Asset Class Investment Strategies

Liquid Credit

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

Long-term Investors with an ability to tolerate higher levels of illiquidity should default to holding Private Debt over Liquid Credit. We therefore have a 0% allocation to Liquid Credit in both the SAA and TAA of our model portfolio. Although we tactically increased our Liquid Credit allocation to 2% in April 2020, we now reduce that back to 0% on account of spread tightening and record low yields for high yield bonds. However, for clients who are unable to accept the illiquidity of private debt, we still see attractive risk-adjusted returns in structured credit and short duration private lending strategies.

The COVID-19 crisis presented a number of attractive opportunities in liquid credit during 2020, and as a result, we increased our recommended allocation to 2% during the year. However, corporate credit spreads have since narrowed significantly over recent months and, together with declines in interest rates, have brought the US high yield index yield-to-worst to a record low of 4.2%, which we view as an unattractive value proposition after considering the potential for defaults.

For clients who are unable to bear the illiquidity of private debt, we recommend focusing instead on areas where potential for further spread tightening remains or where economic uncertainty creates security selection opportunities, as well as in short-duration private lending. Within structured credit, we are focused on residential mortgage-backed securities and mezzanine tranches of collateralised loan obligations ("CLOs"), which we believe offer insulation from further economic weakness and the potential for further price appreciation. We have reviewed a range of different niche private lending strategies, and are focused on specialised bridge lending strategies where the weighted average life of the loan portfolio is typically 12 months or less. We believe these strategies can deliver high single digit total returns, which translates to expected alpha of roughly 3-5%[1] over the expected return of a 50/50 benchmark of high yield and leveraged loans.

Asset Class Definition

The liquid credit asset class consists of investments in securities which offer contractual income and repayment of principal in exchange for assuming the risk of loss from default and non-payment. The underlying borrower can be a government, a corporation, an asset owner (e.g., a real estate investor), or a consumer. The bond or loan may be secured against assets or unsecured, can be senior or subordinate in the structure, and can be fixed rate or offer a spread above a floating rate of reference such as LIBOR.

The liquid credit landscape is broad, with roughly $50 trillion of assets across corporate bonds (high yield and investment grade) and loans, emerging market debt (both USD and local currency, sovereign and corporate), hybrid securities and securitised debt such as residential mortgage-backed securities (RMBS), collateralised loan obligations (CLOs), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) as shown in Exhibit 1. We exclude developed market sovereign debt from this complex as we expect the returns in that space to be predominately driven by interest rates rather than credit risk.

