The Frontier Line

Thought leadership and insights from Frontier Advisors

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When Out of Stock is a Good Thing

Multi-Asset Credit

25 years

Frontier Advisors

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A better way to shop?

Multi-asset credit ("MAC") as we know it today is a concept which grew following the Global Financial Crisis from a need to diversify risk and flexibly allocate capital, while maintaining an attractive level of absolute returns.

In challenging the status quo (and in other ways), MAC investment is somewhat analogous to supermarket shopping. We look back nostalgically to a time when we all went to specialist retailers for our culinary desires; the local butcher, the grocer, the baker etc. and many of us lament our choice to now support large conglomerates.

Be this as it may, supermarket shopping is more convenient, cheaper and, if you select the right stores, can offer the same high quality of boutique suppliers. Perhaps without the emotional connotation there are clear parallels to this in the asset management world.

Good MAC managers can offer investors a range of benefits from a lower governance burden to a diversified source of income to attractive fees.

We have seen a great deal of innovation in this space in recent years and indeed a proliferation of solutions from a range of investment houses. Not all brands are created equal however; your meals will only ever be as good as the quality of your ingredients and your portfolio will only ever be as good as the quality of your managers. It's essential to shop around to find the best recipe for success.

In this paper we investigate and present the results of our detailed market study and provide some clues as to what separates the wheat from the chaff. While only providing a snapshot of our findings, we welcome the opportunity to discuss the wider results in more detail.

MAC is a broad term describing an alternative debt investment strategy allocating to a diversified set of credit-related asset classes, typically targeting LIBOR+4-6% pa.

The focus is on harvesting credit beta with low interest rate sensitivity within a global opportunity set (sub-investment grade focus) including; high yield bonds, leveraged loans, emerging market debt, structured debt (to name a few) and sometimes includes derivatives and allocations to private credit.

Time to "checkout" the market

Our internal research team and Global Investment Research Alliance ("GIRA") partners have conducted a vast number of meetings with MAC managers over the years. While these have influenced our philosophical thinking about the market, we felt a data-driven study would have the merit of testing any preconceptions.

We sought first to filter the market to identify a sample set of managers for an in-depth study and ultimately selected a basket of 16 strategies representing around $42b of assets under management.

These strategies have a range of profiles; we deliberately selected managers with different styles (for example top-down asset allocation vs focus on relative value trading) and outcomes to determine whether there were any discernible trends emerging. This preceded a significant data-collection survey, the results of which have been analysed using a range of statistical techniques. While we acknowledge that there are potential shortfalls in our approach (e.g. assumptions required, missing data points, short time-periods etc.), it has been consistently applied and provides an interesting indication of some central themes within this ever -growing investment universe.

For the avoidance of doubt, all data presented is based on the US Dollar.

Filling the trolley – method to the madness

You may be a nonchalant shopper, wandering aimlessly down aisles until something catches your eye, or stick to a meticulously calculated list; we all have our own unique processes for filling baskets with goods. Similarly, the processes employed by MAC managers vary considerably and this makes direct comparisons challenging.

With regards to asset classes used, and the operation of risk limits or trading ranges, we tend to prefer managers operating with more flexibility and fewer asset class constraints. Data somewhat supported this view, but the relatively short track records and benign market environment of recent years inhibited our ability to fully test this thesis. In any case, the long-term portfolio benefits of diversification are well documented, and a flexible mandate is best equipped to adapt to changing market signals.

Chart 1 (on the following page) demonstrates that while the average manager allocates a significant proportion of AUM to high yield bonds and loans, there are large ranges operating over time depending on the approach taken.

It is possible to extrapolate casual links between the data sets, but we have not discovered any meaningful trends supporting one style (e.g. top-down selection) being better than another (e.g. bottom-up selection)[1]. Ultimately, we did however find some portfolio management behaviours corresponding to better outcomes:

- We found a meaningful relationship between high portfolio turnover and poorer performance outcomes (the relationship becoming stronger when extreme outliers were removed).

