In the current investment environment volatility remains elevated and low or negative yields prevail in developed global government and investment grade fixed income markets. Many institutional investors globally are seeking to de-risk their portfolios in order to manage this volatility while also trying to maintain reasonable expected returns. Typically investors are looking to reduce exposure to more volatile asset classes such as equities, and increase allocations to historically less volatile assets such as fixed income. There is a need therefore to find asset solutions that offer less volatility than equities and higher returns than are available in many fixed income markets.

In our view, one such solution is Multi-Asset Credit (MAC) investing. As an asset class, credit enables de-risking of portfolios from direct equity risk while maintaining attractive expected returns compared to the very low yields prevailing in government bond markets.

MAC offers access to a broad investment opportunity set. With tactical and dynamic asset allocation, MAC investing is able to profit from relative value opportunities between different credit asset classes and across geographic regions over time. This approach can also help to mitigate risk. Furthermore, MAC strategies can seek to capitalise on the most attractive individual credit opportunities prevailing across the range of credit asset classes.

We believe that the optimum approach to MAC investing combines deep fundamental research with agile portfolio management enabling dynamic allocation between instruments, credit asset class sectors and regions.

**Why Credit?**

In the prevailing macroeconomic environment, with low growth and inflation but sporadically high asset price volatility, it is a challenge to maintain reasonable expected returns while moderating volatility. Credit enables portfolios to reduce volatility relative to equities while maintaining attractive risk-adjusted expected returns relative to government and investment grade bond markets. Credit also enables portfolios to generate income, reducing the requirement to fund liability cashflows from capital. Further, we think that the low growth environment is generally attractive for credit, certainly relative to equities.

In the last seven years, the size of credit markets and the number and breadth of credit securities traded has grown significantly. This has increased the credit investment opportunity set. Meanwhile, challenges to liquidity driven by regulatory change are increasing relative value opportunities, while increased dispersion between individual credits is adding to opportunities for idiosyncratic returns from fundamental research.
Why Multi-Asset?

As the relative value between different credit asset classes shifts over time, MAC investing enables tactical and dynamic asset allocation to profit from opportunities and mitigate risk. With exposure to the full spectrum of issuers and asset types, the multi-asset manager can select the best investment opportunities across different credit asset classes and regions and be nimble in rotating between them. Flexible MAC investing can profit from cyclicality and help to manage credit, liquidity and interest rate duration risks. MAC strategies can also be tailored to different risk and return profiles depending upon investor needs.

Broader Opportunity Set
MAC offers a broader opportunity set than vanilla credit with access to a wider range of issuers and asset sectors. As mentioned, credit markets have grown significantly in size and in number of issuers in recent years.

Relative Value Across Asset Classes
Credit market sectors are cyclical in nature, with this cyclicality driven by variations in fundamentals, supply and demand dynamics, liquidity and regulation. MAC investing can help to both mitigate risk from this cyclicality and profit from it. MAC portfolios can be highly selective and focus on being in the right asset classes at the appropriate time. For example, relative High Yield and Senior Secured Loan spreads have moved significantly in recent years, with Loans sometimes yielding more than High Yield even though they sit higher in a firm’s capital structure.

Figure 1: European High Yield1 vs. European Primary Senior Secured Loans2

Figure 2: US High Yield3 vs. US Senior Secured Loans2
Relative Value Across Geographic Regions

Global MAC managers are able to take advantage of opportunities in relative value in credit between regions. These can be driven by shifts in fundamentals or may be driven by different supply and demand conditions for an asset class between geographies. For example, US and European loan spreads have diverged greatly in recent years, with the yield on US loans shifting from below to above that available on European loans.

Liquidity

As the increase in global financial market regulation and pressures on bank capital have been reducing liquidity in markets, MAC managers are able to take advantage of opportunities created when individual credits or credit asset classes become mispriced due to market technicals. For example, US Loan valuations were materially impacted by retail flows into the asset class in 2013 and subsequent outflows from 2014 onwards. MAC can also help to mitigate liquidity risk as a multi-asset portfolio can opportunistically access the best pockets of liquidity at any time.

Relative Value Within the Capital Structure

Within the capital structure of an individual issuer, greater value may be available in selected parts of the capital structure, often due to broader technical drivers across various asset classes.

