Constructing a debt portfolio without boundaries has many benefits. Picking fixed income assets regardless of type, jurisdiction or rating could, depending on the manager, provide investors with the nimbleness to move to where the risk-return profile is more attractive if markets change. This is what multi-asset credit (MAC) funds are designed to do. Yet there are concerns.

Did these funds perform as the marketing claimed they would during the Covid-induced economic disruption we saw last year? How can managers be expert on the entire fixed income universe? And how can they include ESG into such portfolios? We brought together those who invest in, manage and advise on such funds to discuss these questions and more.

DISCUSSION: MULTI-ASSET CREDIT

What does multi-asset credit (MAC) mean to you, Alex?

Alex den Braber: Managers aiming to capture different credit risk premiums by investing across a range of securities, geographies and sectors within the fixed income universe.

Investors typically select multi-asset credit because they can see, through experience and modelling, better risk-adjusted returns. That is from the diversification you get across the different credit markets.

From a top-down perspective, a multi-asset credit manager can navigate different markets and sectors as cycles change, giving the benefit of not only managing risk, but exploiting the dislocations that constrain single strategies.

Lloyd, you joined Border to Coast to establish a MAC strategy. How is that going?

Lloyd Thomas: To a certain extent, our partner funds are partially invested in a MAC strategy of some description, so we have transitioned them into our MAC proposal.

We are trying to understand where we should be positioned, so identifying where we are in the cycle is important.

There is a lot of work to go into formulating an investment framework and process. It is an absolute return product, which is the first within Border to Coast, so it is a slightly different animal. There is a lot to do.

How easy has it been to create this strategy during a lockdown?

Thomas: There are synergies from working from home in that you can get a lot of the detailed work done, but you need to be in the office to discuss ideas. In our line of work, trading information is crucial.

There is an element of necessity to be around people on the team to gauge their views and then interact with each other. There is a balance to be struck over the next couple of quarters, which hopefully we will get an opportunity to do.

Why are institutional investors employing MAC strategies?

Andrew Cole: Two of our schemes use them as an alternative to illiquids. For one scheme, we were in a queue to invest in real estate towards the end of 2019. Due to the time it was taking to invest and the uncertainties of real estate going through Covid, we changed to a MAC strategy. It is more liquid and had a similar return profile.

I like MAC. It is not a single strategy, so one can look across different fixed income asset classes. The fund we invested in is 70% high yield as well as short duration loans, which is positive in an inflationary environment.

So far it has been reasonably successful, although credit spreads are tight.

Tegolin Harding: There is a sweet spot in terms of the size of scheme when it comes to MAC. Larger schemes tend to have individual credit sleeves within the portfolio and do it more on a holistic basis. Medium-sized schemes want a manager who can move around the credit spectrum to access the illiquidity premium in a more liquid way.

As a bondholder you have more direct influence speaking to the finance director of a company than you do if you are a shareholder.

Andrew Cole, BESTrustees

THE PANEL

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Andrew Cole
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Boards are turning to inflation. A lot of MAC strategies can be cash plus and offer a degree of inflation protection.

How did multi asset credit strategies perform during 2020 when Covid caused such economic upheaval and volatility?

Paul Whelan: When we entered 2020 it was a Goldilocks period. Spreads looked relatively tight, volatility was relatively low and global economies were doing okay. There was no catalyst for further spread tightening, nor were there any reasons why there should be a pickup in defaults.

Clearly that landscape changed fast due to the dreadful surroundings that we saw with the Covid-19 pandemic. That, in conjunction with escalating tensions between certain oil exporting nations in February, led to a huge pickup in market volatility.

Due to the unprecedented nature of the crisis, we saw a huge pickup in demand for cash as all asset classes on the risk spectrum suffered significant mark-to-market losses. Even ultra-safe AAA-rated debt saw an aggressive widening of spreads.

As is always the case, panics create opportunities. Towards the second half of March, we saw a large co-ordinated response from central banks around the world that helped sure up the capital base. We often talk in financial markets about what letter shaped recovery we see, but we need to look more to our mathematician friends. The projection we have seen in credit since the end of Q1 last year has almost been square root shaped. In most asset classes we saw a sharp downturn and then a sharp recovery.

