Mapping a Changed World:

The Case for a Multi-Asset Credit Approach

David Scott
David Torchia

Stone Harbor Investment Partners

January 2014

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A Multi-Sector Investment Strategy

Investors face a global credit environment that has changed substantially over the past few years. These changes are likely to be long lasting, if not permanent. Asset classes traditionally considered high risk have improved in credit quality, while safe haven, higher quality assets have deteriorated. This has resulted in a greater continuum in terms of credit quality across the fixed income universe and increased correlations between historically disparate asset classes.

Against this background, a traditional segregated investment strategy, where clients mandate managers to run segregated sector-specific portfolios, may miss out on potentially attractive investment opportunities or potentially fall short when it comes to protecting a portfolio from market volatility. Instead of a segmented approach, an investor might consider a more flexible multi-sector allocation investment strategy.

Evolution of the Credit Markets

The Old World

Through the 1990s and 2000s, the fixed income world was divided, for good reason, into two broad categories with low-risk credits (e.g., AAA/AA rated sovereign debt, AAA/AA rated securitized debt, AAA/AA rated corporate debt) on one side and higher risk credits, such as high yield and emerging markets debt, on the other. The former were established markets where credit risk and volatility were well understood. Higher risk markets were newer markets where credit transparency was lower and risk appeared greater. This separation was supported by evidence that correlations across these domains were low and that volatility was higher in the newer markets.

Investors generally responded to this situation by giving specific discretionary mandates to their managers as to which categories of debt to invest in, with allocations to lower and higher risk assets determined in a longer-term framework, reflecting portfolio return and risk objectives, but fundamentally separating the asset class exposures. This was a workable and often successful strategy: if a client wanted to limit their exposure to risk, focusing their investments on the high grade sector was typically a reliable way to keep their portfolio's volatility manageable.

The two categories were essentially different worlds. The credit profiles of higher and lower risk assets suggested a largely bifurcated credit risk and gave fundamental rationale to the segregation of exposures. Consequently, managers developed their expertise in specific areas.

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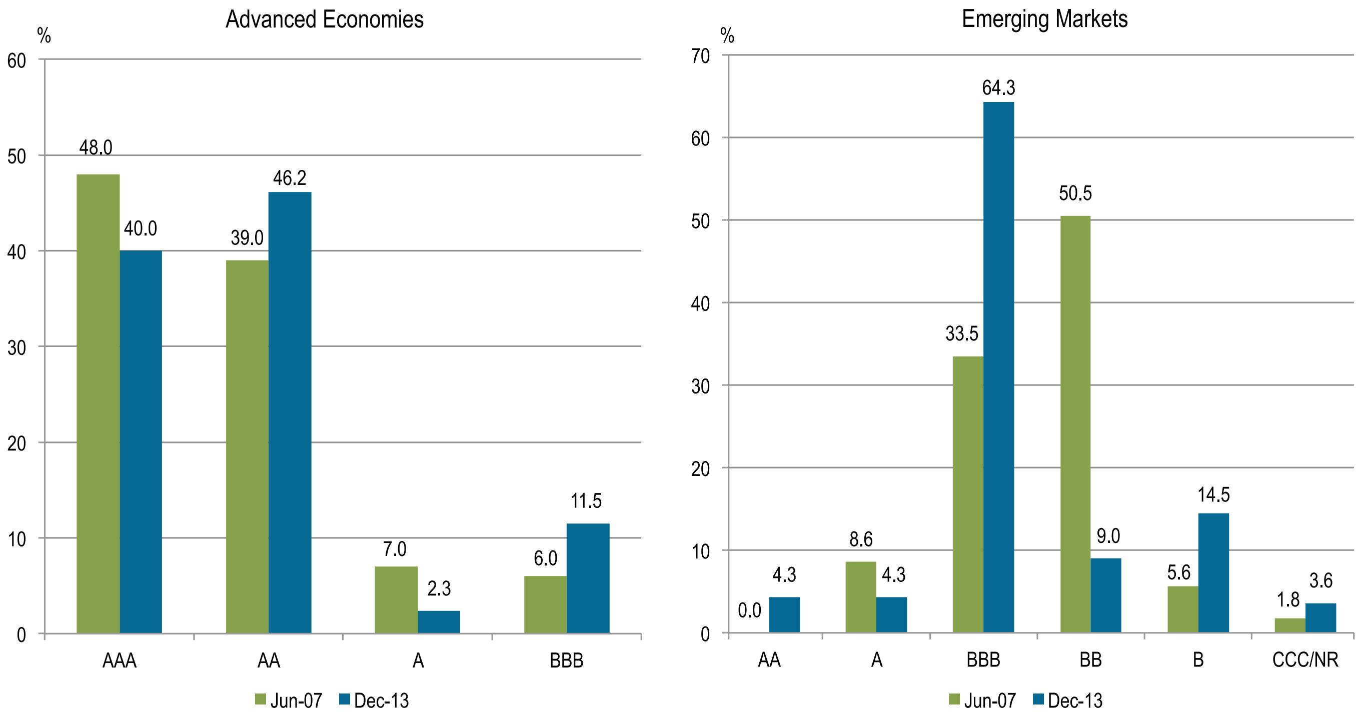
Chart 1 – Sovereign Risk Changes – Distribution of Advanced and Emerging Market Economies by S&P Sovereign Debt Rating (% of Total Market)



