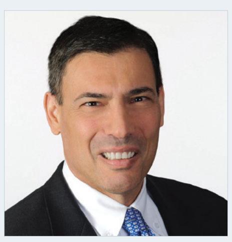
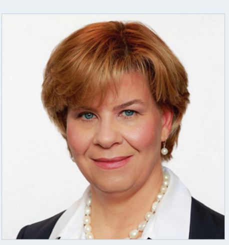
INVESTMENT INSIGHTS

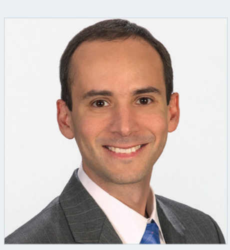
How a Multisector Credit Approach Can Lower Risk, Increase Diversification



Joe Portera
Chief Investment Officer, High-Yield and Multisector Credit



Jennifer Hartviksen
Senior Portfolio Manager, Head of Global High Yield



Ken Hill
Senior Portfolio Manager, Fixed-Income Multisector

Fixed-income strategies are critical in any market environment, but today, with interest rates stubbornly low, institutional investors are seeking yield, which has meant adding risk. The challenge is that investors may find themselves with more risk than they had anticipated. That's where a multisector credit strategy can play a role. It can provide diversification across the fixed-income landscape with the flexibility needed to access return opportunities while also keeping an eye on risk. Invesco's Joe Portera, chief investment officer, high-yield and multisector credit, Jennifer Hartviksen, senior portfolio manager, head of global high yield, and Ken Hill, senior portfolio manager, Invesco fixed-income multisector, discuss the goals a multisector credit allocation can help investors reach, and how.

Pensions & Investments: What have the years of historically low interest rates done to institutional asset owners' fixed-income allocations? Is the problem more acute for, say, corporate pension plans moving to liability-driven investing (LDI) or other risk-transfer strategies?

Joe Portera: Over the past few years, investors have been stretching for yield. You can see this across the allocations of most asset owners, whether insurance companies, pension plans or LDI portfolios. Stepping out into the risk spectrum is fine as long as investors are being rewarded for the level of risk they are taking. There seems to have been a decoupling of the risk/reward concept as asset owners reach for yield in a way that may be too aggressive in the context of the entire portfolio.

P&I: What have they been doing to address this situation? Their portfolio goals, by and large, have not changed.

Portera: Most asset owners have been adding to risk in small increments over the years without realizing how far they've gotten. It's like dipping your toe in the water a few inches at a time, and next thing you know you're in the ocean up to your middle. So far, this hasn't hurt much, as most fixed-income asset classes have done well since the financial crisis. But if the market has any kind of violent correction, the pain will be pretty severe.

P&I: In addition to addressing the low interest rate environment, what are some other benefits of employing a multisector credit strategy?

Jennifer Hartviksen: Diversification is one of the biggest benefits. If an investor is able to layer in a few noncorrelated asset classes, the volatility of returns may fall. This is the best way to add risk in a sensible way.

A second benefit is the ability and flexibility to expand into other asset classes to take advantage of temporary dislocations. For example, in 2014 the municipal bond market experienced outflows [that] caused prices to be pushed to extremely low levels. This meant that even without the tax benefit traditionally seen from municipal bonds, the raw yield was very attractive. Due to the flexibility of our structure, we were able to invest 5% of the total portfolio into this asset class, which gave us strong returns for the year in a sector that may have been ignored by most investors.

> *"If asset owners are looking for a way to add yield in a risk-appropriate way, multisector credit could be a much better match."* **Jennifer Hartviksen**

P&I: What are the major portfolio goals these strategies can help asset owners meet?

Hartviksen: If asset owners are looking for a way to add yield in a risk-appropriate way, multisector credit could be a much better match. If they are looking for something highly uncorrelated where they can invest their surplus funds, an unconstrained fixed-income strategy may be a fit. It very much depends on what the investor is looking to achieve.

P&I: Have managers' efforts been successful? Or are there other ways to tackle this issue?

Ken Hill: Most managers can be successful in helping clients achieve their goals … as long as the manager and client are on the same page in terms of expectation and risk. Most other ways to tackle a multi-asset framework are more difficult, as the client has to be heavily involved in the asset allocation and needs to be able to react quickly.

P&I: Are these strategies best suited for a certain size of asset owner?

Hartviksen: These strategies can work for all asset sizes. For the smaller relationships, having a multi-asset strategy provides the speed, agility and expertise of a manager that is watching the market and can move between asset classes. For the larger relationships, having a second opinion on where the money should be directed is a great alternative for asset owners that manage money in-house. It also gives asset owners that manage money in-house access to sectors such as bank loans or emerging market debt, where they may not have expertise.

P&I: What's the difference between a multisector credit strategy and an unconstrained fixed-income strategy?

Hill: Often investors use the two terms interchangeably, but in reality, they are very different. A multisector credit strategy is a credit-based strategy, so it will broadly follow the returns pattern of the credit markets. This type of strategy will have a normal duration range and invest predominantly in fixed-income credit markets. An unconstrained fixed-income strategy will generally have a much wider band for duration (including negative duration in some cases) and will sometimes have an allocation to equities or esoteric securities. In addition, unconstrained will generally have much more volatility as currency, duration and yield-curve bets are expressed in large measures.