We are sitting today in the position where many sectors in the credit market – except for those most directly impacted by Covid, the likes of airlines, retail and leisure – now have spreads even tighter than we saw 20 months ago, before anyone had heard of Covid-19. That shows how much support has gone into the markets from the central authorities, and how much cash there has been on the side-lines for investors to put to work.

How easy was it to gauge the performance of MAC funds in 2020?

Harding: It was quite difficult. MAC gives you peace of mind that if markets look a bit choppy, your manager will move you into safer areas. But that did not always work during 2020 because loans were hard hit.

It is difficult from a trustee perspective to know whether that is an external factor, a one-in-20-year event or whether the manager is getting something wrong. What they said was a safe and boring portfolio, is proving not to be that safe and boring after all.

Have client expectations from MAC funds changed in recent years?

den Braber: That is a tough one. In its simplest form, investors want the return MAC offers, but they also want diversification. For a pension scheme, that is largely against their equity portfolio. They also want the governance solution, in terms of the holistic oversight and management MAC provides.

US clients are beginning to diversify away from US core and traditional long-only credit. The credit spread of the flat Treasury yield curve is coming down. So, multi-asset credit lets you access other areas, such as sub-investment grade, emerging market debt, securitised credit – all the flavours that offer a better return.

In the UK, there are different reasons for holding multi-asset credit. For some clients, it supports the theme of contractual income or long only income focused strategies. We are seeing a shift in expectations that a MAC strategy can help support that approach.

It has also seen a shift in appetite from clients that have become disillusioned with waning returns from diversified growth funds (DGFs) and absolute return bonds. They see multi-asset credit as an alternative that can provide attractive returns or to de-risk by rotating out of equities to provide short-term security.

MAC can be a governance solution for clients who do not have the skill, nimbleness or luxury of investing across various sectors. It ticks the box for clients who also want simplicity. So, we have seen demand for rationalising complex portfolios.

The big change, which started just over two years ago but has ramped up, is clients want to see evidence of responsible investment in their credit strategies. Managers cannot ignore it. If they do, they are unlikely to get selected.

Cole: We have only been in MAC for a short time as I have become tired of diversified growth funds failing to perform.

There are many strategies within the MAC asset class. For those that are a little racier and want more high yield, they can be an attractive place for schemes to take a little more risk in a controlled way. We are in a low-rate environment, so it is difficult to achieve high returns.

Has there been much product development in this space?

Allen: The big change within the credit space has been engagement on responsible investment and ESG. Clients expect more. It is no longer acceptable not to engage fully on the responsible investment front.

We are seeing more managers evolve their strategies to incorporate aspects of sustainability, whether that be via exclusions or introducing ESG scoring into their process. But it is going beyond integration with more managers coming to market with specifically labelled responsible products.

This is not just a European story anymore. We are seeing more US managers engaging, which is great to see. We are getting to a place where there is better breadth in fixed income with strategies that are engaging on responsible investment, which means we can construct broad MAC funds without losing out on value generation elements like sector rotation.

Historically, it was tricky to do that in sustainable credit because strategies were focused on green bonds or investment-grade credit. It lacked the variety needed to construct proper strategies in this space.

A final point, it is becoming less acceptable to charge higher fees for responsible investment incorporation. It is now seen as something that is expected, which is a positive move.

How are inflationary fears impacting credit strategies?

Whelan: Some sectors are benefiting. The start of 2021 was characterised by a steep sharpening of the underlying interest rate curve as expectations of tightening from the Federal Reserve impacted markets. Certain areas of the credit markets will be immune - if not benefit - from rising interest rates, such as the bank loans market and the floating rate area of the securitised market, which is an often-overlooked allocation, particularly with UK pension funds.

Furthermore, we are beginning to see more differentiations in emerging market economies. For example, a sharp rise in the oil price – from negative to touching $70 per barrel. This has led to a big

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> Paul Whelan, Aon

impact in the differences in finances and risk appetite for countries which are oil exporters, versus countries which are oil importers within emerging markets.

However, some of the other conditions may be somewhat second order inflationary. That has been around the accusation that monetary authorities have allowed conditions to become too loose. This enabled a huge amount of corporate bond issuance to come to market post the onset of the crisis in 2020. It is now expected to see significant large upgrades from high yield, many constituents of which were investment grade when issued, and seeing them return to those major investment-grade markets. Expectations are that another $200bn of high-yield securities could get back to investment-grade status in 2021. That further limits the pool of assets available in the sub-investment grade space. The current environment will provide additional support to credit spreads from here as a lot of investors are on the side-lines looking to diversify.

