Liquid alternatives

Multi-strategy credit portfolios are becoming a popular, and more liquid, alternative for investors unwilling to lock up capital for years at a time. Alcentra's Global CIO **Paul Hatfield** spoke to *PDI* about these products

Q If you were explaining multi-strategy to a potential investor, how would you describe it?

Paul Hatfield: Broadly speaking, multi-strategy offers a solution to provide absolute returns by actively investing in a number of different asset classes. For us, we specialise in corporate, sub-investment grade credit, bank loans and high yield bonds to companies in Europe and the US. We don't do emerging markets or real estate; we don't do investment grade or Asian high-yield either. Within those confines we have expertise in par credit, special situations and structured credit – which for us means CLOs. And we do direct lending, so small SME lending as well.

We've got various types of multi-strategy portfolios because different investors want different solutions, be it liquidity, or risk/return targets. Some only want to do loans but want us to actively allocate between Europe and the US. Some want us to actively manage duration between fixed-rate bonds and floating rate loans as the rate-cycle changes. Everybody wants yield, so where investors can tolerate more illiquidity, we'll suggest some distressed, structured credit and direct lending to boost returns, but these strategies are still based around corporate credit.

The thing with direct lending is you can't really trade it. They are typically bilateral loans, and they are illiquid. You do a lot more work around them before going in to a new investment because you can't sell out if something goes wrong.

Paul Hatfield

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For that reason, it doesn't work so well in a multi-strategy portfolio. So, where we have this in a multi-strategy, it tends to be with two other strategies that are liquid and we leave it fixed in terms of allocation. Our flagship multi-strategy includes everything except direct lending. That includes at least 75 percent loans and bonds in the US and Europe and up to 25 percent distressed and structured credit. We manage those allocations as we see macro factors change and on the basis of technicals in the market, credit fundamentals and valuations.

Q You talk about different clients asking for different things. How do you deal with all their investment goals?

PH: As an example, the strategy has a number of pension fund investors. They mostly want yield and a degree of alpha. We manage their investments on an absolute return basis. We aim for LIBOR plus 450, subject to various factors, but have actually been doing consistently better than that. Particularly for investors like UK pension funds, it can take six months to get approval to go into something like stressed or structured credit. When they want to change that investment, it might take them another six months to get out, and six months to get into a new strategy. By that time, the view they had about why they wanted to change strategies is likely to be out-of-date. They understand Alcentra can identify and execute against opportunities and risks faster and better than they can. So they're happy to mandate us and say: "You do the asset allocations and report back to us". They want yield, but they also want to sleep at night. They want a taste of alternatives to increase their upside return potential.

Q In a competitive market, has pricing pressure led to greater risks being taken? If so, can multi-strategy portfolios combat that?

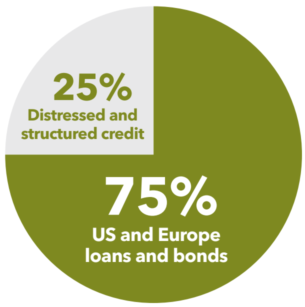
PH: Within multi-strategy portfolios, because we have different types of investments in the various sleeves, there's something of a hedge. For instance, if markets turn sour, the distressed holdings will typically do well. In rising rate environments, while fixed income might trade off, the floating rate loans will benefit.

If you're going into the direct lending area you are buying into senior floating rate loans that are illiquid. For that illiquidity, you're getting a premium. Instead of 3-4 percent as you would get in the broadly syndicated bank loan market, you're getting margins of around 7 percent. We haven't seen huge pressure on deals yet, but there will probably be pressure later on. We think that there is sufficient dealflow, particularly for larger players in the market like Alcentra. The smaller end of the market seems to be where there are lower barriers to entry and significantly more competition and pressure.

Q What accounts for the out-performance? Is it cyclical?

PH: We've been able to add alpha a number of ways: security selection within strategies, tactical shifts among strategies and geographic portfolio shifts. Also, by moving from the US to Europe as a bias, moving from loans to bonds and back again. Then there's that alternatives portfolio – in a typical portfolio it can be as high as 20 percent in stressed and as low as 5 per cent in structured credit.

ALCENTRA'S TYPICAL MULTI-STRATEGY PORTFOLIO ALLOCATION



Source: Alcentra

So it's about making tactical allocations and we believe we've added value in that area. It's not cyclical. We have the potential to outperform across the cycle: up more when things are good and down less when they are not.

Q How do you manage the allocation of the illiquid part of the portfolios?

PH: We use the illiquid alternatives allocation when we think it can add real value.

We manage the portfolios to avoid the risk of liquidity traps in the event that we get redemptions. The strategy typically offers quarterly redemption subject to a notice period, which matches the liquidity of the portfolios we use to gain exposure to the illiquid strategies, so we don't run the risk of having to satisfy redemptions by selling liquid assets, leaving the allocation to illiquid assets to grow as a percentage of the portfolio.

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Q How does capacity for multi-strategy portfolios compare with capacity for single strategy portfolios such as direct lending?

PH: We're managing about €6 billion in direct lending in Europe with plenty more capacity in that area. But in general, multi-strategy portfolios do have greater capacity than single strategy portfolios, and, to the extent they involve liquid assets, they can be quite large. There will come a point when we think multi-strategy is at capacity, but I think we could get to several billion and not suffer any capacity constraints.

Q What are the constraints on investors in your multi-strategy portfolios?

PH: It's typically a quarterly redemption cycle, which, as far as I know, is similar to the offerings of other managers. Because you've got the alternatives you need that sort of timeframe. You've got US high-yield in there, so if you need to do any quick cash-raising, that's the place to do it because it's easy and cheap to execute.

Q Have you seen demand for multi-strategy products change, and do you see it becoming more popular or less popular?

PH: Multi-strategy is experiencing a big increase in popularity for a number of reasons: first, investors are increasingly looking for investment solutions and outcomes, versus benchmark-driven products; second, multi-strategy allows them to get access to more asset classes with fewer managers, which offers numerous efficiencies and benefits; and third, in a world where investors are increasingly thoughtful about where and why they pay for active management, multi-strategy is a compelling case for the value-added associated with active management. Passive investing products have seen significant growth to access beta; this is the other side of the equation, growth to access alpha. ■