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Multi-Asset Credit Investing: Why Now?

INSIGHTS

In today's uncertain environment, high yield multi-asset credit strategies look compelling—especially given their strong track record through the cycle and the potential for attractive income.

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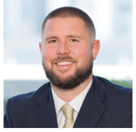

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Investors today are facing a much more complex and volatile investment landscape than that of recent years. From the Global Financial Crisis until very recently, the market largely was characterized by low or negative interest rates, making it difficult for investors to find attractive income-generating opportunities without taking on greater credit risk or extending interest rate exposure. Today, while the rate environment has indeed shifted, investors are challenged with other factors such as persistent inflation and fears of low growth or a recession.

Moreover, long-term asset allocation decisions are taken in the context of investors' intended investment outcomes. For instance, an insurance company may be looking to balance the risk-reward opportunity with regulatory requirements on capital. Meanwhile in the U.K., higher rates—and the resulting higher discount rate that pension funds apply to their future liabilities—have left funding positions looking much healthier than in recent years. As a result, institutional asset owners are re-assessing their overall portfolio composition including their credit exposure.

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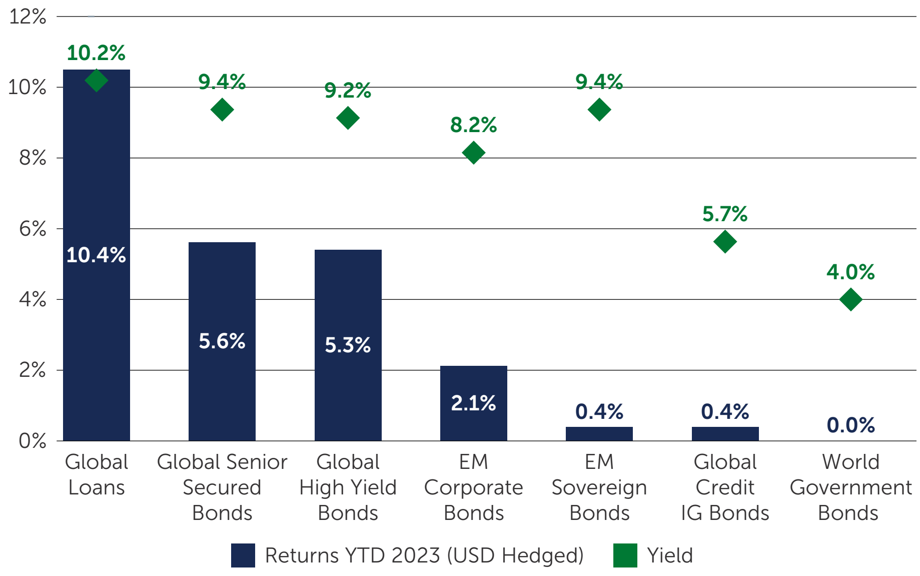
Against this backdrop, we believe a multi-asset credit approach to high yield investing continues to make sense. A multi-asset strategy invests in and shifts exposures across high yield credit markets such as high yield bonds and loans, as well as opportunistic allocations in specialist asset classes like collateralized loan obligations (CLOs). In particular, there are three reasons why a multi-asset credit mandate is compelling:

1. For investors with long-term income requirements, multi-asset credit investing can provide exposure to **diversified sources of higher income with limited interest rate risk**, and in the context of historical outcomes, **an attractive entry point** for potential returns.
2. This approach provides the potential for **compelling risk-adjusted returns** in low growth environments, as well as sufficient levels of liquidity, suggesting it could be a complementary strategy in an investor's portfolio.
3. During periods of market dislocation and uncertainty, a flexible strategy provides institutional investors with an outsourced capability to **dynamically reallocate capital**, and quickly assess relative value opportunities as they arise across various high yield asset classes that may be outside of their core focus.

1. An Attractive Entry Point for Potential Returns

The income profile of a multi-asset credit strategy remains very attractive. Today, yields across most fixed income asset classes are in the 80th–90th percentile versus the last 20 years, with yields on global high yield bonds and global loans currently at 9.2% and 10.2%, respectively.[1] At these higher levels, yields are offering a cushion against potential interest rate shocks or significant movements in credit spreads.