With all the fears about inflation, is this a good time to launch a MAC strategy?

Thomas: If you look at it from a cycle perspective, one of the strengths of MAC is that you have a broad opportunity set and levers to pull to smooth your returns through a cycle.

There will be weaker environments and stronger environments and you will not fully sidestep all the negative returns, but you have the tools at your disposal to manage your fund through a cycle. That is why investors like MAC.

Are investors worried about inflation?

Harding: All schemes are turning their attention to inflation to one degree or another. The larger schemes are fully hedged through their liability-driven investment (LDI) portfolios, but there is a concern that credit mandates will underperform unless they have a large allocation to something that is floating rate.

A lot of my schemes are focusing on ESG and climate change. Investment managers are aware that they will not be appointed unless they can demonstrate their credentials in this area. Everyone will tell you that they are doing an excellent job here, but it is difficult to see what is genuine and what has been generated by the marketing team.

Allen: We work to a framework when building portfolios, which includes incorporating our research team's ESG assessments. We only invest in managers who meet our standards, largely driven by the research from Paul and his team.

How do you avoid greenwashing, Paul?

Whelan: There are a few steps we take to mitigate that risk. One is the good old-fashioned rolling your sleeves up and getting heavily integrated with the managers to discuss responsible investing and ESG considerations.

It is talking with the analysts and fund managers, going through examples, seeing the engagement records in detail to get credible evidence, positively and negatively, of where managers have changed positions due to responsible investing considerations.

Another part of it, which comes back to the old adage of what gets measured gets done, is to have explicit key performance indicators (KPIs) in place with managers. One way we have done that is to work with large managers to create and seed some of the vehicles they are establishing.

As part of that product development, Aon has been shaping those recommendations by putting procedures in place that prevent managers from greenwashing by having credible, sensible targets, which, critically, can be monitored.

Allen: This is not a one-off assessment. Things change quickly in this space, and the pressure on managers means that they are improving. The ongoing monitoring and engagement piece is important. Our managers answer an extensive ESG due diligence questionnaire every year. We discuss their answers with them, set goals and have touch points where we can assess progress.

That process is invaluable. It is easier for a manager to say they are doing something in a one-off meeting and then not do it, than it is to be grilled on the issue every six months, which brings things out in the wash.

Lloyd, how does this differ from when you decide if a manager is walking the walk or just talking the talk on ESG?

Thomas: An ESG process is integrated into Border to Coast and we are supported by a dedicated team. Our partner funds want us to manage and monitor the ESG process correctly.

When selecting managers, we look at their broad ESG capabilities, not just at the MAC level. That is an important factor when selecting funds.

In addition to that, because it is so in demand from investors, we are seeing encouraging signs even in credit, where there are difficult structures and the beneficial ownership is different. We are seeing our managers endeavour to make pro-

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> Lloyd Thomas, Border to Coast

gress in mapping certain traits in their investment processes.

What we have seen has been positive, but to get up to speed with the equity world there is quite a bit of work to be done, but we are travelling in the correct direction.

Andrew, how do you assess MAC funds to ensure you are backing the right managers?

Cole: We look at the investment strategies, the actual portfolios, speak to managers and decide if they fully appreciate the risks that they are taking and how they have performed during difficult times.

Asset managers are fantastic at selling their story. What concerns me is what happens when something goes wrong, because something always goes wrong. I am also interested in their experiences of different credit asset classes, jurisdictions and currencies. So, for example, how are they hedging Hong Kong dollar bonds into sterling?

We try to challenge fund managers as much as we can, but at the end of the day we are trustees, not credit experts.

Going back to ESG. In the credit space, it has been relatively slow to take off in comparison to the equity world, which is surprising. As a bondholder you have more direct influence speaking to the finance director of a company than you do if you are a shareholder. So, it could be argued that credit funds have more power to change what underlying companies are doing.

Harding: Historically, engagement has focused on how your manager is voting. In reality, that has limited impact. It is the conversations when finance directors come to market every three or five years to raise capital that can influence a company's behaviour.

