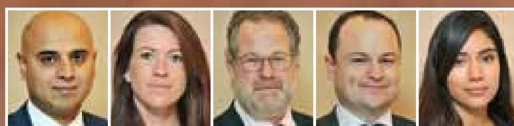
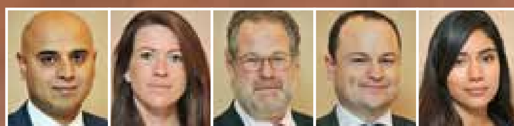
Alternative credit

Moving up the risk curve

Azhar Hussain | Alison Trusty | Giles Payne | Rod Goodyer | Dharmy Rai

NOVEMBER 2017 | PORTFOLIO INSTITUTIONAL ROUNDTABLE

COMBINING DIVERSIFICATION **WITH INCOME PROVISION**

Royal London Multi Asset Credit Fund

In a volatile environment with risks on the rise, finding a diversified solution with the potential to withstand a broad range of economic and market scenarios will become critical. At RLAM, we have developed our MAC proposition to meet demand for greater diversification of credit in a low yield environment. Our Fund concentrates on the 'alternative' part of the credit universe, seeking to provide 'through the cycle returns' through an investment process focused on security.

For more information about the Fund, visit **www.rlam.co.uk**

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A mainstream alternative

Alternative assets have been one of the winners of the banking crisis, which marks its tenth anniversary next year.

The low return environment that has blighted more traditional fixed-income assets since the global financial system almost collapsed has sent pension funds on a quest for a bond proxy. The search for predictable and adequate cash-flows ultimately put non-investment grade credit into the spotlight.

In the 10 years to 2016 that followed, the global private debt market increased four-fold to $595bn, according to Preqin, while assets under management expanded by 7.1% in the first half of 2016.

It is understandable why institutional investors have warmed to areas such as syndicated loans, direct lending and structured credit, assets that were once considered niche or the domain of the banks. The returns could be higher than the 1.2% yield offered by 10-year gilts in November, with insiders claiming that senior debt could return 6% to 8%. More illiquid assets, however, could generate returns of up to 12%.

Alternatives to government debt and high-grade corporate paper is a diverse universe populated by various asset classes, risk profiles and regions, all of which help with risk balancing of portfolios.

Another plus has been that institutions have filled a void created by the banks when they retrenched to their more traditional markets following the crisis.

These returns, of course, come at a price. Some of these products are complex, while investors could face pressure from holding illiquid or leveraged products.

However, low default rates, attractive durations and higher returns mean that these markets could remain an institutional asset class, even after yields in lower risk investments improve.

To discuss these issues we bought together a trustee with an asset manager and consultants to discover where the opportunities lie in what is a complex sector and if the rewards really are worth the risks.

The debate starts on page 4.

Mark Dunne
Editor, *portfolio institutional*

Contents

P4: Alternative credit roundtable
A trustee, asset manager and consultants debate this diverse and often complex investment universe.

P16: Storms ahead? Don't forget your MAC
Royal London Asset Management introduces its Multi Asset Credit (MAC) fund.

P18: Too hot to handle?
Should institutional investors opt for alternative credit to replace the disappointing returns offered by higher grade debt?

