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Multi-Asset-Credit Whitepaper: How are asset managers approaching the opportunity set in multi-asset credit?

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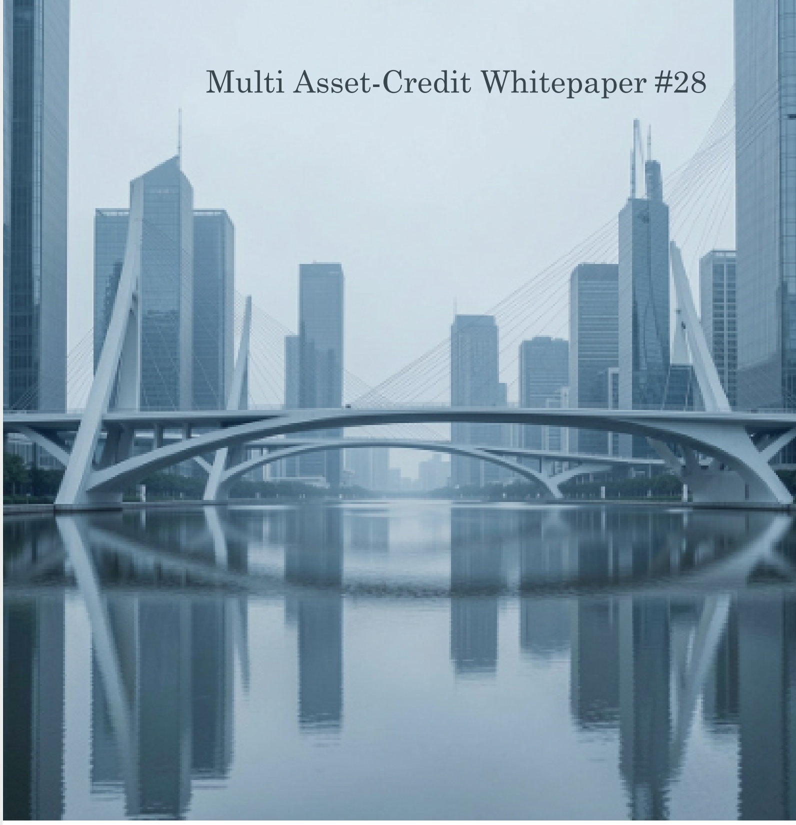

Roundtable sponsor

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sean.thompson@cioinvestmentclub.com

chloe.irapah@cioinvestmentclub.com

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Multi Asset-Credit Whitepaper: How are asset managers approaching the opportunity set in multi-asset credit?

Global fixed income markets have seen repricing recently driven by geopolitical tensions, rising energy prices, and upward pressure on interest rates, highlighting the value of investing across the spectrum of global credit.

This is where multi-asset credit (MAC) strategies have the chance to shine, thanks to their flexibility to allocate to assets dynamically, potentially offering a higher income than single sector portfolios while keeping risk in check.

There are two key approaches to managing MAC. Some asset managers use a core/satellite approach, delegating sleeves to fund managers focused on a specific credit sector, while others take a holistic, bottom-up approach, allocating capital to individual bonds across the market.

Dan Poole, Deputy Head of Public Credit at Pension Insurance Corporation, says either way it's important to have visibility across many sectors, even those you're not invested in.

Poole explains that PIC – which has increasingly brought assets in house as it has scaled – manages its core capabilities internally, while specialist sectors are outsourced.

"Most developed market corporates, government bonds and private credit are in house whereas emerging markets, US taxable municipal bonds and some private placements would be outsourced," he says.

"If you want to have access to the best opportunities, you absolutely need good visibility and the ability to access those sectors."

Poole adds that PIC uses MAC within liquidity and cash-plus strategies with the aim of allowing managers to access the best relative value opportunities. This prompted Lloyd Thomas, Portfolio Manager at Border to Coast, to question how such funds are benchmarked.

