RBC Global Asset Management
PH&N Institutional

Multi-asset credit: flexibility for navigating a low rate environment

The current environment of ultra-low interest rates and very modest domestic bond yields has many investors considering alternatives to the traditional asset allocation approach. As a result, investment in multi-asset credit (MAC) solutions has been growing. The flexibility and dynamic asset allocation that MAC strategies employ helps to provide effective tools to navigate uncertain markets and to pursue higher yields, thus more effectively meeting the needs of today's institutional investor.

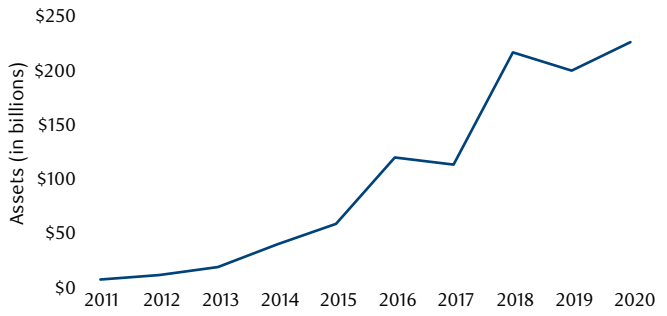
The following paper aims to define the characteristics that make multi-asset credit unique as well as explore the benefits that the inclusion of these strategies can bring to a balanced investment portfolio.

What is multi-asset credit?

MAC is an investment strategy that focuses on building portfolios of diversified credit assets – that is, fixed income securities that carry credit and liquidity risk, and therefore offer higher yields than safe-haven government bonds. Due to their focus on credit assets, MAC portfolios aim to offer fixed income returns beyond those typically achieved through traditional core fixed income allocations. MAC is also commonly referred to as multi-*strategy* credit or multi-*sector* credit, but for the purposes of this article we will use the term ***multi-asset credit*** throughout.

While the concept of MAC portfolios as a distinct strategy type has been around since the 1990s at least, allocations to MAC strategies specifically have grown rapidly over the past decade, with AUM in excess of CAD$225 billion by the end of 2020, as can be seen in Figure 1.

Figure 1: Growth in MAC strategy AUMs
(only showing Composites that report AUM to eVestment)



Source: RBC GAM, eVestment, as at Dec 31, 2020.

The broad and flexible nature of MAC strategies means than one such strategy can look very different from another. There are no definitive guidelines as to which credit strategies are generally included within MAC portfolios; as a result, underlying asset classes targeted, underlying characteristics, and investment objectives can vary greatly. That said, there are a few key features common across MAC strategies. We have listed those below, and expand on each in turn in the sections that follow.

1. They invest in ***credit assets only***
2. They access a ***global investment universe***
3. Investment managers have a ***high degree of flexibility***
4. Investment managers can make both ***strategic and opportunistic allocations***
5. Investment managers can ***use defensive techniques*** to tactically hedge risk

1. Credit assets only

While MAC strategies are generally limited to investing only in credit assets, this does not restrict them to a "narrow" group of assets given that credit markets are extremely diverse, with varying risk characteristics, yields, return expectations, and portfolio benefits. Different MAC strategies may target different subsets of credit assets, and the asset classes chosen will have diverse impacts on a strategy's expected returns and volatility. While there are too many unique subsets of credit assets to list them exhaustively, we have outlined some of those most commonly used in MAC strategies below.

Corporate Bonds	Investment grade rated bonds, issued by developed market issuers
High Yield Bonds	Sub-investment grade bonds, issued by developed market issuers
Emerging Market Sovereign Bonds	Bonds issued by emerging market countries, either in their domestic currency (local currency bonds) or in U.S. dollars (hard currency bonds)
Emerging Market Corporate Bonds	Bonds issued by emerging market companies; these bonds can be either investment grade or high yield
Convertible Bonds	Bonds issued by publicly traded companies that can be converted into a pre-determined amount of equity shares at certain times
Regulatory Capital Bonds	Bonds issued by financial institutions that are converted into equity if bank capital falls below certain limits (triggers), set by financial regulators
Bank Loans	Floating rate instruments that are usually secured by a borrowing company's assets
Structured Credit	Bonds and loans secured against mortgages, auto loans, leases, and other assets
Mortgages	Private lending to commercial and residential borrowers

2. Global investment universe

Access to a broad investment universe is crucial to the successful management of MAC strategies. In order to effectively exploit the flexibility and opportunistic nature of their mandate, investment managers must be able to invest across the broadest investment universe possible, both from a sector and geographic perspective. As global regions, countries, and asset classes are often in different stages of economic growth at any given time, opportunities to capitalize on varying stages of the credit cycle will be present for managers able to look across regions and credit types.