Chair:
Mark Dunne
portfolio institutional

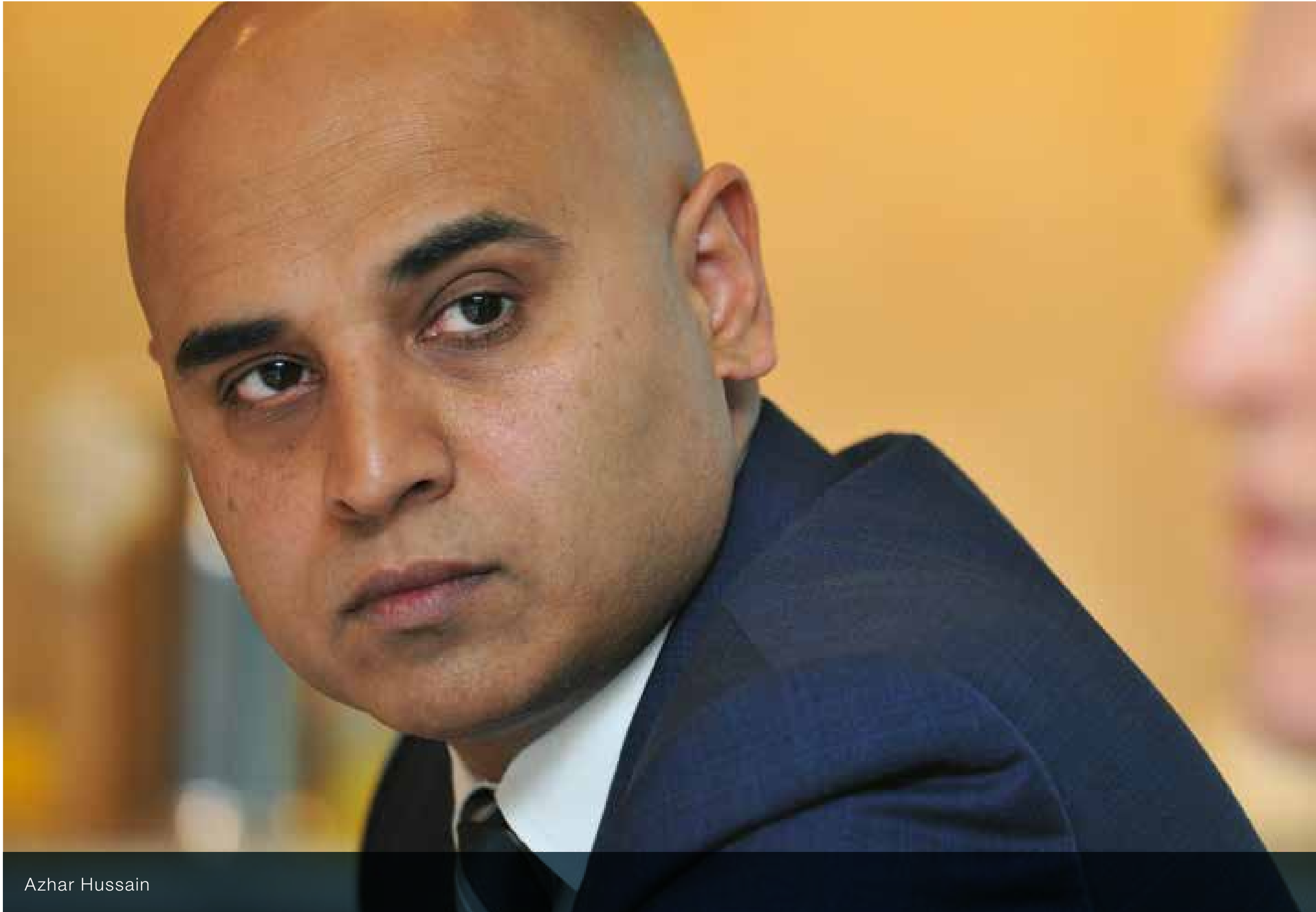
Rod Goodyer
Partner
Barnett Waddingham

Dharmy Rai
Associate, private markets
Bfinance

Giles Payne
Director
HR Trustees

Alison Trusty
Hedge fund researcher
Aon Hewitt

Azhar Hussain
Head of global high yield
Royal London Asset Management


Azhar Hussain

"Funds are becoming too big too quickly and you end up with a different risk to what you were initially targeting."

Azhar Hussain, Royal London Asset Management

What is driving interest in alternative credit?

Azhar Hussain: There is the demand side, but there is the supply side as well. The alternative credit markets are growing significantly post-crisis, making the leverage loan market more accessible. The bank-to-bank market is opening up, particularly for institutional investors, and bond markets have also grown, not least because of quantitative easing. Overall bond yields have fallen, making it easier for corporates to issue debt. So quantitative easing has had an effect on both the demand and supply sides.

Alison Trusty: There were fewer managers that could get your clients access to areas like direct lending, but post-crisis there is proliferation of institutional-quality managers in the universe that we look at.

In some of the more liquid markets with yields being stretched it makes sense for pension funds, in many cases, to give up some of that liquidity to alternative credit for seeking a premium.

What returns are they giving liquidity up for?

Hussain: They have different characteristics and different return streams. It is important trustees appreciate that because there are risks which haven't been shown in the past few years. It's been a relatively easy stretch for quite a while. Our multi-asset credit fund, for example, targets LIBOR plus four to six through the cycle. We chose that level because that's historically what high yield paid. Is the future going to replicate history? We hope so. That's what my fund is targeting, but at the moment we are at the bot-

tom end of that. Spreads have tightened substantially in the last 18 months in all markets. Illiquidity premia has been pushed so the difference between good and bad credit is as small as it's been for some time.

Trusty: Is your fund illiquid?

Hussain: It's a lot more liquid. There's part of the local loan space that is totally illiquid bilateral deals, but I'm in a far more liquid stream. I'm also invested over half in bonds, which are, in theory, safer.

Rod Goodyer: It's fairly typical that liquid funds are cash plus five-ish. If you step into things like direct lending you're looking for a few percent more to reward you for taking on a lot more illiquidity. So it depends what your return needs are and what your liquidity profile is across your other assets.

Dharmy Rai: On the illiquidity side we have seen a focus on senior debt and that's typically about 6% to 8%. For those happy to take on more risk, be that with leverage or having some form of subordinated in their capital structure, I'd say between 8% and 10%. There is even the 10% to 12% range, depending on what you're happy taking on. Generally, it has been focused on that 6% to 8% range and more on the European side. US clients tend to be at the puncher end and that's why those funds seem to have leverage and are usually about 10%.

How leveraged are funds in these markets?

Trusty: US funds may go up to two, two-and-a-half times. But when we are thinking about risk, if they have a good leverage facility and they're lending to high-quality borrowers, we might be more comfortable with them using leverage to juice up returns rather than a manager who is trying to target 8% by lending to riskier borrowers.

Rai: It also depends on if it's lower middle market or middle market lending. On the lower middle market side one times leverage spread is fairly high as they are riskier companies in the sense that they are smaller and less likely to be sponsored. People are prepared to have leverage than go further down to the subordinated piece. But it depends on what they are comfortable with, whether it's a CMO structure or just leverage from the two main banks they work with. They are the details you want to dig into when you're looking into a fund.

Are investors and their advisers using credit agencies when researching funds?

Giles Payne: Not too much. We use consultancies, which is the typical way pension schemes access these investments. The illiquidity point is important. I'm seeing more schemes plan their liquidity much more carefully. They are not worried that they might have 20% to 30% in illiquid assets, but have a much better understanding of when their cash is required. When, for instance, private debt might be drawn. So you may well be looking at some quite liquid private debt opportunities as almost like a buffer fund. It's just planning your liquidity and historically people have been worried about illiquidity, but it really is about understanding what illiquidity means: is it three months? Six months? Five years? A lot of these assets are quite desirable, so they're saleable but we don't want be forced sellers.

