



The Case for Global Multi-Credit Investing

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We believe investors should seek global managers with successful track records.

EXECUTIVE SUMMARY

As investors search for attractive risk-adjusted returns in challenging markets, they increasingly view sub-investment grade credit as an important component of a globally diversified fixed income portfolio. Credit markets have evolved since the global financial crisis and now provide a broad opportunity set for investors across sectors and regions. These changes require investors to take a more global, flexible and dynamic approach to credit investing. Sub-investment grade credit including high yield bonds, secured bank loans, structured credit and distressed debt in the US and Europe offer attractive relative value opportunities for managers who possess deep understanding of the macroeconomic and technical factors that favor different markets at different times. As issuers become more thoughtful about where and how they access credit, investors are responding in kind by adopting holistic approaches to multi-sector credit investing rather than single-sector siloed ones. The benefits of doing so can include increased ability to avoid concentration in a single borrower across separate sectors or regions and the enhanced potential to optimize the risk-reward profile of aggregate credit allocations. Sub-investment grade credit markets are complex and driven by both local and global forces, so BNY Mellon's credit specialist affiliate Alcentra argues that investors should seek global managers with successful track records who can avoid any "home bias" because of their deep expertise in both US and European markets.

Sub-investment grade corporate credit is a less familiar asset class than equities or traditional fixed income.

THE CASE FOR CREDIT

Alcentra believes that the sub-investment grade corporate credit markets can offer attractive risk-adjusted returns at a time when investors are wary of the volatility associated with equity markets influenced by government policy and when the yield on more traditional fixed income asset classes such as sovereign and investment grade corporate credit has been compressed by the weight of capital attracted to these sectors.

In fact, with five-year German government bonds being *issued* at negative yields, the traditional role of sovereign bonds as a liability-matching asset has been sorely challenged. Investors willing to participate at these levels are likely doing so in anticipation of mark-to-market gains from further spread compression, not because of the certainty of returns from holding to maturity. Consequently, the predictability of returns from this asset class has been eroded.

As a result, the search for yield as a driver of asset allocation appears stronger than ever and investors are increasingly turning to credit markets as a source of attractive risk-adjusted return. Credit offers a more predictable return in the form of a credit spread that will be achieved at maturity (unless the borrower defaults) regardless of whatever market distortions central bank intervention might create. Since much of the credit universe references floating rather than fixed interest rates, investors enjoy the added advantage of benefiting from any rise in interest rates.

MULTI-SECTOR OPPORTUNITIES FOR INVESTING IN SUB-INVESTMENT GRADE CREDIT

Sub-investment grade corporate credit is a less familiar asset class than equities or traditional fixed income and is comprised of a number of different, but interconnected markets, including high yield bonds, secured loans, structured credit and distressed debt. Relative value in each of these markets varies as a result of macroeconomic and technical factors, favoring different markets at different times.

Without easy access to information on the specific sub-sectors of the credit markets, many investors find it difficult to determine the best mix of credit investments to achieve their objectives at any given time. We believe experienced credit managers dealing in these markets on a daily basis are better equipped to allocate across these sectors and regions as risks and opportunities shift. We explore the benefits of taking an informed and dynamic multi-sector approach to credit investing and highlight some of the factors investors should consider before selecting a manager.

ASSET ALLOCATION CHOICES

Investors may choose from a variety of asset classes within sub-investment grade corporate credit, principally US and European high yield bonds, senior secured loans and related structured credit products.

Senior secured loans provide a floating rate of return, which is particularly attractive when interest rates are close to zero and the next rate move is likely to be upward. They are secured instruments with a covenant structure that provides a higher degree of security of repayment. As regulation has reduced banks' appetite to hold loans, capacity in the market has diminished. Yields have risen as a result, attracting more institutional investors into the market.

However, since the financial crisis, many larger companies that have traditionally borrowed via the loan market have increasingly refinanced themselves in the high yield bond market, taking advantage of the high levels of liquidity on offer. Bonds typically offer a less secure investment with the potential for lower recoveries in the

event of default, but the market is easy to access and trades frequently. It is also a fixed rate asset class, so for a given credit spread, bonds will have a higher absolute yield when the yield curve is positively sloped. This characteristic means investors should take care when allocating between the bond market and the loan market.