3. High degree of flexibility

Since MAC strategies rely heavily on an investment manager's ability to select attractive assets across credit asset classes and geographies, it is important that managers have the flexibility to quickly pursue opportunities as they arise. For this reason, MAC strategies are often classified as "unconstrained" due to the high degree of investment manager freedom allowed, though this term can be somewhat misleading. In reality, most MAC strategies operate under a variety of different investment guidelines and typically cannot short-sell bonds. However, these strategies do tend to have significantly fewer constraints than a traditional core fixed income strategy. Beyond the broad universe of global credit assets available to investment managers discussed in the first two points above, there are two prominent ways in which managers are provided a high degree of flexibility:

- First, the ***investment limits*** placed on the managers of MAC strategies are often very wide. For example, limits on specific asset classes can be intentionally wide (e.g., a 0% to 40% allowable allocation to high yield bonds) to allow a manager to invest heavily in or divest entirely from an asset class, depending on its relative attractiveness. Another way to implement wide allowable limits is by placing generous boundaries on a specific risk characteristic, such as interest rate duration or credit quality.
- The second key to manager flexibility is the ***strategy benchmark***. In most traditional fixed income strategies, exposures are managed relative to an index benchmark. However, in MAC strategies, investment managers are often permitted a greater degree of flexibility – we found that approximately 75% of MAC strategies[1] do not employ a traditional market benchmark. Instead, they either use no benchmark at all or they target a total return above a more stable, lower-return benchmark such as cash or inflation.

[1]eVestment, as of June 30, 2021

Those MAC strategies that do employ a market benchmark usually use a blended benchmark consisting of a mix of different indices that represent some of the more common asset classes found within MAC, such as high yield bonds, corporate bonds, emerging market debt, and others. Strategies that employ a traditional market-based blended benchmark are typically managed with less of an "unconstrained" style and are therefore expected to be more predictable but less flexible than MAC strategies employing a non-traditional benchmark.

4. Strategic and opportunistic allocations

The highly flexible "go anywhere" nature of MAC strategies allows these strategies to be very opportunistic in the way they seek out attractive investment opportunities across their global credit universe. An investment manager is expected to leverage all of their expertise to not only evaluate a specific asset class, but also to compare the relative attractiveness of all asset classes within their allowable universe by considering the relationship between all of these asset classes (including factors such as correlations, regional and sectoral concentrations, drawdown, etc.) in order to construct the best risk-adjusted portfolio possible at all times.

As credit cycles evolve across regions, countries, and sectors, with a wide variety of local economic environments influencing circumstances at any given time, investment managers must be nimble and resourceful in order to capitalize on opportunities. Therefore, most MAC strategies can be expected to change their asset mix regularly, often on short notice, and particularly during times of elevated market volatility. Making timely changes to the asset mix is key to creating value for portfolio performance, not only to the upside, but also in protecting against drawdowns during times of market stress. For this reason, experience in multi-asset tactical asset allocation is critical for a MAC manager to be successful, as is experience and expertise in each underlying asset class.

5. Use of defensive techniques

The use of defensive portfolio management techniques within MAC strategies is key to creating value in periods of credit market weakness. The tools available to an investment manager will vary by strategy, but the flexibility and opportunistic nature of MAC strategies discussed above enable defensive portfolio management practices to be employed.

For example, MAC strategies often have the ability to divest entirely from certain asset classes if they are deemed to be at high risk of a drawdown. This is a degree of flexibility not typically permitted in traditional benchmark-focused strategies. One consideration associated with the ability to fully divest from an asset class is the possibility for a MAC strategy to run a high cash (or other safe-haven security) balance for a period of time if an allocation to an asset class is significantly reduced as a defensive measure and not immediately re-allocated. While it is important that an investment manager monitor and justify this "cash drag" within a portfolio, the stability and liquidity of a high cash balance when attractive opportunities resurface can validate this approach.