[1] Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

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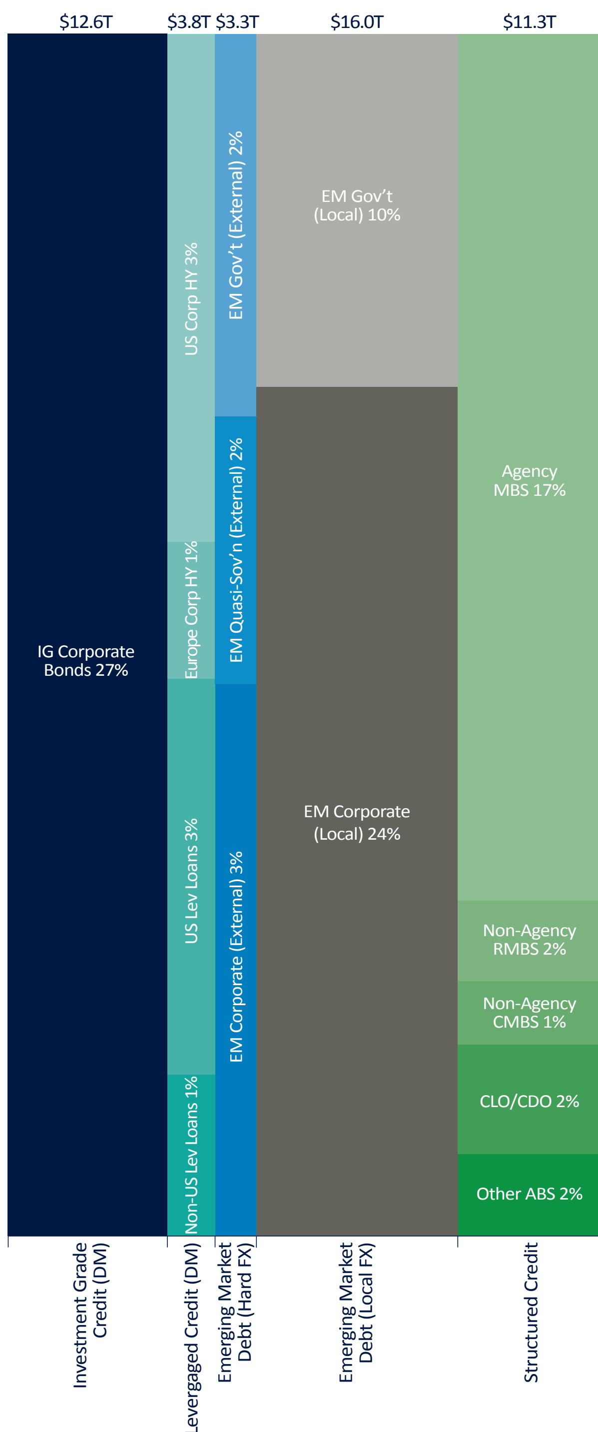
Each sub-segment of the credit market is driven by its own fundamental and technical factors. As a result, valuations and performance can diverge substantially, creating opportunity for those who can dynamically allocate across liquid credit.

Exhibit 1

Overview of Liquid Credit Universe



Source: *Bloomberg Barclays, BIS, IMF, SIFMA. Data as of December 2020 and January 2021*

Notes:

1. In some areas, data may not include non-index credits and as a result may understate the size of debt stock.

2. The breakdown shown excludes Developed Market sovereign debt, which we generally categorise as "Fixed Income".

Role in the Portfolio

The role of the liquid credit asset class is to provide: 1) a contractual income yield and 2) an alternative source of returns to equities. Though we expect credit to offer a source of returns that is differentiated from equity, the returns from credit and equity are still somewhat correlated. Given the seniority in the capital structure and the relative security of contractual cash flows, we budget credit beta, as proxied by a blend of corporate high yield bonds and levered loans, at approximately 30% of the equivalent risk of global equities over the long term.

Over the long term, we expect a return of 3.3%[2] from the asset class beta (as measured by high yield bonds), a function of the long-term risk-free rate and the expected risk premium from credit risk, adjusted for losses from defaults. However, credit is a vast asset class and each sub-sector of credit offers a different risk/return profile.

Golden Rules

— Adding value via security selection is more challenging than in some other asset classes due to lower volatility of the instruments and the negative skew inherent in credit.

— There is value to be added from investing tactically into dislocations across sub-sectors of credit driven by transitory illiquidity.

— Manager outperformance of credit benchmarks is most often driven by taking increased credit or interest rate risk and thus purported "alpha" must be scrutinised.

— Credit funds need to have the appropriate terms, duration and structure to prevent a liquidity mismatch given the elevated risk of sudden changes in market liquidity in credit markets. Managed accounts or fund-of-ones are preferable to mitigate these risks as well as to allow targeted control of investment exposures.

— We prefer to allocate to specialists due to the value-add that comes from deep knowledge of fundamentals, market technicals and legal documentation.

Market Overview

Credit markets sold off sharply in Q1 2020 as the COVID-19 crisis took hold. As the crisis deepened, liquidity in funding markets evaporated, leading to widespread deleveraging across financial markets. In response, the Federal Reserve quickly rolled out a range of intervention programs to stabilise funding conditions and backstop markets.

