Credit for diversification or diversification of credit?

The idea that diversifying assets can lead to a smoother investment experience isn't exactly an innovative thought. Rather, it's a fundamental principle, one that is absolute and regarded as gold in our industry.

As a result, considerable time and effort is put into building equity and fixed-income portfolios across various sectors, geographies, market caps, and maturities. When introducing credit to a broader asset allocation, does diversification across sources of credit get the same attention? It should.

During the zero-interest-rate-policy era, managers developed new products and strategies to cater to the appetite of yield-seeking investors. Now that rates are up, fixed income is once again viewed as a viable source of return, and investors are using it to mute some of their equity concentration risk. To that end, credit can be a diversifying source of returns, but the principles of diversification within a return-seeking credit strategy hold true. (See Correlation anxiety and the reality of diversification.)

Building portfolios with compensated risks.

The world is made up of compensated risks (equity, duration, credit, etc.), also referred to as risk premia. Well-built portfolios combine these premia in a thoughtful and diversified way. While most portfolios are thoughtfully diversified across their equity and duration buckets, investors often consider an allocation to high-yield bonds and/or emerging market debt as satisfactory for their return-seeking credit exposure. However, they tend to ignore other diversifying sources of credit, including floating rate instruments.

When building portfolios, SEI recommends allocating to a full suite of credit exposures, including structured products (CLOs, ABS, MBS), sovereign and emerging market debt, high yield, private credit, and even distressed debt hedge funds. We believe in diversification at every level, both across and within varying risk premia. CLOs and ABS hone in on credit risk, but because they are floating rate assets, they do not take on interest rate risk, so they become a good source of diversification for a credit portfolio. Both emerging and developed market debt take on country risk, which is different from corporate credit risk.

	Collateral Type	Fixed	Floating	Interest Rate Risk	Credit Risk	Country Risk
CLO	Public and private secured loans backed by specific corporate assets		x		x	
ABS / MBS	Diversified assets—mortgages, auto, credit cards, etc.	x	x	x	x	
Direct Lending	Private loans backed by private corporate assets		x		x	
Distressed	Public or private loans or bonds, typically unsecured by specific assets		x		x	
High Yield	Corporate bonds, typically unsecured by specific assets	x		x	x	
EM Debt	Corporate and sovereign debt in developing economies	x		x	x	x

Consider the correlation matrix below. While the diversifying sources of credit are positively correlated, none is perfectly correlated (100%). Each can contribute to dampening volatility from these higher-returning flavors of credit.

- Exposure to junior CLO tranches can put up long-term returns comparable to stocks but carry only a 44% correlation to the S&P 500.
- Exposure to the bottom of the CLO capital stack also diversifies a return-seeking credit portfolio with only 53% correlation to EM Debt and 46% correlation to Non-U.S. IG Corporates. Many are looking for access to Direct Lending, which has produced an average monthly return of 1%, but that high return comes with a 5.6% monthly standard deviation.
- Structured Credit (CLOs, ABS, and MBS) can mitigate some of that high volatility without materially impacting the return potential of a return-seeking credit exposure like Direct Lending.

Correlations	CLO BB	ABS / MBS	High Yield	EM Debt	Distressed	Direct Lending	Non-U.S. IG Corp	S&P 500	MSCI ACWI	BBG Agg
CLO BB	100%	71%	65%	53%	77%	69%	46%	44%	51%	13%
ABS / MBS	71%	100%	64%	57%	65%	56%	70%	38%	43%	49%
High Yield	65%	64%	100%	78%	75%	77%	76%	78%	83%	49%
EM Debt	53%	57%	78%	100%	55%	56%	66%	62%	74%	58%
Distressed	77%	65%	75%	55%	100%	78%	49%	60%	66%	10%
Direct Lending	69%	56%	77%	56%	78%	100%	55%	76%	77%	18%
Non-U.S. IG Corp	46%	70%	76%	66%	49%	55%	100%	58%	60%	74%
S&P 500	44%	38%	78%	62%	60%	76%	58%	100%	97%	34%
MSCI ACWI	51%	43%	83%	74%	66%	77%	60%	97%	100%	38%
BBG Agg	13%	49%	49%	58%	10%	18%	74%	34%	38%	100%

