M&G Investments

Multi-asset credit update

Preparing for potential changes in the fixed income environment

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- Valuations, fundamentals and individual bond characteristics all play a key role in evaluating potential risks and opportunities in current market conditions, whereby spreads are at historically tight levels.
- We believe one of four potential future scenarios could play out, depending on the direction and speed of travel of spreads from here. In each case, we would look to adjust our positioning relative to benchmark indices using the same, consistent investment process that has seen us navigate previously challenging environments.
- Our portfolios are currently positioned using a 'barbell' approach. Allocations to defensive assets, such as cash and short-term government bonds, should provide the flexibility to adjust portfolio positioning if valuations become more attractive. Meanwhile, short-dated high yield bonds, including fallen angels and other candidates for ratings upgrades, offer running income alongside – in selected cases – some defensive characteristics in potentially weaker market conditions.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

The importance of valuations, fundamentals and individual bond characteristics

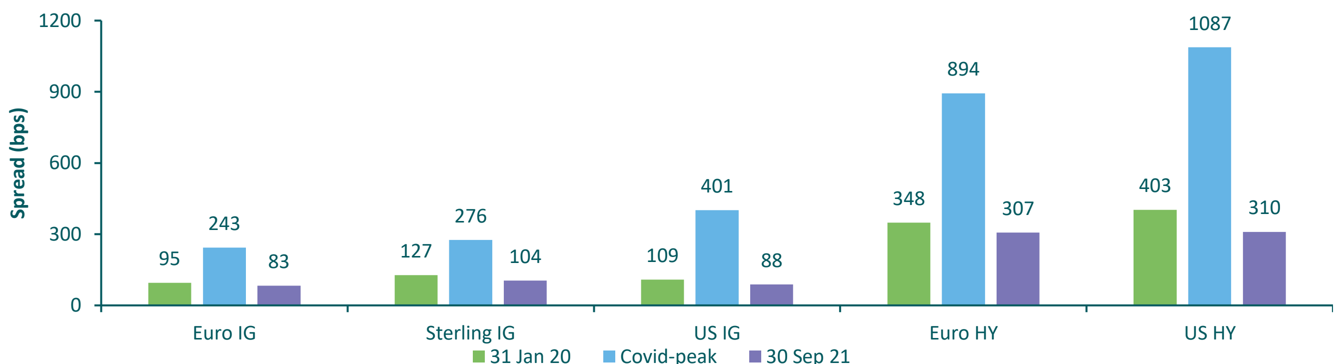
Traditionally, when we update investors on our multi-asset credit positioning, we focus primarily on two areas: valuations and fundamentals.

More recently, we have also emphasised the importance of considering the features of individual securities that can drive their potential performance. In particular, we believe it has been essential not only to consider features of credit risk, but also the characteristics of the bonds in question.

Last year, for example, we chose to invest heavily in long-dated investment grade bonds at around the peak of spreads. Why? Because even if those long-dated investment grade bonds did not have the same capacity to tighten as high yield bonds, their significantly longer spread duration meant that the total return from a smaller tightening was at least comparable. At times of extreme valuations, these decisions can play a crucial role in driving potential portfolio returns.

Before diving into our current multi-asset credit positioning, we believe it is important to make some observations about valuations. Above all, top-down credit market valuations are tight. There are, of course, individual issuer valuations that defy this generalisation, but from a market or ratings perspective, valuations are stretched, as can be seen in Figure 1.

Figure 1. Spreads: pre-, post- and peak of Covid crisis



Past performance is not a guide to future performance.

Source: M&G, ICE BofA indices (ER00, UC00, C0A0, HEAD and H0A0), government OAS spreads. Covid peak at 23 March 2020, except Euro IG, Sterling IG at 24 March 2020. Data as at 30 September 2021