Dean Wetton, Managing Director at Dean Wetton Advisory, proffers that with broad bond mandates they use both a return benchmark and a risk benchmark.

"For example, a return benchmark might be cash plus 3% and the risk benchmark might be the Global Aggregate Bond Index, or a combination of Global Agg and High Yield," he says. "In the short term, we'll look at the investable benchmark and in the longer term, we'll look at a combination.

No free lunch

Both the top-down and the bottom-up approach can have their drawbacks. For example, managers of core/satellite strategies may struggle to secure support from managers of sub funds or could have to over diversify to access specific asset classes, with some such strategies holdings as many as 1,500 names.

"No approach is perfect by any means," says Peter Martin, Chief Investment Officer at the Medical Defence Union. "However, in the top-down approach, a drawback can be too many bonds."

He continues: "The top-down allocator simply cannot know 1,000 bonds in sufficient detail and is wholly reliant for stock selection within the sub-sleeve and there could be inconsistent positioning when looking holistically across the portfolio.

"In addition, responsible overlays can be challenging in such an approach. On the other hand, the bottom-up approach may sacrifice diversify in opportunity set and may suit a more focussed credit approach."

Owen Murfin, Global Fixed Income Manager at MFS, adds: "If you're a multi sector manager, it can be difficult to get buy in from all the individual sector teams without buying a mutual fund."

Murfin also questioned whether sub portfolio managers can be relied on to share their top picks.

"Do people really give you their best ideas? That is the driver of a high information ratio that clients want. But I don't think it's necessarily for sale, because it can be put to higher-fee products. You're therefore allocating to broad-based portfolios and if you don't have some control in that, you can have cross correlation."

The different risk profiles of MAC strategies can also mean they vary wildly in their approach to volatility and the credit quality of their holdings. Rickey Thevakarrunai, Director, Public Markets, at bfinance, posits there are three popular approaches to capital allocation.

"Cash plus absolute term mandates, which tend to be lower duration, hold more investment grade, so they don't have as much high yield exposure and there is less credit risk," he explains.

"On the opposite end of the scale, some multi-asset credit strategies are entirely sub-investment grade. Often the benchmark is 50% high yield bonds and 50% leveraged loans. Many managers also allocate to securitised credit, which includes ABS, MBS and CLOS. These strategies also tend to be low duration but have the highest credit risk.

> *If you're a multi sector manager, it can be difficult to get buy in from all the individual sector teams without buying a mutual fund.*

He continues: "Then there are the in-between strategies that are benchmarked against Global Aggregate Bond Indices. These mandates might hold government bonds or could be more credit-focused, including a mix of investment grade and high yield corporate bonds alongside some securitised or emerging market debt. Duration in these are typically higher and can range between four to six years."

Thevakarrunai is seeing more interest on the pure leveraged finance side of MAC, where investors want the leveraged loans and securitised exposure but often don't have sufficient assets to allocate to them directly.

"MAC products allow clients to have access to an area which they don't normally have access to," he adds.

A safe place

The unconstrained nature of MAC mandates means managers can use duration to actively tilt portfolios and harness capital appreciation when interest rates fall, primarily through gilts and floating-rate instruments. However, MAC managers tend to focus on generating returns from credit spreads rather than rate exposure.

Thomas takes a core/satellite approach to MAC and is happy to let duration run.

"We don't have an LDI programme so we can run duration. It's an underutilised source of return for LGPS more broadly because they have a lot of equity," he says.

Thomas describes the MAC strategy as a diversified, multi-asset, income-generating portfolio that behaves differently to investment grade funds. Border to Coast has a separate inflation-linked bond fund to offset the impact interest rate movements have on future pension obligations, so gilts do not feature in the MAC strategy.

"The MAC strategy is a solution for the partner funds to get a diversified, well-governed, single point of entrance to the higher yielding element of fixed income," he explains.

Martin says gilts, government bonds and US treasuries are arguably an essential component in the opportunity set of MAC portfolios. When sentiment is bearish, the manager should be able to be defensive, and he argues there is no reasonable excuse for not having this in the armoury after the fallout from the great financial crisis and lessons learnt then.

