Investing in Unconstrained Fixed Income Strategies

Executive Summary

Q4 2016

Investment consultants continue to support the inclusion of fixed income assets as part of a well-diversified portfolio. Traditionally, fixed income strategies have used market capitalisation-weighted, investment grade indices as benchmarks. The volatility of these strategies has always been highly correlated with the underlying index with the result that their performance has been largely determined by the characteristics of the index (i.e. their beta was close to 1). Under this approach it is critical that investors' choice of benchmark reflects their ideal mix of market exposures. Since the credit crisis and the subsequent fall in yields many investors are questioning whether traditional indices meet their requirements.

Low yields suggest low future returns and hold the potential for negative returns if yields rise unexpectedly. This, together with the search for alpha, has seen investors allocating to unconstrained fixed income products to complement either their traditional index based products, or liability-matching solutions. This less constrained approach offers more diverse sources of return and, by allowing the manager greater freedom to diverge from the index, may overcome some of the weaknesses of traditional market capitalisation weighted indices.

In response the investment management industry has been quick to offer new fixed income products, but, as yet, there is no settled description of what constitutes an "'unconstrained" bond product. Unconstrained fixed income products come in many guises and are described variously as multi-sector fixed income, absolute return, total return, strategic bond, multi-asset credit and other, more niche, strategies involving asset-backed securities and forms of illiquid credit. These products may all be unconstrained, but they have little else in common and the investment processes tend to be manager-specific. Understanding the key characteristics of these different products and how they are implemented is arguably more important than their categorisation as "unconstrained".

We think that classifications of unconstrained fixed income products may be unhelpful, and can mask considerable diversity between risk and return profiles and sources of absolute and relative returns. We believe the best approach for investors looking to allocate to unconstrained fixed income is to work closely with the asset manager to implement strategies that accord with their specific expectations and objectives, rather than to buy an off-the-shelf product.

> "The classifications of fixed income products are uninformative."

Fixed income presents investors with new opportunities

Central banks use of quantitative easing and negative policy rates has influenced the performance of markets since the Global Financial Crisis. In bond markets this has inflated the price of sovereign debt, lowered yields and rekindled issuance in the corporate debt markets. This environment has been especially favourable for fixed income markets, helping to sustain a 30+ year bond bull market, and has seen traditional fixed income products deliver positive total returns.

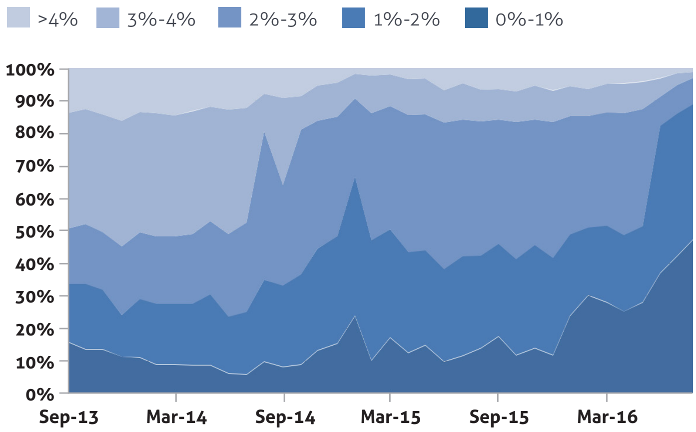
Institutional investors typically use fixed income strategies either as an alternative to equities or for liability matching. Bond indices have played a critical role in effecting these asset allocation decisions, as they have provided investors with a proxy for the risk and return characteristics of the underlying bond asset classes. Examples of these indices include the FTSE Actuaries UK Gilts or JP Morgan Bond indices, which are market capitalisation-weighted, investment grade indices. By selecting one of these indices as a benchmark the investor is setting the starting point for managers to take active positions reflecting their views on relative value in bond markets. This approach, together with the investment constraints found in traditional products, means that the investors' choice of benchmark may dominate portfolio returns, and the chosen benchmark may have exposures that do not reflect the investors' ideal mix.