Finance directors can get a cheaper cost of capital if they demonstrate that they are hitting their ESG goals. That is moving the conversation forward because everyone is aware of the importance of this. It is starting to fit together.

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>
> Philippa Allen, Aon

How easy is it to get ESG into a MAC fund?

Thomas: A lot of work has been done on technical integration over the past few years, so it has become easier.

It is a problematic asset class. It is not as easy as getting ESG into equity, but that is not to say it is impossible. It is plausible to integrate ESG into MAC, we just need true buy-in from all managers, not greenwashing.

A cheaper cost of capital is a big incentive for a company. Soon it will be easier, more straightforward and it is evolving in the right direction.

How are MAC funds making a positive ESG impact?

Allen: Managers are approaching this in different ways. As a starting point, they are integrating ESG considerations in their process, so scoring securities and engaging more with companies.

We are also seeing managers taking an additional step of restructuring or launching products to be explicitly sustainable. The two main themes here are that credit strategies tend to be climate aligned – so investing in green bonds – or are aligned with the UN Sustainable Development Goals.

Those seem to be the key areas where managers are demonstrating that they are doing this sensibly. That is the approach we take within our own MAC fund.

What changes do mainstream MAC strategies have to make to be more sustainable?

Whelan: We are somewhere behind the equity space but are moving in the right direction. Integrating ESG as a financial risk is now pretty much taken for granted as a requirement.

We have moved on from ESG strategies being about excluding the so-called sin factors to positive ESG engagement.

More corporate issuers are coming to market with sustainability linked KPIs, which are measurable, sensible and tangible goals that impact the cost of capital positively if the issuing entity achieves them.

The fixed income market is somewhere behind our equity colleagues in terms of

ESG and responsible investing-specific benchmarks, but we are seeing exciting developments with Paris Accord-aligned benchmarks in the fixed income market. This gives us far more evidence to interrogate fixed income managers. As I said previously, what gets measured gets done. It is having managers report in a pragmatic way on their achievement, rather than just saying that they have reduced carbon by 20% versus a benchmark. That is simple to do. You only need to exclude a small proportion of the issuers in the benchmark to have an enormous impact on the carbon footprint of a portfolio.

Secondly, it is quite a naive decarbonisation process that might help today, but we want to see an evolution and a commitment to achieving net zero.

It is about engaging more with investors, showing more evidence and reporting more. It is simply being more accountable by evidencing these decisions and reporting in a comparable way across strategies and managers so investors can make informed decisions.

How easy is it to measure the ESG impact of a MAC fund?

den Braber: It is hard. You need the oversight and expertise from someone who has rolled up their sleeves and got stuck in with the manager. Ultimately, clients want to see evidence. So, we need good data quality. It is evolving and improving, but it has a long way to go.

Also, within that data not all aspects of sustainability are captured. A lot of it is assumption driven, so it is not particularly robust. Different data providers will give you different information.

One example is a well-known utility company. There is one score for that entity, so if they issue a two-year bond, a 10-year bond or a green bond you get one score regardless of which credit you invested in. That is hard to look through and analyse from a pure data perspective.

We have talked about sustainability and ESG, but investors are looking at these through different lenses. Some will have a climate metric focus with others focusing on the Paris Accord or the UN Sustainable Development Goals.

The data is patchy in credit. It will improve. It is in its infancy, so clients need to be patient. Back to the key point, if they do not report it, it does not get done. So, we need to keep pushing and engaging.

How much value do you put on these ESG scores, Lloyd?

Thomas: The data is fallible, but it is improving. It is not a perfect science, but it is moving in the right direction. That progression is important.

There are examples of good work being done by managers. They are trying to digest it, which is difficult to do instantaneously to reflect the demand of investors. It takes time and a large amount of resource.

It is understandable that this is a progressive process. It is not binary. You cannot turn it on and off. It needs to improve and that will take time, but it will be better.

Andrew, we did not get your views on inflation.

Cole: It is not something we are particularly discussing with our managers, but we are within the trustee and investment committees I sit on.

In most schemes I am involved in we are in good position in that we are significantly hedged, so inflation is not too much of a concern for our liabilities. The real concern is with respect to how inflation could affect our asset portfolio. This is something we are looking at.