"I am of the view there is no reasonable argument for not including safe harbour government bonds and/or cash going forward in the opportunity set in order to protect the investment in inherently uncertain and risk off periods.

"Similarly, having the ability to use swaps for interest rate management. There may be periods when the rates sensitivity needs active management and the duration position arising from the MAC should not just be a consequence of physical bonds being held."

Wetton points out that MAC strategies are growth mandates typically targeting cash plus 3%, which he says he would accept volatility for.

Ultimately asset owners have to be aligned with what managers are willing to accept, for example whether they are prepared for drawdowns.

"There will be spread widening, it's a question of how its managed and what – if any – drawdown mechanisms are employed within a risk budget," Martin adds.

Thevakarrunai points out that while at the lower end of the quality spectrum there will be material drawdown in high volatility assets, asset owners should remember MAC is a long-term product.

"Even though you have a cash plus 4% target, that's going to be over a five-to-seven-year cycle. You have to accept the risk that there will be periods that these strategies will experience a significant drawdown," he says.

Of greater concern is whether permanent impairment is going to be a feature of a credit cycle in the future. Murfin is of the view it will be.

"2022 was seen as this big test, but it was more a total return test than a credit cycle test," he says. "The problem is these drawdowns might not be temporary. You could actually lose, particularly in private credit."

Even though you have a cash plus 4% target, that's going to be over a five-to-seven-year cycle.

Emerging markets

The discussion moves to investment opportunities and the increasing popularity of emerging market debt in MAC strategies on the back of the dollar depreciating, fiscal reforms in EM countries, and attractive valuations.

Owen notes EMD is currently offering positive real yields, and many countries now have independent central banks and are fiscally responsible.

"Many people feel it's wrong not to have emerging market exposure in a MAC setup," he says. "It has as much credibility to be part of an asset allocation lineup as high yield or structured products."

However, EMD is a vast asset class and country selection and evaluating the different sub asset classes within EMs is paramount, he adds, noting the potential for restructurings is always a concern.

"EMD is not without its defaults and workouts and that can be time consuming," he says. "Working with different stakeholders in EMs – who are typically trying to look after the population rather than the creditors – can be quite acrimonious."

Owen highlights South Africa as an attractive country to invest in.

"South Africa has been really cheap at times but it always comes back and you're often rewarded for holding 30-year South African bonds," he says.

"One of the key anchors is an independent central bank; that inflation credibility has kept South African bonds together. Recently, they've lowered their inflation target and we're positive on South Africa as fiscally it's improving after the work-off of the utility companies, which have been restructuring."

Thevakarrunai agrees that EMD looks attractive from the current valuation standpoint because on the investment grade and high yield side spreads are close to record lows.

In terms of where EMD fits within a MAC mandate Thevakarrunai suggests that from a skill set perspective it's macro oriented, meaning its best placed in a dedicated EMD allocation.

"The leveraged finance side requires a completely different skill set. They're focusing on bottom-up credit selection," he says.

> *South Africa has been really cheap at times but it always comes back and you're often rewarded for holding 30-year South African bonds,*

> *There's more inflation in the world. The dollar is challenged, but whatever your view is on the US, it's still prevalent.*

"There are only certain managers who have the teams that manage EMD, because an emerging market debt team is predominantly focused on top-down sovereign analysis, which is distinct from bottom-up credit analysis. To access EMD in your MAC allocation you need to have one of the bigger managers who have different teams they can plug into."

Local currency EMD is a different ball game altogether, Thevakarrunai adds. "A lot of these products won't have that much local currency debt exposure, because that has a completely different risk and volatility profile."

Border to Coast has a strategic allocation to EMD, both in US dollars and local currency, which can be quite volatile, Thomas says, adding that as emerging markets go through cycles it is often used as a tactical allocation tool, and holding a strategic allocation can be challenging.