There is an increasing appetite for global fixed income products among our client base. However, popular global bond indices, such as the Barclays Global Aggregate Index[1] which tracks US$47.3tn of investment grade debt, for all their scale and breadth still suffer from the shortcomings of market capitalisation weighted indices. Yields have fallen since the Global Financial Crisis and Figure 1 shows an example of not only the increase in the proportion of low yielding bonds, but also the narrow range of yields available: 80% of UK bonds now yield less than 2%. Globally, government bonds with a combined value of US$7.1tn are now trading with negative yields. More than 25% of securities in the Barclays Global Aggregate Index are yielding less than zero (Figure 2). Sovereign yield curves in Germany, Switzerland and Japan are now negative out to 14, 30 and 12 years respectively.

While the Barclays Global Aggregate benchmark is allocated across 41 different countries and 24 different currencies, the debt issued in three major currencies dominates: US dollars (45%), euros (24%) and Japanese yen (16%). In addition, the duration of this benchmark increased to a record of 6.8 years in April from around 5.3 years pre-crisis. Bond benchmarks with greater duration contain more exposure to losses from rising interest rates – and to gains from further falls. Although global monetary policy remains easy, interest rates seem certain to rise at some point and, if unexpected, will lead to losses in benchmark-orientated allocations.

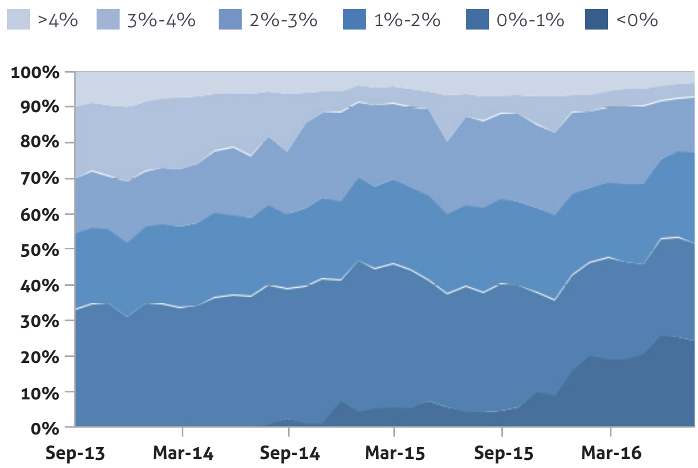
[1] The Barclays Global Aggregate Index tracks high-quality segments of the debt market such as, sovereign, corporate, agency and mortgage backed securities from both developed and emerging markets.

Figure 1: GBP bonds by yield



Source: Cameron Hume CaTo Analytics

Figure 2: Barclays Global Aggregate Yield Distribution



Source: Cameron Hume CaTo Analytics

Investors are allocating to a wide range of strategies

Low yields and the potential for negative returns if yields rise unexpectedly have encouraged investors to allocate to unconstrained fixed income products as a complement either to their traditional index based products, or to their liability-matching solutions. An unconstrained product allows the manager significant flexibility with regards to managing currency, credit and rates exposures and to take off- index positions in order to meet a client's particular return objectives. This less constrained approach offers more diverse sources of return and, by allowing the manager greater freedom to diverge from the index, may overcome some of the weaknesses of traditional market capitalisation weighted indices. Unconstrained fixed income products come in many guises and are described variously as multi-sector fixed income, absolute return, total return, strategic bond, multi-asset credit and other, more niche, strategies involving asset-backed securities and forms of illiquid credit. These products may all be unconstrained, but the distinctions between them are not always clear. However, unconstrained fixed income products do share a number of common attributes:

1. a return pattern that is distinct from that of traditional fixed income benchmarks;
2. the ability to invest in a global opportunity set, with greater freedom of investment permissions to take advantage of various market environments;
3. the aim to provide a diversified set of uncorrelated risk exposures in curve, currency, inflation, credit, and sectors which can be precisely hedged using derivatives to potentially enhance returns and manage portfolio volatility;
4. an investment horizon that may be longer term or favour particular asset classes; and
5. a greater reliance on manager skill and less dependence of the total return on the overall direction of fixed income markets.

