Finding the Right Mix

Navigating the New Menu of Credit Investments

- The range of credit investments available to investors has grown materially in recent years – giving allocators much greater choice when it comes to portfolio construction.
- At this late point in the business cycle, we believe credit investments are attractive. In fact, credit can be thought of as "equity lite" – a way of generating positive returns without the drawdown potential found with equity investments.
- We believe Unconstrained Credit Strategies are an important component of this menu of choices – with the ability to provide investors with a unique return stream and liquidity not found in other non-traditional credit products.
- As such, these strategies are an ideal complement to less liquid credit investments

Over the last decade there has been a significant expansion in the range of credit exposures allocators can access. As banks have pulled back from certain types of lending due to onerous regulatory requirements, asset managers have moved in to fill the void. This has resulted in a greater breadth of credit investments available to allocators - going far beyond traditional public corporate bond markets. These additional exposures now offer investors a wide array of options to help diversify credit and liquidity risk by targeting different markets and different levels of a borrower's capital structure.

The Growing Menu of Credit Investments

Market Type	Exposures
Publicly Traded	Investment Grade Corporates
	High Yield Corporates
	Emerging Market Debt
	Securitized / Asset-Backed
	Bank Loans
Private Debt	Direct Lending
	Infrastructure
	Commercial Mortgages
	Mezzanine
Specialized	Distressed Debt
	Trade Financing

Decreasing Liquidity

Note this is a representative list of the larger credit asset class

The institutional community has strongly embraced these options – illiquid strategies in particular. It is worth noting that many of these "new" asset classes are defined by their liquidity – or lack thereof. For many of these types of investments, investors are effectively paid an additional return for assuming this liquidity risk. And while we agree that many investors are probably "liquidity rich", we think the concept of diversification should still be applied to one's credit exposure - not only on the basis of issuer, sectors and geography but also in terms of liquidity and return profile.

Investors have incorporated this expanded range of credit strategies in their portfolios in different ways. There is no "right" or "wrong" way to bucket these new credit strategies. Some investors have added these strategies to a bucket of alternatives that sit alongside the equity and fixed income categories. The idea being that strategies within this bucket individually and collectively produce a return stream that will offer diversification benefits with respect to the "traditional" asset categories. This bucket might also include long-short equity and global macro, for example. Other allocators take the approach of putting these credit strategies within the fixed income bucket of the portfolio as a complement to / replacement for traditional bonds. The justification for this is that the primary return driver for many credit strategies is a combination of interest rates and a compensation for taking credit risk. In this case, if there is an alternatives bucket it will generally be reserved for "true" alternatives such as commodities, managed futures, life settlements claims, etc.

More interestingly, some very large institutional investors have moved to abolish the "fixed income" bucket altogether, and replaced it with two separate asset classes – government bonds and credit. This approach recognizes that credit is itself a distinct asset class – with its own unique risk premium (default risk). This approach has been given academic legitimacy in recent years, and can have notable advantages in risk management (particularly stress testing) of the portfolio.[1]

At this point in the current cycle, it may also make sense to think of credit as "equity lite". Given market consensus that the current economic cycle is mature and that equity valuations are quite elevated, we believe that investors should start to recognize that credit has a hybrid nature. It's an asset class that provides an excess return, but with less downside risk and volatility than equities due to capital structure seniority. It is for this reason that credit has sometimes been referred to as "equity lite". A diversified basket of credit exposures may help to shield one's portfolio from significant drawdowns without sacrificing full upside potential (versus a move to government bonds or cash-like instruments). The table below clearly illustrates that the diversified credit basket provides lower drawdowns and shorter recovery periods versus major equity indices.

The Drawdown and Recovery Experience Shows That Credit Acts as 'Equity-lite'

Asset Class	Market	Total Return	Max. DD	Recovery (Months)
Equity	S&P 500	9.5%	-46.4%	24
	Russell 2000	10.3%	-47.3%	21
	MSCI World Ex. US	2.8%	-52.9%	55
	Equity Average	7.5%	-48.9%	33
Credit	US Investment Grade	5.0%	-15.4%	8
	US High Yield	8.1%	-32.5%	8
	Emerging Market Debt	5.9%	-19.7%	9
	Real Estate Debt	4.2%	-45.4%	21
	Private Debt	9.2%	-7.7%	3
	Infrastructure	8.4%	-23.2%	10
	Unconstrained Credit	4.8%	-21.9%	11
	Securitization	3.7%	-2.5%	5
	Credit Average	6.2%	-21.0%	9

Source: eVestment, Cliffwater, Bloomberg and Preqin
Based on quarterly and monthly returns for common inception and end dates (March 2008 to June 2018) – Please see disclaimer for further details

What are Unconstrained or "Absolute Return" Credit Strategies?