As of 31 December 2013
Sources: Barclays; J.P. Morgan

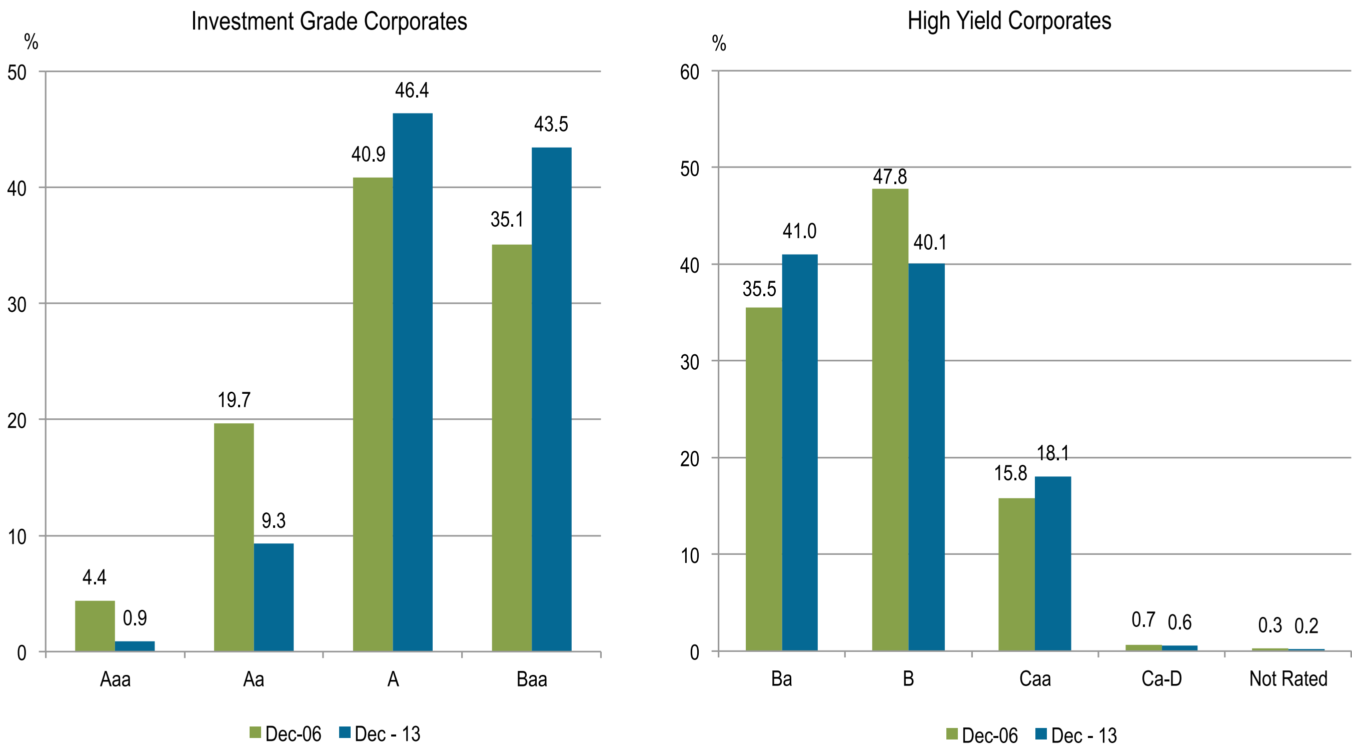
Investing in high yield and emerging market debt, for example, required a special skill set for managers and a high tolerance for risk and volatility by clients.

