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Multi Asset Credit

Reviewing your credit exposure – is it time to consider a multi-asset approach?

It seems that whoever you talk to in the pensions industry about their current hot topic, the answer is Multi-Asset Credit (MAC). But what does this term really mean? The answer, it appears, depends who you ask. When you also consider Absolute Return Bond (ARB) funds, which are often talked about in the same breath, the potential for confusion is rife.

The purpose of this newsletter is firstly to consider the role that credit typically plays within a portfolio. We then compare this to the types of asset MAC/ARB funds hold before considering the strategic and tactical case for such funds.

What role does credit play within a pension scheme portfolio?

Whilst bonds will act as a diversifying asset in a typical portfolio, for a defined benefit pension scheme a credit portfolio will tend to be heavily focused towards Sterling denominated investment grade credit. To understand why this is we need to consider the dual role that credit typically plays within a portfolio:

1. To provide some interest rate protection and thereby provide a level of matching to the funding assumptions; an asset that has exposure to movements in mid and long-dated interest rates, i.e. gilt yields.
2. To provide some excess returns over and above that available on Gilts. Again, this is often required within an actuary's funding model.

Given the Sterling investment grade market has the closest link to Sterling denominated liabilities, with a slightly longer duration than the global bond market, it is easy to see why pension schemes' focus has been on this part of the market.

However, the Sterling investment grade market is a small component of the global bond market; its current market cap is £540bn compared to the global investment grade bond market of £12.5tn, with a further £1.4tn in high yield and emerging markets. Does this historic focus solely on one part of the market remain justified? Let's start by considering the current state of the broad credit market.

MAC/ARB investing aims to open up the available universe of credit investments. The approach involves gaining exposure to a wide variety of areas of the credit market, both by geography and instrument selection.

At the same time the approach involves removing, or significantly reducing, the interest rate exposure associated with a traditional bond investment approach. The approach involves active management and should not be managed against a market benchmark but against a measure of cash returns.

How is the credit market currently positioned?

It almost doesn't matter which part of the credit market you are considering; yields are close to record lows in absolute terms and the spread, the additional yield on credit over government bonds, is closing in on pre-crisis lows. The charts to the right set out the absolute yields in the top chart and the spread in the bottom chart.

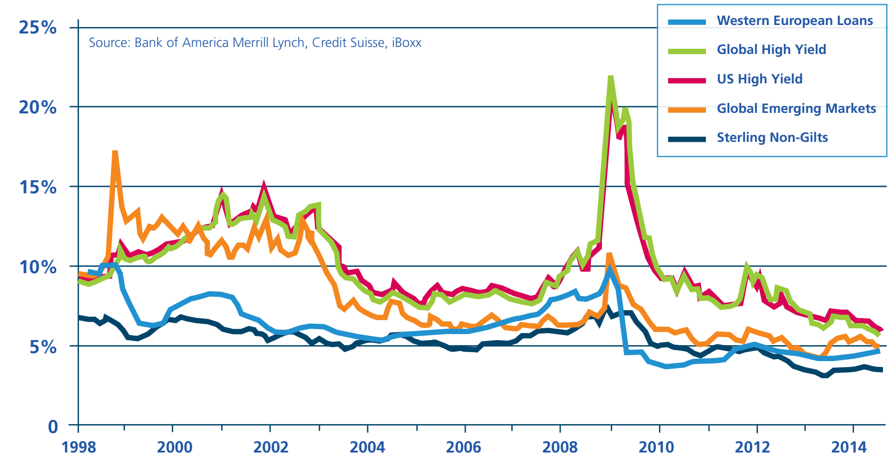
If we take US High Yield bonds as an example, the current annual yield is 5.94% compared to an average yield over the past 15 years of 9.9%. The spread is currently 3.6% compared to an average spread of 6.2% over the past 15 years.

A similar story is true in investment grade credit, where the spread has fallen to around 1%. Whilst this remains above pre-crises lows of around 0.63% there has been a significant change in the composition of that index over the period.

