



cio investment club

Whitepaper #9

November 2024

Multi Sector Fixed Income Whitepaper: A strategy for an evolving global landscape?



MSFI



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A strategy for an evolving
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Multi Sector Fixed Income Whitepaper #8



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Introduction

Multi-sector fixed income is a strategy that seeks to manage risk and maximise returns by investing in a range of fixed-income sectors.



In our roundtable, our panel discusses the challenges, risks and opportunities MSFI presents to fund managers and advisors when considering their overall strategies.

With the market that is seeing a growing interest in fixed income investments – particularly in high yield and loans – it's a trending investment strategy. Some, though, have concerns about its long-term viability and performance.

Market dynamics have changed in the core liquid fixed income market, particularly in the high-yield sector. With less issuance and lower diversity of companies active in these markets, risk management strategies are being re-evaluated. For strategies to achieve success, the market needs specialists in making investment decisions who can navigate high-yield and emerging market debts.

Yet other questions remain for investors: How do they integrate ESG factors into investment strategies? How should it be bundled? Where would they invest if it looked like the market was heading for a crash? Does an MSFI strategy provide a good balance between added value and cost? How does a client choose the right manager for their needs? What is a suitable liquidity profile? Should EM be part of the portfolio?

Our panel also discusses the governance issues around multi-sector fixed income, and how the market sees high yield investments. We will also cover innovative investment strategies focusing on environmental issues, and how to facilitate more agile pension and other institutional investment strategies.

MSFI strategies undoubtedly will have an impact on the current investment landscape, and on how investment strategies evolve in the coming years. We will be discussing all of this and much more.



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A strategy for an evolving global landscape?

The first thing to consider is the broad universe of securities from which the MSFI strategy can draw from, and how the global economy would impact it in the short, medium and long term.

Panellists took a broadly upbeat view of the economic outlook for fixed income, albeit with a warning of some pockets of uncertainty in the market.



“Inflation is less of a problem, but it's not completely gone,” said Flavio Carpenzano, Investment Director, Capital Group. “Pre-Covid, China was the engine of global growth. Today we expect the US is going to be the main driver of global growth instead. The US has been more resilient than expected, as consumption is still quite solid. Remember, 65-70% of GDP in the US is driven by consumption. The labour market is softening, but there is not massive unemployment.”

Carpenzano noted that from a fixed income perspective, the cost of funding for companies has remained stable, despite a significant increase in interest rates.

“That’s because the corporate sector - liquid, high yield, IG corporate – massively increased their maturities post covid,” he said. “As a result, even though interest rates increased, companies didn't have to refinance at that higher level. So, the cost of funding has been pretty resilient, keeping margins relatively low, along with the need to lay off staff.”

Jonathan Heston, Deputy Head of Credit Research, XPS Group, expected inflation to stabilise around 2.5% or 3% in certain cases, “so we are moving into an environment more like the 1990s, with higher growth, high productivity and moderate inflation.”

Mark Parry, Head of Manager Research, Barnett Waddingham, agreed with the broadly positive

outlook on falling interest rates and that developed economies would be the engines of global growth instead of China.

However, he added some notes of caution: “In terms of funding, whilst corporates have been able to push the wall of refinancing out, they're still going to face higher funding costs. They're not as high as the peak, but they're going to be higher than they were before.”

Parry warned of signs of “incipient stress” in elements like consumer loans and auto loans.

“There's a range of possibilities, but the assumption is that everything's going to be fine, and that there is no second order effect from higher rates,” said Parry. “That is perhaps optimistic.”

With the growth outlook in the UK and Europe less rosy than the US, despite the world’s largest economy wrangling budget issues and a yawning fiscal deficit, Parry wondered how sustainable the current conditions would be.

On balance, he argued, the global economy was heading for period of more moderate growth and returns but added: “That doesn't mean there aren't some pockets of concern, areas of excess and some things that need working out as we get back to the new moderation.”

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Investors' needs in the new market environment

Panelists reasoned that the suitability of MSFI depended on an active approach and required managers to consider a far wider range of issues. The increased range of fixed income investment options would lead to a growing range of potential outcomes for investors, and managers need to be discerning about their security selections.

"All of a sudden, there are other factors - liquidity, underlying risk," said Parry. "Do we want US consumer loans? Do we want high yield? Do we want emerging markets? So, there isn't, perhaps, the cookie cutter approach that you might have been able to take in the past."

Paul Whelan, Partner and Co-head of Fixed Income Manager Research, Aon, added that as the universe of potential investments is constantly evolving, it will require managers with wide capabilities to keep pace with the opportunities. He noted the potential for emerging market corporates to become increasingly attractive and numerous in the future.