- Strategies that apply an active, opportunistic approach to publically traded credit assets.
- May use unconventional tools such as leverage and shorting to manage risk and generate return.
- A significant component of the return usually comes from effective reading of the market, as well as skill and conviction in positioning the portfolio.

[1] See Asvanunt & Richardson – "The Credit Risk Premium".

Within the menu of choices, Unconstrained Credit strategies provide three key benefits to investors – a unique return stream, liquidity and flexibility. These strategies typically generate a significant portion of their return from the investment flexibility and responsiveness that the majority of bond investors (institutions that tend to be large and mandate-constrained) don't have. These strategies aim to generate capital gains through active and opportunistic management of the portfolio. The other credit strategies we have identified tend to have more of a passive "income focus" – and the bulk of returns in these areas will be driven by a combination of credit risk and liquidity risk.

Unconstrained Credit Strategies Provide a "Different" Return Stream

	Unconstrained Credit
US IG	0.35
Global IG	0.51
Private Debt	0.62
Real Estate Debt	0.06
Structured Credit	0.00
Infrastructure	-0.28
US HY	0.81
Emerging Mkt. Debt	0.49
S&P 500	0.58
Russell 2000	0.60

Low/medium correlation to public markets due to highly active style

Low correlations to "new" credit allocations, especially those with illiquidity focus

Higher correlation to high yield with managers focused on that section of the market

Higher correlation with credit acting as "equity-lite"

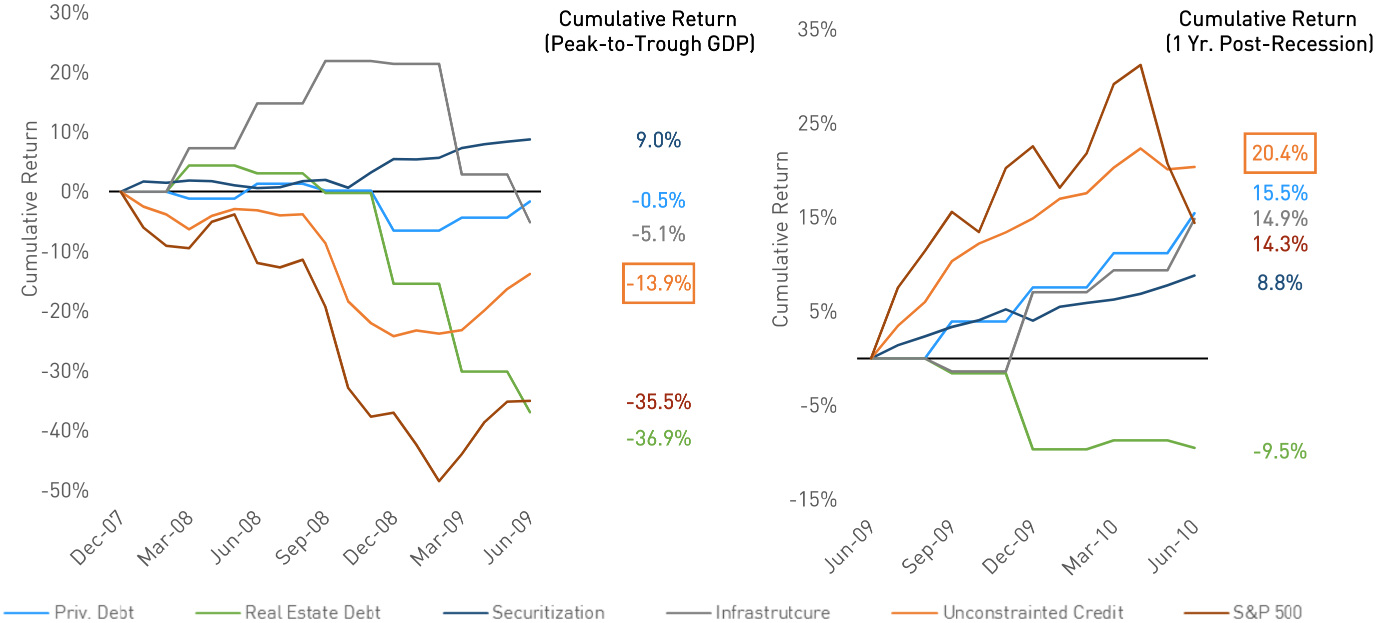
Source: eVestment, Cliffwater, Bloomberg and Preqin
Based on quarterly and monthly returns from full data set for each category from 1998 through 2018.
Please see disclaimer for further details