Investment consultants have introduced their own classifications for the various unconstrained fixed income products to simplify the assessment and selection of managers. The risk and return profiles and investment processes within these classifications vary greatly. Table 1 compares some general features of a traditional investment grade strategy with global multi-sector and absolute return vehicles.

Table 1: Comparison of Strategies

Characteristic	Global Multi-Sector	Absolute Return	Benchmark Orientated
Benchmark	Bond Index, Libor or other custom indices	Libor or similar	Bond Index
Return Objective	Target return based on volatility profile or Benchmark+100bps to Benchmark+300bps	Typically ranges from Libor+100bps to Libor+600bps	Typically ranges from Benchmark+50bps to Benchmark+200bps
Source of Return	Strategic beta, sector-rotation and alpha strategies	Tactical beta, sector-rotation and alpha strategies	Benchmark + alpha strategies
Volatility Profile	Ranges from 400bps to 1000bps	Generally 200bps to 600bps	Similar to underlying index
Duration Profile	-2 to 8 years	-6 to 8 years	Benchmark +/- 2 years
Derivatives Usage	Medium	Medium to High	Low to Medium

The eVestment global unconstrained fixed income universe has grown from around US$92bn in 2009 to close to US$500bn by the end of 2015, invested across 125 different manager products. With the proliferation of unconstrained fixed income products there is little consistency in the way these products are categorised producing confusion among investors, and muddling the process of assessing and selecting managers. These products may all be unconstrained, but they have little else in common and the investment processes tend to be manager-specific. Understanding how these different products are managed and their key characteristics is more important than selecting them on the basis of their category.

Strategies should reflect specific objectives

Cameron Hume's approach is to target a return over our clients' chosen benchmarks, which could be any high quality bond index, Libor, a liability profile or other custom benchmark. We aim to meet our clients' return objectives with an overlay of our active strategies. Our active strategies have no strategic beta allocations; we seek to diversify across currency, rates, credit and inflation and our positions are focused on specific opportunities. Examples of our positions include views within a single-country yield curve or between yield curves in two currencies.

Some investment consultants classify our approach as idiosyncratic relative value, which is a style of absolute return fixed income. However, our investment approach has also been variously classified as global multi-sector fixed income, global unconstrained and global broad bonds in different manager databases. When we compare the characteristics of an example targeted return approach, as detailed in the table 2 below, it is understandable why our approach is considered as both multi-sector and absolute return. If our example client had chosen a Libor benchmark for instance our active strategy would likely be included in the absolute return universe in the manager databases.

Table 2: Example Cameron Hume Strategy

Characteristic	Cameron Hume Targeted Return
Benchmark	Barclays Global Aggregate (unhedged)
Return Objective	Benchmark + 200bps
Source of Return	Alpha strategies – currency, rates, credit & inflation
Volatility Profile	Maximum 600bps
Duration Profile	-2 to +2
Derivatives Usage	Medium

We think that classifications of unconstrained fixed income products may be unhelpful, and can mask considerable diversity between risk and return profiles and sources of absolute and relative returns. For us, the defining characteristic of the example portfolio we present above is that it aims to meet our client's investment objectives. We believe the best approach for investors looking to allocate to unconstrained fixed income is to work closely with their asset managers and implement a strategy in accordance with their specific objectives, rather than to buy an off- the-shelf product.

Contact

Keith Logan
keith.logan@cameronhume.com
T +44 (0) 131 603 6988
M +44 (0) 7860 925 131

Author

Keith Logan is Client Relationship Manager at Edinburgh-based fixed income specialist Cameron Hume Limited

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