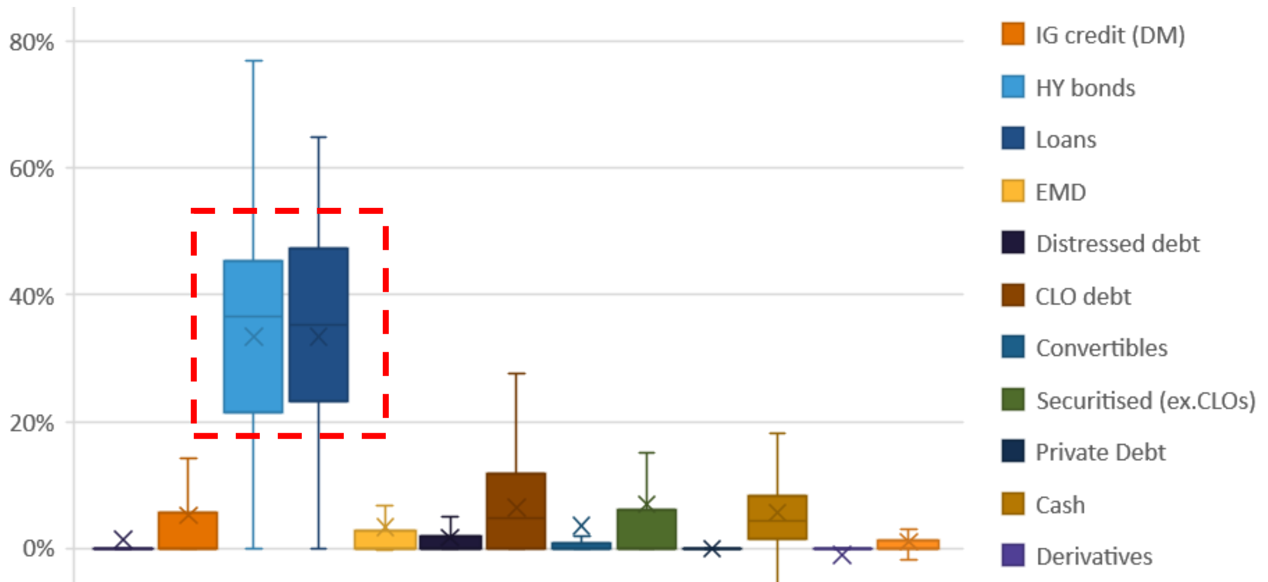
The risk limits and restrictions utilised by MAC managers vary considerably, with many opting for a highly unconstrained approach. Examples of restrictions include; minimum exposure to USD assets, maximum exposure to particular asset classes (e.g. loans, EMD etc.), duration limits, minimum average credit rating.

- We also found evidence that high turnover was aligned to higher variability in asset class allocations. There is not compelling evidence that the link between these asset class shifts over time is affected by portfolio concentration – i.e. high conviction portfolios do not necessarily experience greater deviations in asset class positioning.

Chart 2 (on the following page) shows performance relative to the number of months managers changed asset allocation to high yield bonds by 3% or more each month – this is illustrative of wider asset class movements over time. While it's fair to say this chart should be taken with a pinch of salt (the correlation coefficient is not the strongest), it does suggest that frequent movements in top-down positioning may not result in the best outcomes. We discuss the success (or otherwise) of manager top-down positioning later.

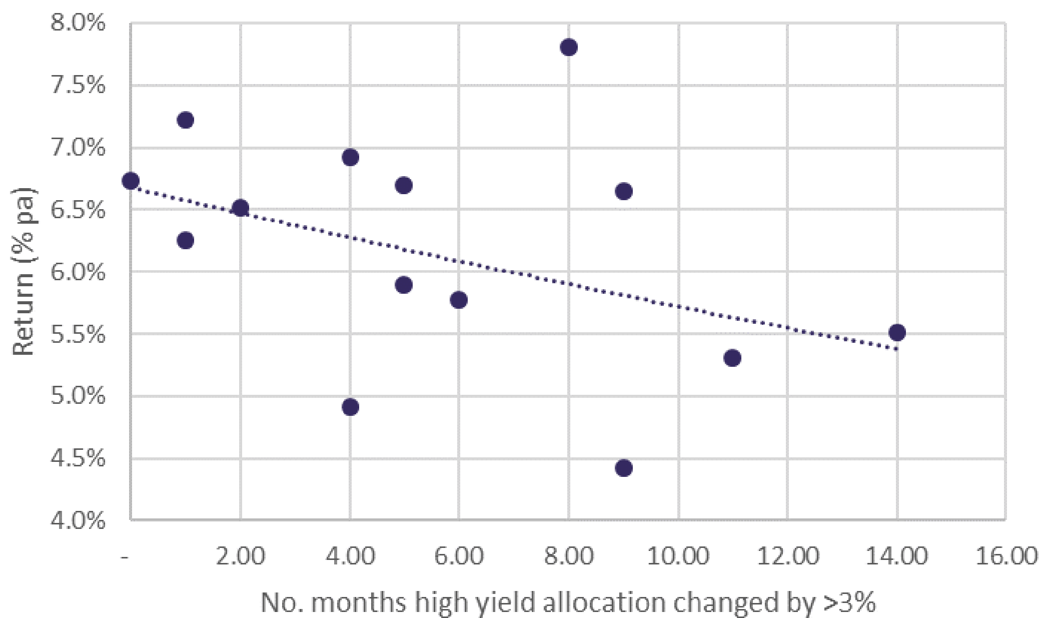
[1]While some observations are interesting, we acknowledge that the correlations are not statistically significant and an inherent crudeness to the methodology makes

Chart 1: High Yield Bonds and Leveraged Loans are the core allocations for the "typical" MAC manager



Source: Investment Managers, Frontier. The time period is from inception of manager mandates.

Chart 2: Frequent changes in asset allocation may hinder performance



Source: Investment Managers, Frontier. Three-year data to 30 September 2019.

