A deeper look at flexible credit strategies and the critical role of manager selection

From the Field
November 2024

Key Insights

- Investor interest in flexible credit mandates has increased on the view that their dynamic positioning could enable them to better navigate more difficult credit environments.
- Although these portfolios have the flexibility to navigate challenging markets, our analysis shows that not all managers utilize this latitude to the same degree.
- Our analysis highlighted the fairly barbelled universe of strategies—those demonstrating higher degrees of alpha versus those that appear more reliant on ebullient credit conditions—necessitating a deeper evaluation of manager skill.

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Investor interest in versatile multi-asset credit (MAC) portfolios has notably increased after the 2022 credit market downturn. Due to the flexible nature of MAC portfolios, investors perceive these mandates as capable of tactically allocating among credit sectors in an effort to enhance returns and reduce volatility, especially on the downside. Are investors getting what they seek from these strategies?

Investors should employ a careful, "buyer beware" approach to strategy selection. Our analysis indicates that some strategies have underutilized the flexibility implied by the product category, in which case investors might end up with more market risk (beta) rather than strategy-driven returns (alpha). Our findings show that strategies that actively adjusted their portfolios typically performed better, especially in managing downside risk.

Some commonly held investor beliefs about multi-asset credit prompted our Multi-Asset Solutions team to examine whether:

- MAC managers are dynamic in their credit exposure positioning.
- MAC strategies have the ability to outperform less flexible fixed income credit strategies.

- Flexible mandates allow managers to adjust to a variety of investing environments.

- MAC strategies provide opportunities for downside risk mitigation.

We studied a cohort of long-tenured MAC strategies[1] to better understand how dynamic their positioning was and whether this dynamic management led to outperformance and reduced downside risk.

How dynamic are multi-asset credit managers?

To begin, we selected strategies from the eVestment multi-asset credit universe[2] with a minimum of 10 years of performance history, leaving a cohort of 37 strategies. We constructed two risk factors: credit risk[3] and duration[4]. We assessed the variations of credit exposures to evaluate how actively a strategy adjusted its portfolio by running 36-month rolling regressions of the returns on the factors for each manager in the cohort. Strategies with significant variations in their credit positioning over the 10-year period were considered more dynamic.

We categorized managers into two groups based on the variations in how they adjusted their credit exposure:

Dynamic Managers: These strategies frequently adjusted their portfolios. This group had 36-month rolling credit beta dispersion that fell in the top half of the distribution of the cohort. Based on our analysis, they actively increased or decreased risk positions in an effort to enhance performance in both rising and falling markets.

Static Credit Managers: These strategies were in the bottom half of the credit beta dispersion distribution of the cohort. They maintained more consistent credit exposure, appearing to rely on market risk for returns. They adjusted their portfolios less frequently.

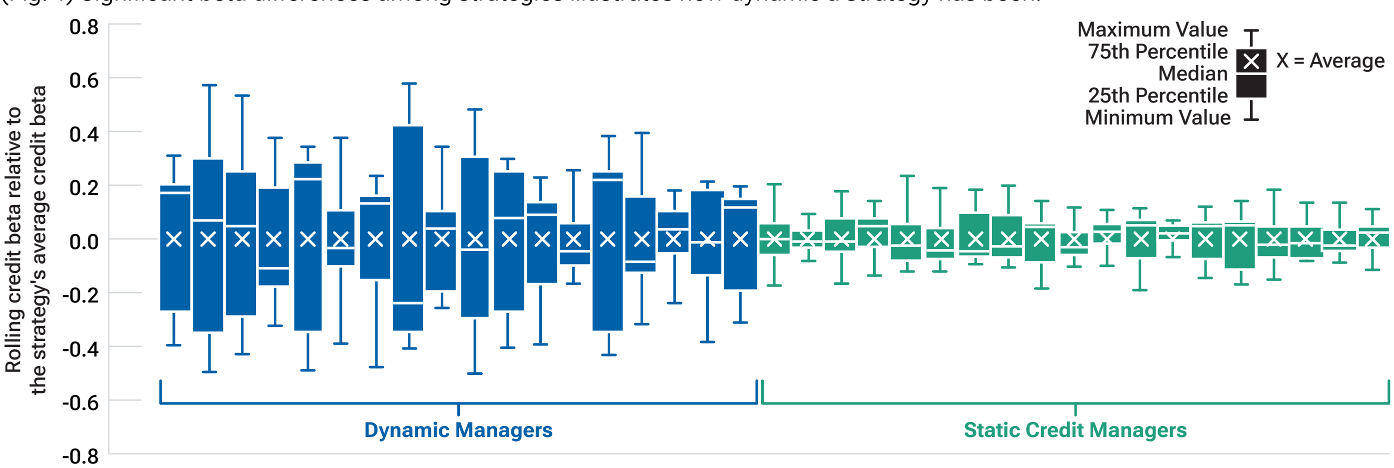
Figure 1 shows the credit beta dispersion of the MAC strategies in this cohort over the past 10 years. The very large historical dispersion in how strategies within this cohort dynamically adjusted their exposure to credit illustrates that some strategies have more meaningfully changed their portfolio's credit exposures than other strategies in the peer group.