"It's important to interrogate whether your managers can adapt and have the expertise in those universes," Whelan said.

Peter Martin, Investment Officer, Medical Defence Union, also backed MSFI as a valuable strategy in the current environment, though he also noted its apparent complexity for many investors.

"Once you go into the weeds it's a very complicated universe and most investors, including pension funds, will never have the expertise and the time to go into those sub-sectors," he said.

"So, they need a mechanism to access that universe. For me, it's a question of having a multi asset manager who can access a broad opportunity set, but they need to be expert in those areas," said Martin.

Chetan Ghosh, Head of Pensions OCIO, Schroders, concurred.

"We are increasingly seeing MSFI become a simplified and consolidated governance solution within the corporate UK defined benefit (DB) space," said Ghosh.

"It fills a return need with higher expected returns than investment grade credit and gilts, while outsourcing the delivery of the additional return within a vast sub investment grade universe to a specialised fund manager. The governance consideration seems to trump the fact that one manager is unlikely to be a master of all the sub investment grade trades for this type of investor," he added.

XPS's Heston said, for the moment, the main questions he was receiving from trustees were around the current high yield, high-rate environment. However, he argued these clients should not be overly concerned with the nominal levels of yields but with spreads, as the risk-free rate should already be taken into account in their funding assumptions.

"Spreads are important for a pension scheme, and their strategy, and spreads are very tight at the moment," he said. "Allocations to credit will be dependent from scheme to scheme, as some will be de-risking, but for others, there's an argument for potentially re-risking, particularly since the gilts crisis, and particularly for schemes considering run-on."

Heston explained in a post-gilts crisis environment, higher allocations to LDI were required, due to the lower levels of leverage, which meant schemes had to look for higher returning assets to deliver similar levels of return.

"We can all agree that credit spreads are tight, but that's where you need to do your job, to do credit research," Carpenzano said. "We still see plenty of opportunity where spreads are tightening 15-30bps. However, you need to go bond by bond."

Adding to the complexity for investors has been the pace of change in multi-sector credit, according to

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There's tremendous choice, and with that choice comes the need to actually get under the hood, figure out how it works

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Punil Chaubal, Insurance Investment Advisory Leader, WTW.

"When I started my career, multi sector credit typically meant liquid credit," said Chaubal. "Today, semi-liquid and unconstrained credit are in the mix - all of these are flavours of multi sector credit."

He noted that private credit is also disrupting the fixed income landscape.

"The high yield market has become so much more concentrated," he said. "The good names, the good double B issues, have been upgraded. It's become a lot more concentrated in industrial, cyclical names."

Panellists agreed with his point that borrowers have a lot more choice, due to the number of "private credit shops offering better, attractive deal terms, weaker covenants etc."

"This means insurers are allocating more increasingly to private credit," he continued. "Obviously, gilts have a low-to-zero capital charge versus corporate bonds, where you have to take the credit risk, the duration, and so on."

Where spreads are so tight, does it make sense to be allocating to liquid investment-grade credit, he asked.

Ghosh provided a different view on his definition of MSFI.

"The proliferation of MSFI has largely been around the consolidated provision of sub investment grade exposures and less to do with investment grade credit. That said, high yield spreads are also quite tight at the moment but less so in senior loans," he said "MSFI managers are primed to take advantage of relative value deliberations like these."

Parry picked up on the theme of extremely wide range of options available.

"There's tremendous choice, and with that choice comes the need to actually get under the hood, figure out how it works, when it works and what it does for you – the process and likely future outcomes," he said.

While noting that no fund manager "gets it right all the time in any form of investment, there needs to be predictability; there needs to be the ability to forecast within sensible limits," Parry said.

For many investors, the attraction of fixed income lies in its income generating capacity and Martin argued that maintaining spread across duration was a key measure.

"For a lot of investors, the ability to draw income is highly important," said Martin. "I view this as being about the ability to get the spread throughout the duration. So, income diversification is important and MSFI is a good diversifier."

Heston contended this was particularly true for smaller DB schemes that may lack the capital to make individual allocations in underlying assets so would instead access that diversification through a multi-sector fund.

"It keeps their strategy diversified through a credit one-stop shop," he said.

Heston noted that many MSFI funds were managed to have low duration, "because they are quite dynamic - the underlying asset allocations can be changed," he said. "To avoid interference with an LDI hedge, you obviously want that duration to be quite low, so it could fit quite well with the pension scheme risks."

Whelan, meanwhile, pointed out that typical multi-asset credit funds had low levels of sterling credit exposure and so duration in those funds was less of a factor for UK pension clients.