Fresh ideas vs longer shelf life

Qualitative questions formed a component of our study and revealed that 75% of managers agreed the "illiquidity premium" can meaningfully add value to fixed income portfolios. Despite this, it is notable that almost none of the managers we have researched (including those beyond the scope of this study) include allocations to illiquid private debt within portfolios. This is likely the influence of regulatory requirements within comingled fund structures (UCITS etc.), perceived client demand and product specifications. Anecdotally however, we have seen significant interest from clients with separately managed accounts to include private assets within their MAC portfolios to reduced risk (lower correlation) – although this is beyond the scope of this paper.

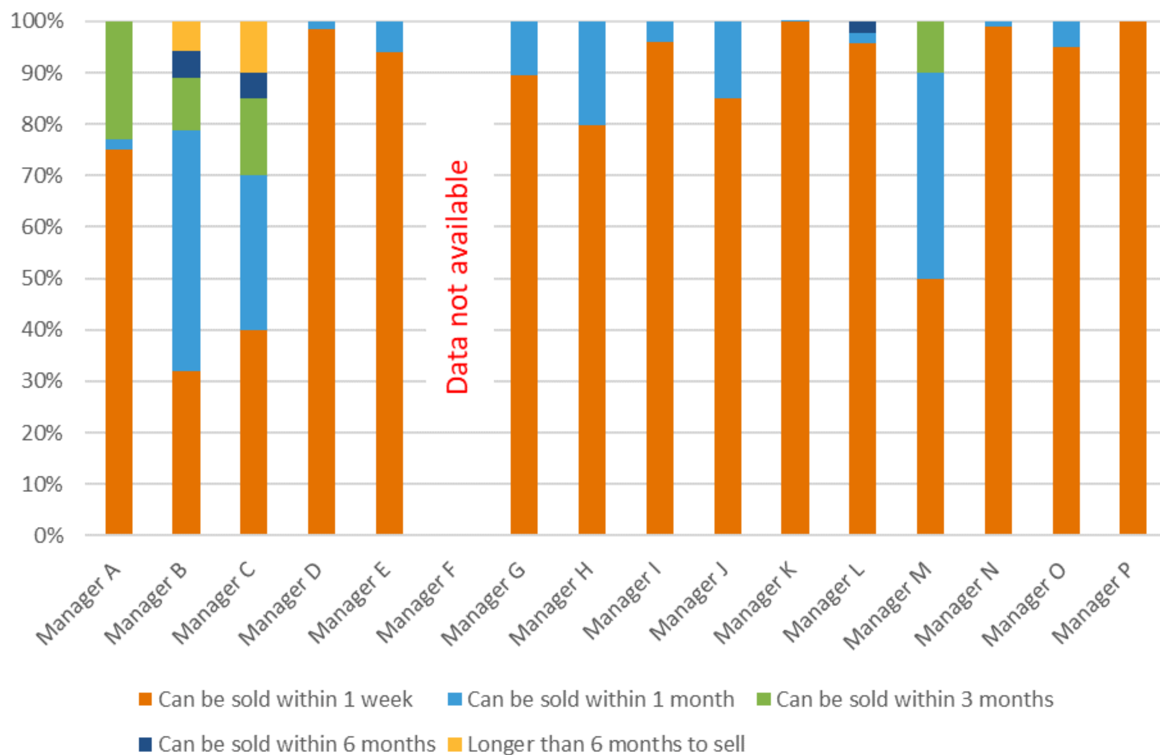
Typical pooled MAC products cover a wide spectrum of redemption arrangements, determined by underlying market liquidity. Strategy terms range from daily dealing to "semi-liquid" quarterly dealing, subject to 95 days notice.

Both are reasonable depending on client specific requirements and are not in themselves that interesting.

Unsurprisingly, those funds investing a greater proportion of assets in "less liquid[2]" markets tend to have stricter redemption schedules. It is more interesting that we see fund managers offering the same return target, say LIBOR+4% p.a., despite having significantly different liquidity terms. This appears somewhat inconsistent with beliefs that the "illiquidity premium" should meaningfully add value. Indeed, we have not found compelling evidence that strategies operating less frequent dealing (as a proxy for portfolio liquidity) have provided for better outcomes over the past five years – credit ratings have a greater influence and being illiquid doesn't always correspond to low quality. While data is somewhat limited, this suggests to us that private credit may be an area in which typical MAC managers have comparatively less skill compared to liquid markets. Indeed, locking up capital limits the ability to actively alter top -down asset allocation.

We still believe there is value in private credit as part of a total diversified portfolio, but this is possibly an area better suited to a separate strategic allocation.

Chart 3: Most MAC managers maintain highly liquid portfolios



Source: Investment Managers, Frontier. Data shown as at 30 September 2019.

[2]For context, when we assess "less liquid" markets this covers thinly traded areas, for example lower rated and smaller issues, as well as more traditional private assets.

Premium packaging vs discount brand

High quality packaging may convince shoppers a meat pie is worth buying, but it's not until you read the fine print you realise that the beef content is staggeringly low. Applied in a financial context, while credit ratings are helpful, they are not a guaranteed quality assessment.