We accounted for the notable difference in the average credit levels of the MAC strategies in the cohort by aligning each strategy's average credit exposure at 0. Relative to their "typical" credit tilt (mean credit beta), the group we classified as "Dynamic Managers" has historically shifted its credit allocations much more actively than the "Static Credit Managers" group.

[1] Based on eVestment Mutli-Asset Credit universe. Sample limited to those with at least 10 years of history.
[2] The universe is defined by eVestment as "Fixed Income strategies that have the freedom to invest opportunistically across multiple credit sectors. Multi-Asset Credit (MAC) products are not constrained to an index and often look to generate returns above a cash benchmark (such as LIBOR). These strategies differ from traditional core credit offerings in that they typically allocate to a broader range of credit instruments—such as high yield bonds, bank/leveraged loans, convertibles, Emerging Markets Debt (EMD), and asset-backed securities (ABS). Unlike broader Unconstrained fixed income strategies, Multi-Asset Credit products concentrate specifically on credit investments."
[3] Credit risk is represented by the excess return of 80% Bloomberg Global IG Corporate Index and 20% Bloomberg Global High Yield USD Hedged Index over duration-matched Treasuries.
[4] Duration is represented by the return of the Bloomberg US Treasury Index.

Distributions of MAC strategies' credit beta positioning

(Fig. 1) Significant beta differences among strategies illustrates how dynamic a strategy has been.



Past performance is not a reliable indicator of future performance.
As of March 30, 2024.
Betas are the 36-month rolling betas to credit derived from a two-factor model (duration and credit).
The average credit beta for each manager is set at 0 for comparison.
18/37 strategies in this cohort were identified as "Dynamic Managers" 19/37 strategies in this cohort were identified as "Static Credit Managers."
Source: eVestments, analysis by T. Rowe Price.

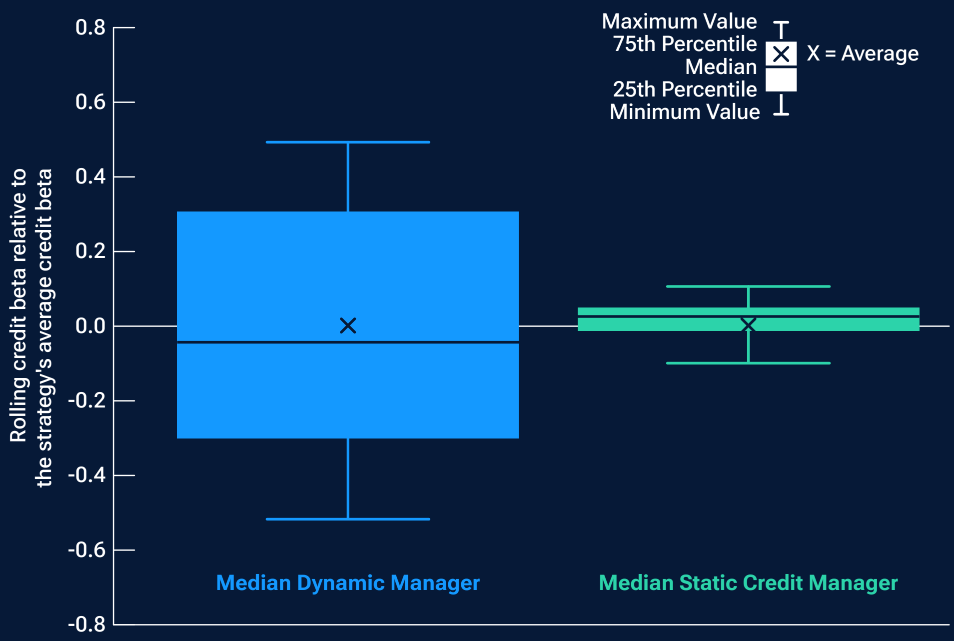
An example

To demonstrate these results, we analyzed the median (based on breadth of credit beta dispersion) Dynamic Manager and the median Static Credit Manager. We compared each strategy's credit exposure under two scenarios: a conservative posture (at the 10th percentile of the manager's 36-month rolling credit beta compared with its mean credit beta) and a more aggressive posture (at the 90th percentile of the manager's 36-month rolling credit beta compared with its mean credit beta).

