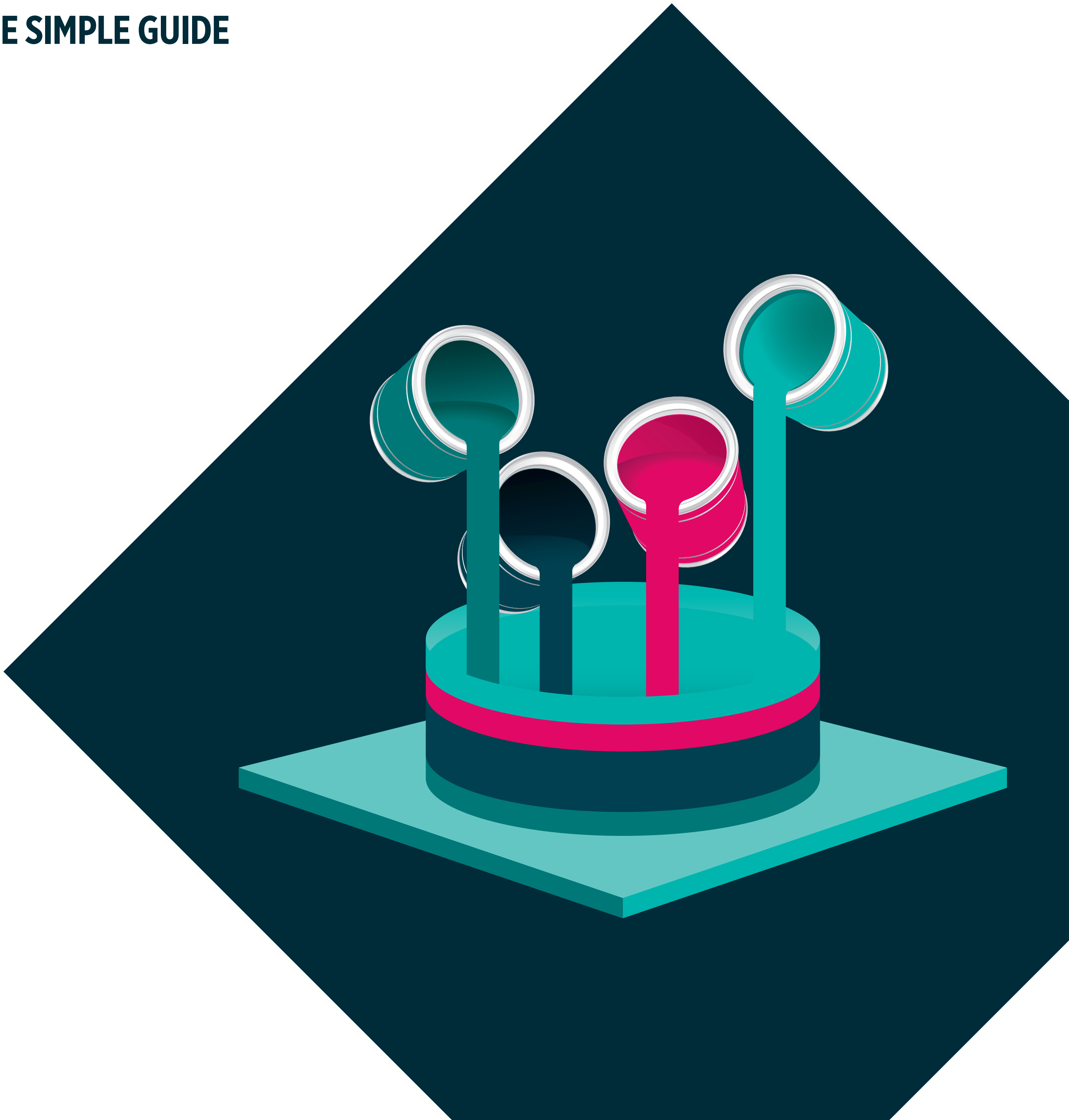
PENSIONS AND LIFETIME SAVINGS ASSOCIATION

