RBC Global Asset Management

Multi-Asset Credit

Why now is a good time for MAC

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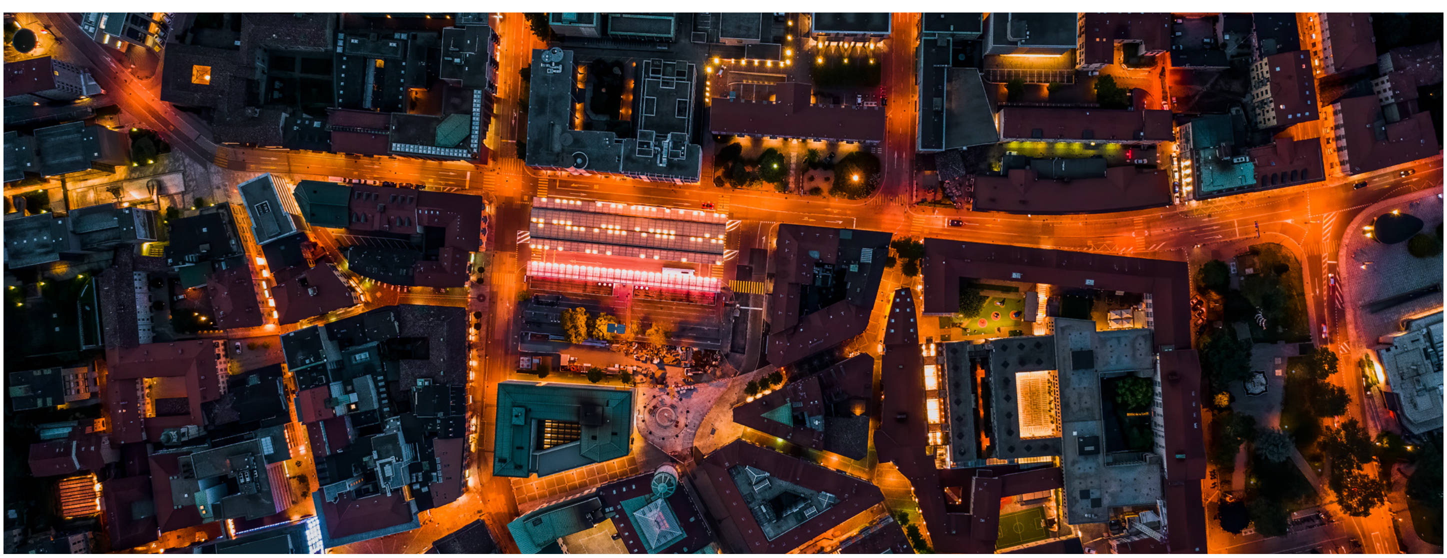
Multi-asset credit has been a popular choice for investors over the past decade and that popularity was fuelled, in part, by low yields in traditional (investment grade) credit markets. As central banks around the world dropped interest rates to near zero, the hunt for yield pushed investors into higher yielding credit such as high yield and emerging markets. MAC grew out of this demand, offering a convenient 'package' of higher yielding credit in a single vehicle.

The question is, as interest rates start to stabilise at higher levels, does the rationale for MAC still stand? In this paper, we analyse the merits of MAC in today's world.

	January 2013 →	January 2023
Fed (upper bound)	0.1%	4.5%
Bank of England	0.5%	3.5%
Investment Grade Corporates	2.7%	5.2%
High yield (US)	5.7%	9.0%
S&P 500 (dividend yield)	2.3%	1.8%

