Payden&Rygel

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AN INVESTMENT FOR UNCERTAIN TIMES: THE BENEFITS OF AN ABSOLUTE RETURN STRATEGY A CONVERSATION WITH PAYDEN & RYGEL'S ERIC SOUDERS

Eric Souders is a director and lead strategist on the global unconstrained fixed income team with a focus on absolute return and multi-asset credit solutions at Payden & Rygel. He is responsible for oversight of idea generation, strategy implementation and risk management.

Absolute return strategies can mean different things to different investors. Tell us about Payden's absolute return strategy and what you seek to achieve.

Payden's absolute return strategy came from a client request. The client was looking for two things: Preservation of capital and a reasonable long-term return over cash.

Our version of absolute return ties into the heritage of the firm, which is focused on balance sheet assets, corporate cash, and emphasizing preservation of capital. To this, we add the ability to deliver a steady, consistent, repeatable stream of income and return above cash over medium-term periods of time.

Absolute return is a very broad category. At one end of the spectrum, you have very conservative solutions which resemble money market funds. At the other end there are hedge fund type strategies that use leverage. Our strategy sits somewhere in the middle of that spectrum.

What is the difference between a core bond and multi-asset strategy?

The biggest difference is the benchmark. As a core bond manager, you have to acknowledge the benchmark's characteristics. You can't deviate too far from that benchmark without incurring a significant amount of tracking error.

That benchmark is going to have a reasonably material interest rate duration profile, typically around six or seven years. In a period where interest rate volatility is high, investors are accepting that degree of interest rate risk as a starting point with limited flexibility to deviate from it.

You're also going to have a substantial amount of exposure to government bonds, agency mortgages, and investment grade corporates because of the benchmark. The benchmark will have less exposure to areas that we think will add value going forward, like emerging markets and securitized credit.

In an absolute return strategy or a multi-asset credit strategy like ours, we don't have a benchmark. Our starting point is cash. We have an investible universe, but we don't have a benchmark that we have to acknowledge. And so, we don't have to import what we call the common factor risks associated with that benchmark. We have full latitude around what we can do in this strategy.

Of course, there are constraints. We have limitations in terms of duration ranges and sector limitations, et cetera. There are guardrails, but we have significantly more latitude when compared to a core bond mandate.

Protection of principal is a primary objective. How do you go about achieving that in volatile markets?

As bond investors, it's really about the generation of income and coupon and return of principal at maturity.

You need to focus first on the downside and how can I as a bond investor mitigate that? The bond market provides some compelling features at the front end of the yield curve.

The short maturity end of the bond market has a unique pull to par profile. So long as you do your credit work correctly, you can get comfortable buying two-, three-, and four-year securities, because you know they will pay off at par if you've done your credit work correctly. During periods of drawdown and volatility, those securities are much more resilient from a price standpoint when compared to 10-, 20- and 30-year maturities.

A short maturity focus is a critical foundation to our strategy but there are also some other important ingredients. Diversification is key. You want to incorporate various types of securities that provide different themes and different pockets of behavior and performance when markets can become more volatile.

You don't want to be over diversified, though. For example, you don't want to have too much diversification in emerging markets because then you get everything in that market, and you know some countries will have difficulty. It's that balance between having some diversification but also being pragmatic about not having too much.

Position sizing is also very important. And, finally, liquidity. Market liquidity can become very fractured during periods of volatility. Liquidity is particular important in multi-asset portfolios that allow for active management and rotation and participating in opportunities when they arise. It's become more important to have a reasonable amount of persistent liquidity over the last five to 10 years.

What asset classes do you consider for your strategy?

This strategy participates in all parts of the public fixed income market, including investment grade and below investment grade opportunities.

The broad categories are corporate credit, including investment grade and high-yield bonds, and bank loans. In government bonds, we invest in developed country government bonds as well as emerging market or developing market government bonds. Securitized credit also offers a wide range of opportunities, such as asset backed securities, both consumer and commercial, residential, mortgage credit, commercial mortgage credit, and collateralized loan obligations, or CLOs.

The good news is that the bond market has grown in size and scope the last 10 years, particularly securitized credit.

We're participating in all parts of the market. We draw upon the good credit work that's being done at Payden across all of these areas and integrate the best ideas into a multi-asset portfolio.

What is a typical allocation to an absolute return strategy?

