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Multi asset credit: investing through Covid and the credit cycle

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This is a follow-up to the report that we published in early 2020, looking at how the **Royal London Multi Asset Credit Fund (MAC)** is designed to perform through different phases of the credit cycle. In this update, we consider the fund's performance through the unprecedented turbulence of 2020, in which we experienced all the phases of the credit cycle in a matter of weeks as the Covid-19 pandemic hit developed economies, markets across all asset classes, and governments and central banks stepped in to provide some certainty and avert disaster. We finish by considering some of the challenges that may lie ahead and why we believe the fund should perform well through future uncertainty.

While we would not hope for, nor expect, a repeat of the unfortunate tail risk event of 2020 for some years, it provides a useful demonstration of both MAC's flexibility and resilience in a range of market conditions, as well as how our investment philosophy and process guided our thinking.

Introduction

Since MAC's inception in late 2017, global financial markets have experienced several bouts of volatility, ranging from concerns about tepid global growth, through rising defaults to inflationary pressures. This culminated with an extraordinary 12 months, which comprised of a combination of human and economic circumstances not previously seen in modern economies. Society had to rapidly adapt to a deeply uncertain environment that initially seemed to pose an existential threat to our way of life and economic wellbeing. In the end, herculean efforts by governments, policymakers and private citizens demonstrated the adaptability of the human race as well as the global economy.

While less vital, the challenges faced by markets and their investors have also been considerable. Entering 2020, high yield and investment grade credit spreads were in the low 300 basis points (bps) area and hovering around 100bps, respectively. By year end, spreads were not significantly wider than those levels. However, this masked a period of extreme volatility and market uncertainty. Selecting assets to generate a consistent return proved challenging. A multi asset credit strategy

Figure 1: The Multi asset credit universe

Characteristics	Traditional	Alternative	Illiquid
Return	✓	✓✓	✓✓
Volatility	✓	✓✓	✓✓✓
Liquidity	✓✓	✓	✗✗
Credit markets	Global Sovereign Investment Grade	Secured High Yield US HY European HY EM Corporates US Leveraged Loans European Leveraged Loans Securitised Credit	Distressed debt Direct lending Real asset debt Speciality finance

Source: RLAM. For illustrative purposes only.

focused on the alternative part of the investment universe (figure 1) proved very beneficial in a challenging year.

What is MAC?

The MAC investment process is predicated on RLAM's investment philosophy – credit markets are inefficient and credit sub-sectors have their own cycles – and combines top-down and bottom-up approaches to construct a portfolio of best ideas.

Strategic positioning is based on our view of where we are in the credit cycle, which is a function of interest rates and defaults. Taking this into consideration with how different assets behave through the cycle, we arrive at an optimal portfolio across asset classes, ratings, sectors and geographies. By targeting a portfolio duration of under five years and assessing asset liquidity, the strategy can reinvest in the most attractive opportunities, as market conditions change.