Figure 1: YTD 2023 Fixed Income Returns and Yields

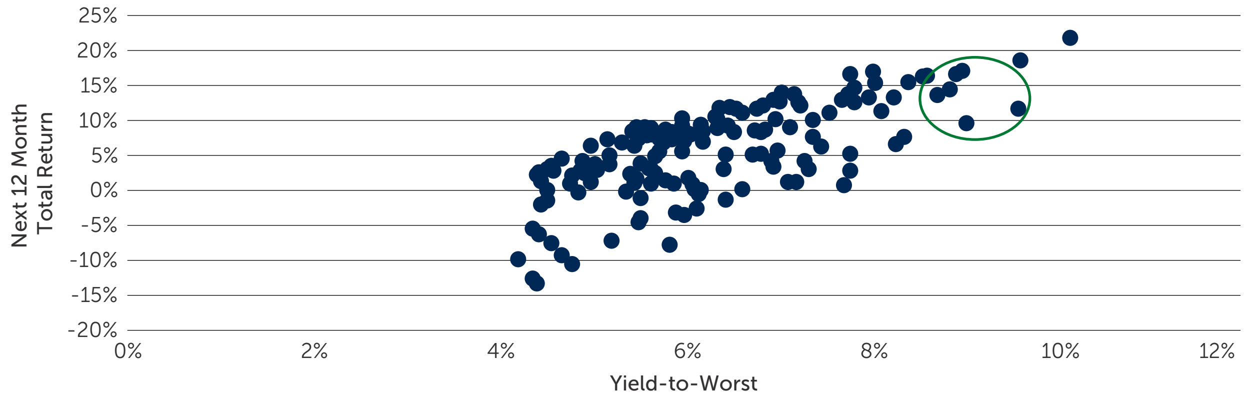


Source: Credit Suisse, Bank of America, JP Morgan. As of October 31, 2023.

Why is the income important? Beyond the practical needs for cash distributions that investors may have, over longer periods of time income provides the vast majority of total return in high yield. Looking at yields today, the forward 12-month return profile of bonds and loans when yields are at these levels is attractive. Figure 2 illustrates this relationship for the global high yield market since 2010. At the current level of yield, global high yield has typically provided returns in excess of 10% over the following 12-month horizon. Similarly, in the syndicated loan market, discounted loan prices have historically been a strong indicator of potentially attractive future returns. For instance, since the GFC, U.S. loans priced below $96 have delivered positive 12-month forward returns **(Figure 3)**. A similar dynamic exists in the European loan market, although the prolonged impact of the sovereign debt crisis in 2009–2010 modestly depressed prices for longer **(Figure 3)**. In both cases, loan coupons are at post-GFC peaks, providing a high level of income in these segments of the market.[2]

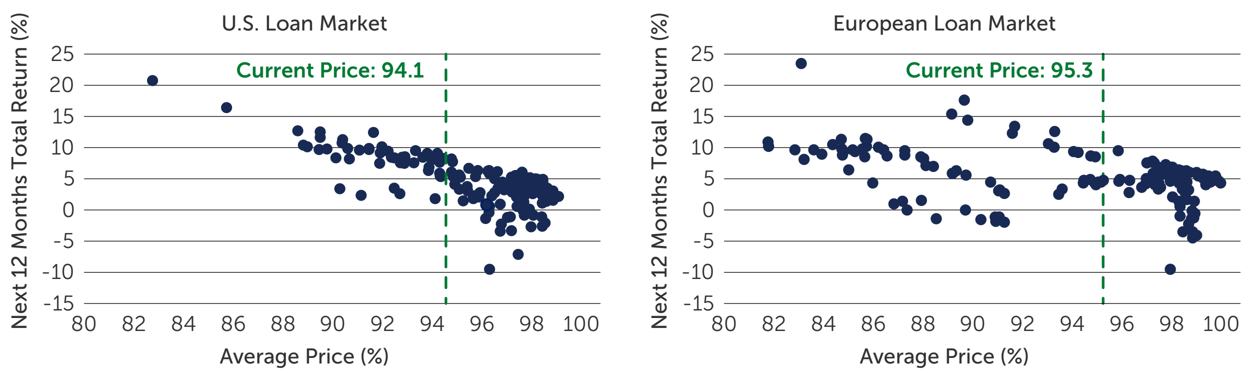
1. Source: Credit Suisse; Bank of America. As of September 29, 2023.
2. Source: Barings; Credit Suisse. As of September 29, 2023.

Figure 2: High Yield Bond Yields Near Current Levels are Rare and Have Historically Led to Strong Double-Digit 12M Forward Returns



Source: Barings and ICE BofA. As of September 29, 2023.

Figure 3: Average Prices and 12M Forward Returns in U.S. and European Loans



Source: Barings and Credit Suisse. As of September 29, 2023.