REGIONS MATTER

Investors must also consider whether to take their exposure in the US or Europe. The US market for both loans and bonds is deeper and more diverse than the European market and trades more frequently, offering greater liquidity. However, the volume of capital entering the US market, particularly so-called hot money flows from the more volatile retail sector, has driven new issue spreads tighter and put pressure on covenants, resulting in weaker deal structures with lower recoveries in the event of default. In contrast, the European market is less influenced by retail money flows, has retained strong covenant structures and new issue margins have remained higher.

Relative value between these four allocations (US bonds, US loans, European bonds and European loans) is constantly changing. Managing this ongoing change requires a flexible mandate that can respond by adjusting exposures in order to maintain the best risk-adjusted returns across the four sectors.

For example, sub-investment grade high yield bonds rallied strongly in 2012 as the momentum of capital chasing yield through this easy-to-access asset class drove spreads tighter. The Credit Suisse Western European High Yield Index delivered a return of 22.99% for 2012, but only 9.10% for 2013 as the capacity for further spread tightening decreased. Despite the favorable characteristics of loans compared to bonds during 2012, high yield bonds provided the better risk-adjusted returns.

Since the global financial crisis, the quarterly returns generated by US loans, US high yield, European loans and European high yield have varied widely over time. A hypothetical portfolio allocated 100% to the best-performing of these four asset classes would have returned an annualized 24.3% over the past five years. The asset class receiving that 100% allocation, however, would have changed over the course of that time. During the first quarter of 2010, for example, the portfolio would have been allocated 100% to European high-yield bonds, which were the best performing asset class during that period. Two years later, in the first quarter of 2012, the portfolio would have been allocated 100% to US loans, which were the top performers.

Managing ongoing changes in relative value requires a flexible mandate.

Over the last five years, US and European high-yield and loan markets have converged and borrowers increasingly operate across markets.

Over the last five years, a fixed allocation to each sector delivered an annualized return of 15.8%. However, the ability to dynamically allocate to the best-performing sectors each quarter had the potential to increase the result to 24.3%, highlighting the potential additional return generated by correctly choosing the right asset class to be exposed to at any time. At the same time, picking the worst-performing asset class every quarter would result in a much lower return of 8.6%. Results will vary depending on the time period chosen but nevertheless illustrate the potential benefits of identifying a skillful manager who takes a dynamic approach to asset allocation within credit. A multi-sector credit solution provides the manager with the flexibility to vary asset allocation within pre-defined boundaries as relative value shifts.

HOLISTIC VS. SILOED APPROACHES

Investors have traditionally viewed these four markets as separate asset classes, determining allocations on a top-down basis and parceling out sub-allocations using a siloed approach with specialist managers who create their portfolios independently of each other. Historically, each market was characterized by a discrete set of borrowers. Few borrowers in the sub-investment grade market were able to access multiple markets in order to finance their operations.

However, over the last five years, the US and European high yield and loan markets have converged, and today borrowers increasingly operate across these markets. Figure 1 shows how a company such as Virgin Media illustrates how large corporate borrowers now routinely access all four markets.

Figure 1: Sophisticated borrowers are issuing in multiple markets offering different relative values

Issuer	3-Year Yield		Yield-to-Worst		Discount Margin		Spread-to-Worst	
	U.S. Loan	European Loan	U.S. Bond	European Bond	U.S. Loan	European Loan	U.S. Bond	European Bond
Dell	4.91%	4.73%	5.91%	–	4.66%	4.50%	3.89%	–
Ineos	4.26%	4.30%	6.48%	6.64%	4.02%	4.14%	5.28%	5.63%
UPC	3.90%	4.33%	4.00%	4.21%	2.94%	3.53%	3.75%	3.82%
Virgin Media	3.59%	4.53% (GBP)	5.55%	5.23% (GBP)	2.79%	3.30% (GBP)	3.14%	2.91% (GBP)
West Corporation	3.66%	–	3.68%	–	3.42%	–	3.46%	–

Source: Bloomberg and Alcentra Analytics

Virgin Media bonds and loans trade at different valuations in each of the markets. While the borrower and the credit risk are the same, each instrument delivers different returns. A risk-efficient portfolio would take exposure to Virgin Media in the market that offers the best risk-adjusted returns, not spread across the different markets in which the name trades.