By the mid-2000s, divisions between credit markets had already begun to blur, and with the economic crisis in the fall of 2008, whatever barriers remained started crumbling quickly. The subsequent global recession and the wild disruption of the credit markets in the 2008-2009 period left a dramatically changed landscape in their wake.

The vast majority of sovereign credits (by value) are now investment grade. Corporate credits now largely span the single A to single B range. Effectively, both sovereign and corporate credits now cover a much tighter range of credit quality with implications for volatility, correlations, and investment opportunities.

Just prior to June 2007, for example, AAA rated issuance accounted for 48% of the debt from advanced economies. By December of 2013 this had fallen to 40%. The proportion of BBB rated debt rose from 6% to 11.5% (see chart 1). While this shift may appear modest at first glance, the improvement in the rating of emerging markets debt has been very pronounced. Emerging markets local currency debt is now 92% BBB rated or better, emerging markets hard currency debt is now 64.3% BBB compared to 33.5% in 2007. These moves suggest to us that the sovereign market is likely to become more homogeneous over time.

Chart 2 – Credit Quality Convergence

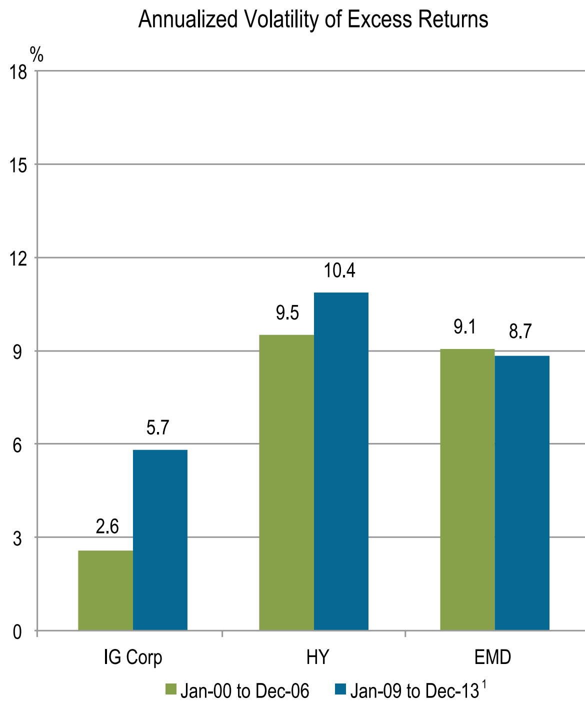


As of 31 December 2013
Sources: Barclays, J.P. Morgan, Stone Harbor Investment Partners LP
Past performance is not a guarantee of future results.

In corporate credit, the trend of convergence in credit quality across high yield and investment grade is also evident (see chart 2), although in this instance it is driven by a deterioration in investment grade corporate credit quality. In part, this reflects the change in the nature of bank risk. No longer are banks seen as having quasi-sovereign exposure and being a reliable source of liquidity to corporate borrowers. As a consequence, the vast majority of the investment grade corporate market is A and Baa rated, compared to a high yield market, which remains largely Ba and B rated. Therefore, the behavioral characteristics of investment grade credit are increasingly similar to the high yield market.