Rai: That's an interesting point. We've had conversations with a few asset managers recently who have a private debt fund and are offering a more liquid leverage loan solution to drawdown the capital. All the money is invested up front and then they have the drawdowns, which the manager puts into the debt fund as and when they find a strategy.

The emerging markets are reported to be back in fashion after a few difficult years. Have you seen more cash flowing into those areas?

Hussain: Parts of the emerging world are investable. I divide it into investable and non-investable because in my career the markets have expanded from the US into Europe and are now moving into what I call the rest of the world, which is a mix of developed markets that people class as emerging markets. There are areas which are very investable, parts of Latin America, for instance, such as Chile. There are other parts which clearly have issues and there's Brazil which is coming out of a recession. There are lots of corruption scandals but at least they've been rooting out some of the corruption which you don't see in other areas. As an investor I want to see a level playing field. That's the most important thing. There's got to be no informational disadvantage for me to enter that market. That's why parts of the emerging world haven't

fully entered my investable universe. Hence either there's not enough diversity in terms of the sectors or there just isn't the corporate governance to invest in those companies.

Trusty: The growth in the emerging markets' corporate debt market has been pretty significant post-crisis, so in theory there should be a lot more opportunities to invest in. I sit in the hedge fund team covering distressed debt and that's been an interesting area within emerging markets. Given some of the stressed political environments in a lot of those countries there have been a lot of opportunities within that space.

Talking about governance, where are you getting your information from? What kind of due diligence are you doing?

Hussain: Regularly meeting our companies is important because the reality is that leveraged companies change quite considerably. Only 3% of high yield bonds mature and that's not because they default. Only 2% or 3% do. It is because most of them get taken out early. High yield companies are just leveraged projects in transition. That's what leverage finance is. That transition means that your risk points can change quite a lot, which is why when you get into the less liquid parts of the market you've got to be careful to pick the right companies and ensure you've got the right structures to manage those companies if the investment goes wrong.

Rai: It's interesting you mention the illiquid side. For that investors tend to only look at Europe and the US. There has been an increase in the number of funds coming out of India and there is a push towards South America, but it is something that is not really in portfolios. For anyone that likes a global fund they'll tend to do Europe, the US and a bit of Australia, but there is nothing else. Even with Europe there's a split between the Nordics and Southern Europe, which tends to be covered less like Spain, Portugal and Italy, particularly because of all the regulation. Even within that spread you're not looking at emerging market countries because it's still risky within Europe.

Hussain: One of those reasons is the jurisdiction issue...

Rai: …and regulation.

Hussain: It's legal and regulation. So if it goes wrong I need to know what my creditor rights are.

Rai: And they don't have any.

Hussain: Absolutely. That's my issue as an investor. Even in France the bankruptcy law is not creditor friendly, so the leverage loan market has found a solution: we issue through Luxembourg, but the point is that is a solution for a developed market.

Trusty: If you think of the yield on European high yield debt, it doesn't feel that you are that well rewarded for what is a low default rate.

Hussain: It's all about perspective. You've got to think about it in terms of the spread as well. As a spread the European high yield market looks attractive at 300 over.

Rai: It is better than direct lending at 1.2%.

Hussain: Direct lending is a great example in terms of default rates. What I want to see as an investor is that a company I am investing in has been around for 10 years because then I can see what happens to it in different environments. Similarly, I expect my investors to look at my markets and ask how long they've been around. What are the risks and how are you going to manage them in the next down cycle? Parts of the direct lending world worry me because there isn't a track record. That track record was within the banks and that's a different type of structure than a fund. So behaviour will be different and that's important for investors.

Rai: That's why the team is important. A lot of funds have taken teams from those banks, but equally there are plenty that haven't been around or they have come from a hedge fund or distressed debt as opposed to issuing at those levels.

Hussain: I'm less worried about individuals. If you were directly lending in RBS back in 2008 you didn't default on the issuer because it was in your interest to keep that alive. That's different from a fund. You've got different demands, issues and incentives. That's the worry that some of the newer parts of the less liquid markets are worried that there isn't a track record and too much capital is flowing into it too quickly.

Payne: Too much capital too quickly is going to be interesting. There's limited capacity in terms of take up and I don't know whether it will play through but one of my clients is seeing slower deployment than

Alison Trusty

"Companies need to borrow and if they are no longer gaining access to the banks, someone has to step in."

Alison Trusty, Aon Hewitt

expected through one or two funds. That's quite a big manager and they talk a strong game about requiring suitable levels of covenant. It's a question of whether other managers are willing to accept a slightly lower covenant and if that then becomes standard within the market because there's more money chasing these opportunities. Pensions schemes are paying more attention to this, part of the reason is they like the idea of LIBOR plus rather than a spread. It goes back to needing cash to pay benefits. The LDI argument doesn't matter. Losing money because you're actually improving your funding position is fine when looking at the funding from a balance sheet risk point of view, but from a trustee point of view I've also got to look at where I'm going to get my £100 to pay Mrs Smith in 2018. So if that £100 is worth £98, I've got to find the £2 from somewhere else.

Goodyer: A lot of LDI investors are looking at this and they're looking precisely at the spread. It doesn't matter if the nominal yield on high yield doesn't look particularly attractive if I'm still picking up a few percent above LIBOR then that's enough to cover what I need for my funding. Spreads therefore are naturally getting compressed across a lot of these markets just from the money coming out looking for any kind of spread above cash.

