The wonderful world of MAC

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The extraordinary levels to which interest rates have fallen have overturned decades of conventional market wisdom on asset class performance. Bonds and equities, having enjoyed a bull run over the last 30 years, now face a far more precarious future. Amid the longest economic cycle in history, investors are increasingly concerned about the risks of a turn in the market and the increasing difficulty in finding attractive places to invest to achieve return and yield objectives.

Against this backdrop, multi-asset credit (MAC) strategies have gained popularity as they provide investors with access to a broader range of tools with which to optimise risk and return through the credit cycle. Diversification can reduce risk compared to a single asset class approach, while dynamic asset allocation combined with bottom-up credit analysis allows investors to position themselves towards the areas of the market with the strongest return prospects.

The investment universe

The opportunities available for multi-asset credit funds are typically vast, including leveraged loans, high yield debt, investment grade credit and asset-backed securities. These asset classes each have distinctive investment characteristics, suitable for different stages of the credit cycle. For example, while investment grade credit may be suitable in a period of recession, conventional or emerging market high yield may be preferable during a recovery.

The table below provides a brief summary of the investment characteristics of the primary multi-asset credit classes, while figure 1 shows how they each performed between 2001 and 2019.

Our kind of MAC

Multi-asset credit funds typically fall within three categories. The 'traditional approach' places a great emphasis on global sovereign and investment grade debt. This ensures that liquidity is plentiful but has less of an income component, with returns coming more through capital gains. However, these benefits typically come at the cost of relatively low returns. By contrast, the 'illiquid approach' focuses on such asset classes as distressed debt, direct lending and specialty finance. Yet while this can lead to higher return prospects, there can be material risks in terms of liquidity and volatility should assets need to be sold.

Our approach falls within the 'alternative' category, favouring asset classes like leveraged loans, high yield bonds, investment grade credit, securitised corporates and emerging market corporates. In our view, such an approach can characteristically deliver comparable returns to the illiquid approach, with less volatility and reasonable liquidity. We intend to generate a return in line with the high yield market, but with less volatility, centred on five key principles:

- **Risk over uncertainty** – Seeking risks that can be measured and actively managed
- **Volatility aware** – Finding steady sources of income with limited price fluctuations
- **Security focus** – Favouring covenants, structure and security; features that can mitigate risks
- **Selective and liquid** – Filtering for the best credits, investing in securities that can be actively traded
- **Nimble and responsive** – Investing dynamically, moving swiftly between investments as market conditions change

Asset Class	Characteristics
Leveraged loans	Floating rate instruments which are higher up the capital structure, largely secured and mitigate exposure to interest rate risk. Generally offer a stable source of income and better structural protections than bonds, though they may be slightly less liquid.
Investment grade credit	Typically stronger credit profiles with less risky capital structures. Higher quality and can demonstrate defensive characteristics, but a lower source of income. Sensitive to interest rate changes due to typically longer duration.
Asset-backed securities	Very wide market enabling investors to mitigate correlation. Largely backed by underlying assets, which can be very diverse. Good source of income comprised of fixed- and floating-rate assets.
Conventional high yield	Sub-investment grade. Strong credit stories. Good source of income and growth catalysts. Performs particularly well in the recovery and benign stages of the credit cycle, as well as part of the late stages.
Short duration high yield	All-round asset class. Stable, low volatility with income, cash comes back quickly creating a natural churn for the portfolio.
Secured high yield	Higher up the capital structure for more protection. Can provide structural support during the late and recessionary stages of the credit cycle.
Emerging market high yield	Volatile but can provide very strong returns, particularly during the recovery and benign growth stages of the credit cycle.

Our journey

Early headwinds

RLAM's MAC fund officially launched in July 2017, following 18 months of development. The timing of the launch proved challenging given the sustained rally in financial markets at the time, in which nearly all credit asset classes were performing strongly. However, this also meant that it was an ideal testing ground to determine the robustness of our investment process. Drawing on our analytical framework for understanding the credit cycle, we surmised that we were in its late stage. We consequently positioned the fund defensively by focusing on asset classes that provide greater protection, namely leveraged loans and secured high yield.