March 2019

MULTI STRATEGY ALTERNATIVE CREDIT

MADE SIMPLE GUIDE



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FOREWORD

IN THE PREVAILING MACROECONOMIC ENVIRONMENT, IT IS A CHALLENGE TO MAINTAIN REASONABLE EXPECTED RETURNS WHILE MODERATING VOLATILITY. MULTI-STRATEGY ALTERNATIVE CREDIT (ALSO KNOWN AS MULTI ASSET CREDIT, OR MAC) ENABLES PORTFOLIOS TO REDUCE VOLATILITY, I.E. DE-RISK, RELATIVE TO EQUITIES, WHILE MAINTAINING ATTRACTIVE RISK-ADJUSTED EXPECTED RETURNS RELATIVE TO GOVERNMENT AND INVESTMENT GRADE BOND MARKETS. IT ALSO ENABLES PORTFOLIOS TO GENERATE INCOME, POTENTIALLY REDUCING THE REQUIREMENT TO FUND LIABILITY CASHFLOWS FROM CAPITAL.

In recent years the size of credit (fixed income) markets and the number and breadth of credit securities traded has grown significantly, increasing the range of credit investment opportunities. Meanwhile, challenges to liquidity driven mainly by regulatory change are increasing the relative values between different credit asset classes, while increased variability of returns between individual credit assets is adding to opportunities to identify returns specific to those assets through analysis of their characteristics.

FLEXIBLE MAC INVESTING CAN PROFIT FROM CYCLICALITY AND HELP TO MANAGE CREDIT, LIQUIDITY AND INTEREST-RATE DURATION RISKS

MAC investing offers access to a broad investment opportunity set within credit. With exposure to the full spectrum of issuers and asset types, a manager can select investment opportunities across different credit asset classes and regions and be nimble in rotating between them. Flexible MAC investing can profit from cyclicality and help to manage credit, liquidity and interest-rate duration risks.

MAC strategies can also be tailored to different risk and return profiles depending upon investor considerations. There is a need, therefore, to find asset solutions through partnerships that offer the portfolio management flexibility to position portfolios appropriately.

Trustees considering an investment in a MAC strategy should understand what the investment strategy is designed to achieve and how it could fit into your investment portfolio. This guide aims to introduce the opportunities offered by MAC, give an overview of the benefits they can offer, and set out some of the risks and considerations that trustees should bear in mind.

1 INTRODUCTION

WHAT IS MULTI-STRATEGY ALTERNATIVE CREDIT?

MAC investing utilises tactical and dynamic asset allocation with the aim of generating returns from a broad range of credit (or fixed income) asset classes, mitigating risk and managing duration (or interest rate sensitivity), as the relative value between different credit asset classes shifts over time.

The range of asset classes or investment universe used in MAC strategies varies slightly between providers, but the common feature is **breadth**. MAC portfolios will typically invest right across the credit spectrum, including in assets that would not usually be found in pension schemes' traditional fixed income portfolios. A typical MAC portfolio will include:

- investment grade bonds,
- high yield bonds,
- senior secured loans,
- asset backed securities (ABS), and
- convertible bonds.

Depending on the manager, there may additionally be exposure to emerging market debt, distressed debt and direct lending. We define the most common asset classes in section 2.

The investment manager will typically combine asset allocation across these different fixed income investments, with the aim of being in the right asset class or geography at the right time (and to avoid being in the wrong asset class or geography at the wrong time) – this is the **tactical and dynamic** element of the strategy.

Another key feature of the strategy is a **stable return target**. The aim is to generate a positive absolute return at a certain level each year, likely to be in the region of mid-single digit investment returns with low volatility over the cycle. For many institutional investors, a MAC portfolio will form the stable core of an investment portfolio, possibly supplemented by specific allocations to other asset classes to meet the needs and circumstances of the scheme such as the desired return target and funding level.

In order to achieve these goals, schemes must pick an investment manager that can undertake deep fundamental research (analysis of the value of a particular security) to identify the most attractive securities at any given time (and to avoid defaults) and has the ability to allocate the portfolio nimbly from one asset class to another in search of investment returns. The following sections look at some typical sources of return for managers of these strategies.

WHAT ARE FUNDAMENTALS?