Trusty: I agree, but there is a structural shift here. There's a lot of money coming in but the banks aren't going to come back to this space, so there is a big argument for alternative capital, like institutional investors which are going to be the lenders going forward. Companies need to borrow and if they are no longer gaining access to the banks, someone has to step in.

Hussain: It's a natural development of the economy, as we see in the US, to have disintermediated capital

in different parts of it. The small and medium-sized sector hasn't had that in Europe and the UK for a long time. So the next development is taking that away from just being private to being a little more public because there's no reason why a company shouldn't have a capital structure that is virtually the same as a company half its size. For the most part it's the private equity world that is entering the market now. These are different from the businesses we had pre-crisis when they were family-owned, now they are private equity-owned SMEs which are leveraged for a purpose. Senior secured means something very different. I've seen it in high yield how that definition has meant different things. You can get a lot of volatility in senior secured because if you're secured in a retailer, what are you secured on? A brand? So it's going through that and understanding what's in the box and hoping that as a manager you have diversity so if something goes wrong you're not going to get hurt.

Trusty: It has been a benign period for defaults, so some of these managers didn't have to go through a recovery situation and that would be telling those fund managers that have the expertise to work out a recovery if there is a default versus those that maybe don't have that experience and are going to take much more of a loss.

Rai: What's interesting about the definition of senior secured is that it's slowly changed to mean uni-tranche or first lead and you get a difference in the multiple that that will cover. More interesting are the covenants and the capital going in. The largest funds that closed 40% to 60% over their initial cap earlier this year are coming back to the market early next year with new funds that are slightly nuanced but very similar. If not early next year they're coming back at the end of this year signifying that they've deployed 70% of the £2bn to £3bn of capital they raised. This raises questions over how they managed to deploy that so quickly and yet still have a secure, strong pipeline that they are happy to raise another fund? For me it's actually come down to how true the covenanting is. If you have 15% to 25% headroom then that's true covenants, but it is getting to the point where if it's a sponsored relationship those are starting to get waived and so it's more important to have a structure that ensures you can monitor the company. So whether you could forego covenants or you have 35% headroom it doesn't mean anything. If a manager

said: “Okay, I have three covenants on these deals and it’s not tight”, it makes no difference. What you want to have is a manager that understands the documentation. So if there is a restructuring then there’s something that they could do, or it has a structure that’s amortising so you know that if you’re not getting back this money they would be breaching its covenants. That’s where it matters. You could forego that and it would be okay, but it’s about understanding those companies and how you are doing the deal.

What do you look for when selecting a manager?

Payne: It’s difficult. Being slightly cynical, if you select purely on beauty parade you are influenced by who is the best presenter, which is dangerous because it doesn’t make them the best fund manager. You do need to have proper research done in advance so that you can ask questions to understand what these people are doing.

The point about managers putting second funds to market very quickly after a close is really a question of people understanding that there’s a lot of money going into the market. Asking for money and actually getting money into the market are different things and you’ve got to understand how that money’s being deployed and the quality around it. Your point about teams is very good. You can have a manager saying that we are trying to do this, that and the other because they think it will attract money to the fund, but the counter to that is the team may not have all those representative skills to do this, that and the other so you need to go a bit further behind it.

Trusty: European distressed debt has been an interesting area. We see a lot of US distressed debt managers raise $3bn, $4bn funds and then struggle to put that to work because they didn’t necessarily have the local presence over here. We focus on managers experienced in Europe, have good networks but also limit capacity. So we focus on funds that maybe limit capacity at about $500m. That makes a real difference because a lot of the deals are smaller, they’re not going after big non-performing loan portfolios which we’ve seen the banks selling and there has been high competition for. Instead they can go after single loans, work out the restructuring and you’re seeing a difference in their ability to deploy capital.

That's for the benefit of the investor because ultimately if you're investing in a fund that doesn't deploy capital the returns are going to be impaired.

Hussain: Capacity is incredibly important. The European bond market has grown quickly and the direct loan market is going the same way. Funds are becoming too big too quickly and you end up with a different risk to what you were initially targeting. I manage global funds because I want that diversification. I don't want to be over concentrated in the UK because funnily enough some people might vote for Brexit and suddenly things change. Also you get sector diversification with individual companies that have been around for a lot longer, which helps. That's important because if you're over concentrated you could end up with a lot of risks, particularly if you are marketing something and you end up in something very different.

Goodyer: On that we've seen some attraction. Some clients have gone into funds that can be a bit more nimble, that aren't so constrained and saying: "We are specifically going to do this kind of lending." They can react to what's actually happening in the market and where the value is because we don't really know how the market is going to develop.

Rai: Diversification is important, especially with direct lending. Ultimately, if you have one credit that does badly it has a massive effect on returns, whereas in private equity something that shoots the lights out makes up for anything suffering in the portfolio.

Hussain: What worries me is when I see how leverage markets develop we get waves of issuance by sectors. The TMT sector in the early 2000s needed a lot of capital investment. It came to high yield markets to borrow that money, now what happened to those vintages? Sectors blow up all the time for different reasons just as we saw the energy sector two years ago. What worries me is that there's an over focus on the UK when actually as a UK investor you should be getting global exposure because the UK, especially with some of these new areas, is concentrated in certain sectors.

Rod Goodyer

How are alternative credit investors protecting their funds from volatility?