Most of our clients outside of the US are looking for a global diversified multi-asset approach that can deliver consistent and repeatable returns over time. And so, this strategy typically serves as a centerpiece to their fixed income allocations. Most of our non-U.S. clients are delegating the asset allocation decision to us.

With the interest rates at highs and the S&P on a run, is this a good environment for an absolute return strategy?

This strategy has been around 15 years, so we've experienced periods of low rates and high rates. We've experienced periods of significant credit spread volatility as well.

This strategy's benefit is that it tries to beat cash returns by a specific amount. Interest rates fluctuations actually benefit the strategy. Higher cash rates just simply mean higher all-in yields for us because we're looking at credit spreads above cash, and higher volatility presents better opportunity in areas like credit.

We're likely entering or have already entered a new regime for financial markets. As part of that regime, you'll likely see higher volatility in interest rates, inflation, and credit spreads for the next one to two years. As a result, having latitude around asset allocation decisions, being able to adjust duration and credit risk without being tethered to a benchmark, we think is important. It offers investors more latitude in an environment where there's more uncertainty.

What's your view on recession, a soft landing or no landing? How would these scenarios impact your strategies?

Our base case is for an economic soft landing the next three to six months, but that's priced in. And so right now, we're really thinking about the probability of no landing. What's the probability that economic activity remains very durable, more durable than the market is pricing? We think higher than the market is pricing.

It seems that given the uncertain environment, it's a good time to consider a multi-asset or absolute return strategy.

In an environment where you have more uncertainty and more volatility, you want more latitude and more flexibility. You don't want to narrow your opportunity set. You want to broaden it. You want to be able to benefit from having a manager that makes active decisions around asset allocation as it pertains to volatility in particular markets.

Dispersion—or the differentiation in performance across asset classes—is likely to pick up as well in the next one to two years. Factors affecting emerging markets may not play out the same way in corporate or securitized credit. Having a broader toolkit during a period of higher volatility and higher uncertainty is absolutely what you'd want as an investor.

In this environment which asset classes are you favoring and which are you avoiding?

We think that areas that are exposed to interest rates remain vulnerable. That includes bank loans, especially distressed bank loans. Because they're floating rate, bank loans very sensitive to the path of interest rates and ultimately the policy of the Federal Reserve. As interest rates move higher, their debt service costs have gone up. We've been very selective in bank loans, preferring high yield bonds instead. Residential mortgage credit, commercial mortgage credit, we think those areas remain vulnerable as well.

There are bright spots though. I think one interesting thing about our strategy is there are certain areas that we might dislike holistically, but there are specific parts of those areas that we actually might like and vice versa.

I'll give you an example. In general, we think commercial real estate is vulnerable. Office has been in the headlines for months, if not quarters. There's a lot of uncertainty around returning to work. Vacancies are elevated. Offices is very prevalent in the headlines, but an area like multifamily commercial real estate has been quite durable, partially because home affordability is so poor.

The more unaffordable a home is, the more someone must rent an apartment, and the stickier the rent profile of that apartment will be. We are not overly constructive on commercial real estate as a broad asset class, but certain parts of it, like multifamily apartments, look quite interesting.

Now, on the flip side, we've been optimistic about the consumer. Coming out of COVID consumer balance sheets got an extraordinary amount of reinforcement. And by the way, coming into COVID, the consumer was in pretty good shape. Households had been de-levering for 10 or 15 years after the Global Financial Crisis, a much different scenario when compared to 2006 and 2007.

In a normal business cycle, the jobs market and consumer are the last thing to go. We've seen volatility and difficulty in housing, crypto, nonprofitable tech, and regional banks. There have been pockets of the market that have really struggled in the last year, but not really the consumer.

We like consumer-facing areas, particularly in the asset-backed securities market. We like autos. You need to drive your car. You need your car to get to work. It's one of the most coveted assets, if not the most coveted asset that people use from a functional standpoint, and it faces the consumer, and auto loans are short-term in nature. They're usually five to seven years. We can get comfortable around the shorter duration profile of an auto loan relative to a 10-year commercial real estate loan or a 30-year residential mortgage credit loan.

Is there anything else potential investors and current investors should know?

The absolute return strategy offers a compelling profile. Yields are elevated. Credit spreads continue to remain elevated in some areas. The yield of the strategy is around 7.5%, while the average maturity in the portfolio is only three years.

Compared to a core bond strategy, the yield relative to the maturity profile is very attractive. In addition, investors have more latitude around asset allocation and therefore opportunity for flexibility and diversification.

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