We had considerable exposure to high-quality B and BB rated credit (figure 2), and we were fairly balanced between Europe and the US. Europe offered a reasonably benign environment with support from the European Central Bank (ECB), even as political uncertainties threatened growth. The US provided positive economic growth and tax reforms, compensating for the risk of Federal Reserve (Fed) interest rate hikes. Despite being a sterling-based fund, we limited exposure to the UK due to the ongoing uncertainties surrounding Brexit and the broader political landscape.

Given our view on the credit cycle, we were keen to minimise volatility and so limited our exposure to cyclical sectors, such as automotives, retail and basic industries, in favour of sectors that would be resilient throughout the credit cycle,

Figure 1: Asset class returns over 19 years (hedged to GBP)

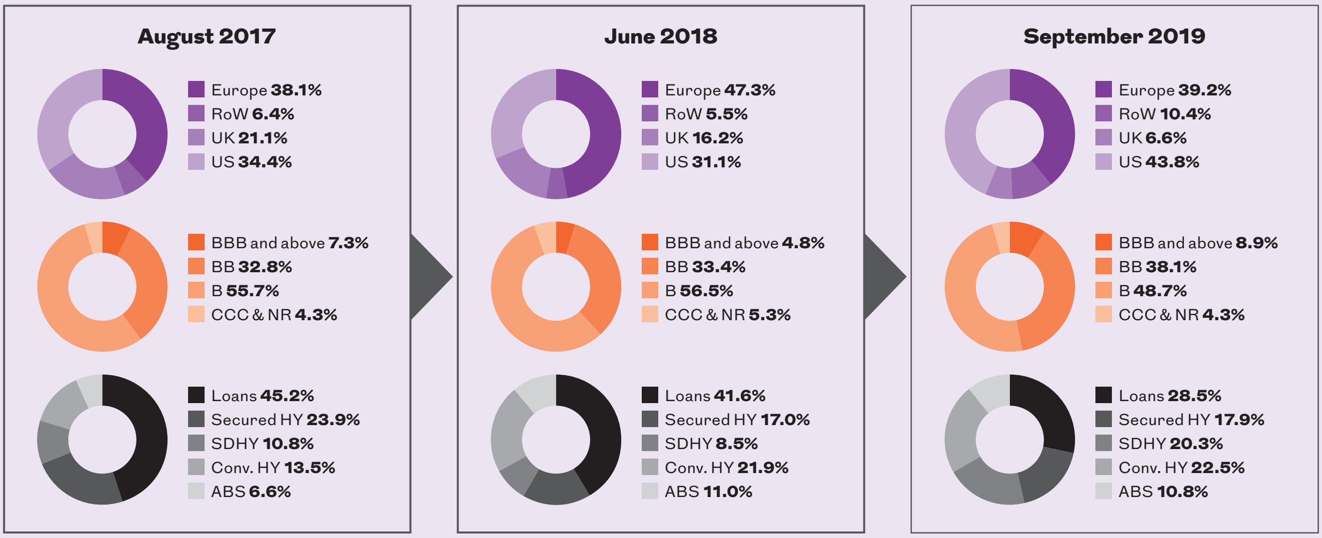
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
1	7.54	5.09	32.18	15.92	11.20	9.44	3.55	-23.19	66.17	18.33	4.44	23.03	9.21	3.52	3.83	17.12	7.63	1.66	12.22
2	6.58	3.37	28.82	14.17	8.17	8.99	3.53	-26.91	47.70	13.99	2.79	16.68	8.17	3.35	2.94	14.71	6.28	1.48	11.76
3	5.52	3.37	25.85	13.54	7.84	8.90	2.92	-27.48	46.71	13.72	2.64	16.17	6.39	3.16	1.08	12.28	5.97	-0.66	11.40
4	3.99	2.20	13.82	9.49	6.37	7.95	2.86	-30.43	45.02	12.80	1.22	10.88	5.95	2.48	0.15	9.31	4.14	-2.06	6.72
5	2.10	-1.34	13.71	8.55	5.64	7.06	2.74	-33.20	42.71	10.53	-0.61	10.01	3.29	2.33	-0.18	7.40	3.35	-3.43	6.25
6	0.53	-1.48	4.53	7.69	5.38	5.75	-26.32	-37.80	6.26	8.81	-0.76	8.17	1.69	-1.29	-2.05	2.71	3.11	-3.90	2.54