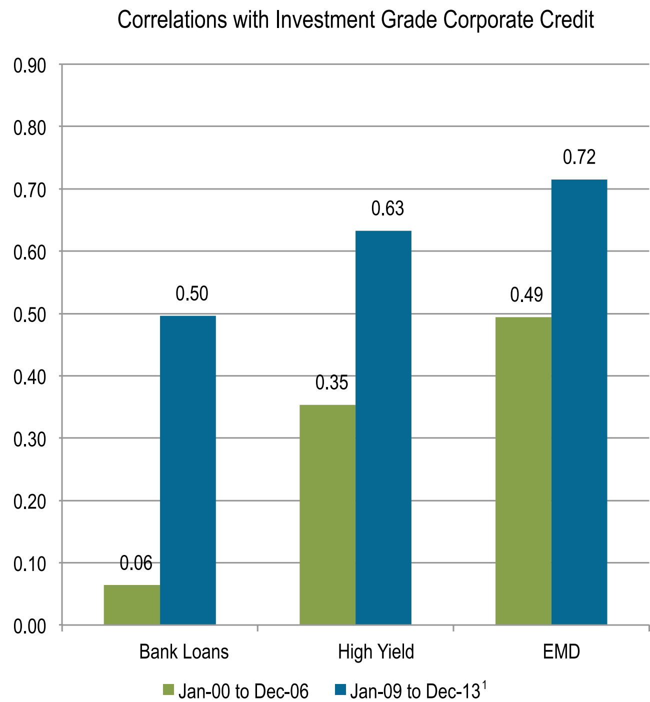
A deterioration in investment grade credit is driving a convergence of credit quality across investment grade and high yield

Chart 3 – Increased Volatility of Excess Returns



As of 31 December 2013
Sources: Barclays, Stone Harbor Investment Partners LP
[1]The period from Jan-07 to Dec-08 has been excluded as we believe it is not representative of typical periods of volatility.
For full description of the Barclays Capital U.S. Investment Grade Corporate Index, Barclays Capital U.S. High Yield Index, Barclays Capital Emerging Markets Debt Index, please refer to the endnotes.

Chart 4 – Changing Correlations



As of 31 December 2013
Sources: Barclays, Credit Suisse, Stone Harbor Investment Partners LP
[1]The period from Jan-07 to Dec-08 has been excluded as we believe it is not representative of typical periods of volatility.
For full description of the Credit Suisse Leveraged Loan Index, Barclays Capital U.S. High Yield Index, Barclays Capital Emerging Markets Debt Index, please refer to the endnotes.

For example, the annualized volatility of excess returns relative to Treasuries (the volatility of the credit return component of bonds) for investment grade corporate debt was 5.7% between 2009 and 2013, compared with 2.6% between 2000 and 2006 (see chart 3). It is now running at between 50% and 70% of the same measure for high yield and emerging markets debt, compared to less than 30% before the crisis. By contrast, emerging market debt's annualized volatility of excess returns remained broadly stable at around 9%.

Along with this, the correlation of the credit component of investment grade returns with the same element of loan and high yield returns has risen substantially (see chart 4).

Investment grade credit is increasingly behaving in a similar way to high yield from a volatility perspective

So, consider the change to be two forces pushing towards the middle: as investment grade credits have diminished and weakened, higher risk credits have strengthened and expanded.

The "New Normal"

This is the real "new normal" of the mid-2010s as we see it: a convergence of credit quality across a wide spectrum of credit sectors leading to a narrowing of volatility differentials across asset classes and increased correlation. We think of the "New Normal" not in terms of a new paradigm in rates but more in terms of a different market structure for credit. In turn, the diversification and return benefits associated with a portfolio of discrete allocations is likely to be lower while the need to manage allocations to control risk and return will be larger.