Derivative instruments are another tool in the downside protection toolkit frequently employed by MAC strategies. Derivatives are used to quickly reduce credit risk or geographic risk within a portfolio without having to sell individual investment positions, saving valuable time and also reducing trading costs. Derivatives may also be used in interest rate duration management, as an investment manager can adjust the sensitivity of a portfolio to changes in interest rates while remaining invested in the most attractive areas of credit markets. This is a particularly attractive feature of MAC strategies in times of interest rate uncertainty, and a key benefit we will expand upon in the next section.

Benefits of using a MAC strategy

Now that we've covered what a MAC strategy is, we can examine some of the benefits of employing such a strategy within an investment portfolio. There are many reasons an investor might consider using a MAC strategy within their investment portfolio; in the following section, we discuss several key benefits that are particularly relevant in the present environment. All of these benefits are drawn directly from the key features of MAC strategies discussed in the previous section. They are:

1. **Capitalizing on the global credit cycle**
2. **Yields and interest rate sensitivity**
3. **Risk management**

1. Capitalizing on the global credit cycle

As mentioned previously, MAC strategies invest across the global credit universe, and investment managers have a high level of flexibility to allocate heavily to those areas of the market that appear most attractive, at any given time. There are two primary types of opportunities managers seek to exploit:

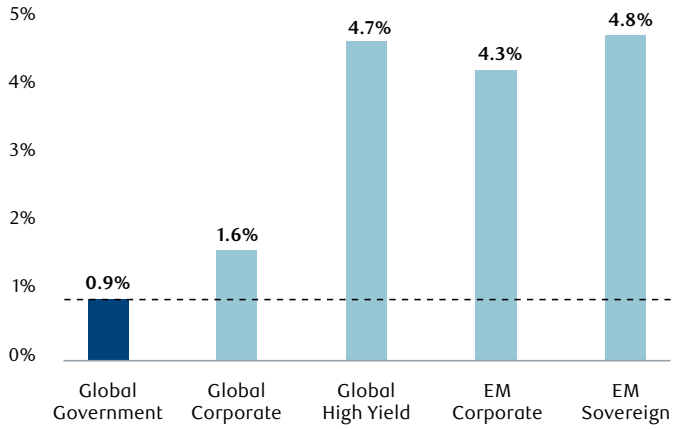
- *Regional differences in the economic cycle.* Despite the increasingly globalized nature of economies and financial markets, there remain distinct differences between economic conditions in different parts of the globe at any given time. Economic growth, central bank policy, default expectations, and sector attractiveness can all vary meaningfully by region. Global monetary policy support measures are a present day example of such differences, with some central banks beginning to gradually withdraw their stimulus measures, while others have clearly communicated a willingness to continue stimulus into the foreseeable future. Different monetary policy approaches will influence interest rate expectations in those regions, as well as the bonds that may be included as part of the asset-purchase programs and the sectors that have benefitted from policymaker support.
- *More attractive valuations.* No single type of credit asset is most attractive from a risk/reward perspective at all times. The list of asset types that offer the most attractive yields or the best opportunity for capital appreciation are continuously changing based on market conditions. During times of market volatility, the ideal window to make a shift between assets can sometimes be only a matter of days. This is where MAC strategies can shine, as their flexible mandates allow them to quickly shift allocations in a way that more restrictive strategies cannot.

2. Yields and interest rate sensitivity

This is a topic that is especially relevant in the current environment. As discussed in our recent publication The Role of Bonds in an Ultra Low Interest Rate Environment, bond yields globally have been declining for nearly 40 years and are currently at historically low levels. Astonishingly, a quarter of the current global bond market carries a negative yield, with 90% of the market yielding less than 2%.[2] With accommodative monetary policy likely to remain a macroeconomic feature for some time, we are unlikely to see a significant reversal of this trend anytime soon.

MAC strategies are able to offer relief in the present interest rate environment due to the higher yielding nature of the assets in which they invest. As discussed in our paper referenced earlier, the decline in bond yields is almost entirely attributable to falling government bond yields. The credit spread that credit assets pay above these government bond yields has remained – on average over a credit cycle – quite similar to average credit spreads of decades past. As a result, higher yielding credit assets are able to offer yields (and therefore prospective returns) that remain very attractive on a relative basis when compared to other fixed income assets. The chart below shows the additional yield available from select credit indices over government bonds.