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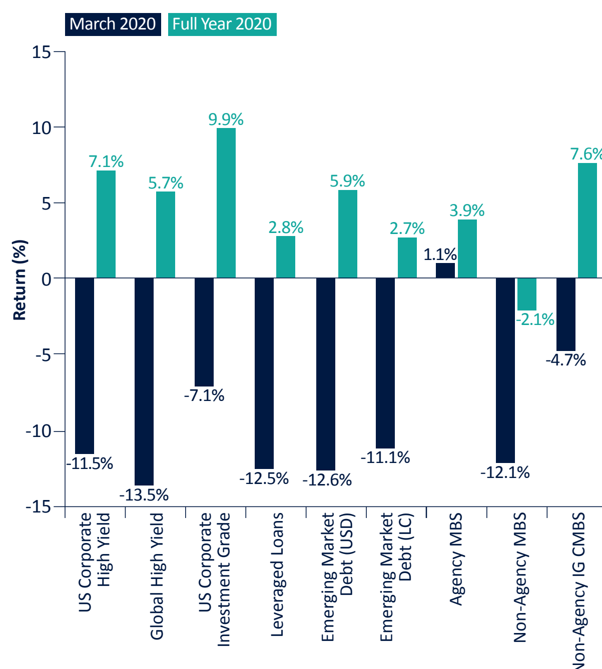
This resulted in a sharp rebound in risk assets in Q2, which continued over the second half of the year. While there was dispersion in performance, the majority of sectors in credit markets finished the year in positive territory. The US and Global High Yield indices finished the year +7.1% and +5.7%, respectively, although the gains were driven predominantly by a decline in interest rates. Leveraged loans finished in positive territory as well, up +2.8% on the year. Meanwhile investment grade credit outperformed due to lower spread sensitivity and longer duration, closing the year up a remarkable +9.9%.

Against this backdrop, structured credit struggled on a relative basis. The sector was acutely impacted by deleveraging during the crisis as certain repo lenders abruptly abandoned the market and daily liquid credit vehicles saw large redemptions, leading to forced selling. Additionally, structured credit lagged the high yield and leveraged loan markets during the subsequent market rally as is often the case due to its comparatively lower liquidity. Furthermore, commercial mortgage-backed securities and asset-backed securities were negatively impacted by COVID-related weakness in the retail, hospitality, and travel industries. Investment grade CMBS performed positively (as seen below in Exhibit 2) over the year, but CMBS securities further down the capital structure only rebounded partially in price. Within ABS, aviation security prices remain significantly depressed due to a sharp drop-off in revenue and uncertainty regarding the trajectory of recovery in air travel.

Exhibit 2
Performance of Credit Sub-Sectors in 2020



Source: *Barclays, Credit Suisse, JP Morgan*

Spreads have tightened significantly as credit has rallied throughout the final three quarters of the year. As seen below in Exhibit 3, the spread on the Barclays US Corporate High Yield Index was 368 bps at 2020 year-end, well below the historical average of 536 bps and at the lower end of its trading range in recent years. Leveraged loan spreads have also narrowed but to a lesser extent, with the spread on the Credit Suisse Leveraged Loan Index at 486 bps, slightly above the historical average of 466 bps. We view leveraged loans as more attractive than high yield on a relative basis, as we discuss in more detail below.

Opportunities for 2021

While the market dynamics of 2020 led to relative underperformance of structured products versus other credit sub-segments, looking forward structured credit appears poised to outperform. As mentioned, the US High Yield Index currently has a yield-to-worst of 4.2%, but this does not take into account any impact from defaults. A modest 3.5% default rate with a 35% recovery rate (in-line with historical numbers) would result in a circa 2% loss-adjusted return for the year. The low starting yields and spreads in corporate credit create heightened sensitivity and negative asymmetry to any worsening in fundamentals or rise in interest rates, with the 5-year US Treasury now yielding a near-record low of +0.4%. However, we still see opportunities to obtain high-single digit returns in structured credit and specialised lending strategies. We provide further information on our recommended portfolio on the following pages.

