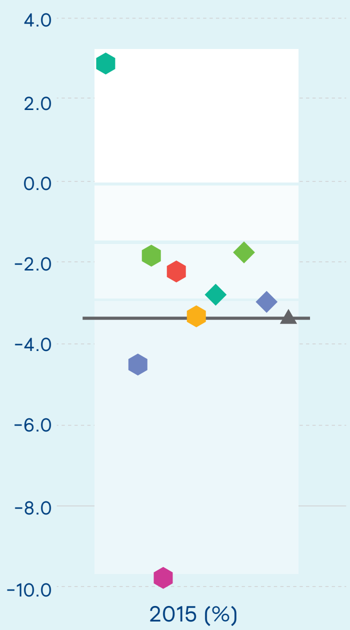
FIGURE 4. PERFORMANCE CHARACTERISTICS VS. 50/50 HIGH-YIELD LOANS (AFTER FEES, OVER THREE YEARS ENDING MARCH 2017)

Source: Mercer Insights

Figure 4 shows the return and risk characteristics of the universe of managers and strategies contained in Mercer's MAC universe, set out by quartile. As at March 2017, this covered 47 manager strategies. The tables also feature icons representing individual managers that are A-rated. We can see that over this three-year period to the end of Q1 2017, the median MAC manager returned +3.9% p.a. This compares favorably with market returns in the region of 3%–4% p.a. From a risk or volatility point of view, the MAC strategies exhibited a median volatility (standard deviation) reading of 4.2% compared with a volatility reading of 4.8% for a 50:50 loans:high yield index and individual high-yield asset class standard deviations, which tend to be higher.

Another aspect of performance worth examining is how the MAC managers have done when markets were weak, since one of the aims of MAC strategies is to provide some degree of downside protection in negative market environments. In this regard, we can look to a period such as 2015 when yield markets were weak for the reasons discussed earlier in this paper.

FIGURE 5. MAC MANAGER RETURNS VS. 50:50 HIGH-YIELD LOANS RETURNS



Source: Mercer Insights

MAC strategies emerged in 2013/2014 and managed to provide market-like returns with lower downside risks during an eventful period for riskier bonds.

As per Figure 5, we can see that the return from the median MAC manager compares reasonably well with index returns for loans and high yield. The median manager outcome was -1.3% versus a 50:50 loans:high yield index return of -3.4%.

So, at a high-level examination, we can reasonably claim that the MAC strategy concept has so far managed to achieve its broad objective of providing investors with market-like returns with lower exposure to downside risks.

Clearly, Figures 4 and 5 also show quite a range of return and risk outcomes from the MAC managers, and, indeed, this is to be expected given the level of diversity within the universe. When we look at the performance patterns achieved by our A-rated managers over the past three years, we can see that the higher returns have generally been achieved by the “deep credit” managers, but typically with a slightly more volatile return pattern along the way. The more conservative managers have tended to lag a bit in relative returns (again, not surprising), and both they and the managers that run broad portfolios across a wide number of asset categories have tended to provide a lower-risk outcome over time.

A final point is that our comments so far have looked at returns from the universe of MAC managers, rather than at the subset of mangers that we rate highly. In this regard, we can state that in the defined periods, our A-rated managers performed better on average than the universe median manager returns quoted in Figures 4 and 5.

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CLIENT ACTIVITY AND RESEARCH COVERAGE

Mercer's research coverage of MAC managers has formed a substantial part of our research focus since 2013, and MAC has been an area of high activity with our clients. Many clients have used MAC strategies as part of a de-risking process via which they aim to reduce portfolio reliance on equities and yet maintain a decent level of overall return.

From a portfolio construction viewpoint, the lower volatility of high-yield asset classes compared with equities is a distinct advantage, and hence return expectations from MAC strategies are attractive on a risk-adjusted basis compared with equities.

MAC strategies are attractive on a risk-adjusted basis compared with equities.

As discussed earlier in this paper, the more conventional factor of the "search for yield" has been a big driver of demand, especially from investors who historically have allocated fixed-income assets to investment-grade and sovereign space. For such clients, who might not have a history of investing in — or a knowledge of or familiarity with — higher-yield fixed-income markets, moving to MAC strategies has proved a very effective way to build exposure to such asset classes.

In research terms, Mercer has ratings on more than 40 managers from across the globe, and more than 60 managers populate our GIMD™ database with MAC strategies. Clearly, within our system, we assign the highest rating to a relatively small number of managers. But that said, the heterogeneous nature of this universe means that we are very mindful of ensuring that a diversity of different approaches is found within the grouping of our highest-rated managers. Thus, when looking at particular client investment requirements, we are able to match the various investment goals of the client (in terms of risk or target return or asset mix, etc.) with appropriate managers and strategies. The success of the MAC concept as a strategy is evident from the fact that we have conducted more than 80 specific searches on MAC mandates for clients over the past three years, placing over $6.2 billion of assets, while in our fiduciary business, we have $3.4 billion of client assets invested in MAC. Furthermore, we know of clients who have allocated to MAC strategies without necessarily going down the route of traditional manager searches. The success of MAC strategies looks set to continue as the factors that led to the development of MAC continue to resonate for investors, and this continues to be an area of focus for our fixed-income research process.

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