Figure 2: Global bond index yields



Source: RBC Global Asset Management, Bloomberg, JP Morgan. Data as of June 30, 2021.

- Global Government represented by Bloomberg Barclays Global Aggregate Government Bond Index
- Global Corporate represented by Bloomberg Barclays Global Aggregate Corporate Bond Index
- Global High Yield represented by Bloomberg Barclays Global High Yield Bond Index
- EM Sovereign represented by 50% JP Morgan Government Bond Index-Emerging Markets Global Diversified, 50% JP Morgan Emerging Markets Bond Index Global Diversified
- EM Corporates represented by JP Morgan Corporate Emerging Markets Bond Index Broad Diversified

Beyond the yield "cushion" provided by higher yielding assets in this low yield environment, another major concern for investors in today's environment is the risk of rising interest rates. As a result, duration exposure and the management of rate sensitivity is an important factor in portfolio construction.

[2]Bloomberg, as of June 30, 2021

This brings us to another key advantage of MAC strategies: because they generally invest in lower duration credit assets, and often have the ability to hedge interest rate risk tactically, MAC strategies tend to be less sensitive to rising interest rates than more traditional "core" fixed income strategies with exposure to government bonds. There is, however, a trade-off: higher yielding, lower duration credit assets carry higher levels of credit risk than government bonds, which are considered a safe-haven asset in times of market volatility. Therefore, investors concerned about rising interest rates can view an investment in MAC as offsetting interest rate risk through greater credit risk. It is very important for an investor to consider their risk tolerance in such a circumstance, as lower interest rate risk may be attractive, but not all investors can tolerate the higher credit risk that comes along with it.

3. Risk management

The ability of MAC strategies to carefully manage risk and to be defensively positioned in times of elevated market uncertainty is another key benefit for investors. This is especially prominent in less constrained MAC strategies that have the ability to reduce their allocations in certain asset classes to zero. A key theme throughout this paper is that the flexibility afforded to MAC managers is a significant benefit when managing downside risk. Risk management in MAC strategies is carried out at the total portfolio level, where all risk exposures are consolidated to determine the overall risk positioning of the portfolio. Investment managers will manage how much overall credit risk, interest rate risk, liquidity risk, and currency risk – amongst others – is present within the portfolio and will dial exposures up or down based on their macroeconomic views. In many cases, derivatives may be used as an efficient and cost-effective way to implement tactical changes to risk levels within a portfolio, rather than transacting in individual securities.

MAC managers will also closely monitor and manage the risk levels within each asset class to ensure that they are providing the desired attributes to the overall portfolio. For example, a preference within one asset type towards a specific sector or region (for example, a bias towards North American technology companies within convertible bonds) would need to be managed across the MAC portfolio's other holdings, to avoid unintentional over-exposure to a specific sector or region.

Adding MAC to an investment portfolio

The benefits provided by a MAC strategy will vary depending on the existing assets held within an investment portfolio, but generally, the increased diversification offered by a MAC strategy can have a valuable effect on the expected portfolio performance in terms of returns, volatility, and drawdown risk.

In an effort to quantify the benefits of adding a MAC allocation to a balanced portfolio, we have illustrated two potential approaches to an allocation below. We have assumed a "pre-MAC" baseline investment portfolio consisting of 40% global equities, 40% domestic universe bonds, and 20% alternatives. Based on our modelling and illustrated in Figure 3, this baseline portfolio has an expected long-term return of 4.3% and annual volatility of 6.5%.