Hussain: Valuations are so tight and getting protection is not just against interest rate duration, it is spread duration, too. We don't talk enough about spread volatility, but that's what can really hurt you in leverage markets. So I have a target duration of zero to four but at the moment I'm running at two years. I'm going to get cashflows back and hopefully the markets will turn and widen so I can eke a little more return out, but if they don't that's fine because at least I've got the certainty of cashflows back and I won't get the volatility that I perhaps would have done for a longer duration product. That's really important because people sometimes are misled by the safety of the title investment grade, but actually the volatility in investment grade is higher than high yield. That matters because risk-adjusted returns are different now. Your return prospect in the investment grade market is a lot lower so investors should focus more on risk-adjusted returns, the amount of volatility you're going to take to get that return. That should be your real driver. There is a real opportunity at the front end of the credit market still, particularly now that's where you want to be.

Goodyer: Spread duration is something trustees don't really understand. A lot of people talk about buying floating rate instruments and they think they're immune from what the market is doing. In the last few years there have been relatively benign conditions with nice, stable returns coming through. At some point there is going to be a shock to that and people will see that you can get losses on these things in the

Giles Payne

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Giles Payne, HR Trustees

short term when spreads push out. I'm not sure that is communicated enough by some of the people in marketing.

Payne: The issue with that is, yes you can make payment losses but if you hold to redemption you don't suffer actual losses. It's how you are considering using these assets in your portfolio. If you're looking at them as cashflow tools and you're holding to redemption the volatility in between is a mark-to-market issue and it might be an accounting issue, but it's not actually. Default is your key issue.

Hussain: What is important is when that volatility forces you to divest that asset, that's when it matters.

Payne: That's why I was talking about planning your cashflow carefully and making sure you know where it's coming from so you're not going to be a forced seller at a depressed price. That's absolutely key and it is where understanding your layers of cashflow and having a proper plan about where you're going to get the cash out of your portfolio to pay your benefits as a pension scheme investor is important.

Goodyer: It is also making sure you understand when you are doing your actuarial valuation the nature of how those spreads move and that you're not then triggering contributions. It's just making sure you've got the education piece for everybody in the room as to how these assets really behave.

Rai: I've had conversations with clients who think that because it's an illiquid asset class that there is no volatility. They have this belief that nothing bad happens until it's paid back. It is important to note that a lot of funds will do mark-to-market.

Payne: You'll see it on a daily or monthly basis coming through the asset values of your scheme, but if you design your valuation basis carefully enough and you're not necessarily using a gilts plus valuation,

Dharmy Rai

you can smooth that and work around expected returns as opposed to having the full effect of spreads coming through straight into your asset values.

Hussain: It is recognising liquidity and volatility are linked. Illiquidity and volatility are entirely linked. You have to choose sometimes if you want an entirely illiquid portfolio which would exhibit no volatility whatsoever or something which is far more volatile but is liquid. It depends what your characteristics are, actually as a pension scheme you might not need those cashflows. As a manger what is important is to try and value that illiquidity premium and ask: "What am I getting paid for?" What I'm getting paid for is structural inefficiency which you will find in the loan market, for example, because retail investors can't access it and institutional investors can't exit it because it doesn't settle in a normal fashion. That creates an inefficiency that I should be able to exploit. The cost of that is illiquidity, but the benefit should be lower volatility.

Trusty: Obviously some credit funds can short, which is a way to manage volatility. The continuing upward trend in credit markets hasn't paid off for short bond positions but one could argue that if we see more volatility there should be more winners and losers to come out in the credit markets and therefore getting down to the security selection within credits we should be able to pick the winners and go short on the losers. That would create a much more hedged portfolio in the credit space.

Hussain: You need people to go short to make it a properly functioning market.

Trusty: We've seen it in structured credit where some managers may be short some of the index with heavy exposure to retail. So there is a broad spectrum for some of these managers to play with but we need a bit of volatility to pick up for it to make sense.

What we haven't touched on yet is structured credit.

Trusty: With some of the issues raised in the crisis, a lot of investors are still wary of this space. But actually it is a less efficient market and there's a pick-up in spread versus equivalent credits in corporate markets. There are interesting areas that are securitised that you can get exposure to through structured credit. We're talking to clients more and more about it but haven't seen the volume of investors near this as they are in some of the other credit markets.

Payne: There's an understanding that there's value there, but there's also an understanding that you've got to look incredibly carefully at the structures.

Trusty: That complexity lends itself to why there is a pick-up in premium.

How do you benchmark funds in these markets?

Hussain: We use a LIBOR plus target. Most of the private debt space pretty much uses that. I could reference benchmark my fund to underlying credit classes, but I'm not sure how much use that would be. What I want to offer investors is a return through a cycle. So if I'm shadowing a benchmark I'm going to end up leaning towards that whereas what I'm trying to do is protect cashflow to provide income. That's what my fund is designed around, it is LIBOR plus four, therefore I don't want a negative return and through the cycle I shouldn't deliver that. On the flipside, with benchmarking you get rewarded for potentially giving a negative return.

Payne: It is important that trustees dig beneath the target and understand how much capital preservation is an absolute focus. Is it a focus where it is more important getting plus five? And where does it fit in the hierarchy? Fund managers will vary significantly in their approach to that.

Goodyer: These funds are quite hard to benchmark in the short term because the market moves up and down. The implication of what you're holding will vary, but I agree that LIBOR plus translates well over the longer term because most schemes are fairly well hedged and therefore you're getting a fixed spread above LIBOR. If you're picking that up, it's doing its job and that's what the trustees want is to sleep well at night because their managers are doing a good job.

Trusty: It's harder for the less liquid funds. You can look at the track record of similar managers and try to benchmark it that way.

Rai: The most important thing is looking at their net return target and whether they've achieved that or if the deals they are looking at are in line with their investment policy and style.

How much longer has alternative credit to run until investors return to more traditional assets?