The Evolution of Multi-Sector Allocation Strategies

What is a multi-sector allocation strategy? Essentially, it is an approach where clients enable managers to create portfolios that seek to achieve an attractive total return by investing in all sectors of the fixed income market (investment grade, high yield, emerging markets debt, loans, securitized, etc.). These strategies are most effective, in our view, when asset managers have very broad discretion to invest anywhere in the world of fixed income in pursuit of a client's investment objective.

The approach has evolved gradually over the past two decades. Traditionally, fixed income managers would manage their portfolios against various market benchmarks like 10-year Treasuries, using standard methods like overweighting or underweighting corporate bonds or using yield curve trades to try and outperform their benchmarks. This eventually led to the inclusion of non-benchmark assets in portfolios, and managers started asking clients to extend their mandates into specific "riskier" sectors, such as high yield bonds.

At first, this was a very modest expansion: a manager would limit the portfolio, devoting a maximum of perhaps 20% to less proven sectors. Based on our experience, as investors grew more comfortable with the portfolio's expansion, some of these guideline limits were relaxed. The maximum cap for "higher-risk" assets moved to being 40% or 50% of portfolios, and more and more asset classes became available. This leads us to today, when the latest generation of multi-sector allocation strategies are unconstrained. These strategies have entirely dispensed with the notion that a portfolio has to be anchored to traditional investment grade securities, or to any particular sector, for that matter.

Types of Current Strategies

There are a variety of multi-sector allocation strategies investors can pursue. For example, investment strategies can be benchmarked against LIBOR, traditional aggregate indices, blended benchmarks or adopt a targeted total return approach without a benchmark. In all cases, however, the building blocks of the strategies are fundamentally the same; the difference lies in how a manager brings them together.

The variety of names used to identify multi-sector allocation strategies can create a degree of confusion. Because managers can interpret these strategies in a number of different ways and can take strikingly different approaches, potential investors may feel overwhelmed by the choices they face. While there is no consensus on terminology, chart 5 describes Stone Harbor's multi-sector capabilities, as an example of how managers are approaching this broad opportunity set.

As investment grade credits have diminished and weakened, higher risk credits have strengthened and expanded

In addition, various multi-sector allocation approaches use a varying degree of asset allocation techniques:

- **Tactical sector allocation.** Markets have grown and matured relative to previous cycles, garnering broader acceptance. Return dispersion creates opportunities for managers to seek to add return through asset class and sector rotation strategies. The potential to add alpha through tactical asset allocation is demonstrated when looking at the wide range of sector returns experienced since 2000 (see chart 6).

  The intent of the tactical sector moves is to capture general market direction, rather than precisely timing market peaks and troughs. Series of incremental allocation changes may produce attractive levels of alpha while potentially avoiding significant transaction costs. The most effective approaches, in our view, implement tactical shifts through both cash markets as well as synthetically using index credit derivatives.

- **"Best ideas" approach.** Rather than creating a diversified portfolio, the manager selects a smaller number of concentrated positions in each sector. While we believe that there certainly are periods where "best ideas" can be effective, however, it is questionable whether such an approach is sustainable through a market cycle.

- **Core approach.** If a manager has a proven track record in a specific sector of the market, they may take an anchor-like position in the sector, which becomes a dominant part of the portfolio. This may work for clients who already have individual exposure to several fixed income sectors and look for a "completion" portfolio approach. Inevitably, in our opinion, this could lead to a "one dimensional" nature of the returns and exclude the significant potential return that may be generated from a dynamic asset allocation.