Fundamentals include the basic qualitative and quantitative information that contributes to the financial or economic well-being and the subsequent financial valuation of a company, security or currency. Analysts and investors examine these fundamentals to develop an estimate as to whether the underlying asset is considered a worthwhile investment; that is, whether it is fairly valued in the market.

Fundamental analysis is the evaluation of the fundamentals of a security in order to compare its economic position relative to other securities, the broader market or to its own performance over time. For MAC this will include both an assessment of the probability of default, and the likely loss given default for secured assets such as senior secured loans.

2
CREDIT ASSET CLASSES AND THEIR CHARACTERISTICS

MAC INVESTING WILL COMBINE ASSET ALLOCATION ACROSS THESE DIFFERENT FIXED INCOME INVESTMENTS, WITH THE TACTICAL AND DYNAMIC APPROACH DETERMINING WHAT SHOULD BE INVESTED IN AND WHEN, WITH THE ULTIMATE AIM OF ACHIEVING THE ABSOLUTE RETURN TARGET.

INVESTMENT GRADE CREDIT

As the name suggests, investment grade bonds are bonds issued by companies which are rated "investment grade" by the credit ratings agencies (BBB- or higher by Standard and Poor's, or Baa3 or higher by Moody's). The market is large, capitalised at approximately $9 trillion globally at the current time, and these bonds are often regarded as relatively "defensive", less likely to be adversely affected by weaker economic conditions. On the other hand, the level of yield attached to them over and above government bonds is often low, reflecting the stability of these companies, and like government bonds they tend to have a relatively high duration, or sensitivity to interest-rate changes.

ASSET BACKED SECURITIES

An Asset Backed Security is a security whose value and income payments are derived from and collateralised ('backed') by a specified pool of underlying assets. These pools of underlying assets vary and can include payments on credit cards, car loans, student debt, mortgage payments and similar streams of revenue. The investment universe is notably varied and can require considerable fundamental research to analyse.

CONVERTIBLE SECURITIES

A convertible is a bond that can be converted into a predetermined amount of a company's equity at certain times during its life, usually at the discretion of the bondholder. Essentially, a convertible is a bond with an embedded equity option.

Convertibles also frequently offer idiosyncratic opportunities where the specifics of the bond documentation offer material potential upside in the event of M&A or other corporate activity.

SENIOR SECURED LOANS

Senior secured loans, or bank loans as they are sometimes called, are private loans made to companies whose credit rating is sub-investment grade. As the name suggests, a senior secured loan will be senior in a borrower's capital structure and secured on assets. Holders will typically have the first claim on the assets and cashflows of a company, with the loans themselves secured on assets which can be sold in the event of problems. The rights of lenders to protect their capital and the obligations on the borrower are set out in each loan credit agreement in the form of a series of covenants or requirements. Recovery rates in the event of default for loans have historically been significantly higher than for other creditors at 80% in the US and 70% in Europe.

Loans pay interest at rates that change periodically on the basis of a floating-rate lending rate, typically based on short-term interest rates plus a fixed spread or risk premium reflecting the credit risk of the borrower. This floating-rate structure also means that loans tend to have a lower interest-rate duration, or sensitivity to interest-rate changes, than other fixed income securities with similar maturities.