Despite some positive directionality, we found weak evidence supporting the view that lower average credit ratings resulted in greater portfolio risk (as measured by standard deviation). Some may argue this indicates a level of manager skill in credit selection (or the fact that a reasonably good credit environment had rewarded lower grade credit) but for others it simply reflects that credit ratings are not an effective means of assessing portfolio risk. There is consensus amongst managers that the latter has at least some part to play with over 80% contesting the view that credit ratings are an appropriate measure of intrinsic risk. Nevertheless, analysing movements in credit ratings does provide insight into process and over longer time periods to September 2019, we found positive correlation between a lower average portfolio credit rating and higher performance – this may be a result of technical and/or fundamental factors.

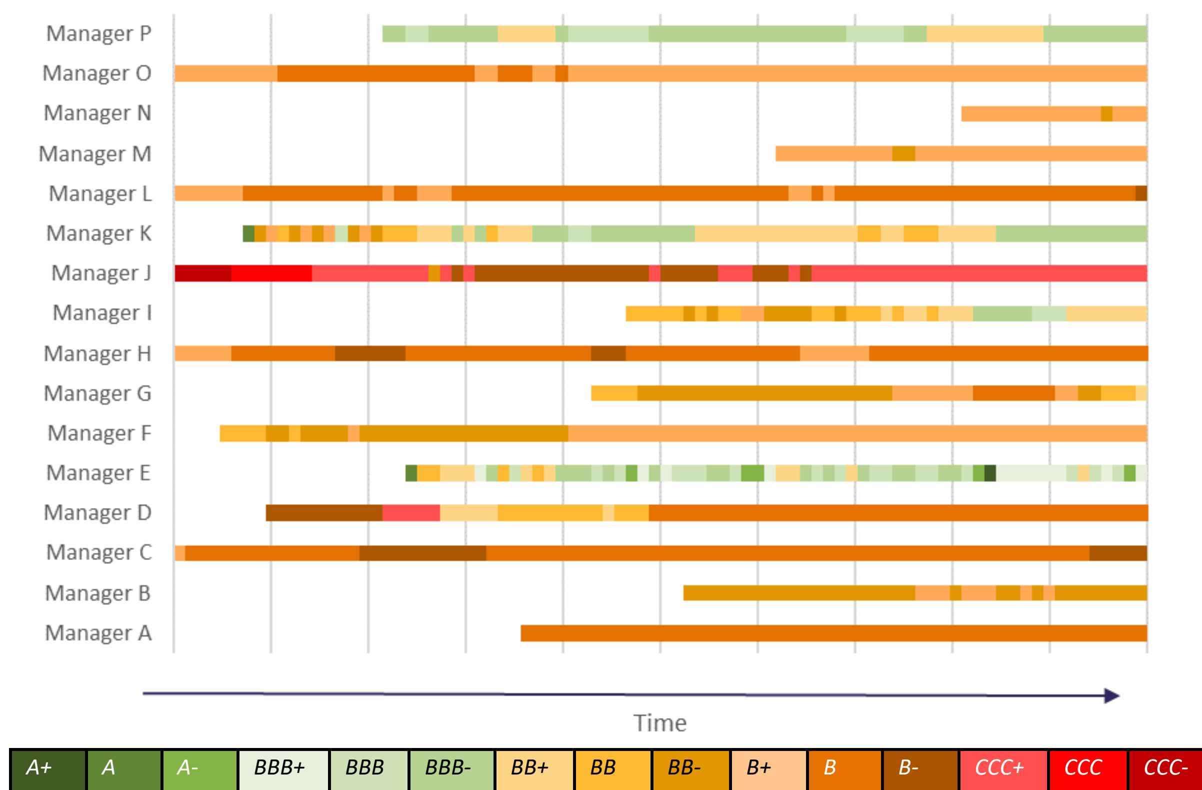
It is evident from Chart 4 that some managers are much more active at trading between rating bands compared to others.

Despite this, we have not found statistically significant evidence of a link between portfolio turnover and credit rating over time or that changing ratings frequently has resulted in better outcomes. Moreover, we also found little evidence of a link between the direction of change up or down the credit curve (de-risking or re-risking) and performance, which suggests that sometimes this has "worked" and at others it hasn't.

There is some evidence to suggest that over the longer run, managers employing a lower average credit rating will experience greater absolute returns, although having the flexibility to take risk off the table has also been key for the most successful strategies. We do not believe managers in this space alter credit ratings to reflect FX or rates views (e.g. investment grade credit is longer duration and higher convexity to interest rates) given that duration management is not a core alpha component of most strategies, many operating within very narrow interest rate sensitivity bands.

For completeness, we note that as expected, option adjusted spreads ("OAS") do have a positive relationship with lower credit quality, though the strength of this varies between managers and time periods (over more recent periods in particular, there is generally a strong correlation between higher OAS and lower rating).

Chart 4: Credit ratings vary considerably over time and between managers



Source: : Investment Managers, Frontier. Data shown over the 7-year period to 30 September 2019.