Chart 5 – Stone Harbor Multi-Sector Allocation Strategies

Strategy	Typical Benchmark	Target Excess Return (gross)	Tracking Error / Volatility	Asset Allocation Style
Core Plus	Global or Domestic, Aggregate / IG Indices	Approximately 100 bps	Tracking Error 2-3%	Max 20% allocation to non-benchmark risk assets
Multi-Sector Total Return	Global or Domestic, Aggregate / IG Indices, portable on to other benchmarks	150-200 bps or more	Tracking Error 3-6%	Extensive allocation to non-benchmark risk assets
Diversified Global Credit	Strategic benchmark of credit asset classes Examples: 33% HY/ 33% Loans/ 33% EMD or 33% IG / 33% HY / 33% EMD	Typical range from 100 bps – 300 bps depending on guidelines	Tracking Error 3-6%	Tactical allocation versus strategic weights
Libor Plus Total Return	3 Month Libor, multiple currencies	Typical range from 100 bps - 300 bps depending on guidelines	Volatility 4-8%	Duration constrained, broad credit market exposure
Multi-Asset Credit (MAC)	No benchmark	Expected total return of 5% - 8% per year	Volatility 8-10%	Unconstrained, broad credit market exposure

Source: Stone Harbor

The target excess returns listed in chart 5 are provided on a per annum basis, over a market cycle of 5-10 years, with the exception of the target expected return for the Multi-Asset Credit strategy, which is presented for the next 3-year period based on Stone Harbor's current view that the present positive market environment will persist. Such assumed 3-year market characteristics are not reflective of a typical market cycle of 5 to 10 years, which includes up and down periods. References to tracking error and performance objectives are targets and there is no guarantee that these expectations will be met. Targets should not be considered as an assurance or guarantee of performance of any investment strategy.

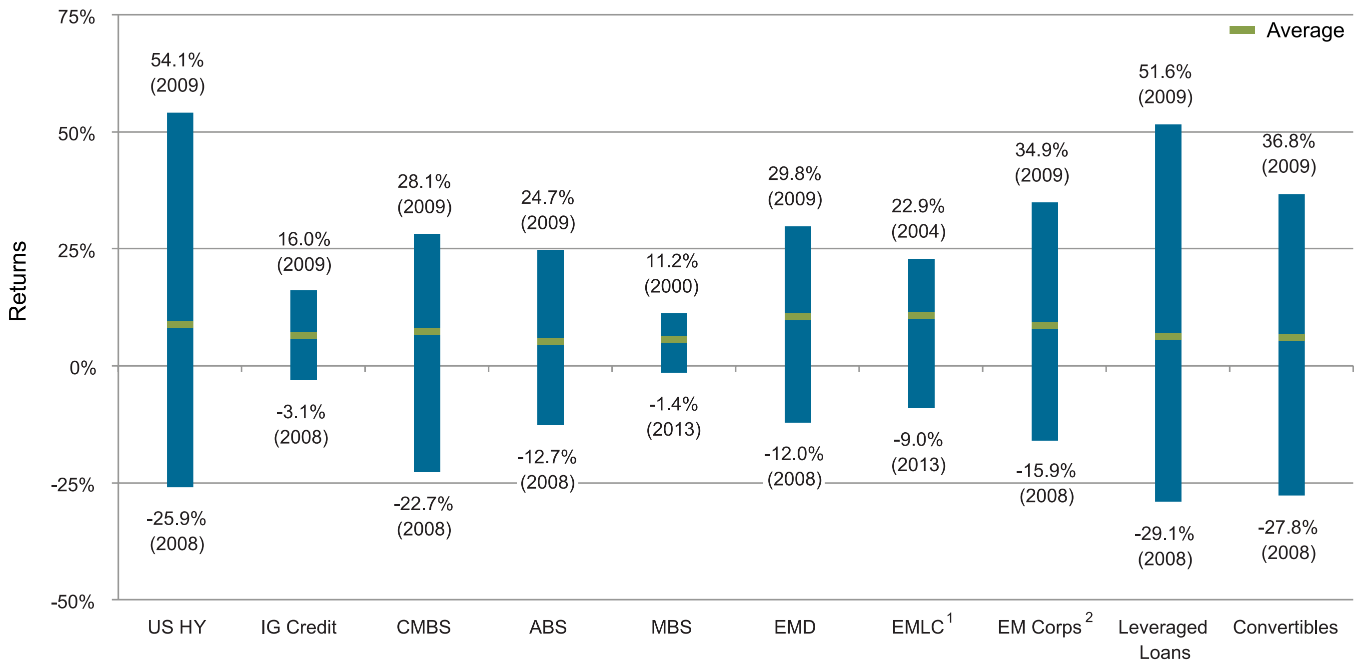
Regardless of which approach a client chooses, there is a common obstacle. In each case, investors may inadvertently hobble their multi-sector allocation strategy by asking the manager to exclude specific sectors. So, for example, if clients already have exposure to securitized assets in another portfolio, they may tell the manager to avoid them, regardless of how the sector is performing or what opportunities are available there.