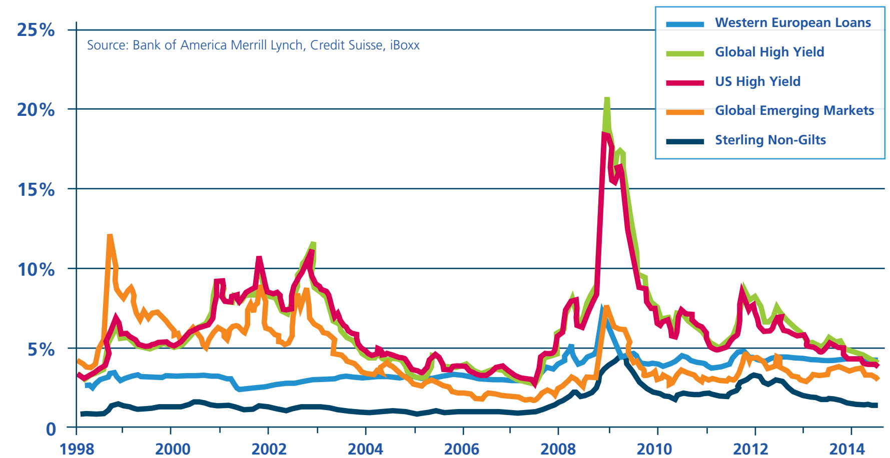
Comparing the current index to that pre-crisis we see a significant increase in the proportion of the benchmark rated A and BBB. The ratings on AAA, AA securities are around their pre-crisis lows, for example AA rated debt has a current spread of 0.63% compared to 0.64% in June 2005.

Trustees should consider the impact of the change in composition of the benchmark index on their credit allocation.

Multi-Asset Credit Yields: Example asset categories



Multi-Asset Credit Spreads: Example asset categories



Are historically low spreads justified? To an extent yes, the level of defaults remain low compared to historical standards and corporates in general have low levels of leverage and large cash amounts. Clearly risks remain; if growth does not follow through and/or interest rates rise, the servicing of this debt may become more problematic. This brings us onto the second area to be concerned about, and that is liquidity.

Liquidity is one of those wonderful things that tends to be there until the point at which you need it. The corporate bond market is fundamentally less liquid than it used to be. Due to new capital requirements banks are far less likely to supply liquidity to the bond market than before the crisis. Schemes therefore need to be very comfortable in the quality of the credit they hold as they may not be able to sell it in the event of another crisis.

What assets might a Multi-Asset Credit fund invest in?

As mentioned above, the Sterling investment grade market is a small subset of the entire credit market. A scheme invested in this part of the market may expect to hold:

- Traditional investment grade corporate bonds

In fact the benchmark index will also include:

- Supranational bonds
- Government bonds
- Sterling denominated emerging market bonds
- Asset Backed Securities
- Some hybrid bonds

One of the key rationales for MAC investing is to fully open up the availability of the credit markets and, as well as those subsets listed above, also potentially allow for investments in:

- Sub-investment grade bonds (High Yield)
- Cash
- Emerging market bonds, both corporate and government, both local and hard currency (typically US Dollar)
- Floating rate bonds
- Secured and unsecured lending
- Loans
- Convertible and hybrid bonds