Bulk discounts available but beware!

It's easy to be drawn to the bold and brightly coloured spectacle of reduced prices; everyone likes a bargain. We have long been vocal advocates of ensuring investors pay a fair price, noting that doesn't always translate to the lowest fee. We have found modest positive correlation between those managers charging higher fees and those with higher performance (clearly an example of correlation not implying causation)! Instead, the performance and higher fees can be somewhat attributed to business structures – for example larger teams are more expensive and have tended to outperform their smaller peers. We found no evidence to suggest that analyst teams organised by asset class have an advantage over those selecting across the capital structure.

Supermarkets have incredible pricing power when sourcing products and much of this saving is passed on to the end consumers. It is reasonable that a similar principle applies to investment management as the costs of managing portfolios does not increase linearly with assets under management.

While we see plenty of managers offering bulk discounts to larger mandates, we have not seen wholesale reductions in fees from managers as overall strategies have grown in size (though this is typical of many asset classes).

This is despite 68% of managers surveyed agreeing there should be opportunities to offer clients discounts. In the short term, this will require concerted effort from investors to challenge management fees but in future it would be wonderful to see more proactivity from managers.

There are, however, reasons to be optimistic as we have seen a good deal of innovation in fee structures from MAC managers and in a very competitive marketplace, there is certainly room for buyers to negotiate. Depending on client size, asset allocation and existing managers, MAC can be cheaper than allocating to individual sleeves with different managers (as a result of readily available size discounts) but we do not believe this is a material consideration on its own.

Sometimes statistics should stay shelved!

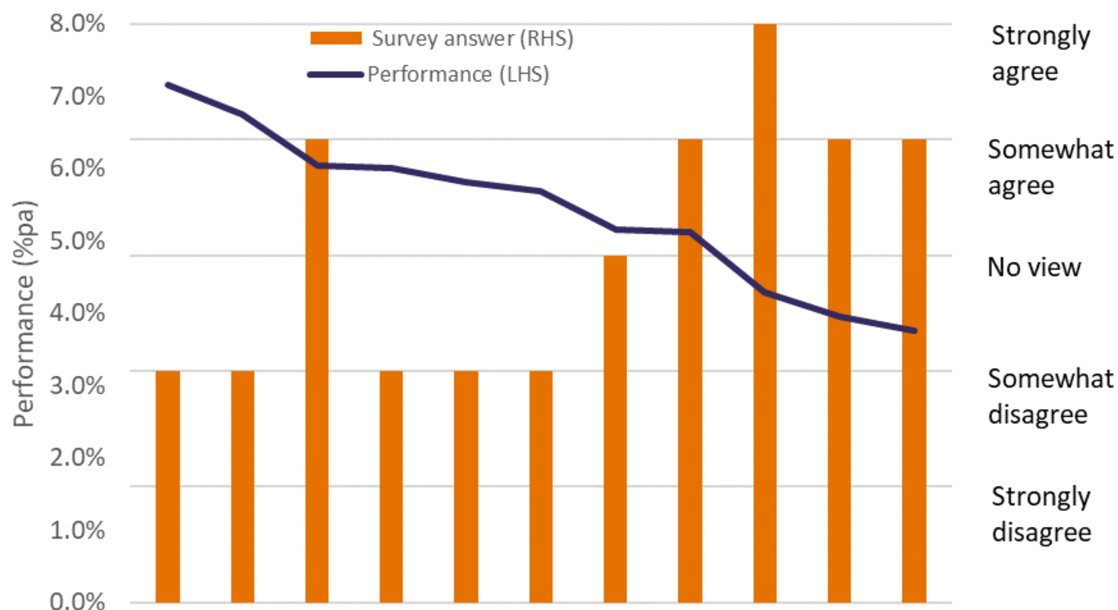
You'd expect the sales of ice-cream and sunscreen to have relatively strong correlation; that doesn't mean one has caused the other… the sun being the lurking variable.

We found statistically significant evidence that managers who believe top-down asset allocation is harder than credit selection have not performed as well over medium-longer time frames. Initially this led to some excitement that we had identified a clear trend of certain processes trumping others.

However, as we dug further, we hit a number of walls, including no clear relationship indicating it was the bottom-up stock pickers who found top-down harder or evidence that 'finding it harder' had changed behaviours in terms of altering allocations less frequently.

Naturally, there are several possible explanations for this seemingly spurious relationship. As investment consultants we don't like to believe in coincidence and there is likely another (as yet unidentified) confounding factor responsible. Indeed, this shall certainly form the basis for further research in the future.

Chart 5: Managers believing top-down asset allocation to be relatively difficult haven't done as well.



Source: Investment Managers, Frontier. Data shown over the 5-year period to 30 September 2019. We note that the correlation coefficient is consistent for longer time periods but fewer managers are represented given strategy inception dates.

Follow the shopping list or mix things up?

