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Right now, it makes sense to sit on the credit fence

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Portfolio Construction **Forum**

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Uncertainty abounds

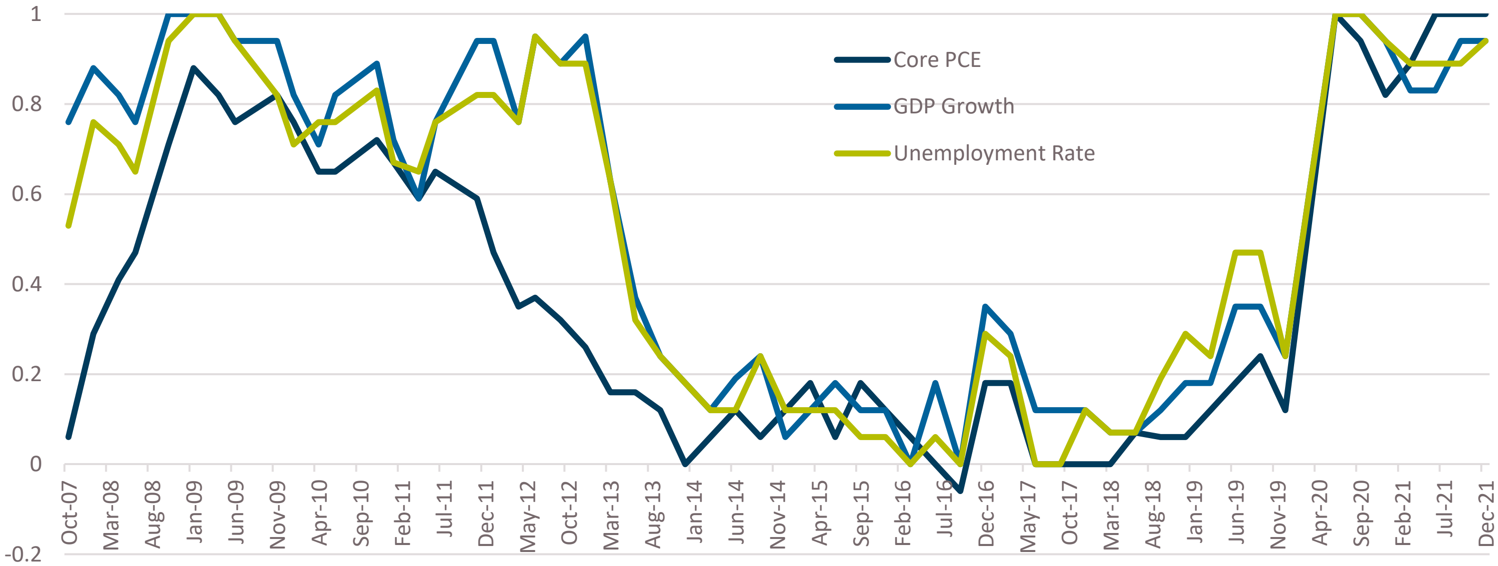
The things keeping me up at night

- COVID lockdowns
- Inflation outlook
- Fiscal tightening
- Chinese real estate markets
- Russia/Ukraine
- Quantitative tightening
- Tech valuations/regulations
- China/US relationship
- Crypto valuations
- Supply chains

