Casting a wide net with Multi-Asset Credit (MAC)

PUBLISHED
October 2020

AUTHOR

Blair Reid
Partner
Senior PM
Multi-Asset Credit

Conditions have changed. Central banks and governments have released tremendous amounts of market support in response to Covid and this in turn impacts asset prices. Whilst in the long run assets always find their 'right price', in the medium term we believe opportunities will shift more sharply between different parts of the credit market. Casting a wide net with MAC is one way of responding to what may be a multi-year, stop-start economic recovery – in our view MAC improves the chances of not only accessing opportunities, but also avoiding the less attractive parts of the market.

No amount of government support can fully compensate for the global economic impact of Covid and its aftereffects will be with us for a long time. Even if a vaccine is found in the short term, behaviours and perceptions have changed with significant consequences: working remotely is now a viable option for many (and often preferred), a lot of businesses can operate surprisingly well virtually, buying online is beating bricks and mortar, business travel is much curtailed, international holidays may be fewer and so on. In time, it may even mean rethinking transport systems and the role of cities if the short term trends gather momentum.

For credit investors two things come to mind: one, there will be rising defaults in parts of the market negatively exposed to these changes; two, flexibility may be the key ingredient to future success.

Flexible mandates

The previous financial crisis was the catalyst for greater flexibility in credit mandates where, as is the case today, government and central bank support impacted asset prices and the role of navigating a safe path was delegated to investment managers. Multi-asset credit (MAC) grew in popularity and the Covid crisis presents a similar set of circumstances for investors: asset prices impacted (mostly inflated) by central banks; risk free rates near zero or negative.

The added complexity this time is changing behaviours, some irrevocably, which will see, amongst other things, industries that facilitate remote working benefit and close proximity activities suffer.

Static allocations to credit markets can serve investors well when the world is broadly static – they serve investors less well during a transition phase. The same can be said for index tracking credit strategies, particularly as defaults rise.

The reality is nobody knows what the next few years holds, but a flexible approach at least allows the investor/manager to react to change.

Working harder to get returns . . .

In many countries the 10 year government bond yields are lower than inflation expectation, so investors expect to lose in real terms. For liability relative investors this may have less of an impact, though for most investors avoiding loss remains a key objective.

Earning, say, cash +3-6% in credit market today requires investors to buy largely sub-investment grade bonds. That comes with attendant credit (default) risk. In many ways it makes sense for investors to provide greater flexibility where there is greater credit risk. It allows the manager to rotate into and out of opportunities.

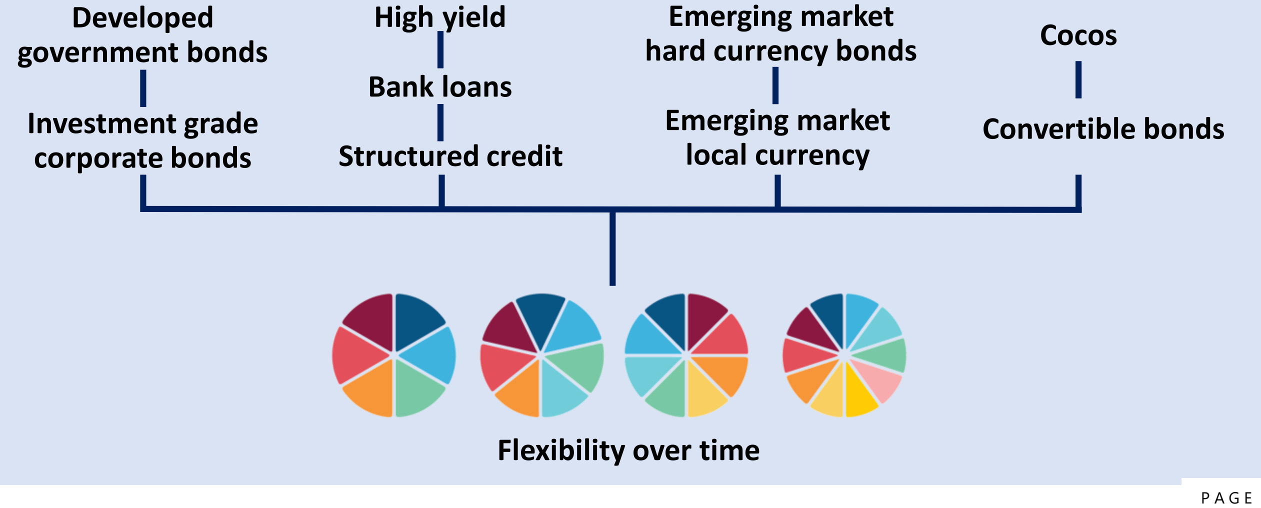
MAC – what asset classes to include?

There is a wide spectrum of MAC products out their from 'narrow MAC' which includes just a few asset classes to 'go anywhere MAC' that does just that. At the current juncture we believe a wide net conveys some advantages. These are both structural and asset class specific and include:

- **Zero weight** - more asset classes provides greater ability to have zero exposure – with plenty of asset classes to choose from, a manager can more easily have zero exposure to parts of the market. This is harder when fewer assets are included.
- **Diversification** - a more diversified MAC exposure is potentially less susceptible to unexpected central bank/government interventions which can have asymmetric impacts on specific asset classes.
- **Convertible bond universe is 'Covid friendly'** – pharmaceutical companies and tech businesses tend to issue convertible bonds and including this asset class gives the manager the potential ability to access some of the winners arising from the crisis

> If you don't know what the future holds, flexibility is a better strategy than hope

Liquid credit Asset Classes



- **Cocos (financial capital bonds)** – this asset class is unique in that, as a bond holder, you may suffer in some way if a bank's capital level falls below a predetermined level. Given the amount of government support for banking institutions – they are largely the conduit of any recovery – we believe there are some great opportunities, on a selective basis, from staying close to parts of the market that directly benefit from central bank support.

- **Developed market investment grade –** within our own flagship strategy we had not purchased any developed market investment grade in 7 years (due to low yields). That changed in late March and April when investors could achieve three or four times the average spread and, although clearly a very sporadic tactical opportunity, the ability to capitalise on unexpected opportunities favours a wide net.

In summary . . .

With risk free rates low for the foreseeable future, in our view yield/return hungry investors will have little choice but to seek out returns from lower credit quality bonds. This comes at a time when unprecedented support has been pumped into markets and Covid restrictions have left some industry sectors beleaguered, some for the long term.

Herein we have argued a wide net is a useful tool, perhaps an essential one. That is not the whole story – the other component is avoiding defaults and credit managers haven't been meaningfully tested since the last financial crisis. And this time it will be different as investors have to factor in government support to a much larger degree.

Whatever awaits us, even more pandemics, as Charles Darwin said, it's not the strongest or most intelligent who survive, it's those who adapt.