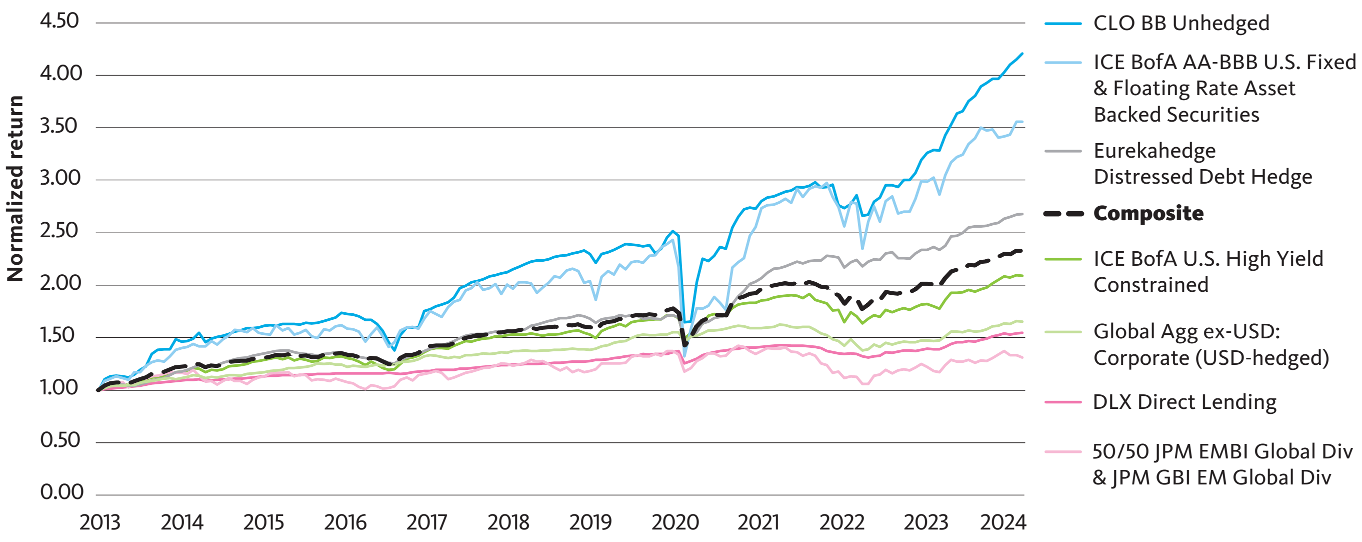
Source: SEI research. As of December 31, 2024. See strategy descriptions at the end of this paper.

Diversification within and across asset classes

Our process for building diversified credit portfolios considers not only the other exposures within the credit bucket, but also the risks across all of a client's assets, creating a robust total portfolio with potentially lower drawdowns and higher risk-adjusted returns. We believe this total portfolio lens helps ensure that.

The chart below shows normalized returns for the components of a diversified credit strategy, as well as an equal weighted composite. The composite has a monthly standard deviation of 2.3% versus average standard deviation of 2.7% for the seven component parts. By combining multiple credit categories, we can lower overall volatility for the strategy, thus delivering a more efficient source of returns over the long run.

Diversified credit composite



Source: SEI research. Data as of 12/31/24. Composite represents an equal weighting of all strategy returns shown.

Could diversified credit benefit your portfolio?

Help improve your total portfolio risk profile

Portfolios and allocations to diversified sources of credit exposure should offer superior long-term, risk-adjusted returns when compared to portfolios with more concentrated allocations. A diversified credit strategy can help you reduce risk, generate stable income, and smooth overall portfolio performance across various market environments.

A strategy designed for your needs

We have worked with organizations like yours to tailor strategies that:

- Diversify across credit exposures to help reduce the overall volatility of your portfolio.
- Optimize allocations to target specific returns while potentially minimizing risk.
- Provide liquidity and flexibility through customized credit solutions that fit your organization's unique needs.

Our credit experts design and build your custom strategy in a model that is simple to implement. In one custom strategy, you can achieve desired exposure across the credit spectrum with diversification to specialist managers of your choice in each area.

Sophistication without complexity

You can also benefit from integrated reporting, improved governance/monitoring, and ease of operations. With over $1.6 trillion in assets under management, administration, and advisement,[1] SEI is a leading provider of investment strategies. We can deliver those strategies in the best wrapper to fit your needs, providing more customization without the complexity—and at a potentially lower cost.

Let's build a more resilient portfolio together.

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A diversified credit strategy offers one potential solution to mitigate risks, generate income, and reduce reliance on equities. By expanding your horizon and asking these difficult questions, you can build a more resilient portfolio.

To learn more about custom diversified credit strategy and see examples of how our experts have helped organizations like yours optimize their portfolio and save time and resources, contact:

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CLO BB represented by the CLOIE BB Index. Distressed is represented by Eurekahedge Distressed Debt Hedge Index. ABS / MBS is represented by ICE BofA AA-BBB U.S. Fixed & Floating Rate Asset Backed Securities Index. Direct Lending is represented by DLX Direct Lending Index TR. High Yield is represented by ICE BofA U.S. High Yield Constrained Index. BBG Agg is represented by Bloomberg U.S. Aggregate Bond Index. EM Debt is represented by 50/50 JPM EMBI Global Div & JPM GBI EM Global Div. MSCI ACWI is represented by MSCI ACWI (NR, USD). Non-U.S. IG Corp is represented by Global Agg ex-USD: Corporate (USD-hedged).

[1]As of December 31, 2024. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities. This information is for educational purposes only and should not be interpreted as legal opinion or advice.

Diversification may not protect against market risk. There is no assurance the goals of the strategies discussed will be met. There are risks involved with investing, including loss of principal.

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