Excluding sectors from the toolkit because of their current yield potential or because a client already has exposure to them could reduce a manager's ability to add value through asset allocation.

Seizing Opportunity in the New World

Both sovereign and corporate credit bonds now span across a much tighter range of credit rating profiles, with important implications for volatility, correlations and investment opportunities. This has also resulted in a higher correlation amongst fixed income credit sectors, making a segmentation of strategies less desirable in our view. An unconstrained multi-sector approach where a manager has the skills to tactically allocate across sectors, may better meet fixed income return objectives going forward.

Chart 6 – History of Best and Worst Calendar Year Index Returns (2000 – 2013)



1 EMLC begins 2003

2 EM Corps begins 2002

Past performance is not a guarantee of future results. For illustrative purposes only. Please refer to endnotes for source information and benchmark definitions.

Authors

***David Scott**, is a portfolio manager for our Multi-Sector Allocation strategies. He has 29 years of industry experience. Prior to joining Stone Harbor, David served as a Managing Director, Investment Policy Committee member and Head of the Traditional Investment Group responsible for the traditional bond product at Salomon Brothers Asset Management. Prior to his time with Salomon Brothers, he served as a Global Fixed Income Portfolio Manager at J.P. Morgan Investment Management. Earlier in his career, David served as a US Dollar Portfolio Manager at Mercury Asset Management and served as a Consultant Actuary for the Wyatt Company. He attained a BSc in Mathematics and Economics from Nottingham University, UK.*

***David Torchia**, is a portfolio manager for our Multi-Sector Allocation strategies. He has 28 years of industry experience. Prior to joining Stone Harbor, David served as Managing Director and Senior Portfolio Manager responsible for directing investment policy and strategy for all Investment Grade US Fixed Income Portfolios at Citigroup Asset Management. He served as an Investment Policy Committee Member at Salomon Brothers Asset Management and as a Manager of Structured Portfolios for the Bond Portfolio Analysis Group at Salomon Brothers Inc. David attained a BS in Industrial Engineering from the University of Pittsburgh and an MBA in Finance from Lehigh University.*

Endnotes

Indices referred to herein are broad-based securities market indices. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

Benchmark Definitions:

The Barclays Asset-Backed Securities (ABS) Index is made up of credit and charge card, auto loan, home equity loan, and stranded-cost utility subsectors. An issue included in the index must have a fixed-rate coupon structure, an average life greater than or equal to one year, and be part of a public deal.

The Barclays Commercial Mortgage-Backed (CMBS) Index has several components (investment grade, high yield, interest-only), but only ERISA-eligible securities with an original deal size of $500 million, current deal size of $300 million, and tranche size greater than $25 million from the investment-grade index contribute to the U.S. Aggregate Index. The CMBS Index family consists of four components: CMBS Investment-Grade Index, CMBS High-Yield Index, CMBS Interest-Only Index, and Commercial Conduit Whole Loan Index.

The Barclays EM USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set.

The Barclays Mortgage-Backed Securities (MBS) Index covers the mortgage-backed pass-through securities of Ginnie Mae, Fannie Mae, and Freddie Mac. The MBS is formed by grouping the universe of over 1,000,000 individual fixed rate MBS pools into approx. 5,500 generic aggregates. Each aggregate is a proxy for the outstanding pools for a given agency, program, issue year, and coupon. The index maturity and liquidity criteria are then applied to these aggregates to determine which qualify for inclusion in the index.