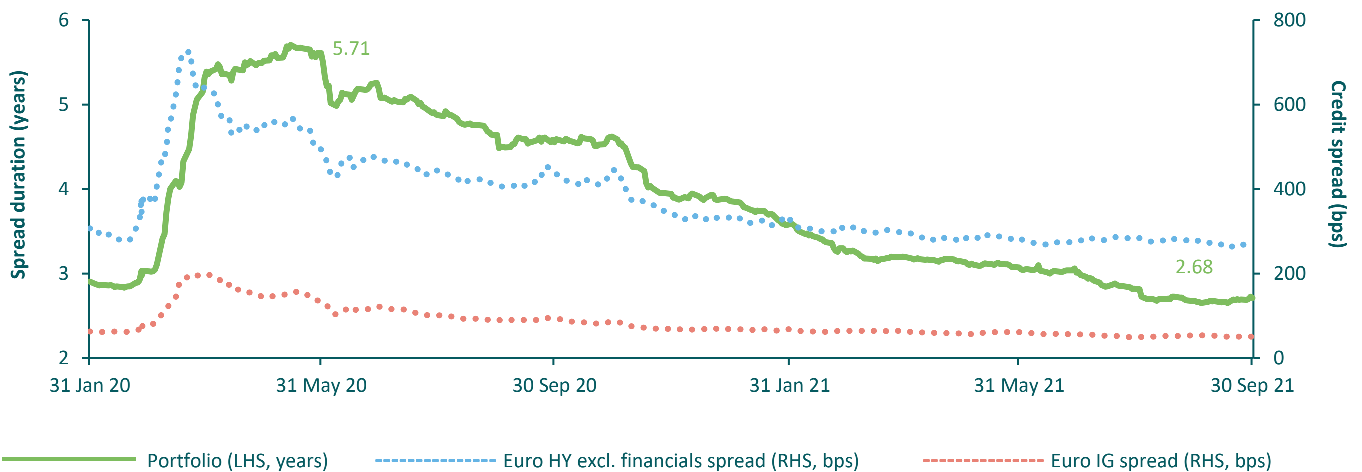
Furthermore, the speed with which markets have moved from one extreme of valuation to another has been astounding. In a more 'normal' environment, markets would have typically moved from cheap to fair value to expensive – and our portfolios would have followed suit, from long risk to neutral to short risk. However, it felt as if we had barely taken a breath before the market swung to expensive levels, and we responded by moving our portfolios to be underweight in credit risk.

Investors are already familiar with the drivers of the current valuations, with economic and monetary policy conditions among them. We can make two observations here: first, the drivers of current valuations are not permanent and, hence, current valuations are also not permanent. Second, one of the conditions that market sell-offs normally require is for valuations to start from a position of being expensive. Cheap markets do not typically sell off aggressively, as there is an inbuilt cushion for the unexpected, but this is not the case when valuations are expensive.

Portfolio positioning

With this in mind, it should come as little surprise that, since January 2020, the spread duration of our multi-asset credit strategies has gone on a full round trip: from c.2.5 years (close to our historic lowest levels) to nearly 6 years (close to historic highs) and back down again towards 2.5 years, as shown in Figure 2.

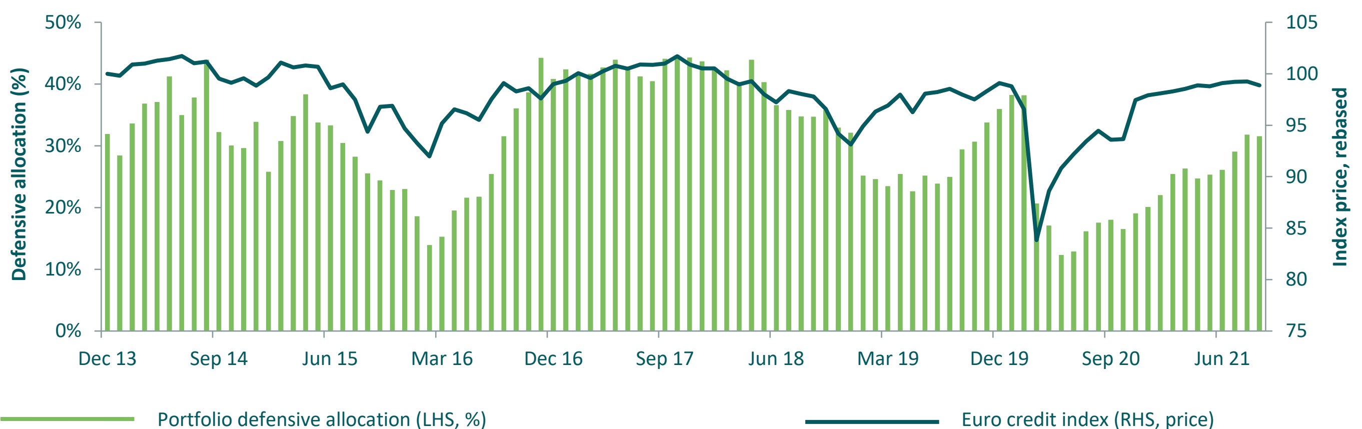
Figure 2. Spread duration (representative M&G multi-asset credit portfolio)



Past performance is not a guide to future performance.
Source M&G, ICE BofA Indices (ER00 and HEAD) credit spreads, as at 30 September 2021.