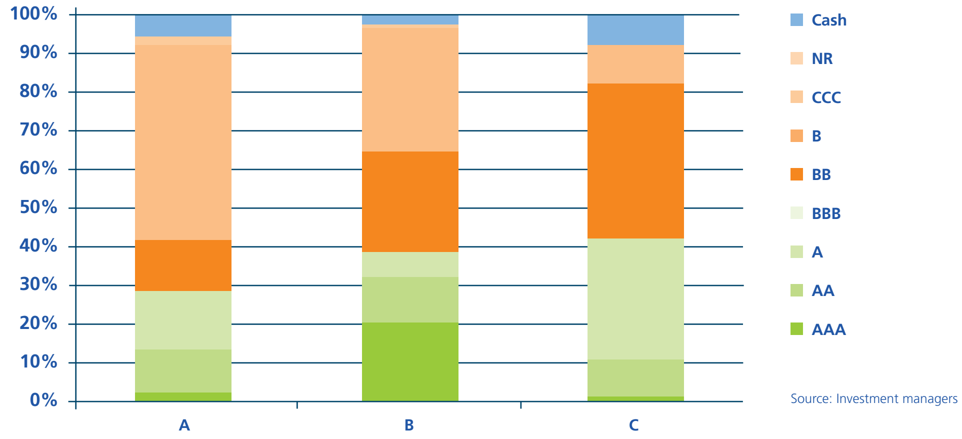
Trustees could make a strategic allocation to any part of the credit market, for example a separate allocation to local currency EM bonds, High Yield bonds etc. However, this has significant governance implications and, therefore, what MAC funds potentially offer is all of this under one roof and the ability to delegate to the manager the choice of which part of the global credit market to invest in.

Is this potential realised? In the chart to the right we set out the asset allocation of three funds that fall under the MAC banner. We see that there is indeed a wider range of asset classes being invested in. However, we also see a significant difference in the asset allocation, whether we consider that by broad asset class or by credit rating.

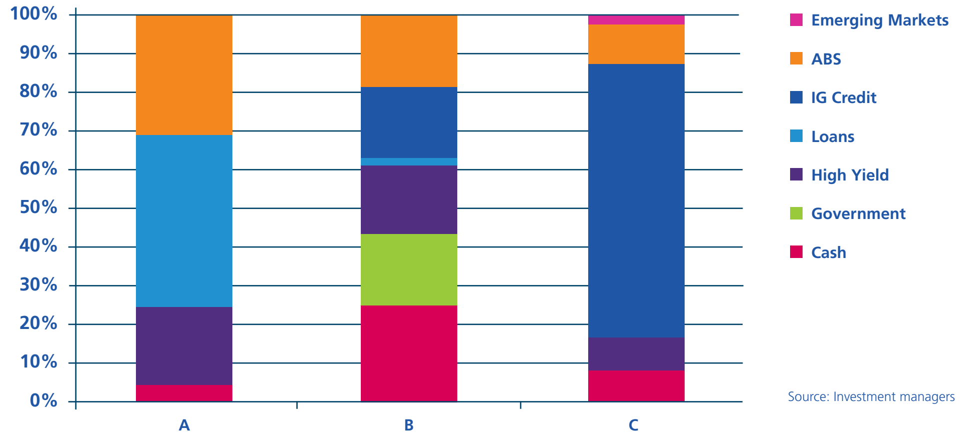
What we can quickly conclude is that different managers will have different areas of expertise and therefore have different ways of managing a MAC fund. It is worth noting that there are certain sectors of the credit market that MAC funds tend not to invest in. These are the less liquid parts of the market and include:

- Private debt (including mezzanine financing)
- Infrastructure and real estate debt
- Direct lending

Ratings allocation of three example funds



Asset class allocation of three example funds



What's the difference with an absolute return bond (ARB) fund?

ARB funds are often mentioned in the same breath as MAC funds. The term 'absolute' shouldn't be taken literally; these funds can and will fall in value in certain market conditions. Whilst ARB funds will tend to invest in similar types of asset to a MAC fund, there are significant differences.

One of the key differences in an ARB fund is the ability to 'short' (benefit from a fall in price) the market or certain investments. MAC funds tend to be long only. There are a number of implications of this difference compared to a MAC fund:

- ARB funds are more focused on investment grade credit given the desire to be able to 'short'. It is very difficult to go short or quickly exit sub-investment grade positions.
- There is a greater reliance on manager skill, known as 'alpha', to generate the returns in an ARB fund. A MAC fund will tend to generate a greater proportion of its returns from exposure to the credit market, known as 'beta'. Manager selection and skill are vital for both ARB and MAC funds.
- We would expect ARB funds to fall less in the event of a downturn in credit markets. They aim to be less volatile than MAC funds.
- In contrast we would expect lower long term returns from an ARB fund than a MAC fund.