Given the portfolio is about 80% dollar-denominated, EMD has its place, adding some diversification through the cycle, he adds.

"There's more inflation in the world. The dollar is challenged, but whatever your view is on the US, it's still prevalent. Yet there's an erosion at the margin, and it's quite likely it will continue."

Martin is more agnostic on EMD.

"I wouldn't say MAC funds must have EMD, but it is in many ways predicated on the skill set on the manager concerned and/or if they are solely reliant on internal resources. In addition, there needs to be absolute clarity on whether the EM expression is for hard, local, governments or corporate credit," he says.

"You tend, in my experience, to see more hard dollar investment used rather than local. EM local is a highly volatile asset. Over the years EM local has probably been one of the greatest sources of volatility in these products; and can be a consistent negative contributor for a considerable period of time. EM can model well but the reality can prove very different."

From the perspective of cash flow matching long-dated Sterling liabilities, Poole says emerging market hard currency debt – particularly sovereigns – is really useful.

"We can't use the local currency because of the need to swap cash flows back to GBP, and there is limited availability of local currency swaps," he explains.

Murfin says another reason for being bullish on EMD is that it is not as volatile as US high yield.

"If you're a multi sector manager, you're looking for ways to get more defensive at times but still have carry. At the moment, for instance, you'd probably be short high yield against being long EMD," he says.

"We've got that on our portfolios, because what inevitably happens is high yield blows up. So you have the same carry from EM hard currency, but not the negative convexity of that blow-up risk.

"A good MAC manager can then use dynamic asset allocation towards US high yield when they think implied default rates are 15%. It's a powerful mix."

Participants

Peter Martin

Chief Investment Officer, Medical Defence Union

Peter is the Chief Investment Officer for The Medical Defence Union and has been with the MDU since 2016. He has over 30 years' experience as a senior investment professional.

Prior to joining the MDU, Peter was head of manager research at JLT Employee Benefits and before this at Aon Consulting. Peter's investment research specialisms have included bonds, LDI and property.

He is currently a member of the Investor Committee of the Association of Real Estate Funds. Peter was also a member of the Society of Pension Professionals (SPP) Investment Committee for many years and in addition was a member of the Investment Committee to the Pensions Board of the Institute of Actuaries. More recently, Peter was a member of the Management Committee for the Association of Member Nominated Trustees and a Trustee for the MDU Pension & Life Assurance Scheme.

He is a Fellow of the Institute and Faculty of Actuaries and also holds the Investment Management Certificate (IMC).

Lloyd Thomas

Portfolio Manager, Multi-Asset Credit – Border to Coast Pensions Partnership

Lloyd is a CFA charter holder with more than 15 years' investment management and fixed income experience.

Having joined Border to Coast Pensions Partnership in 2021, Lloyd manages a Multi-Asset Credit proposition within the £120bn local government pension scheme pool on behalf of 18 Partner Funds. Previously Lloyd held roles at Insight Investment and Mediolanum Asset Management.

Rickey Thevakarrunai

CFA, Director, Public Markets, bfinance

Rickey Thevakarrunai joined bfinance in May 2023 as a Director within the Public Markets Team.

Prior to joining bfinance, Rickey spent 10 years at abrdn as a senior investment analyst covering manager selection for fixed income, equity and multi-asset funds.

Rickey holds a BSc in Economics from the University of Nottingham and is a CFA charterholder.

Dan Poole

Deputy Head of Public Credit, PIC

Dan is Deputy Head of Public Credit at PIC, a leading insurer of defined benefit pension schemes.

Dan leads PIC's internal USD public corporate strategy as well as overseeing external mandates in Emerging Markets and US Taxable Municipal strategies.

Dan is Chair of PIC's Asset Valuation Committee and a member of PIC's Sustainability Oversight Forum. Dan has 20 years of experience in Financial Services, holds the CFA designation and has a degree in civil engineering from the University of Nottingham.