In terms of allocation, we have been reducing risk assets and moving into more defensive positions, including cash; T-Bills; money market funds; short-dated government bonds; and AAA floating rate asset-backed securities (ABS), as shown in Figure 3. These adjustments have been both consistent with the potential opportunities presented and previous episodes of similar valuations that we have experienced.

Figure 3. Allocation to liquid, defensive assets (representative M&G multi-asset credit portfolio)



Past performance is not a guide to future performance.
Source: M&G, price return of ICE BofA Euro Non-Financial 2% Constrained index (HPIC) rebased (31 December 2013 = 100), as at 30 September 2021

When markets are cheap, especially as the result of a sharp correction in valuations, we follow a consistent approach to consider how to react and to make portfolio changes we believe are required. These rapid sell-offs typically cause the prices and fundamental risks of assets to become increasingly out of alignment; in these situations, we are often presented with asset prices that we believe then more than compensate holders for the risks borne.

Expensive markets are more difficult to deal with. Why? Credit pays investors to hold an asset. Expensive market valuations imply that an underweight portfolio position versus a benchmark index may be appropriate, hence lower carry is earned. Each day therefore results in active underperformance relative to a higher yielding benchmark. Essentially, this becomes a question of timing: will markets correct quickly enough, or far enough, to make the loss of carry a cost worth bearing for investors? Similarly, for non-benchmarked investors, returns will slow as attractively priced opportunities diminish.

We cannot forecast the market in the short term. However, we can be confident that, in the long term, normal valuations should eventually reassert themselves. At times like this, we believe a strategy or combination of strategies that allow us to fight another day is required – a strategy that will carry us through a period of expensive valuations and allow us to react when gravity (or reality) takes hold once more, bringing valuations back to more attractive levels, whenever that may be.

Potential scenarios

We can frame the situation investors now face according to four basic potential scenarios:

- **Scenario 1.** Markets fall abruptly and soon, reaching potentially attractive levels over the course of one or two quarters. Similar historical examples include the sovereign debt crises of 2011/12; the global growth and commodity crisis of 2015/16; and the coronavirus outbreak of 2020, as shown in Figure 4.
- **Scenario 2.** Markets fall at a more measured pace, re-establishing potentially attractive valuations over a longer period, say over 12 months, as was the case in 2018.
- **Scenario 3.** Not much happens, and spreads stay roughly where they are today. This is an often forecast market outcome; however, it rarely materialises. In euro and sterling investment grade credit, the indices have ended the year within 10 basis points (bps) of their starting point in only five of the last 20 years. In US investment grade credit, this has only happened twice in 20 years. As for high yield credit, the indices have only ended the year within 50bps twice in euro markets and once in US dollar markets in the last 19 and 20 years respectively.
- **Scenario 4.** Markets become even more expensive than they are now – for this, we believe there are no historical examples worthy of note.

Figure 4. Investment grade credit spread scenarios

Past performance is not a guide to future performance.
Source: M&G, ICE BofA indices (ER00, UC00, C0A0), government OAS spread, as at 30 September 2021.

Given these scenarios, we must consider which assets or combination of assets might serve the purpose of allowing us to 'fight another day', given the range of potential outcomes.

In Scenario 1, other than short-term government bonds and cash, any risk asset would be expected to fare poorly. The good news, though, is that these valuations do not typically persist. Asset prices rapidly move to levels that attract capital – ours and our clients included – and, historically, we have tended to see a fairly rapid reversal from these episodes. Hence, the key here is to remain liquid to be able to react. Defensive assets, such as cash; short-term government bonds; short-dated covered bonds; and high-quality, liquid asset-backed securities all have their place here. These are designed to protect the

net asset value (NAV) of the portfolios, and we would need to adopt a trading mentality to moving into riskier assets. We would potentially lose a little on the defensive holdings during the early stages of Scenario 1, but we would view this as an acceptable cost, given the potential profit on hand.