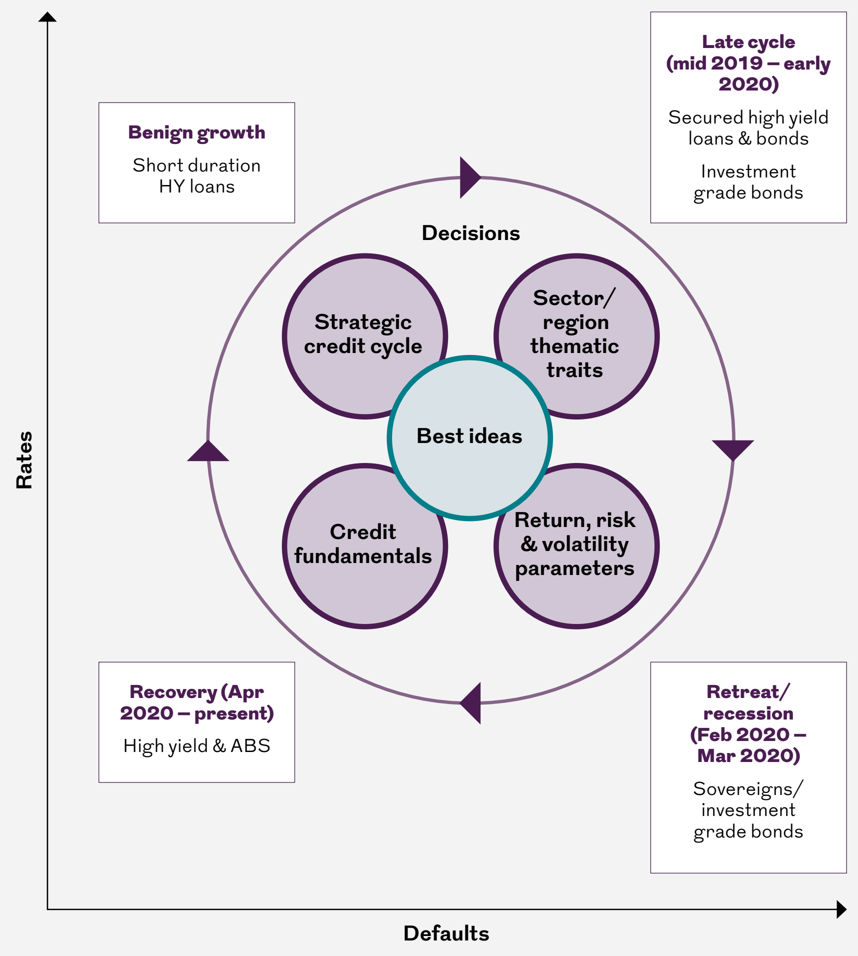
The credit cycle framework (figure 2) aides in the process of asset allocation. An understanding of how assets are correlated in various stages helps the team navigate through various market conditions while improving returns and dampening downside risk.

Our MAC strategy focuses on producing an enhanced through-the-cycle return with stable income, and provided an attractive place to be positioned during the pandemic sell-off. We believe that the consistency of the income since inception (figure 3) demonstrates the benefit of this strategy: it has provided a consistent source of income for investors through challenging market conditions including the taper tantrum in 2013, the global growth concerns of 2018, and through to the pandemic in 2020.

2020: a high-intensity credit cycle

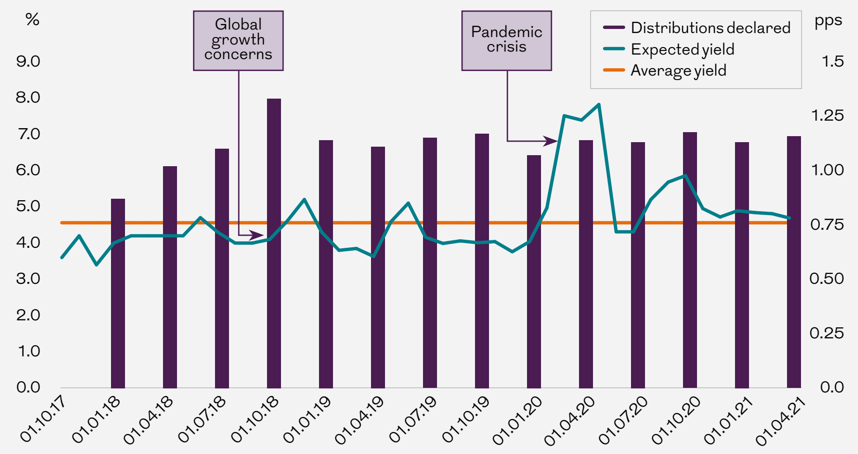
Last year presented a set of societal and financial challenges that were unprecedented in scale and impact in the period since 1945. While these are unlikely to be repeated in the near future, 2020 provides a uniquely

Figure 2: Credit cycle framework



Source: RLAM. For illustrative purposes only.

Figure 3: Income and yield



Source: RLAM as at April 2021.

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.

insightful period of concentrated challenges against which to assess the effectiveness of MAC's investment philosophy and process.