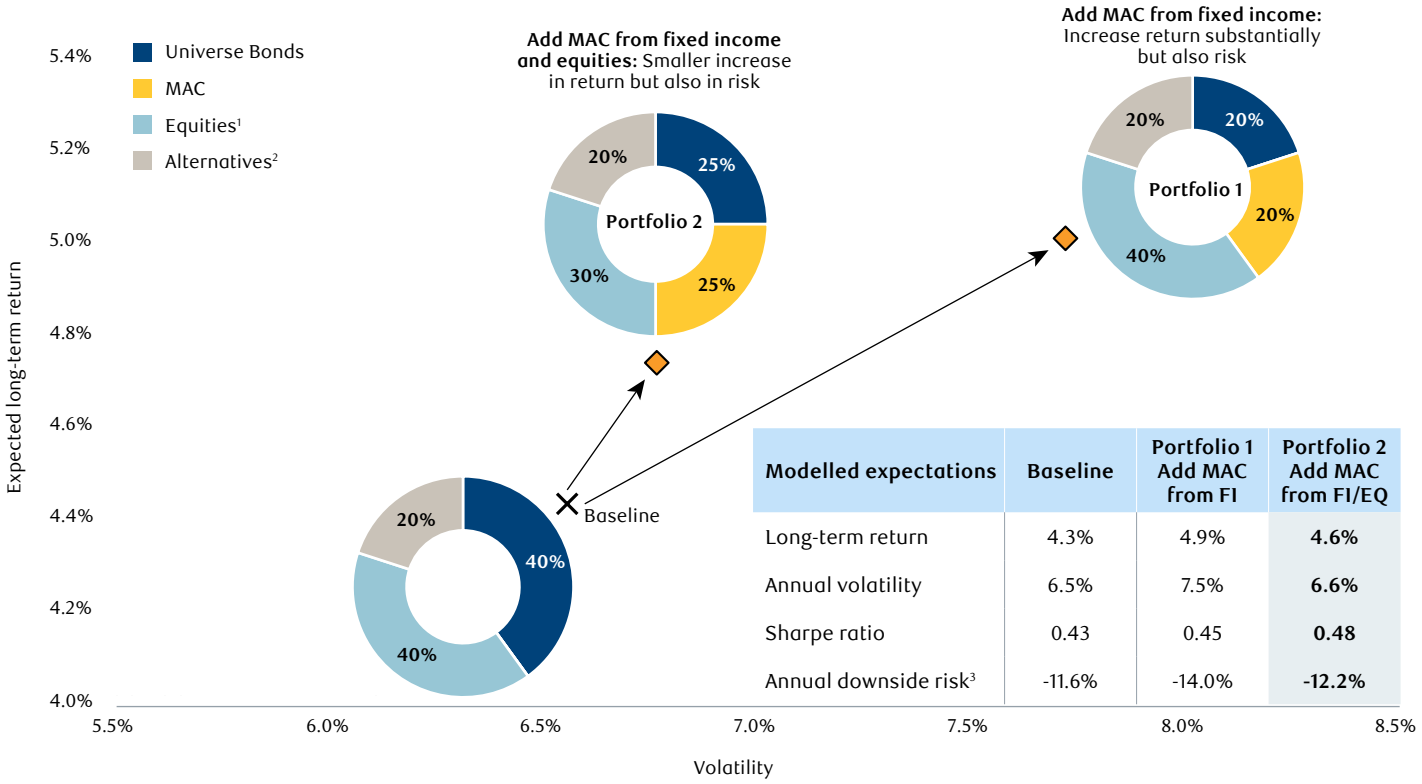
Portfolio 1 makes a 20% portfolio allocation to MAC sourced entirely from fixed income, via domestic universe bonds. This change increases the portfolio's expected return from 4.3% to 4.9%. There is also an increase in portfolio risk; MAC has greater volatility than universe bonds (owing mainly to greater credit risk), and as a result, the expected annual volatility of Portfolio 1 is 7.5% to 6.5% previously. Despite this increase in risk, the reward-for-risk of the total portfolio has increased slightly, as measured by the Sharpe Ratio.

However, there may be investors who are not willing or able to increase overall portfolio risk to the same extent in pursuit of higher returns. In this case, a different approach can be taken via Portfolio 2 that will have a smaller impact on overall risk levels within the portfolio while still providing a meaningful pick-up in expected return.

Portfolio 2 shows this alternative approach to allocating to MAC, with the allocation sourced from a combination of equities and fixed income. In this instance, we have modelled a 25% allocation to MAC with 15% coming from domestic universe bonds and 10% coming from global equities. This mixed approach to funding the MAC allocation results in an increase in expected return to 4.6% verses 4.3% in the baseline portfolio. This is about half the expected increase provided by Portfolio 1, but the real benefit can be seen in the expected annual volatility, which has only increased slightly to 6.6% from 6.5%. This results in higher reward-for-risk for the total portfolio, once again measured by the Sharpe Ratio.