Paying a premium for alpha

Chaubal said that most insurance clients would not employ an MSFI for liability-matching but were instead seeking absolute returns.

“We're looking for this to add some alpha, additional return generation outside core fixed income, or maybe to complement it and provide a bit more punch,” he said. “Multi-sector credit is quite a broad spectrum. You can have very punchy stuff, or you can have it quite constrained. Obviously, the more you narrow down the universe, the less the return potential, and the more you'll start to see returns not too dissimilar to your core credit.”

The solution, Chaubal argued, was to seek managers with good skills and give them sufficient discretion in investment. Additionally, setting meaningful targets such as cash plus, rather than a benchmark, was key: “If we're appointing them to generate absolute returns, that's what we'll assess them on.”

For DC pensions considering multi-sector credit, the key question centred on where they are on their journey, according to Heston. He suggested MSFI could be highly suitable in the transition from accumulation to decumulation.

“In the accumulation phase, you're going to be wanting the higher return,” he said. “In the decumulation phase you're going to want more stability. So, the early decumulation phase is where something like a multi sector credit fund could work, as you are derisking from the punchier equity strategy towards the low-risk strategy.”

Panellists also addressed the issue of fees and whether MSFI funds could offer value for money.

For Whelan, the first issue to challenge was any comparison with passive bonds funds. Investors, he said, need to consider whether passive credit funds can match the income generating ability of other investments.

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In the accumulation phase, you're going to be wanting the higher return

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“There's some massive misconceptions on passive funds,” he said. “Firstly, they're typically not zero fee and might be 25 basis points for a small size ticket allocation in areas such as EMD. Secondly, there's a belief that they always track the return of the index to the nearest decimal, and that they never ever underperform.”

Chaubal returned to his theme of assessing returns performance.

“If you're just looking at something that's diversifying and that's only going to give you 1-2% absolute return per annum, you're going to have a hard time charging a premium fee,” he said. “If it's alpha generation, or more of a total return type strategy, and it's generating north of 5% or 6% in the current environment, then I think a slightly higher fee base can make sense.”

Ghosh teased out the challenge of assessing what represents a value for money fee.

“It is very difficult to determine the value added by a manager, particularly when fund objectives are stated as cash plus or in absolute terms. Clients should not have to overpay just because it's hard to measure the value add,” he said.





Multi-sector fixed income sustainability

However, one area where MSFI does face a challenge, according to panellists, is in the field of sustainability and ESG.



Unlike equity investors, fixed income investors have limited ability to influence the actions of the companies in which they invest, though new methods, such as engagement, stricter allocation decisions and better measurement tools, have already moved the discussion forward.

“The ability to monitor ESG is improving, along with the ability to influence it in fixed income,” said Parry. “It’s a clear investor trend, and something that needs to be considered. The main driver [for investors] may still be return and liability matching, but we can’t ignore ESG. We need to make sure, though, of having the right degree of assessment of ESG and impact, in context of needed client outcomes.”

Whelan said many clients had moved away from passive bond funds to those that actively address climate transition, but he noted that the choice was still limited.

“In general, there have been fewer credible multi-asset credit solutions that have a climate transition aspect. Some of that’s been due to a lack of data and I think that has held some of our DC clients back from making the investment choice of multi sector credit,” he added.

Martin agreed and argued that the focus of the ESG agenda should be on the G of governance and the associated questions of corporate culture.

“A well-governed company, which has a good culture, will manage its environmental risks and manage its

social risks,” said Martin. “If it’s got good governance, you can then probably get a better risk-adjusted return, and your investments will be less likely to be impacted by climate change. Doing the right thing and getting the return go hand in hand.”

The integral nature of ESG to investment was further emphasised by Carpenzano.

“ESG and returns cannot be two separate processes,” he said. “A credit analyst, when they analyse a company, needs to understand how the environment is going to affect it; how the social aspect is going to impact – they need to look at ESG as an investment materiality.”

Capital Group has created over 25 different, sector-specific frameworks, because ESG impacts all sectors in unique and distinct ways.

“You cannot separate ESG considerations because otherwise you are not looking at the whole picture,” said Carpenzano.

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The ability to monitor ESG is improving, along with the ability to influence it in fixed income

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Participants



Flavio Carpenzano

Investment Director, Capital Group

Flavio Carpenzano is an investment director at Capital Group. He has 19 years of industry experience and has been with Capital Group for three years.

Prior to joining Capital, Flavio worked as a fixed income senior investment strategist at AllianceBernstein. Before that, he was a product manager at PIMCO focussed on credit strategies. His early career also includes a role at the Bank of England as an analyst in the markets department.