In addition, high yield has historically had a markedly lower duration profile than other fixed income segments, which makes the asset class less sensitive to interest rate volatility. For instance, the global high yield bond market has a duration of 3.5 years, while government bonds and investment grade corporate credit have durations of 7.1 years and 5.7 years, respectively.[3] Historically, such a low duration profile was accompanied by prices in excess of par—but today, due to the impact of the rapid increase in interest rates, the global high yield bond market trades at a significant discount at 86.37.[4]

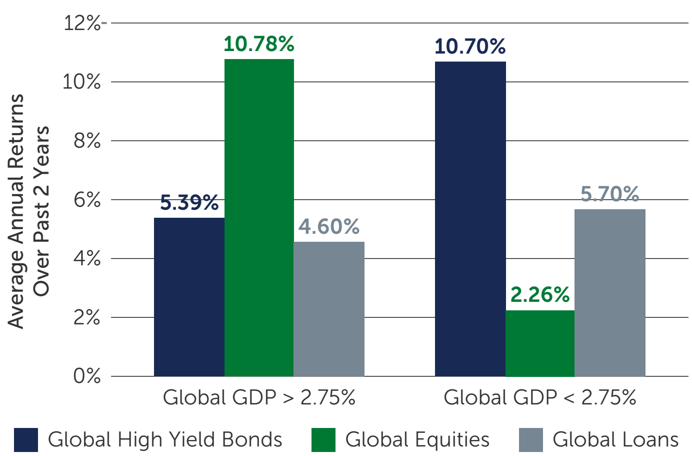
As issuers look to refinance bonds over the next few years, there will be an opportunity to benefit from a strong pull-to-par dynamic. Further, within the high yield market, senior secured loans have even lower duration due to the floating-rate coupon that comprises a one or three month term reference rate plus a fixed spread. The potential return profiles provided by high yield corporates also reflect the technical and fundamental characteristics of each underlying asset class and regional market and, as a blend, have historically tended to smooth overall returns of the strategy.[5]

3. Source: Bank of America and Bloomberg. Govt: LGTRTRUU Index; Corp: I09805US Index. As of October 31, 2023.
4. Source: Bank of America. As of October 31, 2023.
5. Source: Barings. As of October 31, 2023.

2. Attractive Return Potential in Low Growth Environments

During periods of low growth and uncertainty, many investors are faced with the challenge of finding attractive returns relative to the risk they are taking. Historically, investors have turned to equities for higher returns—however, equities require economic growth to perform well, while high yield investments only require issuers to continue to meet the interest payments on their outstanding debt obligations **(Figure 4)**. In addition, implicit in high yield as an asset class is that returns are underpinned by high levels of current income regardless of the price volatility of the equity of the underlying issuer.

Figure 4: High Yield has Materially Outperformed Equities in a Low Growth Environment



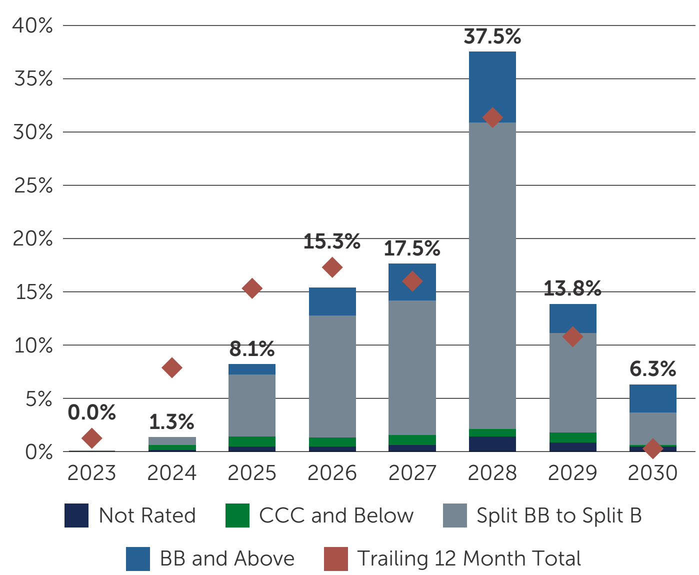
Source: Barings, Credit Suisse; MSCI; Bloomberg; ICE. As of December 31, 2022. **PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.** An investment entails a risk of loss.

In the past, periods of slower economic growth have proven to be some of the most attractive entry points for asset classes like high yield bonds and senior secured loans. The reason often stems from technical pressures such as investor outflows that have led to spreads widening beyond levels that fundamentals would necessarily warrant. With many credit investors seeking the greater relative safety of investment grade assets, the narrower resulting spreads in those assets makes the current risk-reward dynamics of high yield compelling.