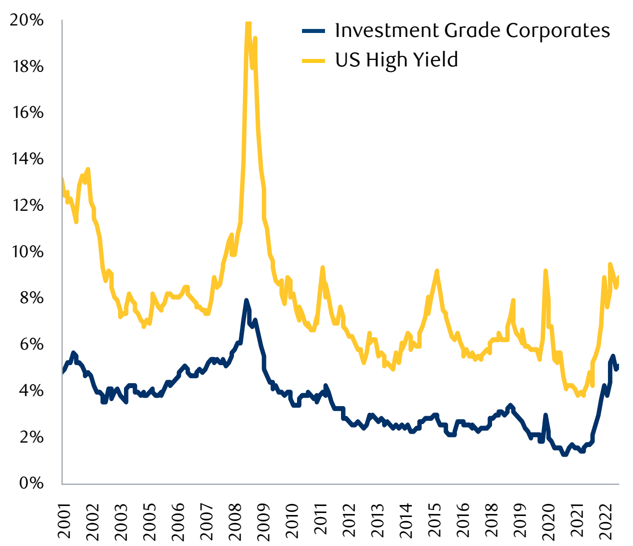
Source: Bloomberg, as at 1 January 2023. Investment Grade Corporates = Bloomberg Global Aggregate -Corporate Index. High Yield = US High yield: ICE BofA US High Yield Index. S&P 500 = 12 month gross dividend yield.



Investment grade credit versus MAC

Is the hunt for yield over? It's a question that very much depends on the individual investor, though there is no doubt investment grade credit today offers the types of yields that investors may once again find attractive as illustrated below.

Evolution of investment grade and high yield: yield to worst (USD)



Source: Bloomberg, as at 1 January 2023. Investment Grade Corporates = Bloomberg Global Aggregate - Corporate Index. US High yield = ICE BofA US High Yield Index.

One complication with this analysis today is inflation. While we expect inflation to fall this year, it is currently running at 7.1% in the US and 10.7% in the UK[1]. Real returns (after inflation) are important as this is what dictates ultimate purchasing power. An investor should care about returns after inflation, albeit for a pension fund it is the returns relative to the liabilities that is crucial.

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Therefore, while investment grade yields have risen, so too have central bank rates as well as inflation and so for many investors there remains a desire to target higher long-term returns than can be achieved via investment grade credit.

[1] US CPI Urban Consumers YoY NSA; UK CPI EU Harmonized YoY NSA, as at November 2022. Source Bloomberg.

What exactly is MAC?

MAC offerings come in many different flavours, from 'narrow' strategies focussed primarily on high yield and loans, to 'go anywhere' approaches which include most credit asset classes and may even include illiquid credit. Common asset classes are shown in the table below.

One common feature of MAC strategies is active asset allocation, the ability to alter the allocations to the various underlying asset classes in response to changing market conditions.

Common MAC asset classes

Investment Grade

Investment grade bonds (rated BBB and higher) issued by developed market issuers.

High yield bonds

Sub-investment grade bonds, issued by developed market issuers.

Bank loans

Floating rate instruments are usually secured by an issuing company's assets.

Emerging markets bonds

Bonds issued by emerging market countries or companies, either in their domestic currency (local currency bonds) or in US dollars (hard currency bonds).

Financial capital bonds (cocos)

Bonds issued by financial institutions that are part of its capital structure.

Structured credit

Bonds and loans secured against mortgages, auto loans, leases, and other assets.

Convertible bonds

Bonds issued by publicly traded companies that can be converted into a pre-determined amount of equity shares at certain times.

Source: BlueBay, as at 1 January 2023.

Flexibility is a valuable feature

The intrinsic flexibility of MAC portfolios can be highly useful in times of economic uncertainty. Whilst we expect (and hope) that over 2023 inflation will become less of a feature, the war in Russia/Ukraine may come to an end and Covid will have less of an impact on economies, as we start the year we can't be certain regarding any of these things.

MAC portfolios can react to unfolding events using three primary levers.

In combination, these three factors dictate the total amount of portfolio risk.

1. **Asset allocation** – in the mix of MAC assets there are safer choices, such as investment grade bonds for example, and riskier opportunities such as emerging markets, although we would note there are many less risky choices in emerging markets too. Cash is also an asset allocation choice, and certainly one we have used to protect portfolios at times. Many MAC strategies allow the manager to have a zero allocation to an asset class, and this is a key advantage over having a range of different managers each managing a separate asset class. Indeed, MAC managers have benefited from investors amalgamating multiple mandates into a single MAC portfolio.

   To provide some insight into the flexibility of MAC portfolios, the ranges below apply to our flagship MAC strategy.

Example asset class ranges

High yield	0%	45%
Loans	0%	45%
Structured credit	0%	20%
Cocos	0%	20%
Convertibles	0%	15%
EMD Hard Currency	0%	45%
EMD Local Currency	0%	20%
Cash	0%	35%
Developed market investment grade	0%	35%

Source: BlueBay, as at 1 January 2023.