The not-so-good news is that, in this scenario, we should expect potentially every other asset held to fall in value and therefore drag the portfolios' NAV down. This should be temporary and the potential rebound – subject to our investment process kicking in and the portfolios re-risking – would likely be much stronger.

Scenario 2 would be by far the hardest for us to contend with. Spreads would gradually widen over a longer period, and valuations would fall —as would portfolio NAV. Spreads would fail to reach levels deemed sufficiently attractive in the short term, and so patience and forbearance would be required. All would not be lost, though; there are some bond characteristics that we could seek out to help us mitigate this unwelcome situation:

- **Short-term bonds.** Subject to companies having the ability and desire to repay their debts, bonds repay at par. If we could identify bonds that will, for example, repay in the next few years with spreads that perhaps would not be deemed generous, but nonetheless offer sufficient compensation for risk, then these bonds would pull in towards par as they approach maturity and the portfolios would earn the carry or spread from them. At current valuations, these 'sufficient' spreads are likely to found in short-dated, callable high yield bonds. To have confidence that these bonds will be called, we would focus on high coupon or heavily covenanted bonds from companies we believe have the ability to repay. These will not always be companies with improving credit fundamentals; rather, we would need to have a high degree of confidence, based on our analysis, that they would repay their obligations as they fell due. As we discuss in further detail later on, we are sceptical that deeply subordinated notes would fall into this bucket.
- **Companies with positive credit momentum.** This comprises companies that we believe are due an upgrade from the credit rating agencies. In normal market conditions, the rating upgrade should drive spreads tighter. In a weak market, spreads may simply stand still as the rest of the market widens – but that would be enough to help protect portfolio NAV.
- **Fallen angels.** Similar to those companies described above, some of these previously investment grade-rated issuers have rating upgrade potential, while for others, a stabilisation of their ratings would be sufficient. In either case, fallen angels have a history of outperforming both better- and worse-rated peers.

Scenarios 3 and 4 would be of benefit to those assets described in Scenario 2, albeit the lighter aggregate risk position would mean that the strategies would be expected to underperform the broader markets. They would at least generate a positive contribution to returns and allow the portfolios to 'fight another day' for when valuations did move to potentially more attractive levels.

Subordinated financials (AT1s) and callable high yield corporate debt

We believe it is also worth examining deeply subordinated financials, also known as additional tier 1 (AT1) securities: these bonds are perpetual securities that pay a deferrable coupon, but are callable at various points in time.

In normal market conditions, investors price these bonds to their first call date, with the expectation that the issuing bank will replace them with newly issued securities. However, when spreads move sharply wider, the bank's ability to reissue at rates low enough to make calling the existing bonds an economically justifiable decision is called into question. As a result, the market begins to price the bonds to a call date far into the future – sometimes assuming that the bonds will never be called. Thus the bonds' duration jumps higher and, as spreads move wider, the bonds' prices begin to collapse. In the depths of the 2020 sell-off, the cash price of some bonds fell by 30+ points .

Callable high yield bonds, which we believe currently present potential opportunities, possess a key difference in that they offer a legal final maturity date, which is often no more than five years out. Therefore, while their duration extends, it does not do so to the same extent as AT1s. They can therefore represent an attractive potential opportunity, depending on pricing and call timings.

Finally, and just to complicate matters, there are subordinated financials with terms and conditions that no longer meet regulatory definitions of capital and so are more likely to be called at the first possible opportunity. We would consider these to be potential opportunities, as they represent a small minority of bonds that have different potential performance drivers and dynamics to the wider subordinated financials universe.

Our conclusions

In current market conditions, we believe a 'barbell' approach represent the most appropriate way of positioning our multi-asset credit portfolios – on one side, a combination of defensive assets, such as cash and government bonds, which should allow us to react when better valuations emerge; on the other, short-dated, high yield upgrade candidates and fallen angels that provide some running income, whilst offering defensive characteristics in case of market weakness. Where possible, we will look to avoid those bonds that represent unrewarded beta, such as long-dated investment grade bonds.

Regardless of which potential scenario plays out, we continue to place trust in our value-based investment process, which has seen us navigate numerous challenging market environments over the past two decades. We believe our emphasis on rigorous, bottom-up credit research, and the resources we have available to us, should enable us to successfully confront future challenges, both in the period ahead and for many years to come.

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