At the same time, slow GDP growth, or even a short period of mildly negative growth, is unlikely to drive a significant increase in defaults. This is largely due to the ample cash cushions and financial discipline of many issuers. For example, U.S. high yield companies' net leverage at the end of the second quarter this year was 3.6x, overall unchanged versus the same period last year.[6] Leverage levels also remain better than in the fourth quarter of 2019, before the pandemic roiled markets. In addition, the credit quality of the global high yield market has significantly improved over the last 15 years—today, BB and single-B issuers comprise 51% and 39% of developed markets high yield, respectively, while CCC and below issuers comprise 10%.[7]

Meanwhile, in the global loan market, where the average credit quality trails that of the high yield bonds market, the ability to refinance existing debt is a logical focus. That said, issuers here have been thoughtful about extending the maturity wall for the asset class over the last 12 months. Today, less than 2% of outstanding loans in the global loan market is due to mature before 2025 versus 9% a year ago **(Figure 5)**.

Figure 5: Global Loan Market Maturities as a Percentage of the Market



Source: Credit Suisse Global Leveraged Loan Index. As of September 29, 2023.

6. Source: J.P. Morgan. As of June 30, 2023.
7. Source: Bank of America. As of September 29, 2023.

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While there are certainly other markets, such as private credit, that have seen demand in recent years due to higher yields, it is important to highlight that this compelling risk-adjusted return profile is available in high yield markets that have active secondary markets and can provide liquidity to investors should it be needed. For investors such as pension funds for whom liquidity is an important risk-reducing consideration, or for those that are seeking an appropriate asset-liability match, a more liquid, high yield multi-asset credit strategy may be a compelling complementary allocation.

3. Ability to Dynamically Reallocate Capital

Even among investors such as pension funds and insurers who recognize the value in a wide-ranging approach to high yield markets and the attractive income and risk-reward potential on offer, reallocating capital in a timely fashion to capture fast-changing relative value opportunities in a specialist asset class can be challenging. Limited time, a lack of dedicated specialist investment capabilities and effective oversight, governance, and risk management are all impediments to accessing this asset class. Additionally, longer-term asset allocation decisions often don't allow for the effective harvesting of relative value opportunities presented in dynamic markets. Investors who are not regular and significant market participants may miss out on advantageous opportunities.

Figure 6: Global High Yield Asset Class Returns

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD 2023
U.S. Loans	1.80%	9.40%	6.20%	2.10%	-0.40%	9.90%	4.30%	1.10%	8.20%	2.80%	5.40%	-1.10%	9.90%
European Loans	-0.80%	10.80%	9.00%	2.10%	3.60%	8.00%	5.30%	3.40%	8.20%	3.90%	5.50%	-1.20%	12.00%
U.S. HY Bonds	4.90%	14.70%	7.20%	2.10%	-5.40%	18.30%	7.30%	-2.20%	14.00%	5.90%	5.40%	-11.20%	4.60%
European HY Bonds	-1.40%	24.90%	9.30%	5.40%	1.50%	11.80%	8.30%	-0.70%	14.10%	4.50%	4.10%	-9.50%	7.70%

Source: Bank of America; Credit Suisse. As of October 31, 2023.

High yield multi-asset credit strategies were created for exactly this reason: to capitalize on the inefficiencies inherent in these markets by using experienced teams that participate in the markets daily. Indeed, managers with well-staffed trading and portfolio management teams that continuously analyze these markets typically are well-positioned to allocate capital in a timely and efficient manner. In addition to trading expertise, active managers also invest in research that provides an in-depth understanding of individual companies. This specialized information gathering process often reveals mispricing opportunities within corporate capital structures and insights into cross-asset relative value. Managers with deep teams providing broad coverage across geographies, as well as investing experience through multiple cycles, are apt to be best positioned to help investors navigate today's evolving landscape.

Key Takeaway

As investors face an uncertain macro backdrop and challenges from income generation to inflation protection, high yield multi-asset credit strategies have the potential to form part of a comprehensive asset allocation solution. With a strong track record of performance across various phases of the economic cycle, the potential for attractive income, and ample liquidity on offer, such strategies may be primed to help investors weather the potential storms ahead.

Barings Global High Yield

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10 YEARS TRACK RECORD IN MULTI-ASSET CREDIT INVESTING

Source: Barings. As of September 29, 2023.

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**As of June 30, 2023*

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