HIGH YIELD CREDIT

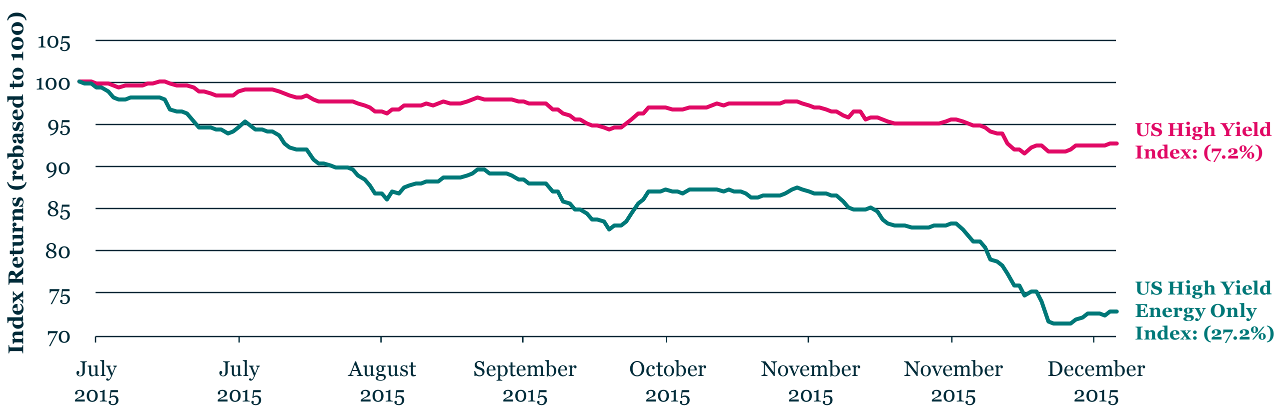
High yield bonds are the counterparts to investment grade bonds, being those which are rated "sub-investment grade" by the credit ratings agencies (BB+ or lower by Standard and Poor's, or Ba1 or lower by Moody's). The market is smaller than for investment grade but still very diversified at $2 trillion globally at the current time. High yield bonds tend to be higher risk than investment grade credit, but offer a commensurately higher level of yield over and above government bonds.

3
OPPORTUNITIES IN MULTI-STRATEGY ALTERNATIVE CREDIT INVESTING

ONE OF THE KEY FEATURES OF THE MAC INVESTMENT UNIVERSE IS ITS BREADTH. NOT ONLY IS THERE A WIDE SELECTION OF ASSET CLASSES TO INVEST IN, FROM HIGH YIELD BONDS THROUGH TO SENIOR SECURED LOANS AND ABS, BUT THE RANGE OF OPPORTUNITIES AVAILABLE WITHIN EACH OF THESE AREAS HAS ALSO GROWN. TAKEN TOGETHER, THIS OFFERS INVESTORS CONSIDERABLE CHOICE, AND ALLOWS INVESTMENT MANAGERS CONSIDERABLE DISCRETION IN ALLOCATING BETWEEN THEM AS WELL AS THE OPPORTUNITY TO MITIGATE RISKS BY CHOOSING NOT TO INVEST IN A CERTAIN AREA.

A good example of the value that a MAC manager can bring is the energy crisis of 2015, when the US high yield market experienced a substantial price correction in the second half of the year (as illustrated below in Future 1), resulting in investors losing more than 7% in a six-month period. Much of this loss was attributable to Energy-related issuers in US high yield.

Figure 1: Avoiding Pitfalls: Energy Exposure in 2015



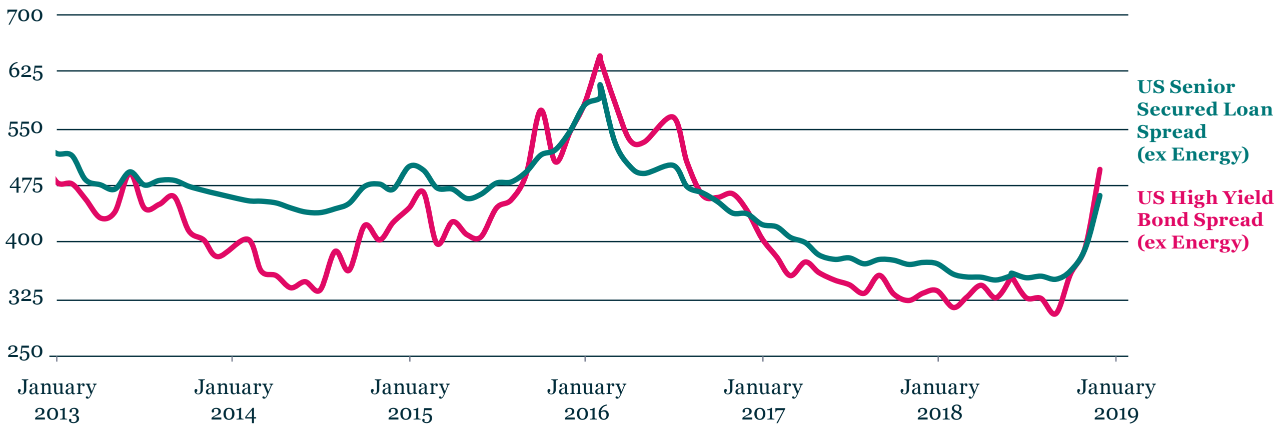
With the flexibility to invest in multiple sectors, and to be able to search for sources of absolute return regardless of benchmark, a MAC portfolio has the ability to avoid a substantial portion of an individual sector, such as Energy. It can therefore potentially avoid such a drawdown or the volatility associated with its price correction and ultimate rise in defaults.