- Secured high yield
- Conventional high yield
- Asset-backed securities
- Emerging market corporates
- US leveraged loans
- European leveraged loans

Source: RLAM, Credit Suisse and BofAML, as at 31 December 2019.

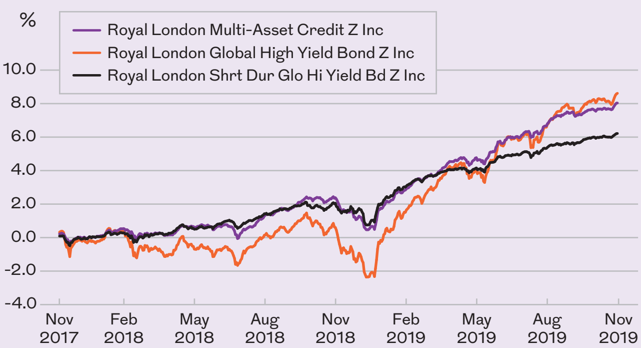
Asset Backed Securities (ABS): Ro12 – The BofA Merrill Lynch AA-BBB US Fixed & Floating Rate Asset Backed Securities Index. Secured High Yield: HW4S – The BofA Merrill Lynch BB-B Global High Yield Secured Bond Index. Global High Yield: HN4C – The BofA Merrill Lynch BB-B Global Non-Financial High Constrained Index. US Leveraged Loan: The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the $US-denominated leveraged loan market. European Leveraged Loan: The Credit Suisse Western European Leveraged Loan Index (Non-USD loans, hedged to EUR) is a sub-index of the credit Suisse Western European Leveraged Loan Index, excluding the $US-denominated Loans. Emerging Market Corporates: EMHB – The BofA Merrill Lynch High Yield Emerging Markets Corporates Plus Index.

Figure 2: Evolution of fund positioning



Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information Purposes only. Source RLAM as at 30 September 2019, subject to rounding.

Figure 3:Cumulative total returns (since inception)

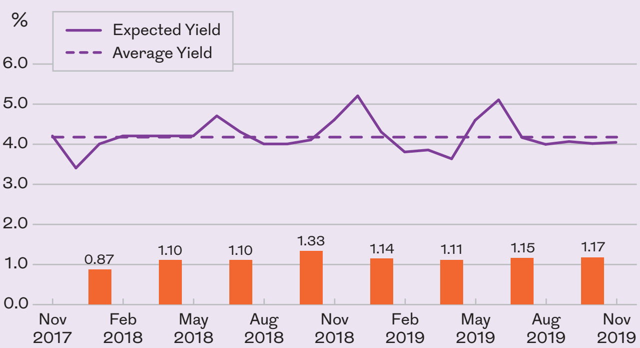


Source: RLAM as at 30 November 2019, gross of fees and gross of tax, for the Z Inc share class. Inception date of the shareclass is 9 October 2017.

* BofAML BB-B Global Non-Financial High Yield Constrained Index.

† BofAML Global Broad Market Corporate Excluding Sub-Financial Index.

Figure 4: MAC expected yield (since inception)



Expected yield is the expected yield on securities taking into account their expected take out.

Source: RLAM as at 30 September 2019.

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.

featuring strong and stable cashflows. We consequently biased the portfolio towards the media, telecommunications and packaging sectors.

Another challenge for the fund at the time of launch was the risk of its cash holdings acting as a drag on performance as we assessed opportunities in a rising market. We nevertheless maintained a prudent approach to investing by not chasing overvalued assets and by focusing on quality. Our aim was to construct a portfolio that would generate a stable income with low volatility under various market conditions over the medium to long term. Getting the right assets, not the speed of portfolio construction, was therefore key.