Previously, our experience has been that markets evolve through the credit cycle over time — in some instances, several months or even years, as was the case more recently. Last year was very different. From the point when the sell-off took full effect to the astonishing recovery following global fiscal and monetary intervention, we effectively completed an entire credit cycle in a matter of weeks.

Informed by the credit cycle framework, the investment philosophy and process gave us a dynamic way to understand the environment of last year's testing times and implement portfolio changes that mitigated downside risks and ensured that we were positioned correctly as the intervention by governments and central banks created the conditions vital to a recovery.

Pre-pandemic positioning

The sharp global sell-off between late February 2020 to late March negatively impacted risk assets across the board and proved challenging to avoid for most long-only strategies. However, going into this period, positioning was particularly key to mitigate the downside and limit losses. This positioning would also prove helpful when the market rallied following the monetary and fiscal intervention by policymakers in late March.

As 2020 dawned, our view was that we were in the late stage of the credit cycle and had been so for quite some time. As a result, we were more defensively positioned, investing in assets that offered better protection such as secured high yield bonds, secured leveraged loans and short duration high yield. We were also positioned in more defensive sectors such as TMT (technology, media and telecoms), non-discretionary consumer, services and healthcare.

Bottom-up credit selection focused on businesses with sustainable cashflow profiles, access to liquidity and high valuations; while individual security documentation was heavily scrutinised to confirm structural protections including seniority (both structural and temporal), debt incurrence limitations and limitations of collateral dilution.

Figure 4: Changes to MAC through the pandemic

Phases of the crisis		Portfolio actions	Rationale
Phase I (late Feb – early Mar)	↑	IG Corporates	Limited losses
Phase II (early Mar)	↑	US Gov't bonds	Limited losses
Phase III (early-late Mar)	↓	HY Corporates	Limited losses
Phase IV (mid Mar – Apr)	↓	Gov't & IG bonds	Better returns
Phase V (late Mar – present)	↑	HY & ABS	Better returns

Source: RLAM. For illustrative purposes only.

During the sell-off

As investors started to appreciate the potential scale and impact of the pandemic, we experienced unprecedented moves in financial markets. In under six weeks, the market effectively completed a full rotation through the credit cycle from late-stage risk to all-out recession, before rallying back following fiscal and monetary intervention. Initially, spreads increased approximately three-fold across high yield and investment grade credit. At this time, the market was pricing in default expectations of more than 50% on a cumulative five-year basis. The credit cycle framework enabled us to adapt quickly, always guided by our investment philosophy and process.

With our late stage view of the credit cycle going into the sell-off, we were adding investment grade risk and reducing high yield bonds (Phase I to III) and, as market conditions continued to deteriorate, we further bolstered our position through adding government bonds to mitigate the impact of the retreat stage of the credit cycle. By the second half of March, our investment grade and government bond holdings helped to absorb some of the volatility and we were able to start reducing those asset classes as imminent policy action looked to provide much needed support to the market. As we entered the recovery phase of the cycle by the end of March, we started reallocating into undervalued attractive opportunities in high yield corporates. With our view that the market was overstating default risk, we continued to increase positioning in quality high yield and from late spring/early summer started to increase our exposure to mezzanine tranches in Collateralised Loan Obligations (CLOs), which more directly reflected our favourable outlook for credit and lower defaults. Despite an eventful 2020, MAC ended the year returning nearly 4.8%.