- In the conservative posture, we found that the median strategy in the Dynamic Manager group was able to reduce credit exposure by 33%, while the median strategy in the Static Credit Manager group could only reduce credit exposure (credit beta) by 12% compared with its respective typical credit exposure. This indicates that Dynamic Managers had the ability to be more than 2.5 times as agile in adjusting credit exposure.
- In the more aggressive posture, the median Dynamic Manager was 2.4 times more responsive than the median Static Credit Manager in this regard.

The median Dynamic Manager compared with the median Static Credit Manager

(Fig. 2) The breadth of beta positioning distribution can affect a strategy's ability to flexibly reposition



Past performance is not a reliable indicator of future performance.
As of March 30, 2024.
Source: eVestment Alliance, LLC, analysis by T. Rowe Price.
Betas are the 36-month rolling betas to credit derived from a two-factor model (duration and credit).
The average credit beta for each manager is set at 0 for comparison.

Bottom line: Our analysis shows that MAC strategies utilized their flexible mandates to varying degrees. For investors seeking flexible credit allocations, it is crucial to assess how extensively the strategy uses this flexibility as this can potentially impact how a strategy performs.

Does a more dynamic MAC strategy typically outperform fixed allocation portfolios or the broader market?

After establishing that some MAC strategies adjust their credit exposures more dynamically, we wanted to assess what impact dynamic positioning had on performance. Keeping strategies within their Dynamic and Static Credit cohorts, Figure 3 shows a comparison of the performance across a range of traditional metrics for strategies at the 25th, 50th, and 75th percentiles for each metric against two benchmarks: a fixed allocation portfolio and the Bloomberg U.S. Aggregate Bond Index.

Our findings highlight three key performance differences among Dynamic Managers and Static Credit Managers.

- The best-performing (75th percentile) Dynamic Manager outperformed (gross of fees) both benchmarks as well as its Static Credit Manager peer and also generated strong risk-adjusted returns, with a Sharpe ratio of 0.8. Similarly, the median Dynamic Manager outperformed both benchmarks and its Static Credit Manager peer.
- The median and top quartile Static Credit Managers also outperformed (gross of fees) both benchmarks, generating solid risk-adjusted returns, but they trailed their Dynamic Manager peers. While they delivered solid returns, they lacked the upside potential seen in the Dynamic Manager group.
- Despite the potential for outperformance due to its flexible credit positioning, the bottom quartile Dynamic Manager underperformed, lagging notably in both excess returns and Sharpe ratio, suggesting that a MAC strategy's success depends heavily on manager skill. This underscores the importance of strategy selection within this category.

Comparing Dynamic and Static Credit cohorts across traditional metrics

(Fig. 3) Difference between top and bottom strategies highlights the importance of manager selection

(April 2014–March 2024)	Annualized Return	Annualized Volatility	Sharpe Ratio	Annualized Excess Return	Tracking Error	Information Ratio
Dynamic Manager: p25th	3.1%	6.0%	0.3	1.6%	6.2%	24.4%
Dynamic Manager: Median	4.6%	7.0%	0.7	3.0%	7.2%	43.5%
Dynamic Manager: p75th	5.2%	9.5%	0.8	3.7%	9.1%	52.4%
Static Credit Manager: p25th	3.8%	6.0%	0.6	2.3%	5.1%	39.6%
Static Credit Manager: Median	4.3%	6.8%	0.7	2.7%	6.1%	48.6%
Static Credit Manager: p75th	4.9%	7.0%	0.8	3.3%	6.6%	58.1%
Fixed Allocation	3.8%	7.1%	0.5	2.3%	6.2%	37.0%
Bloomberg U.S. Agg. Bond Index	1.5%	4.8%	0.3	—	—	—