Volatility resurgence

Two factors are essential for understanding the credit cycle: interest rates and default rates, as shown in figure 5. Our analysis of these guides our asset allocation framework, since different assets perform differently through the credit cycle. Using this framework, alongside our investment philosophy, we determined that at the end of 2017 we were in the late stage of the credit cycle. We combined this strategic view with fundamental credit analysis to ensure that we selected the strongest and most versatile investments for the portfolio in light of our outlook for both default and interest rates.

2018 was a very challenging year, with the drivers of volatility at the start of the year completely different from those at the end of it. In the first half of the year the primary concerns were rate hikes from the Fed and slower global growth. Investment grade bonds, particularly those that were longer dated, sold off strongly in this environment. Our positioning in leveraged loans added significant value since it mitigated exposure to interest rates and gave the fund income at relatively low volatility.

The year also featured a significant sell-off in emerging markets as global growth concerns caused investors to seek less risky assets. This was exacerbated in emerging markets by rising oil prices and as improving US data strengthened the dollar. By the end of the year concerns around economic growth, trade and politics had resulted in a more subdued interest rate outlook, with central banks changing direction towards further monetary policy easing.

Figure 5: Our framework for understanding the credit cycle

Source: RLAM

Adapting to new challenges

Heading into 2019, we witnessed the increased politicisation of economics, as President Donald Trump became highly vocal about tariff policies and Fed rate decisions. This reinforced the case for defensive positioning, so we remained shorter duration and focused on quality. We sought greater protection by moving higher up capital structures and continued to emphasise the importance of liquidity.

Additionally, the uncertainty around Brexit had escalated, with widespread fears about the impact on supply chains and businesses dependent on trade with Europe. We consequently materially reduced our exposure to the UK over the year, while focusing on regions with stronger economies and greater liquidity, such as the US.

Our strategic view going into 2019 placed less concern on rising interest rates, and more on debt structures and protections. Therefore, we gradually reduced our leveraged loans allocation from just under 40% at the end of 2018 near 25% by the third quarter 2019. While the asset class had been very helpful defensively, we concluded that the combination of lower interest rate risk and weaker loan documentation in new issuance meant that there was more value to be found in secured high yield, short duration high yield and investment grade credit.

We improved the average credit quality within the portfolio and used the heightened market volatility to find high-quality opportunities in investment grade and BB rated credits. We increased our exposure to the US, thinking that it would be a more robust market in a down cycle, with much greater depth and liquidity in case we changed our views on particular asset classes and holdings.

Proven success

The past 30 months have provided an ideal showcase for what we want to achieve with our strategy. We have overcome geopolitical risks, liquidity shocks, changing monetary policies, idiosyncratic and gap risk in high yield, deteriorating economic data and Brexit. Yet despite all of the challenges, the fund has delivered a total return that is close to the high yield market, but with considerably less volatility (figure 3).

One of the top priorities for our investors is securing an attractive level of income. As figure 4 demonstrates, the fund has generated remarkably stable and consistent expected and average yields since inception, and has provided a consistent income distribution. Careful stock selection, combined with finding attractive yields through the volatility, can deliver a stable income in all kinds of environments and provide cushioning during bouts of turbulence.

MAC FAQ

What is your outlook for interest and default rates?

Central bank policy stances reversed in 2019 as they moved from tightening to easing, resulting in marked compression of absolute government yields. Interest rates appear to have stabilised now; we do not expect significant further easing. At the same time default rates have started trending gradually higher, and we expect this to continue.

How do you expect recovery rates to fare?

In contrast to previous recessions, we expect recovery rates to be materially lower as default rates trend upwards, even for senior secured debt and leveraged loans. This largely reflects weaker bond and loan documentation, allowing for leakage and subordination with limited covenant protections. Additionally, certain companies and sectors have become over-levered, which dilutes the underlying collateral value for debt investors.

How have you positioned the fund for this environment?