We view leveraged loans as relatively more attractive than high yield. Despite the fact that loans are higher up in the capital structure and historically have offered higher recovery rates, loans currently offer a higher current yield (5.1%) than high yield bonds. Additionally, the loan market features lower allocations to COVID-sensitive industries of energy and travel. Lastly, the low duration sensitivity of floating-rate loans is preferable at current interest rate levels, and we anticipate there may be tailwinds for leveraged loans if interest rates begin to rise and drive investor flows into the sector. Despite these relative benefits, the strong gains in leveraged loans in recent months are cause for caution, as a portion of the potential outperformance from the asset class has already been realised.

We are also finding relative value in many areas of structured credit. Liquidity-driven forced selling was much more acute in these sectors in 2020 and they did not benefit as directly from government stimulus. As noted above, some areas of structured credit have higher risk due to sensitivity to COVID-driven factors, but that elevated uncertainty has created a ripe opportunity for security selection for

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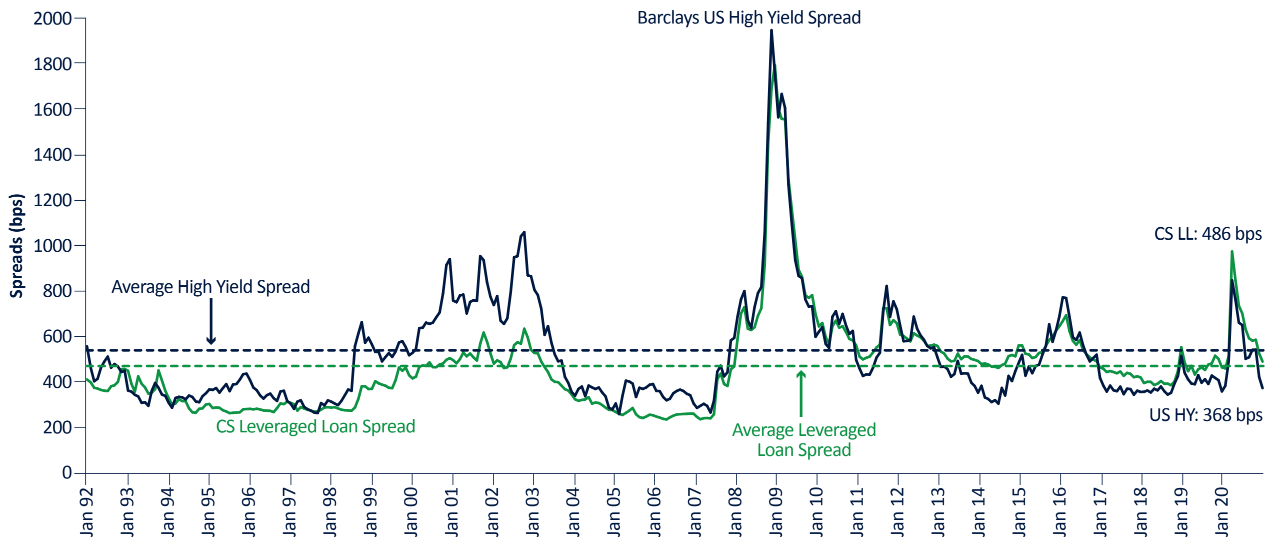
Exhibit 3