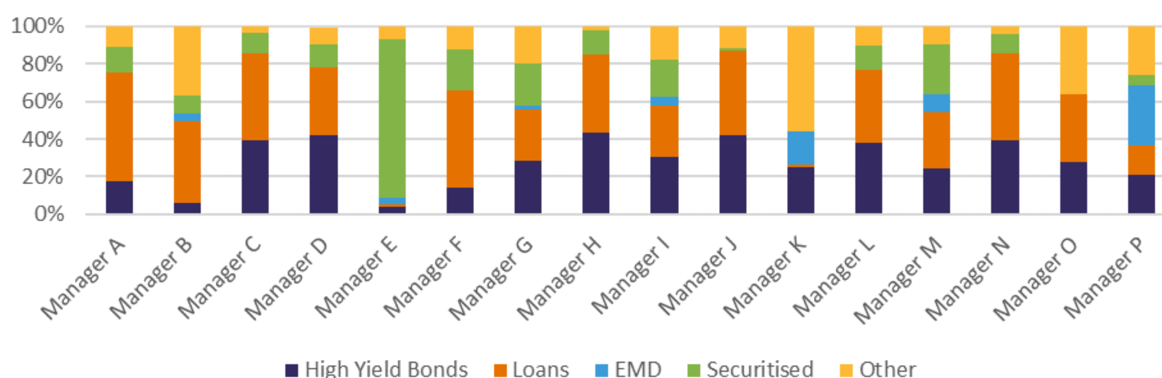
One of the most fundamental questions regarding MAC is whether delegating credit asset allocation decisions to managers will add value over time. The most simplistic way of determining this is to simply compare returns versus benchmarks, but this is crude given the oversimplification of benchmark portfolios and lack of good indices for some asset classes (like structured debt and private credit). Chart 6 below provides a static snapshot of the extent to which asset allocation varies between managers[3].

This sort of analysis leads to charts such as Chart 7 with many managers giving themselves a big pat on the back (higher return for the same or less risk).

Comparing against a simple blended benchmark of 50% high yield and 50% loans doesn't necessarily tell us much when this only accounts for c.60% of asset allocation for the average MAC manager. The other popular alternative of comparing against a LIBOR+ target tells us even less about how these portfolios are actually managed and can dangerously distort the type of risk investors are exposed to.

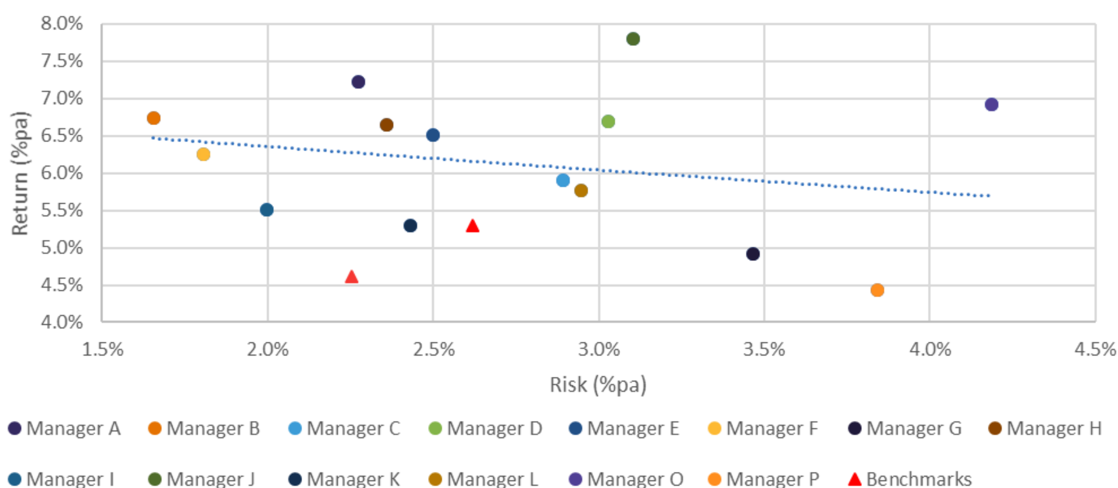
Selecting the right investment vehicle is an important consideration for investors. While many structures provide great flexibility, others like UCITS are more restrictive (e.g. regulation limits leveraged loans exposure to 10%).

Chart 6: Importance of manager allocation within wider portfolio



Source: Investment Managers, Frontier. We note that the broad picture is relatively similar over different time period (though with clear movement over time). The one-year period was selected to maximise the available data.

Chart 7: Risk/Return over the 3-year period to September 2019



Source: Investment Managers, Bloomberg, Frontier. Benchmark 1 shown is 25% US High Yield, 25% European High Yield, 25% US Leveraged Loans and 25% European Leveraged Loans. Benchmark 2 shown is 12.5% US High Yield, 12.5% European High Yield, 37.5% US Leveraged Loans and 37.5% European Leveraged Loans

[3]We note the 'other' category is very broad indeed and covers a great many additional asset classes including, but not limited to; investment grade credit, sovereigns, convertibles, private credit, cash, derivatives etc.

