Payden&Rygel

AN INVESTMENT FOR UNCERTAIN TIMES:

The Benefits of an

Absolute Return Strategy

A Conversation with Payden & Rygel's Eric Souders

Summary:
The absolute return strategy offers a compelling profile. Yields are above 7%, while the average maturity of the strategy is only three years.*

Compared to a core bond strategy, the yield relative to the maturity profile is very attractive. In addition, the absolute return strategy generally has more diversification in addition to more decision-making flexibility versus a core bond strategy. Moreover, the volatility of the strategy tends to be materially lower than the equity market. Therefore, with a running yield of 7%+ and a much lower volatility profile, we also believe the strategy has a compelling profile versus equities, especially in a more challenging macro-economic environment.

Lastly, historic forward-looking returns of the strategy at this yield level suggest it takes a lot to erode a starting yield of 7%+, particularly in the front end of the yield curve.

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

Absolute return is a broad category with respect to the investment universe, manager style, and desired degree of return and volatility. On one end of the spectrum, there are conservative solutions resembling money market funds. These solutions generally offer a low degree of return and volatility, and high degree of liquidity. On the other end, some solutions aim for higher returns with a greater degree of volatility and a lower level of liquidity. The Payden Absolute Return strategy positions itself in the middle of this spectrum.

Formed over 15 years ago in partnership with a client, Payden's Absolute Return Strategy focuses on two main objectives: preserving capital over shorter-term periods, such as 18 months, and achieving reasonable returns relative to cash over medium to longer-term periods, like 3-5 years.

Please refer to the end for important disclosures

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

The main distinction between a core bond strategy and an absolute return or multi-asset credit strategy is the benchmark. As a core bond manager, you must account for benchmark exposure and characteristics, or what we describe as common factor risks. Deviation from benchmark exposures results in tracking error, necessitating consideration of these risks.

An absolute return strategy or a multi-asset credit strategy like ours doesn't rely on a benchmark. Our starting point is cash. We have an investible universe and a return target but are otherwise unconstrained from adhering to a benchmark. Therefore, we don't have to import the common factor risks associated with a benchmark, such as duration, industry exposure, credit quality, etc. This provides a much greater degree of flexibility compared to a core bond strategy.

Importantly, although the strategy lacks a formal benchmark, it does have constraints. This includes limitations on interest rate duration, sector allocation, etc. These limitations are critical for risk management purposes as we seek to narrow the distribution of outcomes, particularly given the asymmetric nature of the bond market, which typically has less upside than downside.

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

As bond investors, particularly in credit, the typical best-case outcome is stable and consistent income with full return of principal at maturity. The worst-case outcome would be complete loss of principal. This contrasts sharply with equities, where on average the distribution of potential return is more balanced.

Therefore, as fixed income credit investors we believe the appropriate starting point is understanding potential downside risks and how that translates to protection of capital. The bond market provides some inherent features that help mitigate downside, particularly at the front end of the yield curve.

One of the main features of fixed income versus other markets, like equities, is legal final maturity. As fixed income securities approach maturity and prices "pull-to-par", price volatility generally declines, provided there is no default. This is crucial for credit investors, since reliance can be placed on credit analysis to help dampen return volatility for shorter maturity securities (2, 3, and 5 years), when compared to longer maturities (10, 20 and 30 years). A short maturity focus is a cornerstone of our absolute return strategy as it helps smooth returns over time.

Diversification across all sectors of public fixed income also plays a vital role, enabling a variety of different themes to be expressed. This diversification reduces our strategy's correlation to broader fixed income and equity markets. However, excessive diversification can be punitive. For example, over-diversifying in emerging markets can lead to exposure to all countries, including those with significant risks. It's about finding a balance to ensure sufficient diversification without overextending.

As credit investors, position sizing is also very important. Positions are sized based on conviction, while ensuring sound risk control, recognizing that we will get some things wrong over time.

Lastly, liquidity is critical. Market liquidity can become fractured during periods of volatility. Liquidity is especially important in actively managed multi-asset portfolios, allowing us to take advantage of opportunities when they arise.

What asset classes do you consider for your strategy?

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

The broad categories include government bonds, corporate credit, and securitized credit. In government bonds, the strategy invests in developed country government bonds as well as emerging market (or developing market) government bonds. Corporate credit encompasses investment grade and high-yield bonds, and bank loans. Securitized credit offers a wide range of opportunities, such as consumer and commercial asset backed securities (ABS), residential mortgage credit (RMBS), commercial mortgage credit (CMBS), and collateralized loan obligations (CLO).

We leverage Payden's broad expertise in these areas for our absolute return strategy.

What is a typical allocation to an absolute return strategy?

Most of our clients outside of the US are looking for a globally diversified multi-asset approach that can deliver consistent and repeatable returns over time. Therefore, this strategy often serves as a centerpiece within fixed income allocations but can also complement a fixed income strategy with higher credit risk or higher interest rate duration.

Is this a good environment for an absolute return strategy?

The Payden Absolute Return strategy has been around for more than 15 years, during which we have navigated periods of low and high rates, as well as significant credit spread volatility.

Because the strategy manages relative to cash and has latitude around decision making, interest rate fluctuations can be beneficial. Higher cash rates simply mean higher all-in yields, while increased volatility can create favorable opportunities in areas like credit.

We are likely entering or have already entered a new regime for financial markets, which will exhibit higher volatility in interest rates, inflation, and credit spreads for the foreseeable future. In this environment, we think it is beneficial to have more flexibility around asset allocation decisions, interest rate duration, and credit risk without being tethered to a benchmark. The ability to adapt without being constrained by a benchmark becomes increasingly advantageous in the face of greater uncertainty.

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

We prefer consumer-facing areas, particularly in the asset-backed securities market. Specifically, we think auto-related ABS is attractive. The car is one of the most coveted assets, if not the most coveted asset from a functional standpoint. Auto loans face the consumer. These loans are generally short-term in nature (5-7 years). The loan pool is diversified. All these ingredients give us more comfort in auto ABS when compared to areas with longer maturity loans that are more sensitive to interest rates and valuation

fluctuation, like Commercial Real Estate. With that said, although we are cautious on Commercial Real Estate more broadly, we do like certain parts of it, namely Industrial properties. Industrial properties, such as warehouse facilities, have been the beneficiary of transformational demand for real-time logistics. We don't expect this theme to abate anytime soon.

We also favor emerging market debt given EM central banks are generally cutting interest rates, growth remains above 4% (despite challenges in China), and inflation has declined to sustainable levels. Emerging markets offers a wide opportunity set with flexibility across regions, with nearly 80 different countries to choose from. Today, we prefer regions like Latin America, which benefit from resource rich economies and an incrementally important global trade footprint.

*as of 8/8/24

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Eric Souders, CFA

Director, Portfolio Strategist

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.