He holds a master's degree in finance and economics from Università Bocconi.



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Jonathan Heston

Senior Associate, XPS Group

Jonathan Heston is a Senior Associate at XPS Group where he is Deputy Head of the credit research team, focussing on public fixed income. His role in facilitating the research of funds and investment managers at XPS provides valuable insights for institutional investors, including the latest innovative products and solutions available.

Most recently, he has been heavily involved in an industry wide search for leading sustainable and impact IG corporate bond funds. In addition to his research responsibilities, Jonathan also works on a number of client teams with appointments that span a range of shapes and sizes, including UK DB and corporate appointments, for schemes ranging from £10m through to £100m+ in assets under advice.





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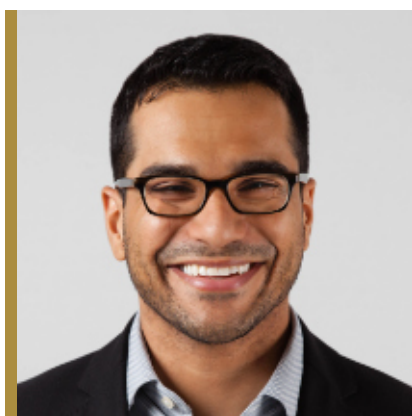
Paul Whelan

Partner, Co-Head of Global Fixed Income Manager Research, Aon

Paul serves as Partner and is Co-Head of Global Fixed Income Manager research at Aon, based in the UK. He is responsible for covering the full spectrum of fixed income asset classes.

Paul is an active member of the UK Fixed Income Views team, working to expand the breadth of the team's output, formulating appropriate scheme hedging levels and informing the advice we give to clients on managing their liabilities. Paul also works closely with Aon's global fiduciary business, Delegated Consulting Services, shaping market-leading fixed income solutions covering liability hedging and return seeking opportunities. Paul represents the UK manager research team on the UK Content Committee team helping drive forwards the creation and marketing of innovative new ideas to the UK client base and beyond.

Paul joined Aon Hewitt in November 2012 after more than 10 years in asset management with Aviva Investors, Henderson and UBS. He has worked in the strategy setting and management of fixed income portfolios for his entire career managing a variety of long-only and absolute return mandates across the fixed income universe. Paul holds a 1st Class Honours degree in Economics from the University of Bath. Paul is a CFA charterholder.



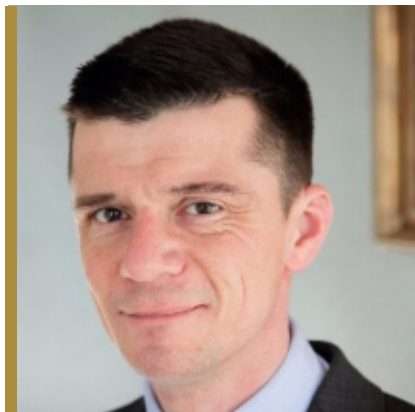
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Punil Chaubal

Insurance Investment Advisory Leader, WTW

Punil is the Insurance Investment Advisory Leader at WTW. He leads a team of over 20 dedicated insurance investment professionals advising on over \$500bn of assets globally. His team are committed to supporting insurers consider their investment strategy, strategic asset allocation and portfolio implementation.

Punil has over 13 years of experience and joined WTW in 2022, working with insurance companies globally. Prior to joining WTW, Punil supported numerous UK and European insurers with management of investments, capital and sustainability risks. He earned a BSc in Mathematical Science from City University and an MSc in Actuarial Science from Heriot Watt University.



Mark Parry

Head of Manager Research, Barnett Waddingham

Mark leads our Manager Research Team. Working closely with our consultants, Mark's team provides independent and well-researched views on investment opportunities, tailored to the specific needs of the client.

A senior investment professional with over 20 years' experience as a multi asset and fixed interest fund manager, Mark has the knowledge and expertise to assist clients with the information and support they need.

Mark also sits on our investment research priorities group, so has visibility of research across different areas. This enables him to identify and develop research opportunities that are likely to benefit our clients.



Peter Martin

Investment Officer, The Medical Defence Union

Peter is the 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).



MDU



Schroders

Chetan Ghosh

Head of Pensions OCIO, Schroders

Chetan has been the Chief Investment Officer for Centrica's pension scheme arrangements within a Common Investment Fund for the last 15 years, now doing that role within Schroders Solutions through an OCIO arrangement. He is responsible for providing support to the Directors of the Investment Committee. His role covers investment strategy considerations, asset class and manager research, and the liaison with the investment advisers.