It's one thing to have flexibility – it's another to use it. By way of example, over 2022 for our flagship MAC strategy cash has ranged from a minimum of 2% to a maximum of 35%. At times we have held no bank loans and no emerging market local debt. For other asset classes exposures have varied over the year.

Over the coming period, we expect this flexibility to be valuable as it facilitates gaining exposure to compelling risk-adjusted opportunities and critically permits a zero allocation to areas of the market that become less attractive.

2. **Security selection** – another lever is security selection and here the manager has a vast selection of securities to choose from. From a risk perspective, one of the key ways of increasing or reducing risk is to move up and down in terms of credit risk. For example, when the manager wants to reduce risk, one way to achieve this is to sell the lower credit quality bonds (perhaps rated B and below) and increase the allocation to higher credit rated bonds.

   Another approach to risk management is to accent or avoid particular sectors. For example, within high yield over 2022, the energy sector was the top performing sector whereas broadcasting was the worst performer. A MAC manager has the flexibility to completely avoid sectors likely to underperform, and overweight those expected to produce higher returns.

   One key attribute of successful MAC managers is a clear process to calibrate the attractiveness of opportunities across credit sectors e.g. how does a high yield opportunity compare to an emerging market opportunity? The ultimate goal is create a portfolio of highest conviction ideas across the credit spectrum.

3. **Hedging** – part of the flexibility of MAC portfolios is the ability to hedge investment risks. For example, a MAC manager can often partially or fully hedge (insulate) a portfolio from rising interest rates. Or, if a MAC manager believes in the short term the high yield market might fall, though doesn't want to incur the transaction costs of selling bonds, it can purchase a derivative to partially protect against falls in high yield markets.

> **"From our perspective a successful hedging strategy generates positive returns over time and doesn't represent a long term cost to the portfolio."**

Most MAC portfolios are designed such that returns are driven by the coupon from bonds and any capital appreciation. Hedging is not an 'everyday' feature, though in times of economic stress hedging can play a much larger role. As we enter into a period of potentially peak interest rates for many economies and the prospect of recessions in many developed and emerging markets, short-term hedging has a critical role to play in protecting capital.

MAC managers approach hedging in different ways. From our perspective a successful hedging strategy generates positive returns over time and doesn't represent a long term cost to the portfolio.

[2] JPM High Yield Bond and Leveraged Loan Market Monitor, Dec 2022.

What about rising defaults?

Increased economic stress and rising interest rates tend to lead to higher defaults among bond issuers. This year we expect default rates to pick up from the very low levels of recent years.

This is where rigorous credit analysis comes to the fore. A good credit manager assesses the probability of an issuer defaulting and can (hopefully) avoid bonds that may become impaired or default. It's not a perfect science and unexpected things can and do happen, though the long-term success of a credit manager depends on their ability to avoid impaired bonds.

What do we anticipate in terms of defaults in 2023? We expect defaults to rise, though only to levels associated with a mild recession. As an indication, for US high yield the default rate (by the number of bonds) for both 2021 and 2022 was 1.5%[2]. We expect this to rise to between 3% and 4.5% over both 2023 and 2024.

Even if defaults rise, it is not a reason to avoid higher-yielding credit and MAC strategies. The higher yields on offer exist to compensate investors for expected defaults, and if a manager can avoid all or most of the defaults, enhanced returns can be achieved.

The 'yield cushion'

We don't expect the days of ultra-low interest rates to come back any time soon. Indeed, we expect central banks to do their utmost to avoid a return to zero interest rate policies. In this context the 'yield cushion' has returned whereby bond investors have some protection against negative returns by virtue of a bond's positive yield. For example, if a bond is yielding 6% per year it would take a market fall of roughly 6% before an investor would have a negative annual performance. Higher yields means higher cushions.

> **"We don't expect the days of ultra-low interest rates to come back any time soon."**

In contrast to bonds, equity yields have tended to be flat or even fall over recent years. As we saw in the table on page 1, the S&P500 dividend yield stands at 1.8% today, down from 2.3% 10 years ago. Today MAC portfolios tend to exhibit much higher intrinsic yields than many equity indices.