P&I: How can different approaches to a multisector credit strategy help investors' individual goals? In other words, are these strategies customizable?

Portera: These strategies are highly customizable. Invesco's traditional multisector credit blend consists of investment-grade credit, emerging market debt, bank loans and high yield. We have clients that have asked us to create portfolios with much higher allocations to investment grade (above 60%) and other clients are interested in very low allocations to investment grade (below 10%). The important thing is partnering with a manager [who] can design and implement exactly what each client is looking for.

What an asset owner should look for in a manager is someone that has the infrastructure

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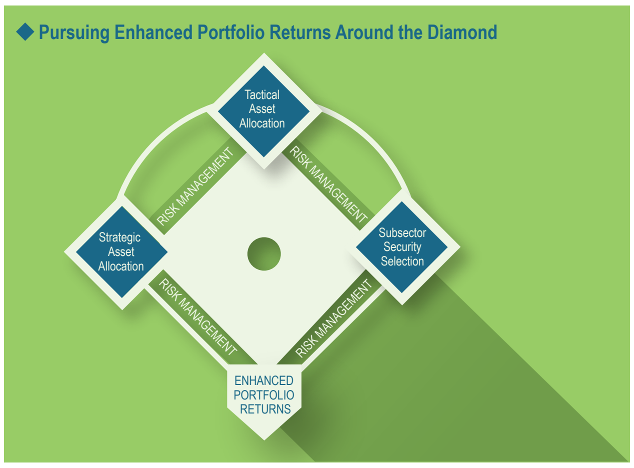

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to understand all the major fixed-income asset classes to compare relative value, and the ability to move quickly and seamlessly between those asset classes to add yield while avoiding the pitfalls that eventually turn up in fixed-income markets.

P&I: What is the framework for a basic multisector credit strategy?

Hartviksen: Each manager has a different framework for how they run multisector credit, so it's not always apples-to-apples. We started with a risk-parity framework to determine what we thought would be a good long-term risk-adjusted return when building the asset mix. We believe that a risk-parity approach would allow the strategy to deliver a more stable, diversified asset allocation over time. It provides a baseline asset mix around which the investment team can tactically pivot in response to market conditions. We set minimum and maximum ranges for these tactical bands to keep risk within acceptable bounds. We call that our "tactical asset allocation," or TAA. The TAA gives us room to move within the various asset classes to take advantage of market dislocations, but we set minimum [and] maximum targets to keep the managers from getting too far out of bounds on the risk spectrum.

In addition, we allocate up to 20% of the total portfolio to what we call the "opportunistic sleeve." This allocation allows us to express concentrated views in sectors or individual securities we feel have a strong catalyst for outperformance over the next three to 18 months. For example, we currently have an overweight to bonds across several asset classes to express our view on technology, media and telecommunications. This helps us show our views on how rapidly changing tech trends will impact certain industries going forward. In the past we have used the opportunistic sleeve to express views in municipal bonds, CMBS, RMBS and ABS.

P&I: How do you differentiate yourselves?

Portera: We believe that using the risk-parity approach as a starting point gives us good perspective on how to build a solid all-weather portfolio. We differentiate ourselves by how we build and monitor the portfolios. We use Invesco's strong fixed-income platform to understand relative value between all the major fixed-income sectors and to give us a clear macro view. We use the portfolio manager and analyst teams to build highly concentrated portfolios from the bottom up. Lastly, we use our robust risk capabilities to monitor and measure risk on a daily basis to ensure that every holding in the portfolio is contributing on an individual as well as consolidated basis.

P&I: Since the multisector credit segment has grown relative to other credit segments over the past several years, has it become more challenging for managers to find yield/return?

Hill: No, the changing state of the credit segments has not caused it to become more challenging to find yield. The market itself has been the key source of challenge. For example, back in 2001 you could get a 5% yield by owning 10-year U.S. Treasuries. Today, you would have to invest in BB/B-rated high-yield bonds to achieve that same 5%. That makes for a significantly different risk profile and requires a much heavier involvement to ensure that the risks are being evaluated and minimized as much as possible.

P&I: What are the most common questions you get from clients or potential clients about the strategy?

Hill: Most of the questions we get about the strategy are around the benchmark. Since no two multisector credit strategies are alike, there is some confusion about what the benchmark should be. Some funds use cash as a benchmark, others use a global aggregate or multiverse benchmark. We use our long-term strategic asset allocation [SAA] blend as a pseudo-benchmark. This SAA is a blend of the four main asset classes (investment grade, high yield, emerging market, bank loans) based on the risk-parity allocations. We figure if we give our clients this blend of assets over a long time horizon, it will be a solid portfolio. That said, we also want to add value on top of the SAA. This is where the tactical shifts and opportunistic holdings come into play. By having the flexibility to move assets around the entire fixed-income space, we can add a lot of value for the clients.

P&I: How do you recommend asset owners employ a multisector credit strategy into their existing asset allocation?

Portera: We think it makes sense for every client to have an allocation to multisector credit. For smaller clients, it's a great way to get full access to the credit spectrum. For larger clients, it's a great way to access the expertise of highly specialized portfolio managers and analysts. •

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