Uncertainty abounds

Even the Federal Reserve confidence levels around forecasts are low

FOMC Uncertainty Indices

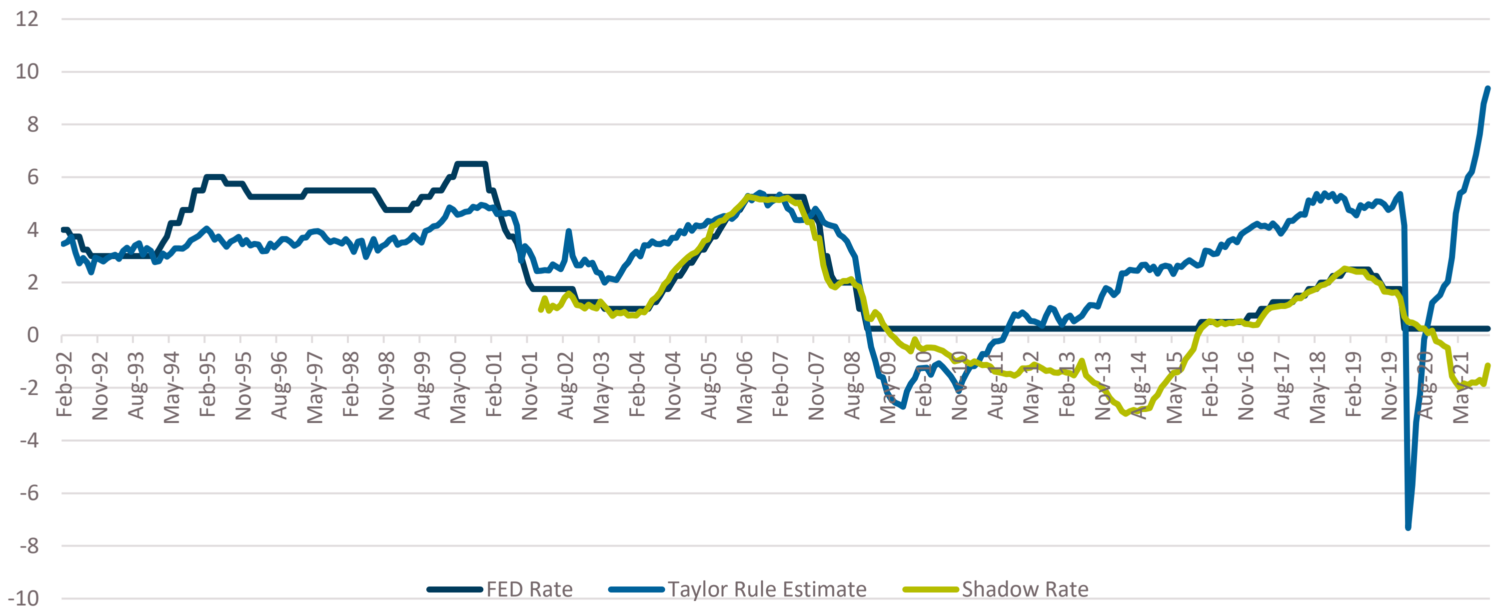


Source: Federal Reserve. FOMC Uncertainty indicators measure FOMC members confidence around key economic projections versus the last 20 years. A score of 1 indicates Higher Uncertainty.

High conviction in my lack of conviction

A battle between markets and central banks

The Taylor Rule is suggested the Fed is behind the curve



1. Source: Bloomberg. The Shadow Rate is the Wu-Xia Federal Funds Shadow Rate which adjusts the Federal Funds Rate for unconventional monetary policy