High Yield and Leveraged Loan Spreads vs. History



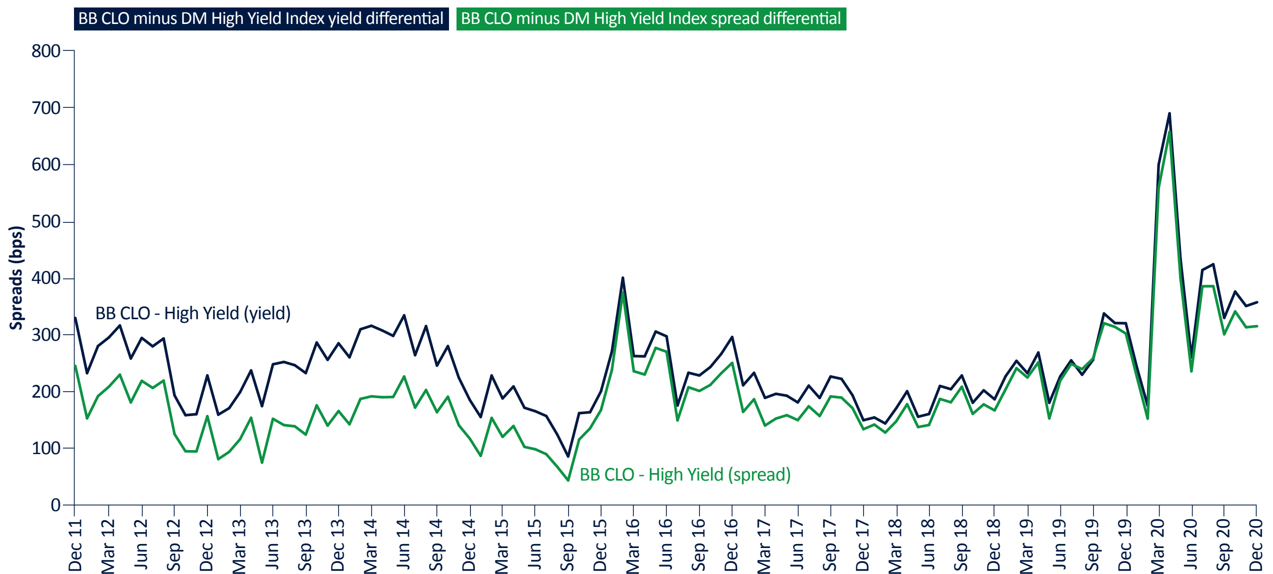
Source: *Barclays, Credit Suisse*

managers with expertise in those areas. Pricing remains attractive relative to liquid high yield. For example, BB CLOs have historically averaged a spread premium of +197 bps and a yield premium of +248 bps over high yield; as of January 2021 there was a spread premium of +315 bps and a yield premium of +357 bps over high yield. Mezzanine CLOs offer a yield-to-maturity of 8.3% currently, with potential for modest additional upside from price appreciation.

Elsewhere in structured credit, we have invested alongside managers with expertise in RMBS. The fundamental underpinnings of the RMBS market have improved despite the crisis as individuals have placed increased value on investing in their homes when many offices have limited usage and travel is restricted. The Case-Shiller Home Price Index increased +9.5% in 2020, with a gain of +9.0% coming into the final 3 quarters after the onset of the COVID-19

Exhibit 4

Yield and Spread Differential of BB CLOs over High Yield



Source: *JP Morgan*

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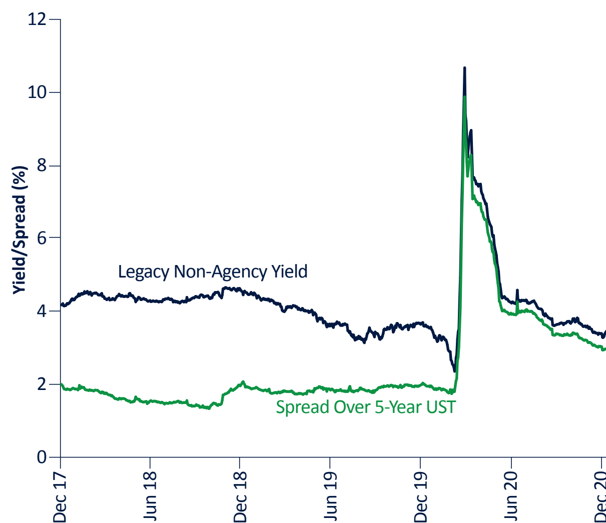
crisis, and default rates on residential mortgages were lower in 2020 than in the years prior. Fiscal stimulus has helped to alleviate consumer cash flow shortfalls, and families have prioritised their mortgage payments. RMBS spreads have tightened meaningfully from the March lows, though they remain wider than pre-COVID (292 bps as of January 2021, vs. 174 bps as of February 2020, see Exhibit 5). One current opportunity in RMBS is identifying securities that have mispriced call option provisions, or where past credit forbearance will ultimately be repaid and create upside. In current market conditions, we believe that skilled active managers can generate high-single to low-double digit gross returns in the asset class.