Outsourcing asset allocation decisions to a manager could result in better outcomes through real time decision making based on current market dynamics – if we assume that managers are skilled at this. Whether or not managers are good at making successful top-down asset allocation choices is a complex question to overcome so we have modelled some simplified scenarios to try and determine if there is any supporting evidence.

At a high level, we stripped out the impact of security selection and “off-benchmark” decisions by focusing on asset allocation deviations between two key asset classes (high yield bonds and leveraged loans) to create a Manager (proxy) return. This involved proportionally increasing allocations to these asset classes to 100% of the portfolio and multiplying by index returns.

We then looked at the real, non-adjusted portfolio return which includes security selection and allocation to a wider set of asset classes. With regards to assessing MAC’s role as a potential replacement for stand-alone credit options within investor alternative debt portfolios, we found compelling evidence of active management adding value and asset class diversification being beneficial.

There was not, however, strong evidence that managers consistently switched assets at the best time (from a top-down perspective).

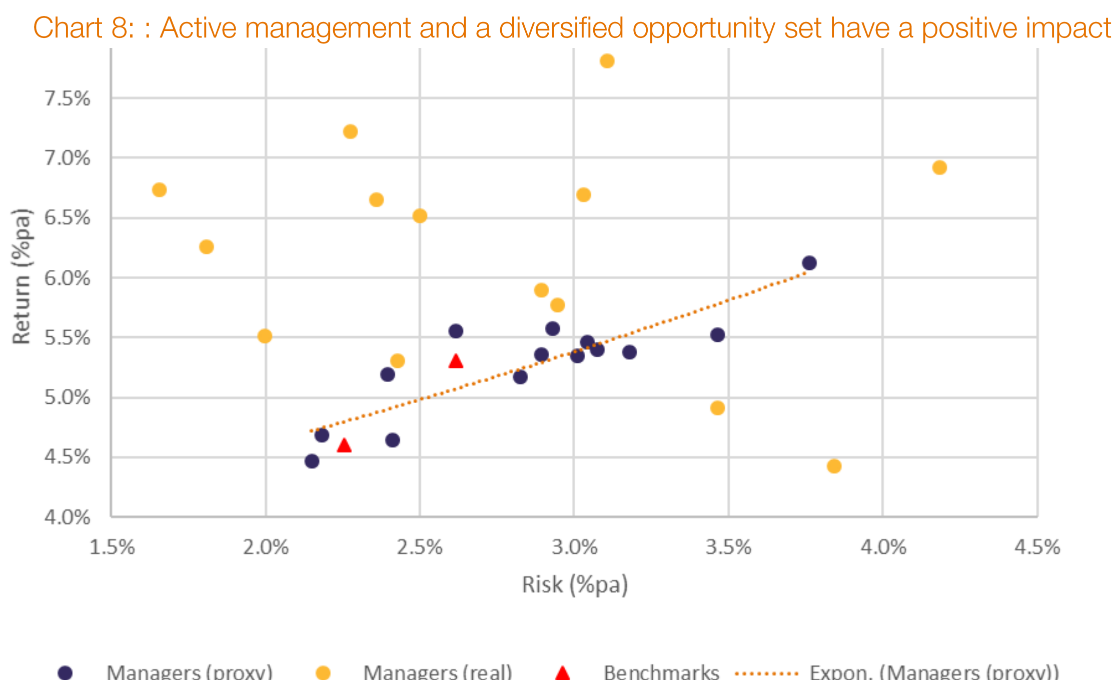
If MAC managers had an advantage at calling market timing and switching between the high yield and loan sectors, we should expect to see the purple dots sitting above the red triangles.

Instead, we see the managers have tended to only increase returns with a proportionate increase in risk.

When we look at the yellow dots in Chart 8, however (actual returns experienced), we see most managers are sitting to the top left of the chart – representing enhanced risk-adjusted returns (we note of course that standard deviation is not the only measure of portfolio risk). This tells us that there is indeed value to be gained from an allocation to MAC strategies offering dynamic exposure to a greater range of asset classes (than just high yield and loans) and/or that the active security selection component has added value vs a passive approach. While there is dispersion in outcomes, we find the overall case for the MAC asset class to be compelling.

In standalone investment mandates it is relatively easy to assess manager performance where well-established benchmarks are available. Assessing MAC manager security selection performance is more difficult given strategies are not always trying to outperform indices within every asset class. For example, a manager may increase allocations to leveraged loans (vs. high yield debt) in order to reduce portfolio volatility and in doing so, deliberately select issuers with a lower return profile. We overcome this to an extent using extrapolated attribution analysis and assessing a manager’s general performance within specific asset class strategies, but we also encourage investors to be mindful of overall portfolio outcomes within MAC rather than getting distracted by the detail.

Chart 8: : Active management and a diversified opportunity set have a positive impact



Source: Investment Managers, Bloomberg, Frontier.