He has 29 years industry experience, primarily from the consultancy side, where he spent 5 years as a pensions actuary and 10 years on the investment side, a large part of which was at Aon. Immediately prior to joining Centrica, he developed the Fiduciary Management offering at an asset manager where he was able to gain valuable experience on improving investment decision making governance structures.



 **RHOTIC**

Elizabeth Pfeuti (Moderator)

Director, Rhotic Media

Former Dow Jones staffer Elizabeth Pfeuti is a member of the Rhotic Media executive leadership team. A highly decorated journalist, Elizabeth has been in financial journalism for almost 20 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes.

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.



In attendance



Max Watson

Managing Director UK Consultant Relations, Capital Group

Max Watson is a relationship manager - consultant relations at Capital Group. He has 14 years of industry experience and has been with Capital Group for two years.

Prior to joining Capital, Max worked as a relationship manager at Neuberger Berman. Before that, he was an associate at Alcentra.

He holds a bachelor's degree in politics with economics from University of Bath.



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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.

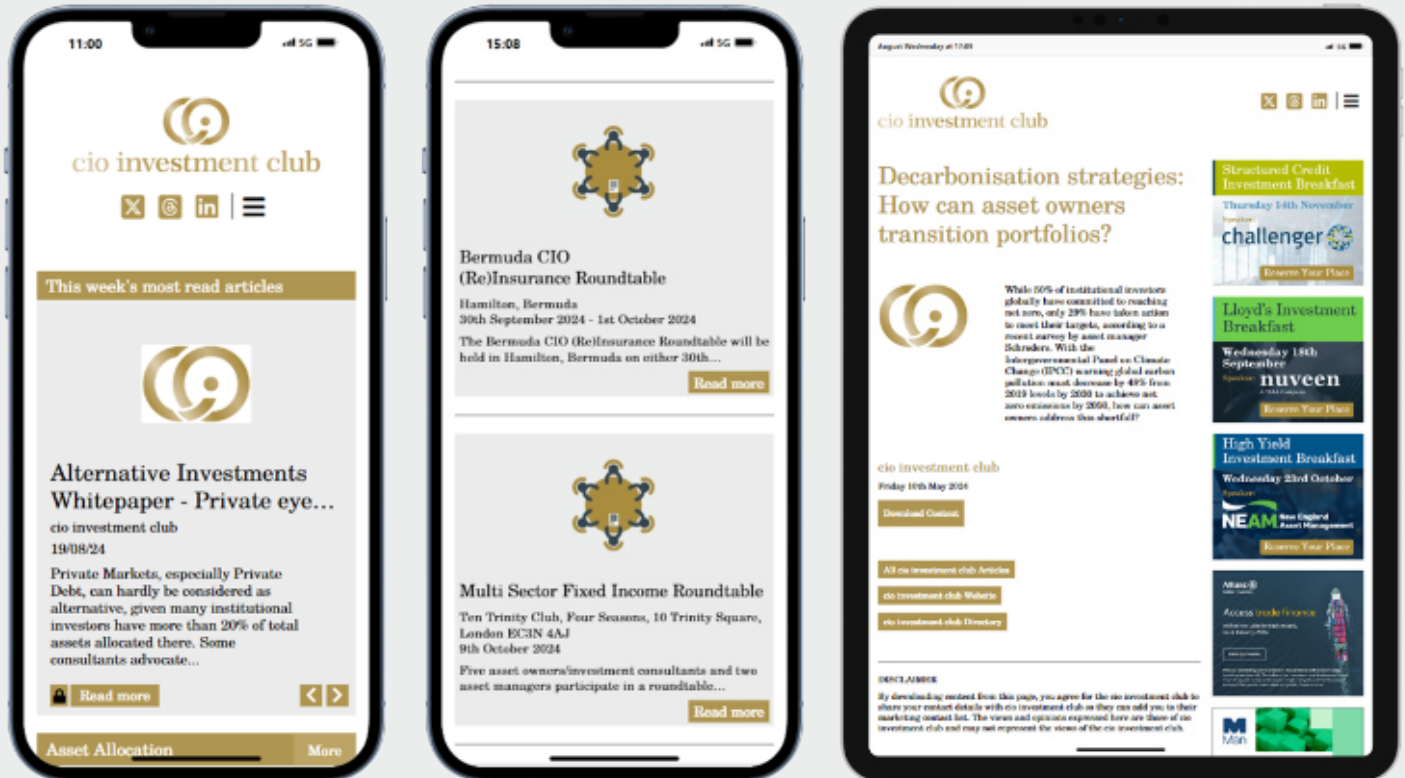
The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.



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