Market rebound

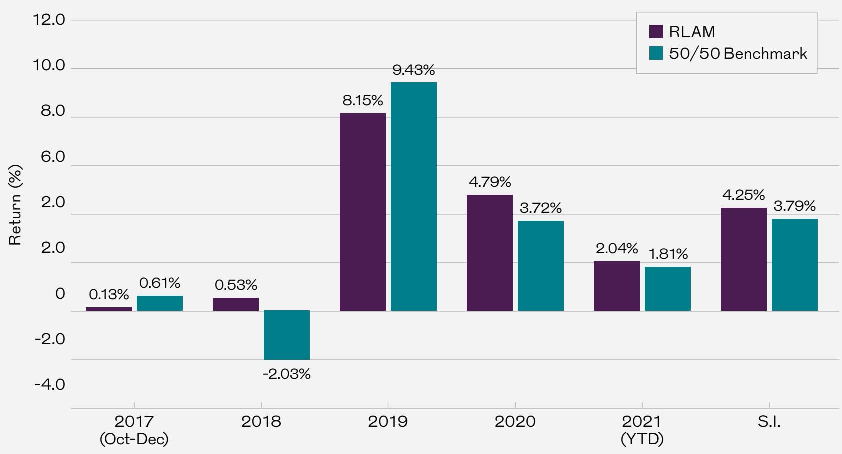
With our favourable outlook on defaults and of the view that the market would continue its recovery, in late Q1 2020 and through the remainder of the year, we increased exposure to high yield and ABS. This was largely achieved by adding exposure in dislocated ABS credits, which had strong underlying collateral and benefitted from an improving default outlook. In particular, we began increasing exposure to high-quality BB tranches of CLOs to reflect our view on improving fundamentals, lower default expectations and a market recovery.

In high yield, we shifted away from short-dated defensive bonds to longer-dated bonds and, in particular, identified opportunities in sectors that had been disproportionately affected by the pandemic in the near term, but were overall solid businesses within their sectors. This included issuers with first order exposure to the pandemic, such as leisure and consumer companies. Moreover, businesses that had been impacted by supply-chain disruptions (second order effects) also reflected an attractive opportunity; and our research team was able to identify several opportunities where the corporate liquidity, fundamentals and valuations were robust over the long term despite the short-term hitches – this included adding risk in credits in the healthcare, industrial, cyclical and infrastructure sectors.

While leveraged loans in Europe continued to underperform for the majority of 2020, we also gradually sought to increase exposure in the asset class to take advantage of the relative value and mispricing between bonds and loans. We also added loans to increase the exposure to floating rate securities (loans and CLOs) as a means of mitigating potential interest rate concerns.

In summary, MAC's credit cycle approach to investment proved critical in limiting losses, while providing dynamism and enabling it to reallocate strategically to new opportunities as they were identified. This enabled MAC to perform relatively well during the depths of the crisis and to outperform the broader high yield and loan markets over the course of 2020 (see figure 5).

Figure 5: MAC performance



Source: RLAM, as at 31 March 2021. Official benchmark for MAC is SONIA, which has returned 0.57% p.a. for the period since inception. Index is 50% Credit Suisse Leveraged Loans Index, 50% ICE BoAML BB-B Global Non-Financial High Yield Constrained Index, GBP Hedged.

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.

Outlook

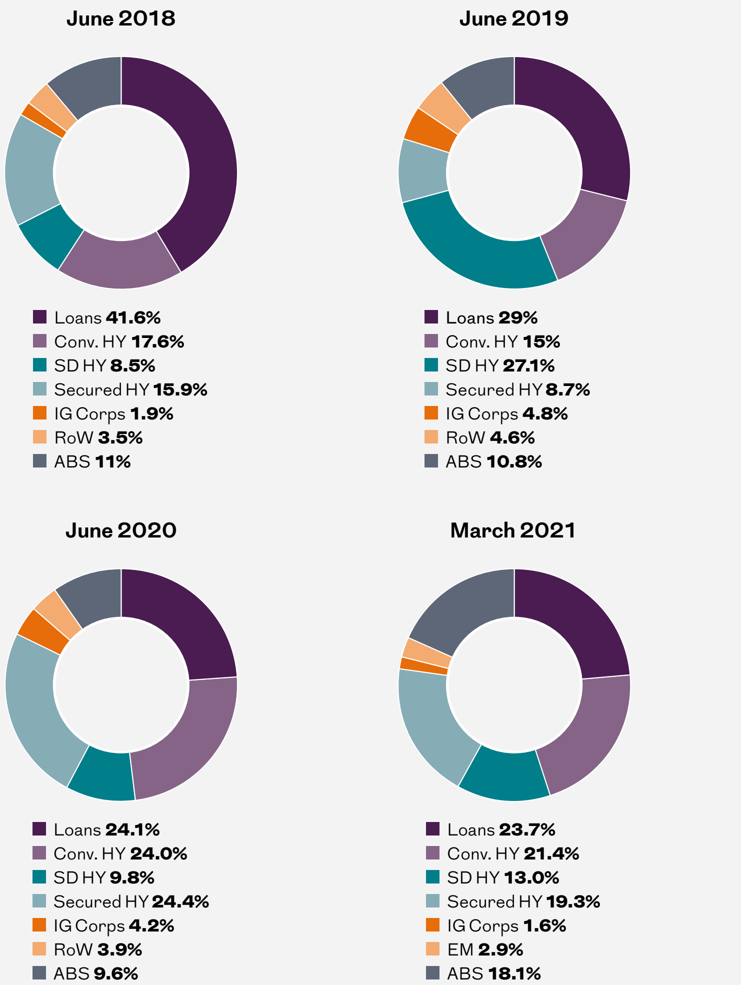
While pandemic-related factors remained the key driver of credit markets through the remainder of 2020 with a two-way pull between vaccine success and new Covid-19 strains and lockdowns, investors started to consider other issues too. With corporate financial performance in the third quarter and beyond showing that many companies were adapting to the changing environment and better-than-expected financial results, focus shifted towards recovery, fiscal spending and inflation risks. Regionally, Brexit concerns dissipated, while tensions rose over vaccine nationalism.