Source: 1Bloomberg, BoAML Euro High Yield Constrained Index (HECO) as at 31 May 2016. The HECO index is designed to track the performance of euro- and British pound sterling-denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets by issuers around the world. 2S&P LCD European Leveraged Lending Review, as at 31 May 2016. For illustrative purposes only. It is not possible to invest directly in an index. 3Barclays Benchmark Index: ‘US High Yield ex Energy’ using the Option Adjusted Spread. The ‘US High Yield ex Energy’ is a subset of the Barclays US High Yield Index excluding all energy-related issuers. 4CQS and S&P LCD as at 31 May 2016, Europe is ELLI (European Leveraged Loan Index) and US is LLI (Leveraged Loan Index) ex-Energy adjustments made by S&P LCD. S&P Leveraged Loan Indexes are capitalization weighted syndicated loan indexes based upon market weightings, spreads and interest payments. Specifically, the S&P/LSTA Leveraged Loan Index (LLI) covers the US market since 1997 and currently calculates on a daily basis. The S&P European Leveraged Loan Index (ELLI) covers the European market since 2003 and currently calculates on a weekly basis.
Individual Credit Opportunities
MAC strategies can seek to capitalise on the most attractive individual credit opportunities prevailing across the range of asset classes. This is important to enable portfolios to maximise the benefit of idiosyncratic return opportunities.

Duration Management
Importantly in the current macro environment, MAC investing can help to manage interest rate duration risk by selecting appropriate duration instruments at differing points in the cycle.

At certain points in the cycle, asset allocation can favour shorter interest rate duration instruments, for example Convertible Bonds, Senior Secured Loans and ABS, the latter two of which are typically floating rate.

Figure 4: Interest Rate Sensitivity Analysis: 1% Increase in Interest Rates

<table>
<thead>
<tr>
<th>Interest Rate Sensitivity vs. Representative Indices</th>
<th>Interest Rate +100bps</th>
<th>Yield-to-Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays Global High Yield Index</td>
<td>(4.29%)</td>
<td>7.28%</td>
</tr>
<tr>
<td>Barclays Global Aggregate Index</td>
<td>(6.82%)</td>
<td>1.34%</td>
</tr>
<tr>
<td>iShares iBoxx $ Investment Grade Index</td>
<td>(8.92%)</td>
<td>3.72%</td>
</tr>
</tbody>
</table>

A 1% increase in interest rates would result in an estimated 8.92% loss for the average global investment grade fixed income portfolio

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Footnote:
1For illustrative purposes only. Credit spreads and all other parameters remain unchanged. The information regarding the indices is included merely to show the general trends in the periods indicated and no intention is made to imply any similarities to any of the indices in composition or risk. The benchmarks are used for comparative purposes only. CQS analysis, Bloomberg as at 5 May 2016.
Credit Asset Classes

The following credit strategies are not a comprehensive list, but illustrate the range that may be included in a MAC portfolio:

### Investment Grade Credit

Investment Grade bonds are those rated BBB- and above. The global investment grade corporate market is capitalised at approximately $8.61 trillion. The size of the opportunity set notwithstanding, central bank actions combined with the prevailing low growth/low inflation environment have materially depressed yields in this segment of the credit markets. Furthermore, the effective duration of investment grade credit is among the longest of all credit asset classes. For these reasons, we believe that the best opportunities currently lie in other credit markets.

### High Yield Credit

High Yield bonds are those that have a credit rating below BBB-.

Typically, High Yield bonds pay higher yields than Investment Grade bonds, but have a higher default rate. The High Yield market has grown substantially in size and breadth since 2009 and is continuing to grow, driven by leveraged buyouts, loan-to-bond refinancing and downgrades of large investment grade corporate bonds and subordinated financial bonds. According to data from Bank of America Merrill Lynch, at the end of April 2016, the global High Yield Credit market comprised outstanding issuance of approximately $2.19 trillion.

We believe an increase in dispersion between issuer performance and higher volatility, along with a muted default environment, provides an attractive backdrop for High Yield credit selection. In the European market, we believe there are opportunities to identify companies with fundamentals which are ahead of their current credit rating or takeover/IPO candidates. In the US, opportunities have arisen around dislocations due to fund flows and large M&A deals with accompanying new debt, re-pricing the secondary market. US High Yield markets, particularly higher-beta sectors, recently cheapened relative to Europe due to contagion from energy-related losses.

