Achieving yield with a multi-strategy approach

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Alcentra's Global Chief Investment Officer, and Ross Curran, European High Yield Portfolio Manager, explain how investors can benefit from a multi-strategy approach to sub-investment grade credit exposures.

Against a backdrop of low, stable growth and extraordinarily low yields, investors are increasingly looking along the credit quality spectrum in search of better risk-adjusted returns. In this piece, we highlight the current macro environment and why sub-investment grade credit should be attractive to investors. Finally, we introduce the multi-asset credit approach to efficiently managing exposures to sub-investment grade markets.

Stable Macro Backdrop

While the past two years were important in terms of central bank policy and the yield curve impact, we think investors should focus on the broader picture. Following ten years of extraordinary monetary policy, central bank balance sheets have become bloated. This has had a profound impact on financial markets, to the extent that over 25% of Global Fixed Income assets now trade at negative yields1. In a persistent low interest rate environment, questions are now being asked of the predictability of returns for traditional fixed income asset classes.

Accommodative central bank policy has certainly helped boost global economies, however, this impact is starting to fade. Economists and markets now expect GDP and inflation growth to slow, then stabilise at these levels in the coming years. We believe this environment is attractive for sub-investment grade markets, as it allows levered companies to service their debts and sustain their capital structures. It is in periods of higher growth, those more suited to equity markets, which can lead to behavior that is detrimental to creditors, e.g. larger dividends.

The appeal of sub-investment grade

While we are attentive to the impact of lower expected growth, we do not see an imminent end to the credit cycle. Corporate fundamentals in the US and Europe are firm. Earnings are positive, leverage is stable, and global central banks have renewed their accommodative rhetoric. We expect default rates, which are still near historic lows, to pick up. However, we do not see a trigger for a spike anytime soon that would warrant repricing spreads at materially higher levels.

With this backdrop in mind, we believe investors will continue to allocate to sub-investment grade markets, given the underlying fundamentals and attractive yield-advantage. Also, these markets have exhibited low relative volatility over time, resulting in strong risk-adjusted returns. In fact, certain sub-investment grade markets' long-term volatility is more aligned with traditionally stable fixed income asset classes, while offering higher yields and minimal duration.

While this risk/return relationship is a backward looking measure, we believe it holds going forward. The benign macro and default rate outlook should help dampen volatility, while yields on core sub-investment grade credit are attractive in this low interest rate environment, e.g. the average US Senior Secured Loan offers a yield of 7%[2].

1 JP Morgan Insights "Why are bond yields going negative again?" as of 5 April 2019

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Multi-Asset Credit Solution

Sub-investment grade credit consists of a number of different, but increasingly interconnected markets, including US and European senior secured loans and high yield bonds, as well as alternatives such as structured credit (CLOs) and stressed and distressed credit. Relative value moves quickly favouring these markets at different times. We believe that experienced managers actively dealing in these markets on a daily basis are best placed to allocate efficiently across markets, regions and sectors as risks and opportunities shift, especially using an integrated, holistic portfolio construction process.

Traditionally, institutional investors approached liquid assets as individual allocations within their portfolios. Within this strategy, many asset allocators made decisions based on top-down views. Capital was then passed to specialist managers to manage on a siloed basis. However, markets have evolved, previously standalone pools of assets are becoming increasingly interconnected. Consequently, some companies now issue debt in more than one of these markets, and in some cases all four, e.g. Virgin Media, Ineos.

While this approach may be well established, it does have drawbacks. The traditional approach gives limited consideration of relative value between markets. As a result, an investor can end up with over-diversified portfolios, as well as outsized holdings in single issuers and sectors. For example, it is conceivable that an investor could build an unintended exposure to a single issuer in all four asset classes with little consideration for relative value between them.

A multi-asset credit approach allows a single portfolio manager to focus on dynamically allocating across markets, while optimising the portfolio by choosing the best risk-adjusted return opportunities regardless of markets and within an integrated risk management construct.

The effectiveness of this approach is particularly evident during periods of heightened volatility. In December, for example, US senior secured loans and high yield bonds underperformed relative to European markets on concerns of a monetary policy misstep, including cross-currency issues of the same capital structure. As the Federal Reserve's rhetoric changed, markets recovered quickly in January.

The multi-asset credit approach enables a response to this dislocation by shifting some of the allocation from European into US assets during the period between the sell-off and recovery. It is at times like these that the benefits of having a manager who can understand where to invest – and react rapidly to take advantage of opportunities – is particularly evident.

A multi-asset credit approach also provides the potential to enhance returns opportunistically. For example, current tranches of CLOs which consist of a diversified pool of corporate credits can trade at yields 300-400bps wider than a similarly-rated single issuer in exchange for less trading liquidity[3]. To achieve similar yields in more liquid asset classes, investors are forced to take on lower-rated risk, such as CCC-rated debt, with potential for materially higher default loss and volatility. A tactical allocation to alternative markets can deliver disproportionately high returns relative to the risks taken at certain points in the credit cycle.

The multi-asset credit approach offers investors access to sub-investment grade credit strategies on an integrated basis with the additional benefits of dynamic asset allocation, integrated risk management, and consolidated reporting. These nimble, outcome-focused solutions can deliver holistic exposure to liquid and alternative assets.

2 Credit Suisse Leveraged Loan Index Yield (3 year life) as of 29 March 2019
3 JPM New Issue CLO Spreads as of 29 March 2019

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