Hussain: The reality is that alternative credit has changed quite a lot over the last ten years because the underlying markets have changed. You can now have diversified credit pools, structured secured debt, high yield and leverage loans in a way that you couldn't before. Investors are investing medium to long term to meet their needs and this asset class is here to stay. It's transformed from the Wild West where only hedge funds operated and charged exorbitant fees to something which is more accessible with a track record and straight forward structures for people to understand the underlying parts and what the risks are. In a way it's the future of the leverage markets because why should the asset allocation decision sit with the trustee? It should be with the specialist who's seen these markets and can pick the best investments.

Trusty: The banks aren't coming back to this space, so there's going to be a place for alternative capital as access to the market grows for institutional investors. The opportunity is not going anywhere. It's multi-year.

Goodyer: It's not just the structural shift on the supply side. It is also demand from increasingly cashflow negative investors looking for income paying assets.

Payne: That's true. As pension schemes mature they'll either look to buy-out, in which case they will buy assets which insurers will take, or they will turn themselves into mini insurance companies. Pension schemes will be looking to make sure they have secure income to pay benefits and this is what this area provides.

Rai: Portfolio construction has changed. You set up the drawing board and discuss your return targets and look at the best way to achieve that given the environment. Given the regulation change and the structural shift the: "okay, here's my equity, here's my bonds and maybe a little bit of real estate", is not something you can go back to.

You can't turn back QE. You can't just take all of that money out of the economy. So how people invest has changed and this is the next step to it. There will be more niche strategies from managers to differentiate themselves and then as the cycle progresses there'll be more special opportunities or perhaps people will look at leverage loan, illiquid or middle market stuff. Those kinds of shifts you could expect but we have probably past the point of saying: "This isn't going to exist anymore."

Storms ahead? Don't forget your MAC

Azhar Hussain, Head of global high yield
Khuram Sharih, Senior fund manager

2017 was a volatile year for fixed income and the stormy environment provided the ideal backdrop against which to test Royal London Asset Management's (RLAM) newly-launched Multi Asset Credit (MAC) fund. Managers Azhar Hussain and Khuram Sharih introduce the fund and update on its composition and their approach to building a fund designed with the aim of generating consistent returns with low volatility through the credit cycle.

Different types of rain

As shown in the table below, our 'alternative' credit approach for MAC seeks to target attractive returns without compromising liquidity or significantly increasing volatility, as is commonly the case at the riskier end of the credit spectrum. Our fund invests in assets across the global credit universe, including loans, high yield and asset-backed securities. The fund is also not constrained by following the allocation of a particular benchmark index.

The fund was launched in July this year and targets lower volatility than traditional investment grade and high yield portfolios. This is a product of the mix of assets held and the focus on high quality security selection and volatility management. As shown in the chart on page 17, fundamental credit selection in combination with diversification across asset classes aims to dampen volatility while increasing certainty of returns.

The Multi Asset Credit Universe examined

Characteristics	Traditional	Alternative	Illiquid
Return (LIBOR)	+2%	**+4%-6%**	+8%-10%
Duration	5 to 10 yrs	**1 to 4 yrs**	N/A
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

Our approach to investing in this area is based on two principal beliefs:

1. Credit markets are inefficient: this is something common to all credit portfolios at RLAM – basically that security is undervalued while liquidity and volatility are mispriced. Our credit research and selection looks to exploit these inefficiencies, from a bottom-up perspective.
2. Credit sub-sectors have their own cycles: a combination of top-down strategic perspective with individual security analysis creates a portfolio comprised of assets across multiple sub-sectors, strengthening the credit quality of the fund and reducing volatility and asset correlation.

Checking the weather forecast: minimising volatility

While it is important to generate returns, we do not chase yield and aim to keep volatility low. One of the tools at our disposal is the use of leveraged loans. Companies utilise loans to raise finance, for

example, for mergers and acquisitions, or restructuring their debt-to-equity profile. At the moment, in an environment of low interest rates around the world, many companies are diversifying their capital structure to include loans, in addition to traditional bonds, taking advantage of low rates.

The coupons of loans are tied to an external rate and are periodically re-set, meaning that they offer protection against a rise in interest rates. They are also short duration and offer an attractive yield and better security than many other types of fixed income investment.

Against a backdrop where we expect interest rates to rise, we think that investment in leveraged loans, given the security and interest rate protection they offer, is a logical step for diversifying your portfolio and adding higher yielding assets. The fund also has exposure to global high yield debt, asset-backed securities and other secured debt. We believe that for long-term investors who need to protect capital and generate an attractive level of income, loans are an essential part of a balanced portfolio.

The all-weather solution: MAC

Our investment philosophy underpinning the MAC fund is consistent with RLAM's overall credit investment approach, which aims to exploit inefficiencies in the market by using our expert research to uncover mispriced opportunities. In our MAC portfolio, we combine our core bottom-up fundamental stock selection process with a top-down strategic allocation view, to construct a portfolio of our best ideas.

By constructing a portfolio across the credit spectrum, our MAC fund aims to generate consistent returns with low volatility. For all long-term investors, stability is a key factor in compound returns, and we believe that our MAC strategy is well-placed to weather the storms ahead.

Spreads vs. Volatilty by Asset Class

Source: RLAM as at 30.09.2017. Indices: High Yield Bonds = BB-B Global Non-Financial High Yield Constrained Index, Leveraged Loans = Credit Suisse Leveraged Loan Index, IG Bonds = BAML IG Global broad market Corp. excluding Sub Fins. Annualised volatility used from January 1999 to September 2017. RLAM's MAC volatility is target volatility of 2-4%.