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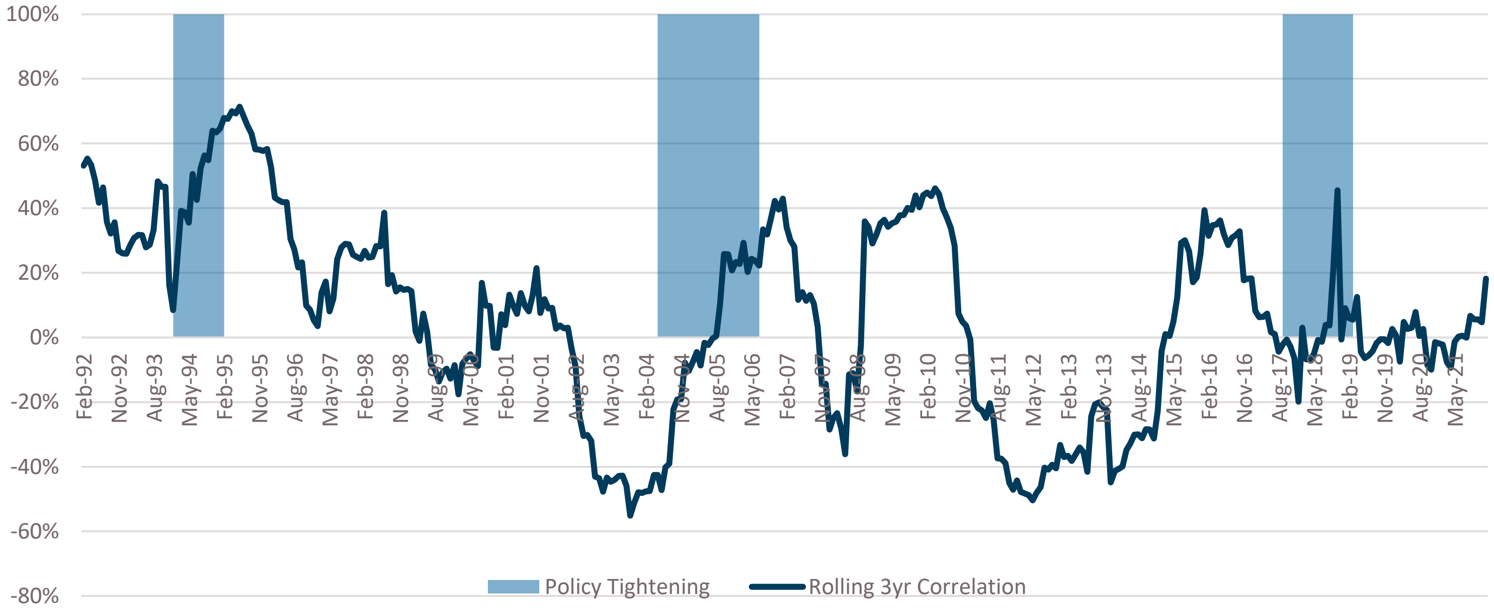
Correlation between rates and equities

How does quantitative tightening change the equation?

Rolling 24 month correlation between rates and equities



1. Source: Bloomberg. Correlation is measured between S&P 500 and ICE/BAML US Broad Market Index based on daily observations

What is the role of traditional fixed income

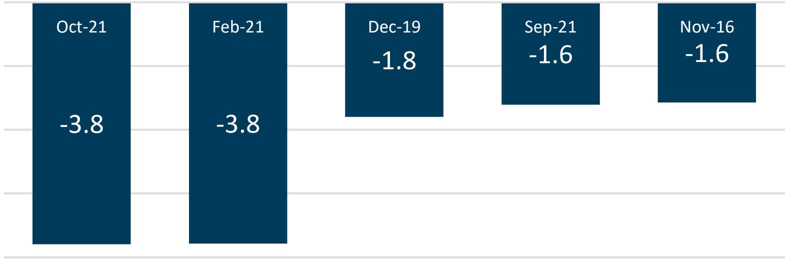
No income, capital at risk, questionable downside protection

Role of fixed income in balanced portfolios:

- Consistent Income
- Capital Preservation
- Downside protection

1. Income – Inflation Adjusted Yield to Maturity is Still Negative

2. Capital – 3 of the worst monthly drawdowns in the last 25 years were in 2021

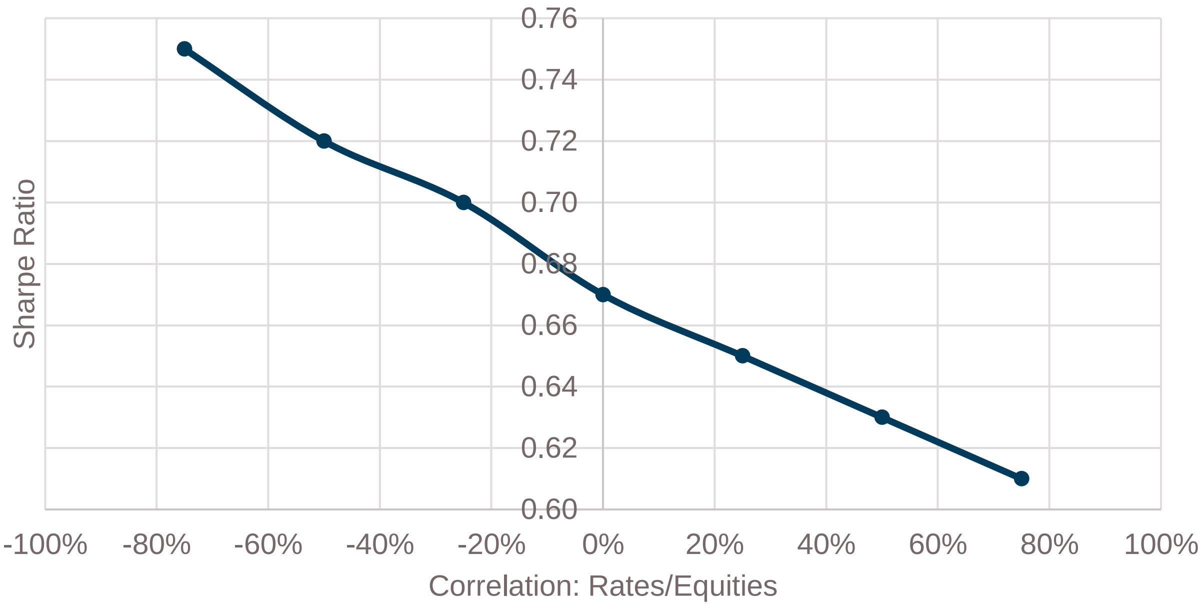


1. Source: Bloomberg. Chart shows the yield to maturity of the US 10yr real interest rate.
2. Source: ICE BAML indices, Bloomberg. Reference index is the Australian Broad Market index.

Correlation uncertainty

The choice of defence depends heavily on your view on the correlation between “offense” and “defense”

60/40 Portfolio Sharpe Ratios at different correlation assumptions



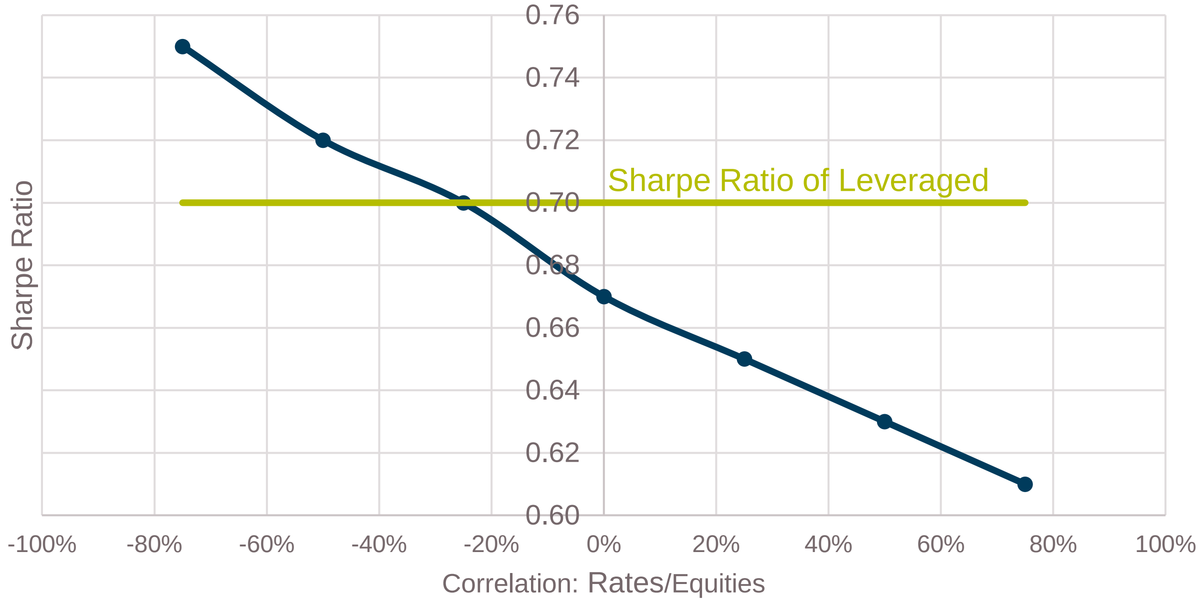
At a 10% volatility, moving from a -20% correlation assumption to a +20% assumption reduces expected returns by 0.50%

1. Source: CIPAM calculations. Analysis assumes a risk free rate of 0%, an equity return of 7.5% with 13% volatility and a rates return of 2.5% with 3% volatility.