Of course there is a certain amount of generalisation in the above; one of the key conclusions is that trustees need to decide on the type of credit exposure they want and which areas of the market they feel are most attractive. Only then should they consider the choice of manager.

So how might a pension scheme use a MAC/ARB fund?

In addition to getting a broader exposure to the credit market the other key advantage of a MAC/ARB fund is that they will have little or no strategic exposure to duration; the box below sets out how this may be achieved. Most will benchmark themselves against LIBOR, or some other measure of cash returns. This offers two potential uses to pension funds:

1. The primary use in our opinion, and where they have generally been used to date, is alongside an LDI mandate. In this scenario trustees separate out the two reasons for holding credit within a portfolio; liability protection and excess return. Here the LDI hedging portfolio, through swaps, repos etc., provides the interest rate and inflation protection. The credit portfolio is then used to outperform the liability benchmark.

2. An alternative use would be for those who hold a traditional credit mandate and still want exposure to credit spreads but feel that the yield curve is currently under-estimating the rate of future rises in yields. As regular readers know, we don't feel this risk will materialise and whilst yields will inevitably rise, we feel the market is currently broadly pricing this in correctly.

So how do MAC/ARB funds remove the interest rate risk associated with credit investments? Again, this varies significantly from fund to fund so trustees will need to understand the mechanics of the fund they are investing in. Common approaches include:

- **Use derivatives, for example short Gilts, to remove the interest rate risk from a corporate bond also held in the portfolio.**
- **Investment in floating rate bonds, where the coupon payment is set relative to LIBOR. These will include secured loans, floating rate high yield bonds and ABS.**

The key point is that trustees need to be aware that this is a two-way risk, as central bankers seem to be trying to remind the market at the moment. In the event that yields rise, but more slowly than expected, a LIBOR-based credit fund is likely to underperform a market benchmarked credit fund.

So is now a good time to invest in such a fund?

If the reduction in yields and spreads on the current portfolio mean your overall portfolio is not expected to generate the returns needed under the funding strategy then trustees need to make their assets work harder or increase employer contributions. The former may mean potentially holding lower rated assets, 'the search for yield', or aiming for greater active manager returns.

Which part of the market you select to invest in will largely depend upon your return requirements and any constraints over short-term performance. Some key questions that will need to be addressed are:

- Investment grade or sub-investment grade credit?
- Tolerance for potential short-term losses?
- Long term or short-term holding?
- Your belief in active management?
- Your views on certain sections of the credit market?

Once these questions have been answered you can then decide the MAC/ARB fund to consider. Given spreads are currently low, return expectations need to be tempered for such a mandate. Almost all areas of credit have provided exceptional returns over the past 5 years; this is extremely unlikely to be repeated over the next 5 years. Careful consideration therefore needs to be taken in deciding whether to increase the overall level of credit exposure at this time, however, it may be an opportune time to re-allocate within credit; ensuring the characteristics of your credit portfolio match the needs of your scheme.

So what should trustees be doing?

MAC/ARB investing is certainly not a one-size-fits-all approach that is suitable for all schemes. What trustees should be doing is re-examining their approach to managing credit risk. This assessment needs to be made in the context of the changing characteristics of the credit market; the deterioration in spreads back towards the lows seen pre-crisis in certain sectors and the falling levels of liquidity.

They should be considering the dual role that credit plays within that portfolio and consider whether their existing approach remains the most efficient way of meeting its twin objectives; liability protection and return enhancement. We feel the existing approach can be improved upon in many cases.

By separating out the dual roles of a traditional credit portfolio and giving the manager freedom to allocate across assets and securities, a more effective portfolio can be established.

The key though is for trustees to first define their objectives and only then to start considering potential managers; although many funds have similar names, what goes on under the bonnet will be vastly different.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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