ASSET MANAGEMENT

Past performance is not a guide to future performance. 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 views expressed are the manager's own and do not constitute investment advice. Sub-investment grade bonds have characteristics which may result in a higher probability of default than investment grade bonds and therefore a higher risk. For funds that use derivatives, their use may be beneficial, however, they also involve specific risks. Derivatives may alter the economic exposure of a fund over time, causing it to deviate from the performance of the broader market. or more information concerning the risks of investing, please refer to the Prospectus and Key Investor Information Document (KIID). Our ref: AL RLAM PD 0004

Alternative credit: Too hot to handle?

Alternative credit is an option for institutional investors looking for a new home for their cash, but should pension funds gain exposure to the sector to replace the disappointing returns offered by higher grade debt? *Roger Aitken* explores the landscape.

Should pension funds and other institutional investors handle alternative credit with care? As a relatively new but growing sector many institutional investors hungry for yield are turning their gaze towards this area.

Increasingly European pension funds have become active in the wider alternative credit space, particularly in private debt. The latter has seen significant growth from just a handful of investment options years ago to dozens of subset strategies today. At least considering this market has become necessary.

Reflecting on growth in the private debt space, alternative asset data provider Preqin estimates that the value of global private debt assets has quadrupled since 2006, reaching $595bn by June last year. Between December 2015 and June 2016, assets under management (AUM) in the private debt sector had grown by 7.1%.

Yet with a diverse spectrum of products on offer in the alternative credit space, navigating and evaluating the potential risk-adjusted returns and the complexity of the underlying assets as well as individual products is not without challenges.

As an emerging asset class that was formerly dominated by the banking sector, alternative credit provides investors with a variety of opportunities for earning income and offers the benefits of portfolio diversification.

With all the various opportunities on offer sharing similar qualities, yields are higher than traditional fixed-income and the cash-flow-matching potential is similar. Some alternative credit strategies contain a floating rate coupon floor to protect lenders from negative rates.

A guidebook published this May by NN Investment Partners' (NNIP) titled 'Alternative credit and its asset classes: A guide to understanding the complex universe of private debt assets', noted: "In the past decade, the European lending landscape has become highly complex, with many players, numerous alliances and partnerships, and a wide range of overlapping terminology."

ALTERNATIVE OPTIONS

The term 'alternative credit' spans a range of strategies and products, from tradeable syndicated loans to direct lending to corporates. It is any credit that is not sovereign debt, semi-government or traditional investment-grade corporate debt. This subcategory includes high-yield, emerging market debt, structured credit and bank loans on the liquid side and private credit, direct lending, specialty finance and distressed debt on the illiquid side.

Even for the experienced professional it is difficult to capture the meaning of the different terms used in this field. As well as direct and syndicate lending, it also includes private debt (senior and subordinated loans), leveraged loans, senior secured bank loans, club deals, private placement, alternative fixed income, mezzanine, senior and unitranche. The latter structures essentially single loans that combine senior and subordinated elements.

Not only can each term mean different things to different players, it can be "just as difficult to decipher the corresponding business models, co-operation structures, alignment of interests of counterparties and the regulatory framework", according to Hague-headquartered asset manager NNIP, which at 30 June 2017 managed around $280bn.

Its 140-page guidebook noted that "exchanging government bonds or investment-grade credits for alternative credit with a similar risk profile provides a yield pick-up of 50bps to 125bps".

Alternative credit offers characteristics with long duration and predictable cash-flows that is also highly suitable for liability matching. Default rates are relatively low and recovery rates comparatively high, which leads to lower write-downs.

Added to that, there is low market value volatility due to mark-to-model valuation, which makes the portfolio less vulnerable to market sentiment and offers a steady cash yield. The alternative credit market size offers a scalable alternative to government bonds and investment-grade credits, but investors should beware of pitfalls.

NNIP head of the alternative credit boutique Gabriella Kindert, a co-author of the guidebook, said: "Despite their differing dynamics and risk parameters, alternative credit investments share a number of common features. These include a deep understanding required to assess the asset class and credit risk, the investment decision is bottom-up and the investment is illiquid.

"Transparency remains an issue in many asset classes," she added. "And, it is not easy to find an appropriate, objective benchmark to assess the quality of investment selection and monitoring."

True sources of alpha generation in alternative credit remain: 1, the assessment of assets on secondary and primary markets; 2, the quality of risk assessment and ability to avoid losses without compromising on the expected portfolio return; and 3, the costs and efficiency in managing assets.

> **"The liquid leveraged loan market is currently very hot, arguably over-heated, with leverage multiples rising, price compression and poor terms."**
>
> Anthony Fobel, BlueBay Asset Management

Wallace Wormley, founder and managing director of UK-based private investment consultancy OSPARA, which advises Pan-European institutional investors including pension funds, said: "For several years now, there has been a growing trend for institutional investors, sovereign wealth funds, pension funds and family offices to consider and use alternative credit in their portfolio constructions."

One reason for this growth, according to Wormley is that "too much investor capital has been tied up in core debt exposure, with not enough alternative sources of return". Another reason cited is that the marketplace has recognised this fact and "rapidly developed more products" within this sub-asset category.

"For example, there is an increasing influence of private credit within mainstream finance and it is playing a role in supporting the real economy," he added. "This change is taking place as the shift from traditional bank lending towards private credit looks to be a permanent one."

There are also regional variations in the growth and uptake in the sub-sectors of alternative credit. Take the US, where about 10 times more capital is allocated to distressed debt compared to continental Europe, Wormley noted.