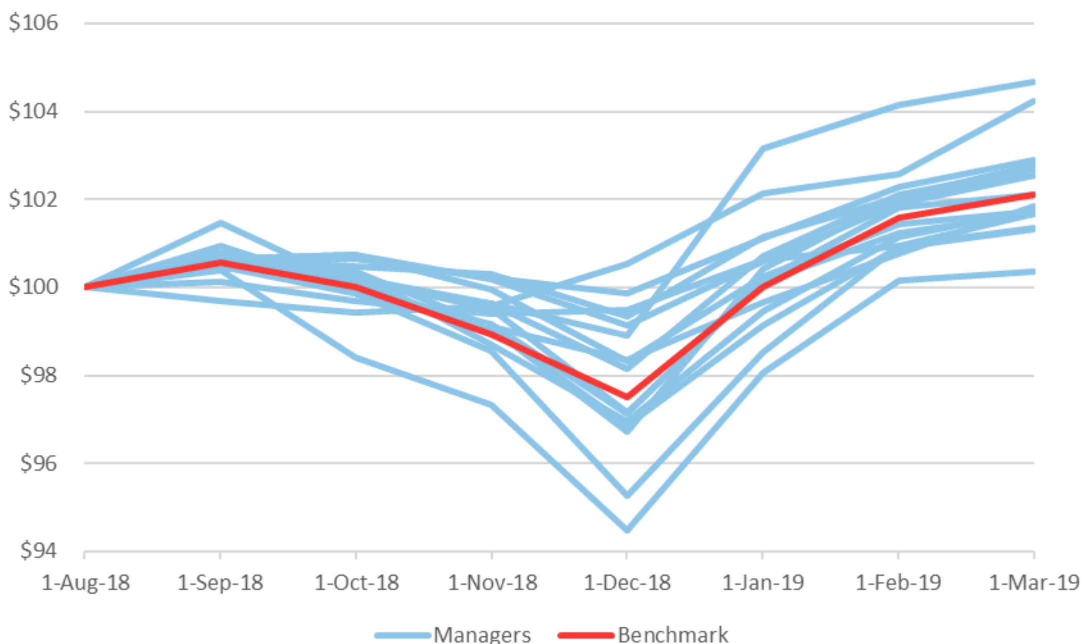
Conclusions in the shopping bag

MAC offers investors a low governance solution for accessing multiple credit-related sectors and outsources the dynamic asset allocation decisions. The often-unconstrained nature of these strategies creates a challenge in defining “typical” within this heterogenous and blossoming market.

It is a well-established solution which is naturally attractive to smaller (sub-$1b) investors but has also seen increased interest from larger institutional investors, particularly in the US and Europe. We believe it would be a reasonable substitute for existing predominantly leveraged loan exposures within client alternative fixed income portfolios. The enhanced risk-adjusted returns from introducing tactical allocations to additional asset classes is a key reason for this.

While it introduces an additional element of manager risk (alpha) from asset allocation decisions, we have confidence that the best in class managers have the necessary expertise to add value here. Indeed, the relatively narrow focus on credit alone (vs. multi-asset funds across multiple sectors) facilitates more readily justifiable relative value assessments. Chart 8 again demonstrates how the best MAC managers have been able to enhance returns by mitigating downside loss vs standalone allocations to fewer asset classes (high yield bonds and loans). We chose this time period as it lies within recent memory and is less dependent on idiosyncratic factors.

Chart 8: : Skilled MAC managers can reduce volatility by investing in a diversified opportunity set.



Source: Investment managers, Bloomberg, Frontier. Chart shows drawdown profile over the volatile Q4 2018 period. Benchmark shown is 25% US High Yield, 25% European High Yield, 25% US Leveraged Loans and 25% European Leveraged Loans.

The final word..

This paper has focused on a small selection of the more interesting observations from our study where the relationships between variables were strongest. We believe however that evidence of no correlation (where we would have expected some) has been equally meaningful for developing our views on the asset class and we are very open to dialogue with interested parties.

It was also positive to see some qualitative responses from managers which placed a great deal of value on back-office risk management functions and the importance of ESG integration into investment decision making (your fair-trade bananas).

What we can say with some certainty is that there are indeed tangible benefits to MAC investment compared to a narrow, constrained portfolio with more limited asset class exposure. The great dispersion we see between managers creates plenty of opportunities for investors to identify strategies best suited for your particular needs.

We believe that the "better" MAC managers within the universe are good replacements for investors with sector objectives tracking securities benchmarks but should be used with caution by those targeting a specific cash plus returns. This is because MAC is not a total return strategy and you should expect a high degree of credit beta – if credit markets take a bath, these strategies will likely underperform cash plus targets.

The results highlighted in this paper are at the very least a call to action for investors with stand-alone asset exposures within alternative fixed income to consider diversifying further. We do not, however, advocate an all-encompassing credit solution and believe that some asset classes like private debt or local emerging market debt (which is highly dependent on FX views) may be more appropriate as separate allocations, and these could compliment a MAC allocation.

While many MAC products appear to have similar processes, its vital you do your research to understand the differences. Not all supermarkets are created equal.

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25 years

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