Below we look in more detail at the range of opportunities that MAC offers.

ASSET ALLOCATION BETWEEN ASSET CLASSES

Credit market sectors are cyclical in nature, with this cyclicality driven by variations in fundamentals, supply and demand dynamics, liquidity and regulation. MAC investing can help to both mitigate risk from this cyclicality and profit from it. For example, as illustrated by Figure 2, US high yield and senior secured loan credit spreads (the additional yield available over and above an equivalent US Treasury bond) have moved significantly in recent years, with loans periodically yielding more than high yield even though they sit higher in a firm's capital structure.

Figure 2: US High Yield Spreads vs. US Loans Spreads

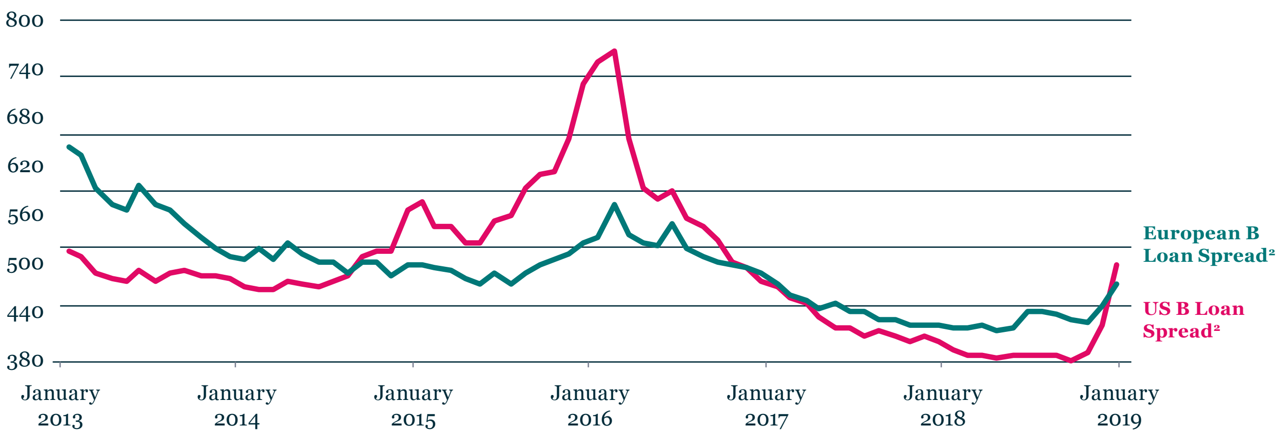


This shifting relative value has presented an opportunity for MAC portfolios to effectively earn more in spread and yet take less fundamental and technical risk. Such market conditions can present themselves because of supply and demand factors in alternative credit asset classes, and reward managers able to identify and allocate to capture such opportunities nimbly.

ASSET ALLOCATION BETWEEN GEOGRAPHIC REGIONS

Just as with asset classes, geographic regions increase and decrease in relative attractiveness, driven by shifts in fundamentals or changing supply and demand condition. Figure 3 highlights that US and European loan spreads have diverged greatly in recent years, with the spread on US loans shifting from below to above that available on European loans before reversing again. The incremental spread in US loans presented MAC portfolios with an opportunity to earn more spread while fundamentally de-risking the portfolios since US loans have traditionally exhibited lower default rates and higher recoveries than their European counterparts.