As of March 30, 2024.
Past performance is not a reliable indicator of future performance.
Source: Bloomberg Finance L.P., analysis by T. Rowe Price. Dynamic Manager and Static Credit Manager: Identified from eVestment MAC category with 10 years of performance data, categorized as Dynamic and Static Credit based on credit beta dispersions.
Fixed Allocation: A hypothetical benchmark comprised of indices across global high yield, floating rate bonds, and emerging market debt, rebalanced monthly: uses the Bloomberg Global High Yield Corporate Index, the Morningstar LSTA Performing Loans USD Index, and the J.P. Morgan EMBI Global Diversified Composite Index. This serves as a proxy for a typical return-seeking fixed income allocation but does not represent an actual investment. Actual investment results may differ significantly. **Bloomberg U.S. Aggregate Bond Index:** A proxy for the broader U.S. investment-grade market. Figures are calculated using monthly data and are gross of fees. Returns would have been lower and conclusions might differ as the result of the deduction of applicable fees. The strategies within each group (Dynamic and Static Credit) were ranked highest to lowest for each metric. The 25th, median, and 75th percentile strategy's value is displayed in the table.

How did MAC portfolios perform in different environments?

One perceived attribute of MAC strategies is that their flexibility may lead to more durable performance in a variety of environments. To evaluate this belief, we considered Dynamic and Static Credit Manager performance across different market regimes.

Our examination focused on performance during different interest rate and credit spread scenarios. Figure 4 illustrates performance patterns that are consistent with our expectations for strategies that have higher credit beta (Static Credit Managers) versus those that seek to generate alpha by actively managing their market exposure (Dynamic Managers).

Rising Rates and Widening Credit Spreads: During periods of market stress, such as in 2022, the Dynamic Managers demonstrated their advantage. Their flexible approach allowed them to tactically adjust exposures, resulting in meaningful outperformance relative to the Static Credit Managers and the benchmarks. In this environment, the ability to de-risk and actively manage exposures became a clear differentiator, as the Static Credit Managers' structural beta left them more exposed to downside risks.

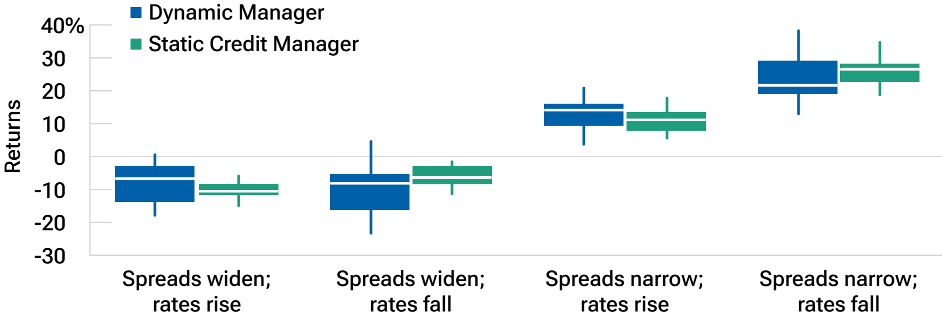
Performance amid different market environments

(Fig. 4) Credit beta appeared to affect strategy performance

Past performance is not a reliable indicator of future performance.
For the period 3/30/2014 to 3/30/2024, we constructed regimes using the monthly change in the U.S. 10-year (rates) and the change in the Bloomberg U.S. Corporate High Yield Bond Index average option-adjusted spreads (spreads). Months when the 10-year rate changed positively are rising rate. When the 10-year rate changed negatively, it is falling rate. Months when HY Avg OAS increases are spread widening. When the OAS decreases, it is spread narrowing. **Methodology for returns calculation: We calculated an annualized geometric mean of the monthly returns for those months identified as each regime for each underlying strategy. The returns are then averaged across strategies within each cohort.** Figures are calculated using monthly data and are gross of fees. Returns would have been lower and conclusions might differ as the result of the deduction of applicable fees.
Source: Bloomberg Finance L.P.; analysis by T. Rowe Price.

Return dispersion by strategy type amid different environments

(Fig. 5) Dynamic Manager strategies had a wider range of results than Static Credit Manager strategies



Past performance is not a reliable indicator of future performance.
For the period 3/30/2014 to 3/30/2024, we constructed regimes using the monthly change in the U.S. 10-year (rates) and the change in the Bloomberg US Corporate HY Avg OAS (spreads). Refer to Figure 4 for information on the performance calculation.
Source: Bloomberg Finance L.P.; analysis T. Rowe Price.

Falling Rates and Tightening Credit Spreads: Conversely, in bullish credit markets where rates were falling and spreads were tightening, the Static Credit Managers tended to outperform. In these conditions, more beta exposure led to better results, and the more stable, high-beta nature of the Static Credit Managers' portfolios allowed them to capture more of the upside.