Time to sit on the fence

Investing in credit allows investors to reduce exposure to the correlation question

Leveraged Loans can provide better outcomes at higher correlations



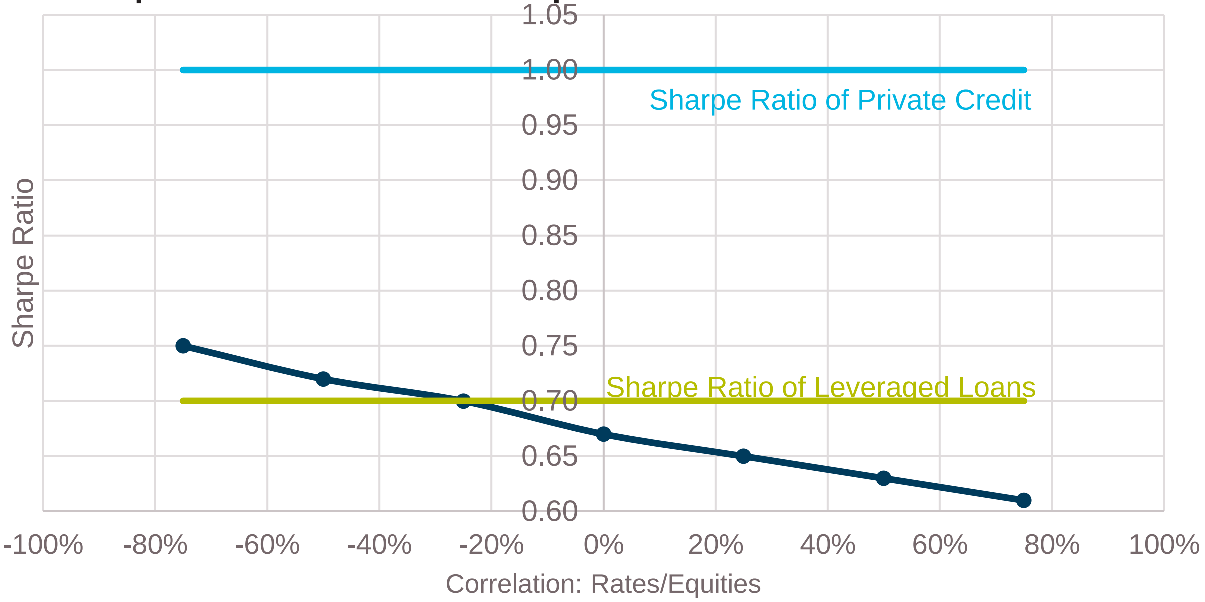
The higher the ultimate correlation outcome, the greater the attractiveness of credit as an asset

1. Source: CIPAM calculations. As previous slide. Leveraged Loans return of 4.3% and volatility of 6%.

Raising the fence

Harvesting illiquidity premia in private credit

A 2% Illiquidity Premium in Private Credit can further enhance returns allowing you to reduce exposure to the correlation question



For those with ability to take some illiquidity, private credit is even more compelling

The short tenors of private credit make expected volatility similar to leveraged loans of a comparable credit risk

1. Source: CIPAM calculations. As previous slide. Private Credit return of 6% with volatility of 6%.

Finally, a warning

- This is not about the numbers
- It's about the relativities
- Uncertainty is elevated
- Historical relationships may not hold
- What was a great defense in the past may not be in the future
- Sitting on the credit fence, and particularly private credit, can allow you to avoid betting on correlation

Next steps

Areas for further investigation

1. Read our research on how blending public and private credit can substitute for more traditional portfolio constructions:
    1. Part 1: https://www.cipam.com.au/public-and-private-perfecting-the-blend/
    2. Part 2: https://www.cipam.com.au/fixed-income-is-changing-and-blending-private-and-public-credit-makes-good-sense/

2. Public research on the 60/40 portfolio:
    1. https://www.bloomberg.com/news/articles/2021-12-07/inflation-is-the-biggest-threat-to-the-bedrock-60-40-portfolio
    2. https://www.afr.com/markets/equity-markets/the-60-40-portfolio-has-worst-loss-since-march-2020-on-fed-shift-20220201-p59sqa

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