Figure 3: US Loan Spreads vs. Euro Loan Spreads



THE BREADTH OF THE INVESTMENT UNIVERSE AND THE OPPORTUNITY TO CAPITALISE ON RELATIVE VALUE OPPORTUNITIES BY TACTICALLY AND DYNAMICALLY ALLOCATING BETWEEN CREDIT ASSET CLASSES AND ACROSS GEOGRAPHIES CAN OFFER INVESTORS REAL BENEFITS

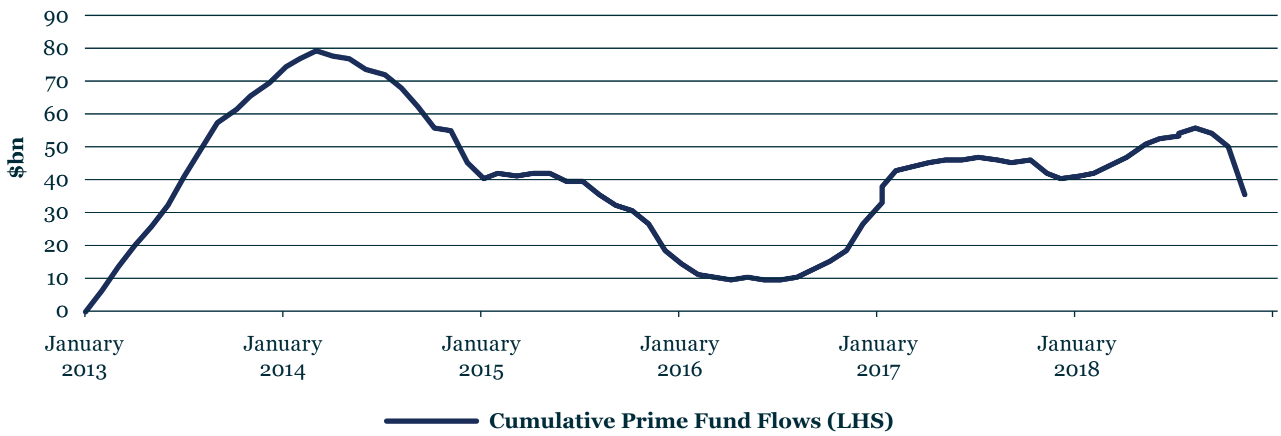
LIQUIDITY

As the increase in global financial market regulation and pressures on bank capital reduce liquidity in markets, MAC managers are able to take advantage of opportunities created when individual credits or credit asset classes become mispriced.

As we saw on the previous page, US Loan spreads were materially affected by retail flows into the asset class in 2013 and subsequent outflows, as shown in Figure 4 below. The multi-billion retail fund outflows, and associated selling of a broad range of assets across a sector, presented an asset allocation opportunity for MAC portfolios to invest in US loans over European loans.

More recently, technically-led weakness in US loan and high yield securities in December 2018 provided a further opportunity for MAC managers to capture opportunities thanks to volatility in the asset classes as a consequence of technical market weakness.

Figure 4: Buying Quality Assets on Retail Outflows



RELATIVE VALUE WITHIN THE CAPITAL STRUCTURE

The capital structure of a company is the way it finances both day-to-day operations and growth. Sources of funds can include bonds (typically unsecured) and senior secured loans (secured) with very different features and credit ratings depending precisely which corporate entity is providing the cashflows.

This is a complex area, but provides a further source of potential investment returns for investors in MAC strategies, as it becomes possible for the investment manager to select the most appropriate part of a capital structure following detailed fundamental research. If a business is attractive but an additional level of comfort is required, senior secured loans can offer that security. If a business is performing well, the manager can decide to invest in higher risk instruments which may not carry that level of security but offer potential higher investment returns.

Figure 5 is an illustration of a capital structure. It is a MAC manager's responsibility to price risk across each issuer's capital structure and capitalise on relative value.

Figure 5: An Example Capital Structure

Potential Recovery	EXAMPLE CAPITAL STRUCTURE	($ million)	Potential Returns
	Revolver	1,350	
70-80%	Term Loan A	2,260	€/L+5-7%
	Term Loan B	8,188	
	Total First Lien Secured Debt	**11,798**	
10-50%	**Senior Unsecured Notes**	**19,465**	€/L+8-10%
	Total Debt	**31,263**	
	Equity Market Cap	**10,897**	
0%	**Total Capitalisation**	**42,160**	€/L+10%

DURATION MANAGEMENT

At certain points in the economic cycle, it can be an advantage to manage interest-rate risk. When interest rates are rising, for example, fixed income investments with a higher duration – or sensitivity to these changes – are particularly affected. Figure 6 highlights that a volatile interest-rate environment can create potential problems for all forms of credit.