Exhibit 5

JP Morgan Legacy Non-Agency Index Yield and Spread



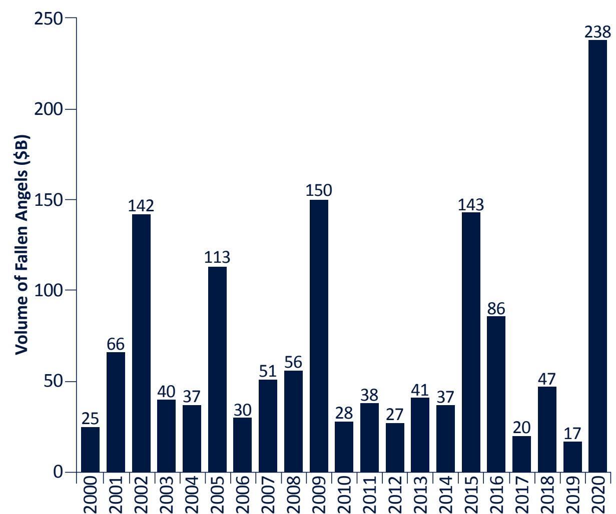
Source: *JP Morgan, Bloomberg*

Managers have also highlighted new or growing opportunities in segments of the market where some banks and other lenders pulled away post-COVID, such as fix-and-flip residential bridge lending. In areas such as CMBS and ABS, prices declined in March and have only partially recovered due to the fundamental issues noted above. While there are clearly risks in these areas, the uncertainty has led to increased dispersion and volatility in security pricing, creating trading opportunities.

Finally, the ongoing financial stress on certain industries and companies related to the COVID crisis has created greater opportunities for active credit investors. High dispersion in the health of company balance sheets and income translated into volatility and dispersion in securities across industries, companies and capital structures in 2020, with a record volume of "fallen angels" (credits that were downgraded from investment grade to high yield). While we are likely past the peak of defaults, past recessions have produced a tail of stressed credits over multiple years, providing continued opportunities for active credit strategies.

Exhibit 6

Fallen angel volume in 2020 was the highest on record



Source: *JP Morgan Markets*

Investment Strategy

As discussed above, we plan to avoid or limit allocations to investment grade and high yield corporate credit in 2021. Instead, our focus is on targeted opportunities within structured credit, including in mezzanine CLOs and with fund investments in managers that have security selection expertise in residential mortgage-backed securities (RMBS), commercial mortgage backed securities (CMBS), and asset-backed securities (ABS). Our recommended allocations are shown in Exhibit 7. We believe we can achieve high-single digit returns by investing in these sectors, with a similar or better downside risk profile than high yield. While there is always potential for adverse mark-to-market movement as was seen in March, those moves were driven in large part by leverage providers exiting the space and consequently, the amount of leverage employed in these sectors has not risen back to pre-crisis levels. As a result, we think the probability of a March 2020 style event reoccurring in structured credit is currently relatively low.