Secondly, owing to the nature of the underlying investments, these strategies can perform an important liquidity role in a credit basket. Unconstrained Credit strategies generally offer investors significantly more liquidity than that obtained when allocating to private debt and other illiquid strategies. Combining the liquidity of Unconstrained Strategies alongside the significant income generated by more illiquid strategies can provide investors with a good mixture of return and liquidity. This liquidity can help buttress the volatility experienced in higher risk exposures found elsewhere in the portfolio or provide dry powder which is ready to take advantage of valuation opportunities as economic circumstances change.

Finally, the ability to dynamically rebalance a portfolio is a key component of managing risk during volatile periods and capturing upside as the economy moves through the cycle. Unlike managers of illiquid credit portfolios (who make the majority of their security selection decision at origination), Unconstrained Credit managers have the ability to provide a dynamic return profile as managers reposition within different stages of the credit cycle to protect downside in contractions/recessions and capture additional upside as the economy moves from recession to expansion.

To illustrate, we look at the most recent peak-to-trough period in the U.S. economic cycle of 2007 to 2009. The data shows that the components of a diversified credit basket performed well despite the economic slowdown due to steady income realization and low mark-to-market volatility. For the same period, Unconstrained Credit experienced a significant drawdown prior to the point that the economy hit recession lows. However, post-recession we see Unconstrained managers exhibiting accelerating outperformance as they were able to reposition to better capture the upside of the economic rebound. This speaks to the ability of these styles of mandates to quickly rebalance themselves given changing market dynamics versus illiquid credit which has less tools to reposition as easily. This acceleration post-trecession also complements the steady cumulative performance exhibited by the more illiquid asset classes.

The Flexibility of Unconstrained Credit Strategies Means Value Capture is Possible Through Re-Positioning



Source: eVestment, Cliffwater, NBER, Bloomberg and Preqin
Cycle dates based on NBER data – Pre recession return based on Dec. 2007 to Jun. 2009 / Post Recession return based on 1 year period ending June 30, 2010 - Please see disclaimer for further details

Conclusion

In recent years, allocators have started to take advantage of the expanded range of credit investments available in the market. As a result, credit allocations have generally grown and become more diversified. We believe allocators should consider including Unconstrained Credit strategies as a key part of their credit portfolio. Just as investors always search for diversification across asset classes we believe Unconstrained Credit is an effective diversifier within the "new" credit portfolio. When matched with less liquid exposures, these strategies have some significant benefits in terms of liquidity and diversification.

Unconstrained Credit = HFRI Relative Value – Corporate Bonds Index [Mar. 1998 – Dec. 2018] / Securitization = Bloomberg Barclays Global Securitization Index (Jan. 2001– Dec. 2018] / Private Debt = CDLI Index (Dec. 2004 – Sept. 2018] / Infrastructure = Preqin Infrastructure Benchmark [Jan. 2008 – June 2018] / Real Estate Debt = Preqin Real Estate Debt Benchmark [Jan. 2008 – June 2018] / US IG = Bloomberg Barclays US Corporate Bond Index [Mar. 1998 – Dec. 2018] / US HY = Bloomberg Barclays US High Yield Index [Mar. 1998 – Dec. 2018] / EMD = JPM EMBI+ Index [Mar. 1998 – Dec. 2018] / S&P 500 = S&P 500 Composite Index [Mar. 1998 – Dec. 2018] / Russell 2000 = Russell 2000 Index [Mar. 1998 – Dec. 2018] / MSCI World Ex. US = MSCI World Ex. US Index [Mar. 1998 – Dec. 2018]