The MAC investment universe typically includes investment instruments with low duration, such as convertible bonds, senior secured loans and ABS, the latter two of which are typically floating rate. By contrast with fixed rate investments, floating rate investments will tend to benefit from rising short-term interest rates, for example in the scenario we show in Figure 7 below.

In turn, this opens up the possibility for investors in MAC to manage interest-rate duration risk by selecting appropriate duration instruments at differing points in the credit cycle. If done correctly, this can both help manage risk effectively for investors and generate investment returns.

Figure 6: US Treasuries and Investment Grade Credit

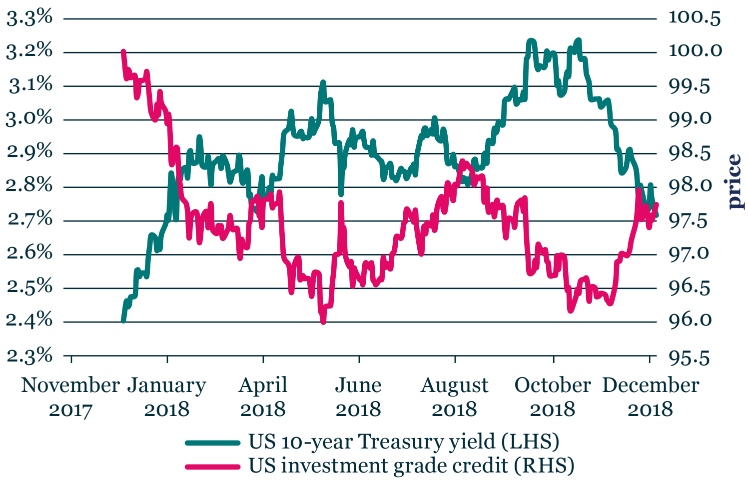
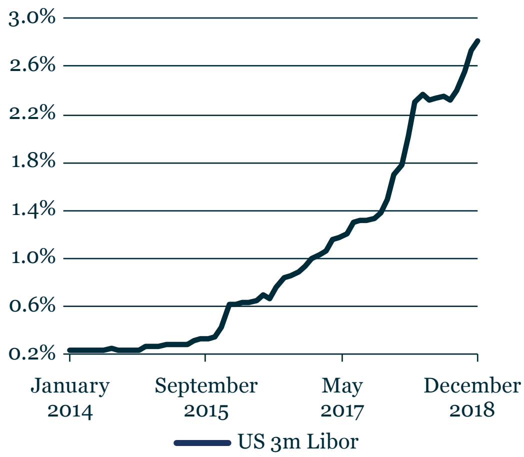


Figure 7: US 3 Month Libor



4
THE RISKS OF MULTI-STRATEGY ALTERNATIVE CREDIT

MULTI-ASSET CREDIT STRATEGIES OPEN UP A RANGE OF NEW FIXED-INCOME OPPORTUNITIES FOR SCHEMES, ALLOWING THEM TO DIVERSIFY AND REDUCE VOLATILITY. HOWEVER, INVESTING IN SECURITIES SUCH AS HIGH YIELD BONDS AND ABS EXPOSES TRUSTEES TO A NUMBER OF OTHER RISKS:

DEFAULT RISK

As noted above, high yield bonds pay higher yields than investment grade bonds, but have a higher default rate. Debts that are higher in the capital structure of the company – such as secured loans – are beneficial as they take precedence over those lower down the structure.

DURATION RISK

This is a measure of an asset's sensitivity to changes in interest rates. which can be reduced by investment in certain sub-investment grade investments, particularly those which are floating-rate such as senior secured loans and ABS.

LIQUIDITY RISK

Investors encounter liquidity risk when they are forced to sell a security before maturity. Securities that cannot be sold quickly and easily without incurring high transaction costs or for a price below their true value have higher liquidity risk. However, individual assets have different liquidity profiles and some may prove relatively easy to liquidate if they are attractive compared to the wider marker.