We remain defensively positioned, taking into account sizing and increasing our exposure to higher-quality and defensive sectors and credits. Given our expectations around recovery rates in the event of a turn in the credit cycle, we have a strong emphasis on picking stocks that will provide stable income with limited volatility, as well as appropriately diversifying across asset classes.

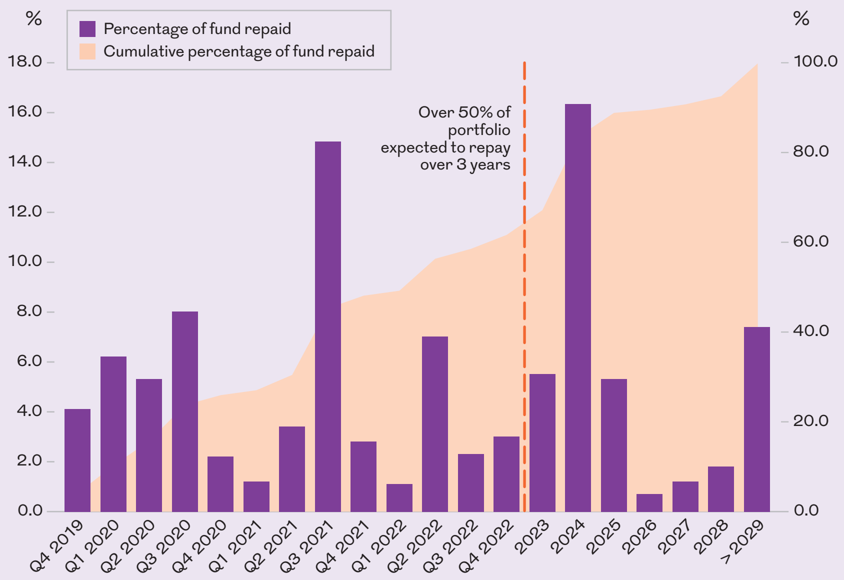
Given the relatively benign interest rate outlook, is defensiveness necessary?

We believe that there are more challenging times ahead of us, involving increased volatility. With interest rates much lower than they were a year ago, the risks are much greater. Conservative positioning has served the fund well so far, with low drawdowns adding to performance, and we think it is prudent to maintain this positioning given the threats on the horizon.

How important is liquidity in your investment process?

Liquidity should be a core concern for multi-asset credit investors, because it determines the extent to which they can respond to changes in market conditions.

Figure 6: Expected maturity profile



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Source RLAM as at 30 September 2019.

There is, of course, a trade-off with liquidity, and assessing the amount by which you ought to be compensated for a given loss in liquidity is part of the skill of investing. Our strategy incorporates liquidity assessment as part of the investment process, analysing several factors that impact an underlying security's liquidity and then sizing the investment accordingly. Moreover, as a shorter-duration strategy, figure 6 exhibits the way in which we have constructed our portfolio to naturally 'churn', enabling us to reinvest as opportunities arise.

The fund has a lot of exposure to B and BB rated debt, isn't that risky?

As valuable as credit rating agencies are in certain respects, they create a lot of inefficiencies for investors. For example, they always treat duration in the same way, and they do not rank security appropriately; both of which considerably impact short- and long-term volatility. By factoring such additional elements into our credit research, we have found numerous credits with volatility characteristics far superior to those implied by their ratings.

Where do the opportunities in multi-asset credit lie?

Markets have become bifurcated between cyclical and defensive credits. Spreads on BB rated credits are near their tightest levels following the financial crisis, even as CCC spreads are near their widest. This divergence opens up fantastic opportunities for us as active credit pickers because it rewards those with credit processes for differentiating between good and bad credits.

Contact us

For more information about our range of products and services, please contact us.

Royal London Asset Management

55 Gracechurch Street, London EC3V 0RL

020 7506 6500
institutional@rlam.co.uk
www.rlam.co.uk

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For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on www.rlam.co.uk

The views expressed are the author's own and do not constitute investment advice.

All information is correct at December 2019 unless otherwise stated.

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