Dean Wetton

Managing Director, Dean Wetton Advisory

Dean Wetton, BComm (Hons), MBA, CFA, Managing Director, founded Dean Wetton Advisory in 2009, recognising the need for a fresh approach to providing investment advice to clients: an approach that delivered straightforward, clear advice in a cost-effective way.

Dean has wide experience of advising clients on a range of investment issues, having previously been Head of the Manager Evaluation Function at P-Solve Asset Solutions and a senior member of Hewitt's Manager Research Team.

Owen Murfin

Global Fixed Income Manager, MFS Investment Management

Owen Murfin, CFA, is an investment officer and institutional fixed income portfolio manager at MFS Investment Management® (MFS®). He is a member of the MFS Global Fixed Income portfolio management team. In this capacity, he participates in portfolio strategy discussions, customizes portfolios to client objectives and guidelines and communicates portfolio investment strategy and positioning.

He is based in London. Prior to joining MFS in 2017, Owen served as managing director and global fixed income portfolio manager at BlackRock for 15 years. Before that, he worked as an associate and global fixed income portfolio manager at Goldman Sachs Asset Management for five years. Owen earned a Bachelor of Science degree with first class honors from University College London.

He holds the Chartered Financial Analyst designation.

In attendance

Beth Brearley (Moderator)

Freelance Writer

Beth Brearley is a freelance writer specialising in asset management, institutional investing and private equity.

A former editor of several prominent B2B titles, Beth has spent almost two decades covering the financial services sector.

Kelly Tran

Managing Director, UK & Ireland, MFS Investment Management

Kelly Tran, CFA, is managing director of UK & Ireland at MFS Investment Management® (MFS®). In this role, she is responsible for new business development and consultant relations for the UK institutional market for defined benefit, defined contribution and endowment and foundation clients. She is based in London.

Kelly joined MFS in 2021 in her current role. Previously, she held various roles over a seven year period with Newton Investment Management/Bank of New York Mellon including client director, commercial sustainability leader and head of UK sales. She also spent eight years at J.P. Morgan Private Bank managing multi-asset portfolios for ultra-high-net-worth clients, covering Russia, Greece and Israel.

Kelly earned a Bachelor of Science degree from the London School of Economics and Political Science. She holds the Chartered Financial Analyst designation. She is also a steering committee member of the Diversity Project and part of the leadership team of its Race & Ethnicity group. She joined the Pensions and Lifetime Savings Association's Defined Benefit committee in 2022 to help shape its retirement income policy agenda. She also serves as a school governor of the Caterham High School in London and chairs its Finance & Resources committee.

Krish Dhanjee

Member of Institutional UK Team, MFS Investment Management

Krish Dhanjee, CFA, is an institutional relationship manager with MFS Investment Management® (MFS®). In this role, he is responsible for developing and expanding global consultant relationships.

Krish joined MFS in 2018 as a consultant relations analyst, before taking on his current role in 2023. He previously worked at Willis Towers Watson as a senior investment analyst for three years.

Krish earned a Bachelor of Science degree in financial mathematics from the University of Kent. He holds the Chartered Financial Analyst designation.

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Ian Coulman

Strategic Consultant, cio investment club

Ian is an experienced investment professional with international experience and strong leadership and management skills. He has a strong investment knowledge of major asset classes and a wide variety of investment products and styles in fixed income, equities and alternative asset classes. His most recent role was Pool Re's Chief Investment Officer, where he was responsible for the development and implementation of investment strategy, strategic asset allocation and the monitoring of the investment managers through whom Pool Re invested. Since leaving Pool Re Ian is now exploring opportunities where he can use his experience and knowledge.

Prior to joining Pool Re as CIO, Ian fulfilled several senior investment roles with Butterfield Bank in Bermuda and AIG in London, Boston and Tokyo. Ian began his investment career with the private Swiss bank Lombard Odier.

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Sean Thompson

Founder & Director, cio investment club

Sean has nearly 40 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.

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