We argue there are several disadvantages to a siloed credit approach:

1. Concentrations to a single borrower can grow unnoticed as each manager independently allocates to that same borrower in different markets, resulting in unintended risk concentration and inefficient allocation of that risk
2. Relative value judgement is not taken between individual investments in different markets, which leads to investment in a borrower or sector in one market that may not be as attractive as an allocation overlooked in a better yielding market.
3. Portfolios become overly diversified, leading to less efficient trading in smaller sized positions and a reduced focus on individual positions

By contrast, a holistic approach allows a single portfolio manager to construct a portfolio of credit exposures that they believe offer the best risk-adjusted return potential regardless of the market in which that instrument is traded. Concentrations to individual borrowers and industry sectors can be monitored across the whole portfolio to conform to pre-determined limits across all instruments.

OPTIMIZATION, NOT DIVERSIFICATION

A multi-sector approach does not seek to diversify an investor's exposure to the financial markets as a whole. Credit markets are inherently highly correlated. Weakness in the high yield bond market is likely to be mirrored by weakness in the loan market. Rather than simply seeking diversification, a multi-sector approach aims to optimize credit exposures by taking advantage of relative return opportunities within credit and ensuring that the desired exposure to credit is taken in the market and in the instrument that can deliver the best return for a given risk.

ENHANCING YIELD POTENTIAL AS MARKETS CHANGE

Multi-credit approaches also provide the potential to enhance returns with opportunistic market themes. For example, an attractive opportunity existed immediately following the financial crisis for managers with deep domain expertise to invest in undervalued tranches of collateralized loan obligations (CLOs). For a while, these securities remained very cheap relative to the value of the loans of which they were comprised as investors avoided these complex and opaquely structured securities, starving the market of capital. Early movers were able to take advantage of the subsequent recovery in pricing as capital re-entered the market. A tactical allocation to this opportunity in a multi-credit portfolio would have delivered disproportionately high returns relative to the risks taken.

Distressed debt can also offer opportunistic benefits when macroeconomic themes depress the overall value of borrowers within a sector without considering each individual borrower's situation and creditworthiness. An example of this was a well-known European food company whose credit valuation was tarnished along with the rest of the industry during the recent horse meat scandal in Europe. However, a fuller analysis of the individual business indicated that revenues were unlikely to be significantly impacted and within months the loans had recovered their value. Managers able to execute swiftly were able to capture this attractive relative value opportunity. This example illustrates the need to construct multi-sector credit solutions with flexible enough mandates so that managers can execute dynamically as valuations change.

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We believe multi-sector credit solutions offer a better way than siloed approaches to generate attractive risk-adjusted returns in a low return world.

IDENTIFYING MANAGERS WITH GLOBAL DOMAIN EXPERTISE AND ASSET ALLOCATION SKILL

Multi-sector credit solutions require a second level of due diligence from investors. It is not enough to select a manager that can demonstrate expertise in a particular asset class. Equally important is the manager's skill in rotating exposures between the different asset classes and managing exposures to some of the potentially more volatile yield-enhancing components of the strategy in a capital- and risk-efficient way. Thus managers need domain expertise as well as asset allocation, risk management and liquidity management expertise. Many multi-sector credit solutions have limited track records, so we believe investors should concentrate on identifying managers with evenly balanced skills across all of the target asset classes and without any natural skew to a "home bias." For example, there are many highly skilled US loan managers, but far fewer have equally developed skills in Europe. The same is true of high yield bond managers who lack the expertise in US and European loan markets necessary to gain access to the most favored new issues of secured loans.

Notwithstanding these challenges, we believe that multi-sector credit solutions offer a better way than siloed approaches to generate attractive risk-adjusted returns in a low return world. In sum, they provide the potential for:

- A single entry point for satisfying an investor's desire for exposure to the many sub-sectors of corporate credit
- A managed solution aimed at allocating to the best risk adjusted return opportunities at any time, eliminating the need for the investor develop the detailed knowledge required to allocate between various sub-sectors themselves
- The opportunity to respond quickly to higher-yielding opportunities on an opportunistic basis without the need to review and approve specialist strategies or managers

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