Flexibility is a valuable feature

The great advantage of MAC is flexibility and the cost of this flexibility is it takes greater governance time and effort to analyse and understand manager performance.

For most traditional fixed income strategies, performance is measured relative to an index benchmark, for example, the target might be index + 2%. This makes it straightforward to assess manager performance and to distinguish beta from alpha.

Many MAC portfolios are cash benchmarked, for example, cash + 4-6% over a credit cycle. This is useful for long-term assessment, though less useful in a year like 2022 when credit markets mostly recorded negative performance.

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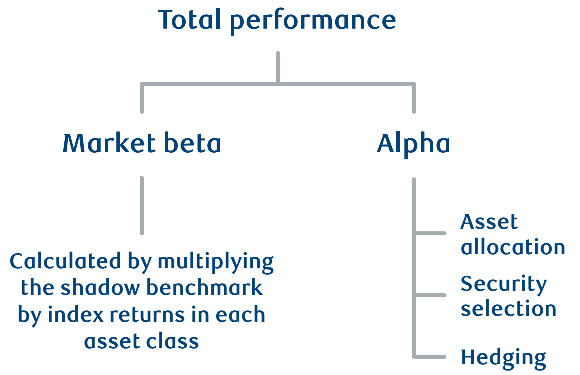
There are different approaches here, and BlueBay's approach is to have a 'shadow benchmark' to provide a sense of relative performance in the short run. For example, a shadow benchmark might be: 30% high yield, 10% bank loans, 10% structured credit, 10% convertible bonds, 10% cocos and 30% emerging markets. Total performance can be split into four buckets as shown below.



Thus it is possible to quickly determine, over any period, whether the investment manager has added value.

In summary

We posed the question as to whether it's a good time to invest in MAC strategies. Here are our top six reasons:

1. **Flexibility** – given the heightened benefit of flexibility in less certain economic times, we believe MAC has the tools to help navigate the expected uncertainty.
2. **Offset inflation** – exposure to higher-yielding credit asset classes can help offset the impact of inflation on nominal returns.
3. **The ability to hedge** – in choppy markets the ability to apply short-term capital preservation hedges can greatly enhance results.
4. **Zero weighting** – the ability to avoid more troubled parts of the credit markets has a distinct advantage over static allocations to credit asset classes.
5. **Attractive yields relative to equities** – the underlying yields available in credit markets are higher than in recent years: for US high yield the index yield is 9.0% as we enter 2023, and it's 10.8% in bank loans and 8.6% in emerging market sovereign bonds[3]. In contrast, the dividend yield of the S&P500 is 1.8%[3].
6. **'Hope' is not a strategy** – if you don't know what the future holds, flexibility is a better strategy than hope!

[3] As at 1 January 2023. US High yield: ICE BofA US High Yield Index; Bank loans: JP Morgan Leveraged Loan Index; Emerging market sovereigns: J.P. Morgan EMBI Global Diversified Index (USD).

Important Information/Fund Risks

Sub-Investment Grade/High Yield
The fund may invest in sub-Investment Grade/high yield securities. These securities typically are subject to greater market fluctuations and to greater risk of loss of income and principal than are higher rated fixed income securities. In addition, it may be more difficult to dispose of, or to determine the value of, high yield fixed income securities.

Emerging Markets Risk
The fund may invest in less developed or emerging markets. These markets may be volatile and illiquid and investments in such markets may be considered speculative and subject to significant delays in settlement. The risk of significant fluctuations in the net asset value and of the suspension of redemptions may be higher than funds investing in major world markets. The assets of a fund investing in emerging markets, as well as the income derived may also be affected unfavourably by fluctuations in currency rates, exchange control, and tax regulations.

Liquidity Risk
The liquidity of a security can fluctuate over time due to market conditions. Reduced market activity or participation and increased market restrictions or impediments may result in greater liquidity risk.

Interest Rate Risk
As nominal interest rates rise, the value of fixed income securities held by the fund is likely to decrease. Securities with longer durations tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

Sustainability Risks
An environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investments made by the fund. There is no guarantee that the measures implemented by the Manager to assess and manage Sustainability Risks will prevent the fund incurring losses.

Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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