### Senior Secured Loans

Senior Secured Loans are senior debt instruments secured by the assets of the borrower. They are debt financing made to medium-to-large-sized corporations, predominantly sub-investment grade, for which the lender receives a floating rate of Libor plus a margin (also known as spread).

The sector offers several benefits for investors. Risk-adjusted expected returns are attractive, with returns of 4%-6% currently available in Europe and the US. Further, a senior position in the capital structure and strong documentation help mitigate potential losses of principal and protect against company re-leveraging risk.

Their floating rate structure also offers natural protection against interest rate duration risk. Against these factors, investors should consider the higher default risk and lower liquidity of Senior Secured Loans compared with the Investment Grade debt market.

Senior Secured Loans offer an attractive way to capture yield spread in a more senior, secured position in the capital structure than High Yield bonds. The asset class has exhibited a healthy new-issue pipeline. In our view, global Loan spreads comfortably compensate for credit risk, however individual deal selection through fundamental research remains critical. We believe a global approach to investing in Loans provides investors with the most flexibility to capture relative value. Recently, we have advocated a rotation from European to US loans given the shifting relative value picture and we expect that opportunity to continue.

### Asset Backed Securities

An Asset Backed Security is a security whose value and income payments are derived from and collateralised ('backed') by a specified pool of underlying assets, predominantly mortgages. In other words, an Asset Backed Security represents a claim on the cash flows from mortgage loans, either residential ('RMBS') or commercial ('CMBS').

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**Asset Backed Securities (continued)**

ABS is an attractive sector for managers with a focus on fundamental credit research. ABS has a complexity premium and therefore provides opportunities for managers with specialist in-house expertise and the ability to analyze the structures and underlying collateral.

We are generally constructive on ABS markets. Unlike most segments of the credit market, the asset class has been slowly shrinking as repayments outweigh new issuance. This leaves ABS in a good medium-to-long-term technical position. Also as fundamentals remain strong we believe the lagging performance of ABS markets more recently will generate attractive returns in the coming months. Yields are currently running at 5%-7%, and we see opportunities across global CLOs, US RMBS, European CMBS and RMBS, as well as whole business securitisation in the UK.

**Convertible Securities**

A Convertible is a bond that can be converted into a predetermined amount of a company’s equity at certain times during its life, usually at the discretion of the bondholder. Essentially, a Convertible is a bond with an embedded equity option.

Convertibles are an attractive asset class, offering participation in the upside when equity markets rise and, because of the bond floor, downside protection when equity markets fall. Studies of Convertible Bond returns have demonstrated long-term performance comparable with that of equities with lower volatility. Furthermore, Convertibles have modest effective duration and have demonstrated low (even negative) correlation with global government bonds and modest correlation with broader Corporate Credit and thus we believe constitute an attractive addition to broader credit portfolios.

Convertibles also frequently offer idiosyncratic opportunities where the specifics of the bond documentation offer material potential upside in the event of M&A or other corporate activity.

**Emerging Market Debt**

Emerging Market Debt is the Sovereign and Corporate Bond issuance of less developed countries and is usually rated below investment grade. The sector provides diversification to developed world credit exposures and has historically paid higher yields and offered higher returns than developed markets.

Given the potential returns, risks too can be higher. Compared with developed markets, Emerging Market Debt has a higher perceived default rate, greater risk of corporate governance issues, and sovereign bonds can also be more volatile.

**Direct Lending / Private Debt**

Direct Lending strategies seek to capitalise on the reduction in bank lending due to regulatory capital and other balance sheet constraints. Private Debt is usually in the form of Loans (Senior, Subordinate or a combination) which are structured and held directly by institutions and funds rather than structured and syndicated by a bank. While the strategy is highly illiquid, returns can exceed those from more liquid Loans.

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8CQS analytics as at 31 May 2016. 9CQS ‘Case for Convertibles’, BoAML ‘Global Convertibles Primer’ 2016.
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(continued on next page)
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Barclays Global Aggregate Index: An unmanaged index considered representative of global investment-grade, fixed income markets.

iShares iBoxx $ Investment Grade Index: iShares iBoxx $ Investment Grade Corporate Bond ETF is an exchange-traded fund incorporated in the USA. The ETF seeks to track the investment results of an index composed of U.S. dollar-denominated, investment-grade corporate bonds.