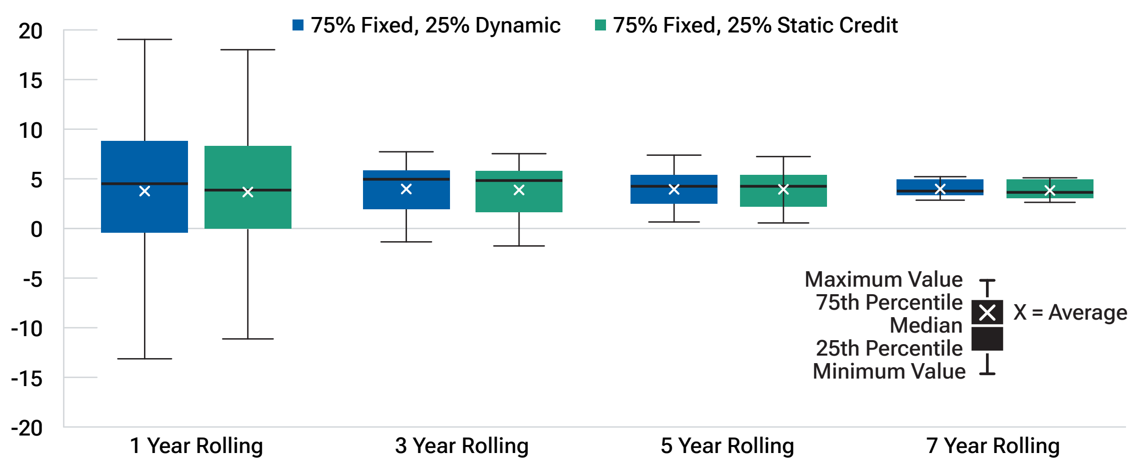
Despite the average performance of Dynamic Managers and Static Credit Managers demonstrating expected results, Figure 5 shows that there has been heightened dispersion of performance by regime. Here, we see a wider range of results for the Dynamic Managers across all regimes. In all regimes, the Dynamic Manager grouping provided more potential for both upside and downside outperformance. Strategy selection is critical in this category.

How do these findings influence portfolio construction?

If allocators can successfully identify skilled dynamic strategies, the resulting improvement in return-seeking fixed income portfolios' performance becomes evident. Given the high tracking error, MAC strategies are often best employed as a complement to a fixed allocation. To illustrate, we constructed hypothetical

Blended hypothetical portfolios' rolling returns over different time horizons

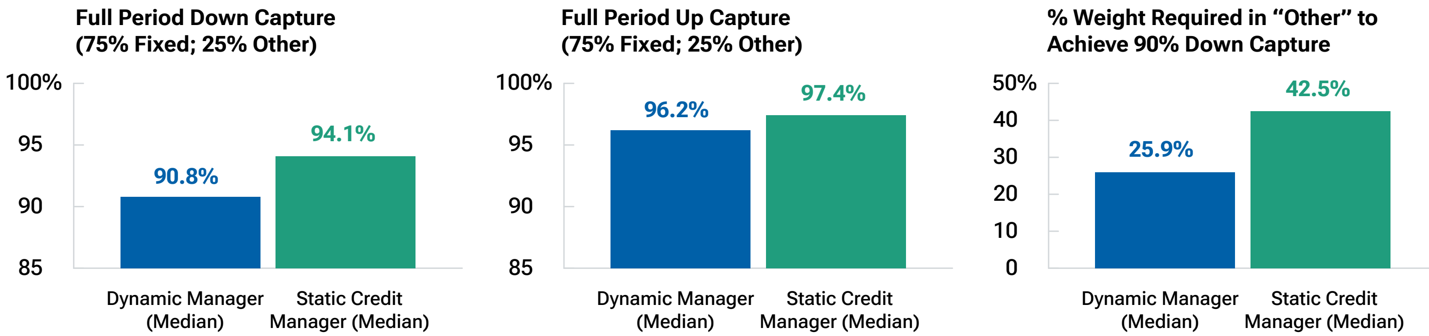
(Fig. 6) Over longer time horizons, the blended hypothetical portfolio containing the Dynamic Manager had a narrower range of results



As of March 30, 2024.
For illustrative purposes only. The blended portfolios shown above are hypothetical and do not reflect actual investments. This material does not provide investment advice or recommendations. It is not intended to forecast or predict future events and is not an indicator of future results. Fees are not assumed.
Actual results experienced may vary significantly from the hypothetical results shown.
Sources: eVestment Alliance, LLC, Bloomberg Finance L.P.; analysis by T. Rowe Price.
Constructed a blended hypothetical portfolio equally invested across global high yield, floating rate bonds, and emerging market debt, rebalanced monthly: modeled by the Bloomberg Global High Yield Corporate Index, the Morningstar LSTA Performing Loans USD Index, and the J.P. Morgan EMBI Global Diversified Composite Index. This hypothetical blended portfolio represented 75% of the portfolio and 25% was allocated to the median (based on annualized returns) strategy in the Dynamic Manager or Static Manager group. See Appendix for additional information on this analysis.