As we look at the next stage of the credit cycle and the outlook for global growth, the impact of fiscal spending and concerns regarding inflation remain in the headlines. Our view is that with consumer debt high and growing, the corporate environment still recovering from the pandemic and personal income and wage inflation limited, the threat from underlying inflation should remain low. That said, expectations of inflation do concern us – even if they ultimately prove to be wrong. As a result, uncertainty is likely to persist in the near term with ongoing interest rate volatility. We saw this during the first quarter of 2021 as longer duration bonds and investment grade bonds in particular underperformed. With interest rates still hovering near the lows and investment grade credit spreads below 100bps, it is becoming increasingly challenging to find opportunities that provide the right balance between capital appreciation and income.

We believe that monetary and fiscal policy will continue to serve as a means to balance market volatility. The unprecedented actions taken by central banks and governments to counter market threats demonstrate the willingness to act quickly and decisively. In turn, this has supported risk assets and kept the cost of funding low. As a result, corporate liquidity has been bolstered and companies have been able to buy time to adapt to the new market environment, leading to lower than anticipated default rates.

With this comes uncertainty and MAC's ability to adapt through the credit cycle positions it well to continue providing investors with a consistent source of income with enhanced through-the-cycle returns. In an environment where rates have been low but concerns regarding policy reversal, rising fiscal spending and taxes have been high, MAC's emphasis on structural protection in the assets it invest in, assets which provide protection from interest rate volatility and asset class and geographic diversity to limit exposure to any one particular area, helps to mitigate such concerns. More specifically, MAC's recent increase in exposure to secured floating rate assets provides this right balance between income and protection. Furthermore, with default rates manageable, selecting the right high yield assets – with strong balance sheets, structural and cyclical tailwinds and adaptive business models – will further bolster returns and provide protection from fiscal and monetary uncertainty.

Figure 6: Summary of MAC's positioning into and through the pandemic



Source: RLAM as at 31 March 2021. Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information purposes only.

In summary, MAC continues to offer investors an attractive means to invest across asset classes, sectors and geographies, while balancing liquidity with risk and return.

Fund risks

Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Leverage risk: The fund employs leverage with the aim of increasing the fund's returns or yield, however it also increases costs and its risk to capital. In adverse market conditions the fund's losses can be magnified significantly.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

Emerging markets risk: Investing in emerging markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Exchange rate risk: Changes in currency exchange rates may affect the value of your investment.

EPM techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the fund to increased price volatility.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Concentration risk: The price of funds that invest in a reduced number of holdings, sectors, or geographical areas may be more heavily affected by events that influence the stock market and therefore more volatile.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

Contact us

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