For investors looking to increase their potential return without taking on much additional risk, the approach of targeting a mix of equities and bonds to help fund an allocation to MAC may be most suitable.

Figure 3: Consider impact with other risk exposures and adjust for optimal fit



Modelled expectations	Baseline	Portfolio 1 Add MAC from FI	Portfolio 2 Add MAC from FI/EQ
Long-term return	4.3%	4.9%	**4.6%**
Annual volatility	6.5%	7.5%	**6.6%**
Sharpe ratio	0.43	0.45	**0.48**
Annual downside risk[3]	-11.6%	-14.0%	**-12.2%**

Hypothetical performance analyses are for illustrative purposes only and there is no guarantee that hypothetical returns or projections will be realized. Please refer to appendix for modelling assumptions and disclosures.
[1]Equities represented by 50% Canadian equities, 50% global equities.
[2]Alternatives represented by 50% absolute return, 50% Canadian core real estate
[3]CVaR 95, which represents the expected average loss during the worst 5% of capital market outcomes.

Conclusion

In conclusion, MAC strategies offer a unique and dynamic way to invest in global credit. The flexibility and diversification that these strategies provide can be a very effective addition to an investment portfolio regardless of whether an investor is experienced in global credit or not. For inexperienced global credit investors it may provide a first exposure to some of these asset classes, while more experienced investors may realize greater portfolio efficiency by accessing global credit exposure via a MAC strategy rather than through internal asset allocation decisions.

In either case, in the current environment of ultra-low interest rates and economic uncertainty, MAC strategies are perfectly positioned to offer the right mix of characteristics to improve expected portfolio performance.

Appendix: Capital market assumptions

June 30, 2021

Asset classes	Representative data series	Expected long-term return	Expected annual volatility	Expected annual downside risk
Universe Bonds	FTSE Canada Universe Bond Index	1.9%	4.3%	-7.7%
Multi-Asset Credit (MAC)	Custom Index[2]	5.0%	8.0%	-16.0%
Canadian Equities	S&P/TSX Composite Index	6.5%	17.0%	-27.8%
Global Equities	MSCI World Index (CAD)	5.4%	14.2%	-25.1%
Absolute Return[1]	HFRI Fund of Funds Composite Index (USD)	4.2%	8.0%	-16.4%
Canadian Core Real Estate[1]	MSCI RealPac Property Index	4.8%	8.0%	-11.4%

[1] Expected long-term annualized return net of fees.
[2] 7.5% ICE BofA 3 Month US T-Bills (CAD-H), 35% ICE BofA Global High Yield Index (CAD-H), 11.25% J.P. Morgan Emerging Market Bond Index (CAD-H), 11.25% J.P. Morgan Corporate Emerging Markets Bond Index (CAD-H), 7.5% J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) (CAD-H), 7.5% Credit Suisse Leveraged Loan Index (CAD-H) and 20% Thomson Reuters Convertible Global Focus Index (CAD-H).

Correlations

	Universe Bonds	Multi-Asset Credit (MAC)	Canadian Equities	Global Equities	Absolute Return	Canadian Core Real Estate Fund
Universe Bonds	**1.0**					
Multi-Asset Credit (MAC)	0.2	**1.0**				
Canadian Equities	0.0	0.7	**1.0**			
Global Equities	0.1	0.4	0.7	**1.0**		
Absolute Return	0.1	0.7	0.7	0.5	**1.0**	
Canadian Core Real Estate	-0.1	0.0	0.0	0.0	-0.1	**1.0**

Capital market assumptions represent the views of PH&N Institutional for the purposes of illustrating and understanding the potential risk-reward trade-off of different portfolio decisions and are established by considering a variety of qualitative and quantitative sources of information including: different forecasting models; internal and external research; existing and implied future conditions as priced by capital markets; and internal views of our fund managers. Expected long term annualized returns are for a 10 year forecast time horizon. Volatilities, downside risk and correlations are estimated from historical data and adjusted as required to reflect future market conditions. Investors should be aware of the limitations using forward-looking assumptions in that there is absolutely no guarantee that future performance will occur according to any ex-ante expectation.

IC21111255 (11/2021)
019PIM127 (10-2021)_TL_MULTIASSETCREDIT_EN_V1_6 11/18/2021