Multi asset Credit Strategies - A more dynamic credit allocation
Capstone Project Summary
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Introduction

Credit conditions are changing rapidly as a new investment regime unlike anything we have experienced in recent history unfolds. High inflation, rising interest rates, diverging global monetary and fiscal policies, and heightened geopolitical risks are all contributing to a more volatile and dynamic market. Global credit markets are now over US$19 trillion[1]. Lending capital to companies all over the world necessitates a thorough understanding of the company's region's business and market landscape, an assessment of corporate fundamentals and investment projections, and a keen focus on risk management, including environmental, social, and governance risks in the local regulatory and legal jurisdiction. The highly dynamic financial conditions and need of generating returns while sailing through volatility, institutional investors require strategies that navigate relative value opportunities across the larger credit investment universe.

For capstone project I contributed in drafting Multi asset credit (MAC) whitepaper which outlined the above global scenario and how MAC strategies offer an efficient approach to accessing credit opportunities across global markets over time. The whitepaper is an educational piece drafted with the motive of creating engagement with institutional clients about credit opportunities.

What is Multi asset Credit?

Multi Asset Credit is a diversified investment strategy that invests across regions and credit instruments to generate alpha and excess returns. MAC strategies can take advantage of broad macroeconomic developments and expand the opportunity set beyond standard fixed income portfolios by allowing investors to lend in a variety of regions and credit grades. MAC portfolios can offer an array of global asset classes and investment products such as investment grade, leveraged loans, high yield, securitised assets, emerging markets etc.

Dispersion and Dynamism

Dispersion creates opportunities. Within an individual market, outperformance (alpha) is often primarily generated through security selection. However, when dispersion is low within a market and security. selection opportunities are more limited, managing market beta more dynamically is more desirable as a source of alpha. Economically responsive sectors tend to demonstrate higher dispersion of returns, and due to heightened responsiveness to global event risks, emerging market debt offers shorter maturities and additional opportunities to exploit risks and rewards. Credit dispersion is persistent over time and the range of outcomes is vast, supporting the need for allocating capital across global credit investment opportunities. In a global investment context, dispersion that exists across markets tends to be persistent, suggesting that a

[1] Bloomberg , JP Morgan and S&P Leveraged commentary and data, as of 31 March 2022

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Industry exposure decisions can be one of the most critical performance elements in a credit portfolio's performance. GICS[3] sector breakdown of Bloomberg US High Yield Index, Bloomberg US Corp Index, S&P/LSTA Leveraged Loan Index, Bloomberg Pan-European High Yield USD Hedged Index, Bloomberg Pan-Euro Corporate USD Hedged Index, JP Morgan Corporate EMBI Global Diversified Index, JPMorgan Asian Credit Investment Grade Index; JPMorgan Asian Credit Non-Investment Grade Index were taken to show heterogeneity and different duration observed. Comparing high yield markets, the US has more exposure to energy (11%) and healthcare sectors (10%), Europe has more consumer (42%) and financial sector (18%) exposure, and Asia has more real estate (15%) exposure. In investment grade markets financial sector has the largest exposure with US having 28% of proportion, Europe with 40% and Asia with 36%. EU loans and US loans have 0 duration due to their floating nature, whereas US investment grade has highest duration of 8 as of 31st March 2022. European government bonds are the most vulnerable, followed by US investment-grade corporates.

For visualising importance of dynamic asset allocation asset allocation, daily total returns of past 10 years from Bloomberg global high yield index, S&P loan index, JP Morgan emerging markets index, Bloomberg US investment grade index, Bloomberg European investment grade index with total returns hedged to $ USD and JP Morgan Asian credit index with total returns hedged to $ USD were analysed for computing annualised return and volatility. High yield and bank loans having 50% each allocation provided highest return of 3.8%. Allocation towards emerging markets led to increase in volatility while providing modest returns. Using investment grade allocations provides an insulation from volatility. Since this model doesn't allow for efficient and real-time changes in allocation which can be crucial to return generation in periods of market dislocation it is important to analyse dispersion. Emerging market debt has been among highest performing instruments as observed in year 2011, 2012, 2016 and 2018. Through this analysis, our impetus is to convey active allocations and relative security selections must be unearthed for better performance and excess returns because one security cannot provide consistent returns.

[2] As mentioned in A constant-volatility framework for managing tail risk - 10.3905/jpm.2013.39.2.028

[3] The GICS structure consists of 11 sectors, 24 industry groups, 69 industries and 158 sub-industries into which S&P has categorized all major public companies. For more information https://www.msci.com/documents/1296102/11185224/GICS+Methodology+2020.pdf

A case study presenting benefits of MAC strategy for pension clients was added as a section in the whitepaper. In recent times, as maturing pension systems become increasingly cashflow negative, accounting for cashflows as an investing aim, alongside risk management and return objectives, has risen in priority, dubbed Cashflow Driven Investing (CDI)[4] by some industry analysts . MAC allocations are malleable and can be integrated with existing allocations. Balancing funds as per asset liability management and managing income through investment grade or equities which are low yielding and volatile respectively, increases importance of MAC strategies in public pension portfolios. MAC strategies should become more prominent in the future as a means of cashflow income with wide and varied exposure to underlying credit strategies[5].

Scope for improvement

For the next whitepaper for multi asset credit, instead of static allocations, we can devise a custom benchmark using indices and having allocation as per a typical multi asset credit fund, we can show the difference in returns with and without MAC portfolio. Credit cycle can be considered because MAC strategies are closely dependent on it, instances of how portfolios can be pivoted for tactical allocation and capturing alpha and how securities are behave in particular cycles can be included. Credit ratings can be illustrated along with sector, yield and duration to show heterogeneity. Prospective readers can determine the flexibility and the need of investing in distressed if there is a need as per their requirements.

Conclusion

For conclusion, benefits for clients apart from financial standpoint were enumerated. The current rise in global interest rates will undoubtedly have an impact on credit markets, but it is unlikely to reverse the size of asset classes under multi asset credit and importance. We also concluded that awareness of the characteristics that distinguish credit from government bonds and equities will rise, as will appetite for various credit investing techniques. With multi asset credit now playing a significant role in so many portfolios, the force to improve its contribution will only grow.

[4] See CDI requirements and funding objectives

[5] A strategic credit allocation for US corporate pensions