The Barclays U.S. Corporate Investment Grade Index consists of publicly issued U.S. corporate and specified foreign debentures that are registered with the Securities and Exchange Commission and meet specific maturity, liquidity, and quality requirements.

The Barclays U.S. Credit Index tracks publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. Qualifying bonds must be SEC-registered.

The Barclays U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The BofA Merrill Lynch Global 300 Convertible Master Index (VG00) consists of 300 convertible bonds from around the world. The bonds are chosen by the BofA ML Index group with the goal of maintaining a tradable index with a low turnover and good repatriation. The index aims to accurately represent the global convertible market, and is designed to be both objective and transparent. The members are selected from liquid convertibles that are over USD 50 Mn in size, making sure there is little to no duplication of underlying shares. Total returns are calculated daily and weighted by USD market value, so that smaller issues do not have an undue influence.

The BofA Merrill Lynch Global 300 Convertibles U.S. Index (VR10) is the North American sub index of the Global 300 Master Index and contains U.S. and Canadian issues.

The Citigroup High Yield Market Index (previously the Salomon Smith Barney High Yield Market Index) is a total rate-of-return index which captures the performance of below investment-grade debt issued by corporations domiciled in the United States or Canada. This index comprises Citigroup's broadest market measure and includes cash-pay and deferred-interest securities. All the bonds in the high-yield indices are publicly placed, have a fixed coupon and are non-convertible.

The Citigroup High Yield Market Capped Index represents a modified version of the High Yield Market Index by delaying the entry of fallen angel issues and capping the par value of individual issuers at U.S. $5 billion par amount outstanding.

The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the $US-denominated leveraged loan market. Loan facilities must be rated "5B" or lower, only fully-funded term loan facilities are included, the tenor must be at least one year and Issuers must be domiciled in developed countries; issuers from developing countries are excluded.

The J.P. Morgan CEMBI Broad Diversified limits the current face amount allocations of the bonds in the CEMBI Broad by constraining the total face amount outstanding for countries with larger debt stocks. Qualifying corporate bonds have a face amount greater than USD 300 million, maturity greater than 5 years, verifiable prices and cash flows, and from countries within Asia ex-Japan, Latin America, Eastern Europe, Middle East, and Africa.

The J.P. Morgan EMBI Global Diversified (EMBI Global Diversified) is a uniquely-weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global. The investment grade only index consists of countries rated investment grade using the higher of the two ratings between S&P and Moody's.

The J.P. Morgan GBI-EM Global Diversified consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. The weightings among the countries are more evenly distributed within this index.

Additional Index Information

Benchmark Returns Name	Benchmark Name	Source
U.S. High Yield	Citi HYM Capped	Bloomberg Ticker: SBHCMCAP
IG Credit	Barclays U.S. Credit Index	Barclays Live
CMBS	Barclays CMBS ERISA-Eligible Index	Barclays Live
ABS	Barclays Asset-Backed Securities (ABS) Index	Barclays Live
MBS	Barclays Mortgage Backed Securities (MBS) Index	Barclays Live
EMD	J.P. Morgan EMBI Global Diversified	Bloomberg Ticker: JPGCCOMP
EMLC	J.P. Morgan GBI-EM Global Diversified	Bloomberg Ticker: JGENVUUG
EM Corps	J.P. Morgan CEMBI Broad Diversified	Bloomberg Ticker: JBCDCOMP
Leveraged Loans	S&P/LSTA Leveraged Loan Index	S&P
Convertibles	Global 300 Convertible Index	Bloomberg Ticker: VG00

Stone Harbor
Investment Partners

New York

31 W. 52nd Street, 16th Fl
New York, NY 10019
+1 212 548 1200

London

48 Dover Street, 5th Fl
London, W1S 4FF
+44 20 3205 4100

Singapore

9 Temasek Boulevard
#09-03A Suntec Tower Two
Singapore 038989
+65 6671 9711

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