Up-market and down-market capture by strategy type

(Fig. 7) The Dynamic Manager missed some up-market capture while reducing down-market capture



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Sources: eVestment Alliance, LLC, Bloomberg Finance L.P.; analysis by T. Rowe Price.
Down (up) capture calculations: The ratio of the geometric annualized return of a portfolio* over periods when the benchmark (in this case the fixed allocation portfolio: a hypothetical blended portfolio equally invested across global high yield, floating rate bonds, and emerging market debt, rebalanced monthly: modeled by the Bloomberg Global High Yield Corporate Index, the Morningstar LSTA Performing Loans USD Index, and the J.P. Morgan EMBI Global Diversified Composite Index) underperformed (outperformed) to the geometric annualized return of the fixed allocation portfolio over periods when it underperformed (outperformed).
*A portfolio composed of 75% fixed allocation and 25% "other" (either the median manager based on annualized returns for the Static Credit or Dynamic categories). To calculate the % "other" required to achieve 90% downside capture: Down capture for several portfolio combinations (x% to "other" and (1-x)% fixed) was calculated.

blended portfolios, allocating 75% to the "fixed allocation" (equal parts global high yield, floating rate bonds, and emerging market debt) and 25% to either the median Dynamic Manager or Static Credit Manager.

Figure 6 shows the resulting distribution of returns for the two hypothetical blended portfolios over four rolling windows: one, three, five, and seven years. Seven years was selected due to our analysis using 10 years of historical data.

We note an interesting observation. Over the rolling one-year window, the hypothetical portfolio that allocated to the median Dynamic Manager had wider dispersion in portfolio returns, including the potential for more downside. However, as we expanded the rolling window, the dispersion of returns for the portfolio with the Dynamic Manager tightened. We see that the portfolio with the Dynamic Manager both outperformed the portfolio that allocated to the Static Credit manager, with less downside.

We further examine the Dynamic Manager downside risk mitigation in Figure 7. We note that while the Dynamic Manager offered meaningfully less down-market capture, that came at the expense of less participation in up markets. However, a lower allocation to the Dynamic Manager was needed to achieve a targeted level of downside mitigation (e.g., 90%).

Careful choices for stronger portfolios

The growth of the flexible multi-asset credit category is driven by a clear goal: to build a more resilient credit portfolio capable of navigating challenging credit markets and ultimately generating stronger asset compounding by avoiding significant drawdowns.

However, achieving this goal requires careful diligence. A buyer beware approach is essential in trying to distinguish between managers truly generating alpha and those relying primarily on beta, helping ensure that investors are not misled by passive market exposure masquerading as skillful management.

Choosing the right dynamic strategy can enhance portfolio returns and reduce downside risk, highlighting the importance of careful strategy selection.

Appendix:

Important information regarding hypothetical results:

The information provided above reflects data for hypothetical portfolios based on the theoretical blending of the indicated benchmarks and eVestment category data. It does not reflect the actual returns of any portfolio or strategy. For the applicable hypothetical portfolios, the assumption of constant benchmark weights has been made for modeling purposes and is unlikely to be realized. Results shown for blended portfolios are hypothetical, do not reflect actual investment results, and are not a reliable indicator of future results. Hypothetical results were developed with the benefit of hindsight and have inherent limitations. Hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Results are based on recognized broad market indexes and eVestment data gross of fees returns. It does not reflect fees associated with an actively managed portfolio. Returns would have been lower and conclusions might differ as the result of the deduction of applicable fees. Actual returns may differ significantly from the results shown above. It is not possible to invest in an index or category. Different time periods would yield different results.

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Capital risk - the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Counterparty risk - an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Geographic concentration risk - to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk - a portfolio 's attempts to reduce or eliminate certain risks through hedging may not work as intended.

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Management risk - the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk - operational failures could lead to disruptions of portfolio operations or financial losses.

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