On ESG, I do not buy into it being harder within the credit sphere in that the number of bonds available to purchase are limited. The fixed income market is significantly larger than the equity market, but the number of issuers is significantly smaller.

I am not so concerned if a manager invests in a green bond or a non-green bond from the same issuer. Green bonds were originally issued because they could get the transaction away 2 basis points cheaper, so from the finance director's perspective there was a benefit.

What I am interested in is getting the higher return and that there is engagement with the financial director from an ESG perspective.

Allen: A lot of the climate aligned and focused strategies are indifferent between green bonds and what are called un-la-

Different data providers will give you different information.

Alex den Braber, Aon

belled green bonds. You are getting a broader approach where managers are engaging with companies and getting impressive commitments because they have that close relationship with finance directors, while looking more at what the company is doing and how those proceeds are used rather than any labelling for marketing purposes.

Harding: Just wanted to come back on investors needing to be patient with ESG data. I would challenge that. My best successes have come when I have been the opposite of patient, albeit in the buy-and-maintain space.

When asking managers to breakdown their portfolio across various criteria, the initial response is that the data is not available. When you respond with: "Find that data or I will fire you," it is amazing how quickly you can get full disclosure. I would encourage investors to be anything other than patient on this.

Allen: We are not patient. A lot of the engagement work we do is about data, transparency and reporting because that is critical to assist managers and for clients to know what is going on. There is a trade-off in that we can be as impatient as we like and push managers to give us information, which they do. The challenge is that different managers provide different data, which is assessed in different ways because it is subjective.

We do not have those solid data sets from mainstream providers that managers are comfortable with.

Managers are taking that extra step and looking at things in their own way. They often disagree with some of the data providers.

So, it is hard looking across a spectrum to get a consistent picture, even though our underlying managers will be responsive with giving data when asked. It just is not a cookie cutter.

There are aspects where we need to be patient for consistency and transparency and providing what can be provided in the meantime.

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> Independent Trustee Services

What do you expect to see in the multi-asset credit space in the next 12 months?

Thomas: I like to frame it using cyclical analysis, to understand the background and identify where we are in the cycle. Ultimately, the background of supportive monetary policy is not going away. Default rates are low and corporate earnings are good, which I caveat with rich valuations. If you look at the covenants, they are issuer favourable. These are signs of a late cycle.

Ultimately, what you take from that is returns should not be stellar, given the backdrop. They should be mid-to-low single digits, with the majority through carry. It is difficult to see where you get additional capital appreciation. There are some pockets of value within the MAC opportunity set, but not much compared to the past six to 12 months.

That is the base case. A resurgence of the virus could challenge that and the global growth outlook. Inflation is not as big a threat as it was two months ago, but is it transitory? It has been interpreted by the market by global yields. If that changes, funding rates go up and puts companies under pressure. Risk assets could also be under pressure and that puts us in a high volatility regime, which would challenge the base case and you could have lower returns. There are, however, a few levers to pull you through that cycle, such as increasing your duration.

Harding: From an investor perspective, demand for MAC might be limited over the next 12 months for two reasons. One, we are in a late cycle, so the return prospects are potentially not what they were.

The second, a lot of people who went to MAC for a couple of a percent over cash every year were shocked in 2020 when their product did not deliver. I am not expecting a huge demand.

Cole: There has been huge fiscal stimulus, we are late cycle and so I would agree that there will probably be less investor demand over the coming 12 to 18 months. However, MAC is a good product. It is the ability of the manager to adjust the duration and adjust the underlying credits within the portfolio. Hopefully, if you have the right manager, they can ride the issues out that inevitably will happen over the next 12 to 18 months.

den Braber: In the current environment, corporate bond valuations are expensive. There are some big buyers out there, namely the Fed and the European Central Bank pushing credit spreads lower.

What we are missing is that dispersion across the credit sectors, and investors wanting to take advantage of that could turn to a MAC strategy.

There is also a theme that investors holding equities, who survived the gyrations in the market, might want to de-risk by rotating into multi-asset credit to crystallise their gains and get more diversification.

From the demand side, I expect to see clients putting different MAC managers together, so using complimentary styles to improve diversification. A multi-manager approach is perceived to be more robust because regardless of how broad the manager is there will be biases in how they manage the portfolio.