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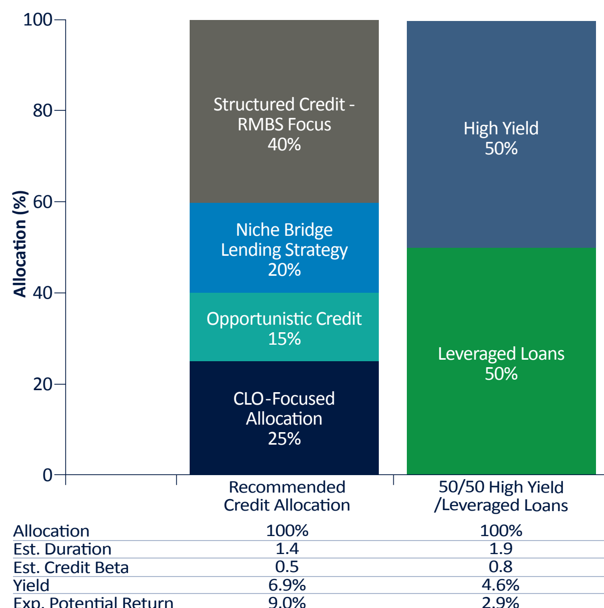
Exhibit 7

Partners Capital Recommended Credit Portf olio vs. 50/50 High Yield / Leveraged Loan Index



	Recommended Credit Allocation	50/50 High Yield /Leveraged Loans
Allocation	100%	100%
Est. Duration	1.4	1.9
Est. Credit Beta	0.5	0.8
Yield	6.9%	4.6%
Exp. Potential Return	9.0%	2.9%

Source: *Partners Capital*

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

We have supplemented our structured credit exposures with allocations to certain niche lending strategies in undercapitalised market segments that offer above-market returns. In general, we are looking for strategies that produce consistent high-single digit (or better) net returns, often with relatively short duration, and have limited sensitivity to a broader market downturn, such as historical tax credit financing and UK residential bridge lending. We favored these strategies entering the year in 2020, but tactically reduced our allocations as the year progressed given there were higher returning opportunities from buying stressed assets across the liquid credit landscape. However, given the rally in high yield, we are now once again focused on less correlated lending strategies to provide a diversifying return stream.

The market volatility in 2020 provided the best market opportunity for trading-oriented and opportunistic long/short credit funds in years, and many managers generated exceptional performance. While it is unlikely that market volatility in 2021 will be as extreme, we still anticipate an above-average opportunity set as COVID-related uncertainty should continue to drive dispersion in the performance of individual credits. As a result, this remains an area of focus in 2021.

Exhibit 8

Liquid Credit Total Return Expectations by Scenario

Scenario	Summary Analysis	2021 Calendar Year Total Expected Return	Weighted 12-Month Return	Long-term Return Forecast	Recommended Deviation from Benchmark for 2021
Upside Scenario: "Warp speed to normal growth" (20% probability)	Beta return of 5.5%: +4% income and +1.5% from duration net of defaults as yields decline. Beta forecast assumes the yield on the global high yield index declines to 4.1% from of 4.4%. Rising Treasury yields are offset by spread compression, with the spread dropping to just 250 bps, a new record low. The default rate remains low as strong growth supports corporate earnings. Partners Capital managers exploit sector tilts to add 50bps of alpha.	**6%**			
Base Case: "The herd slowly immunises" (60% probability)	Beta return of 2.5%: +4% income and -1.5% from duration net of defaults as yields rise. Beta forecast assumes the yield on the global high yield index increases to 5.1% from 4.4%. Spreads compress to 350bps, which is not enough to fully offset rising Treasury yields. The default rate remains low as strong growth supports corporate earnings. Partners Capital managers exploit sector tilts to add 50bps of alpha.	**3%**	**1.3%**	**3.8%**	**0.0%**
Downside Scenario: "Ongoing waves" (20% probability)	Beta return of -10%: +4% income and -14% from duration net of defaults as yields rise. Stalling of global growth results in higher defaults and wider spread. Yield on the global high yield index rises to 8.5% from of 4.4% as spread widens to 8%.	**-9%**			
TAA Implications of short-term returns vs. long-term expectations	Liquid credit has a scenario weighted expected return of roughly 1% in 2021, below our long-term expected return of 3.8%. This suggests that clients should maintain a maximum underweight to the asset class, and within the asset class should skew away from generic high yield bonds in favour of more attractive sub-sets of the credit market.				

Source: Partners Capital Analysis

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