ALPHA OR MANAGER RISK

Every active manager aims to generate returns through their fundamental research, processes and decisions. An incorrect judgement made by a manager could negatively impact the portfolio's performance. Trustees should seek to understand managers' approaches before adopting a MAC strategy – the checklist below is designed to help.

5 CONCLUSION

GLOBAL PENSION FUNDS AND OTHER INSTITUTIONAL INVESTORS FACE MATERIAL CHALLENGES IN THE CURRENT MACROECONOMIC ENVIRONMENT, WITH LOWER INTEREST RATES, POTENTIALLY HIGH INFLATION, CENTRAL BANK ACTIVITY AND SPORADICALLY HIGH ASSET PRICE VOLATILITY.

For many investors, alternative credit in a multi-sector format offers a way of de-risking from equities while maintaining reasonable expected returns with dampened volatility. The breadth of the investment universe and the opportunity to capitalise on relative value opportunities by tactically and dynamically allocating between credit asset classes and across geographies can offer investors real benefits. At the same time, such an approach also involves a number of risks, including the chance when taking an asset allocation decision that it is not a beneficial one. Perhaps the most important risk, however, is that a company defaults on its debt obligations.

The key when considering an investment in a multi-asset credit strategy is to make sure you understand what the investment strategy is designed to achieve and how it would fit into your investment portfolio. Ask what the investment universe is, what their sources of investment return have been historically, and decide whether you have confidence that they will be able to replicate it in future.

As always, asking the right questions is key. The short checklist below will help to frame any discussion with managers in this area.

MULTI-STRATEGY ALTERNATIVE CREDIT INVESTOR CHECKLIST

- What is the investment strategy designed to achieve, in terms of investment returns and volatility?
- Would it be a good fit for your existing investment portfolio?
- What is the investment universe of the manager? Is everything clear?
- What are the manager’s sources of investment return?
- How do they identify sources of relative value?
- How do they avoid defaults?
- If they are large, are they able to avoid “buying the market”?
- If they are small, do they have sufficient resources to carry out research?
- Above all, if anything isn’t clear – ask!

IMPORTANT INFORMATION

SOURCES

Figure 1: CQS as at 30 December 2015. BofA Merrill Lynch Index (H0A0) as at 30 December 2015. BofA Merrill Lynch Index (H0EN) as at 30 December 2015.

Figure 2: Barclays US High Yield ex-Energy Index and S&P LCD European Leveraged Lending Review as at 31 January 2019.

Figure 3: S&P LCD as at 31 January 2019.

Figure 4: S&P LCD, LoanStats and CQS estimated as at 31 January 2019.

Figure 5: CQS estimated.

Figures 6 & 7: Bloomberg, as at 31 December 2018. Potential recoveries and returns are expected and for illustrative purposes only, with no guarantee that they can be achieved. They are based on market conditions at the time of modelling and are therefore subject to change.

INDEX DESCRIPTIONS

It is not possible to invest directly in an index. Barclays US High Yield ex-Energy Index is a subset of the Barclays US High Yield Index excluding all energy related issuers. The index is weighted by the market value of each bond issue. BofA Merrill Lynch US High Yield Index (H0A0) tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. BofA Merrill Lynch US High Yield Energy Index (H0EN) is a subset of The BofA Merrill Lynch US High Yield Index including all securities of Energy issuers. BofA Euro High Yield Constrained Index (HEC0) tracks the performance of euro- and British pound sterling-denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets by issuers around the world. It is not possible to invest directly in an index. S&P Leveraged Loan Indexes are capitalization-weighted syndicated loan indexes based upon market weightings, spreads and interest payments. The S&P/LSTA Leveraged Loan Index (LLI) covers the U.S. market back to 1997 and currently calculates on a daily basis. The S&P European Leveraged Loan Index (ELLI) covers the European market back to 2003 and currently calculates on a weekly basis.

Information contained in this document should not be viewed as indicative of future results as past performance of any Transaction is not indicative of future results. The value of investments can go down as well as up.

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