LIQUID V ILLIQUID

In terms of what investors should choose to invest in from the myriad of options confronting them, perhaps the starting point is to decide on whether to focus on the tradeable part of the market (including high-yield bonds) or the more illiquid section, which is known as direct lending or private debt.

The direct lending market in Europe comprises more than 70 firms each with about €500m of AUM, with only nine firms managing more than €2bn. Despite the pressure banks face, direct lending firms account for less than 0.5% of the European lending market today.

Anthony Fobel, managing partner of BlueBay Asset Management's private debt business, which manages more than €7bn in direct lending funds, said: "Investors seeking to work out who will achieve the best returns will have to delve into the quality of the team, details of the underwriting process, rigor of the due diligence as well as the ultimate calibre of investments."

Focused on 'event-driven' lending to, for example, fund an acquisition or provide growth finance for European medium-sized companies with €100m to €300m of revenue, BlueBay's Fobel added: "These investors will also have to assess whether the team in question has the expertise to manage difficult situations, which will inevitably occur when the markets turn down."

Despite BlueBay's position as one of the

largest and most established players in the fast growing European direct lending market, having recently closed its first senior loan fund at more than €3bn, Fobel noted that this leading position brings advantages as well as challenges.

"We are seeing a certain amount of competition and poor structures from the liquid loan market filtering down into the private debt market for larger deals, although covenant discipline remains a feature for most private debt managers," Fobel remarked.

"The liquid leveraged loan market is currently very hot, arguably over-heated, with leverage multiples rising, price compression and poor terms," he added. "More than 60% of these loans are now 'cov-lite', which is extraordinary given the lessons that you would hope had been learned following the financial crisis - but people have very short memories."

BlueBay sees covenant protection as "vital in preserving capital" in a situation where businesses underperform due to company specific or economic downturns, he said.

But going forward it will be important to pinpoint sectors of private credit that can maintain high barriers to entry for traditional banks.

Nick Warmingham, a senior investment director at investment consultant Cambridge Associates, echoes Blue Bay's Fobel on the quality of the team and details around the underwriting process, pointing out that when underwriting a manager ideally "one would look for a team that has worked together on restructuring situations".

However, noting a paucity of data on how funds have performed during a credit crunch, this makes it difficult for pension funds to examine track record and performance. Hence recognising managers that standout can prove problematic.

RETURN TARGET

Given that yields in the direct lending market have declined of late, the demand and supply dynamics are pushing managers to raise leverage in funds in order to meet expected return targets. That poses challenges for pension funds. As such they need to choose investments that match their return targets as well as managers who are likely to succeed by navigating through tricky times.

But as asset managers are competing to offer lending, they may sometimes alter the covenant lever or leverage lever. In so doing this changes the risk profile of funds. The upshot is that it can prove quite difficult to decipher and understand where managers are taking on added risk.

For investors considering alternative credit it helps to keep an open mind, especially since there are several other asset classes within the sector apart from private debt. Some like Trey Parker, head of credit at Highland Capital, believes there is a "liquidity advantage" to being invested in a tradable asset class versus a non-tradeable one. And, this was despite the higher mark-to-market volatility.

Others like Ranbir Lakhpuri, a portfolio manager at Insight Investment for secured finance, see advantages in syndicated loans compared to direct lending due to lower leverage in the market. That said, the former can exhibit covenant-light transaction and weaker documentation.

For others, the structured credit market is seen as offering opportunities, provided managers take on sensible levels of risk. With a rise in the number of unitranche structures - complex structures that enable higher leverage and a promise of heightened returns from the loans - their risk and complexity aspects could make them a potentially unsuitable investing avenue for pension funds.

CASE FOR THE DEFENCE

Alternative credit and private asset products are certainly appealing given that they could provide a stable investment return, increase the diversification of the portfolio and can be regarded as a defensive asset class.

As pension funds acknowledging that a static 60/40 portfolio allocation to equities and bonds will not be sufficient to meet their long-term target returns, the risk and return profile of alternatives will keep them in the spotlight.

However, as Kindert at NNIP noted: "Due to their illiquid and complex nature, investors should develop the ability to assess the different products, create alignment of interests among stakeholders, and put stronger emphasis on the governance framework to ensure that companies have sufficient guidance to navigate a vastly changing financial world."

> **"For several years now, there has been a growing trend for institutional investors, sovereign wealth funds, pension funds and family offices to consider and use alternative credit in their portfolio constructions."**
>
> Wallace Wormley, OSPARA

Whatever the sub-sector, funds should monitor managers and investments carefully. With alternative credit having grown substantially during a prolonged period of low interest rates, it raises the possibility that risky loans have been extended to less than robust borrowers. As such investors should focus on due diligence and evaluate opportunities across the entire sector.

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Editor: Mark Dunne

Contact:
John Waterson
Phone: +44 (0)20 7822 8522
j.waterson@portfolio-institutional.co.uk

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Contact us to find out more:
John Waterson
Phone: +44 (0) 20 7822 8522
j.waterson@portfolio-institutional.co.uk

Roundtable schedule for 2018

February 2018 – Multi Asset or Liability Driven Investments
March 2018 – ESG or Insurance
April 2018 – Defined Benefit Strategies or Portfolio Structure
May 2018 – Responsible Investing or Deficit Management
June 2018 – Risk Reduction or Diversified Growth Funds
September 2018 – Impact Investing or Factor Based Investing
October 2018 – Property or Infrastructure
November 2018 – Multi Asset or Alternative Credit
December 2018/January 2019 – Liability Driven Investments or Fixed Income

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