HEALTH WEALTH CAREER

THE LANDSCAPE OF BENCHMARK-AGNOSTIC FIXED INCOME STRATEGIES

INTRODUCTION

Over the last decade the number and different types of fixed income investment strategies available to investors have increased significantly. This proliferation has been particularly focused on strategies that are "benchmark-agnostic" and therefore unconstrained in nature, as opposed to traditional "benchmark-relative" strategies, which are measured against a specific bond market index.

We have been supportive of this trend and have argued that a number of flaws are associated with benchmark-relative fixed income investment, including:

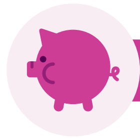
- A structural decrease in aggregate yield in combination with an increase in the interest rate risk (duration) inherent in fixed income benchmarks
- Concentration risk in specific countries, issuers or sectors, therefore resulting in suboptimal diversification
- Structurally higher allocations toward the most indebted entities
- Arbitrary index construction rules, which can result in unnecessary trading and opportunity cost — for example, selling bonds with less than one year of maturity, or bonds downgraded below investment grade
- Tracking-error-constrained investment approaches that limit the ability to allocate to the best risk-adjusted return ideas, and also limit the ability to be opportunistic in off-benchmark securities
- Likelihood of a lower level of alignment between investors' strategic objectives and the outcomes of benchmark-relative investment approaches than for less constrained "outcome-oriented" approaches

However, when it comes to selecting the right strategy type to fit an investor's objectives and overall asset allocation, the myriad opportunity set can prove to be confusing. Mercer has created investment strategy categories or "universes" to help rationalize the expanded opportunity set. However, some of these universes may have overlap with others, and the boundaries between them can become blurred at times. Nevertheless, we have found that this type of categorization has helped investors ascertain how different strategies can fit together to achieve their various objectives. The intention of this paper is to provide a brief overview of the different benchmark-agnostic fixed income strategies that have emerged over the last decade and to review how these strategies might be used in the context of an investor's broader portfolio.

BUY AND MAINTAIN CREDIT

WHAT IS IT?

Buy and Maintain Credit refers to portfolios of predominantly investment grade corporate bonds that an asset manager believes to be “money-good,” and therefore are held to harvest the credit risk premium. Investors are able to gain diversified access to the credit risk premium at a relatively low cost while reducing the inherent biases of traditional credit benchmarks.



WHY INVEST?

We believe that investors with holdings in an active investment grade credit portfolio should consider moving their portfolio to a Buy and Maintain type of approach. Our analysis has noted that an asset manager’s ability to add value within a pure investment grade credit mandate has deteriorated since the global financial crisis. Increased regulation of the banking sector has reduced liquidity and led to fewer “alpha” opportunities, net of transaction costs. In addition, our analysis has shown that traditional active credit managers have added value by either increasing risk (building a portfolio of lower-rated credits) or investing in off-benchmark assets. Either method may increase the strategy’s correlation with other parts of an investor’s portfolio

Investors with passive holdings of investment grade credit could also benefit from switching to a Buy and Maintain approach, given the arbitrary rules that govern bond indices. For example, giving portfolio managers the ability to hold onto bonds downgraded to sub-investment grade status (“fallen angels”) can help increase returns without a material increase in risk.

Buy and Maintain Credit portfolios can also be tailored to meet the requirements of individual investors, whereas benchmark-relative mandates are held hostage to the frequent changes in benchmark characteristics.

ASSET MANAGER APPROACHES

In general, we believe that active asset managers who are good at conducting fundamental credit research and who understand the nuances of Buy and Maintain portfolio construction are well-placed to manage these portfolios.

Although trading should be lower in comparison to a benchmark-relative approach, thereby reducing transaction costs, this approach is not “buy and hold.” Asset managers should actively sell and replace bonds that they believe are at risk of default or a downgrade with potentially severe price implications. Furthermore, some asset managers may choose to sell bonds that have become excessively overvalued, replacing them with credits offering better value, and some managers may tilt the portfolio marginally toward preferred sectors. Given their nature, most of the added value is achieved in the initial implementation of the portfolio, with underlying assets monitored on an ongoing basis from that point forward.

We caution investors that this approach still remains uncommon in North America. Identifying managers to implement this approach in Canada or the US will be difficult, and will require the creation of customized segregated portfolios.

PERFORMANCE MEASUREMENT

There is typically no reference benchmark, and different portfolios may have considerably varying duration profiles. However, over time these portfolios should achieve returns in line with investment grade benchmark indices, adjusted for duration, and with greater tail-risk protection. In practice, the benefits of this type of approach will be most acutely felt over longer periods, or following severe risk-off events — for example, where one or two large credit sectors have borne the brunt of a sell-off.

ABSOLUTE RETURN FIXED INCOME

WHAT IS IT?

Absolute Return Fixed Income (ARFI) strategies invest in a variety of global fixed income assets in a dynamic manner, with the aim of generating positive returns above cash rather than a traditional fixed income market benchmark. This return is dependent predominantly on manager skill — that is, “alpha” — as opposed to structural market exposures — that is, “beta.” Portfolios might include government, corporate and/or emerging markets bonds, as well as currencies, and many will use derivatives extensively to generate short exposures as well as long. A typical return target is 2%–4% per annum over the prevailing cash rate; however, a primary objective will also be preservation of capital.

WHY INVEST?

Given the low level of prevailing yields in many fixed income markets, the distribution of returns is likely to be skewed more toward the lower end of the historical spectrum. The interest rate risk (duration) inherent in bond benchmarks has also increased, meaning that a smaller rise in yields would result in a larger capital loss to benchmark-oriented strategies. We continue to believe that tilting portfolios from “beta” to “alpha” makes sense from a forward-looking return perspective.

We also believe that ARFI strategies can offer a number of advantages from a portfolio construction point of view. For example, ARFI strategies in general have relatively low correlations with other portfolio exposures, such as equities or growth fixed income assets, making them a useful diversifier. Also, in an environment where many traditional asset classes look expensive, the value of liquid capital, which can be accessed at short notice, increases (“optionality”). This makes ARFI strategies a useful portfolio construction tool, given their liquid nature, as a potential “dry powder” allocation.

ASSET MANAGER APPROACHES

Some strategies make use of a low volatility income component to form a core of the portfolio. This tends to be higher quality, shorter duration and focused on harvesting the credit risk premium. Other strategies are more directional in nature, allocating to the most attractive bond asset classes or currencies over a short-to-medium-term timeframe. Many asset managers also make use of relative value trades, which are intended to have a lower degree of market directionality. These trades aim to exploit more idiosyncratic opportunities through offsetting long and short positions. Each of these approaches has advantages and drawbacks; however, in practice, no two strategies are the same and most strategies will incorporate elements of more than one approach. The variability in this universe is something that investors should consider when selecting an ARFI strategy and argues for manager diversification.

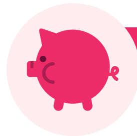
PERFORMANCE MEASUREMENT

Performance measurement is relatively straightforward, as managers have a clear mandate to deliver a positive return over cash, irrespective of the market environment, over short periods of time. There may be periods in which some strategies are better suited to meeting the upper end of a 2%–4% target range, and performance will depend on the approach used.

UNCONSTRAINED BONDS

WHAT ARE THEY?

Similar to ARFI strategies, Unconstrained Bond strategies also invest in a variety of global fixed income assets in a dynamic manner. Many strategies also target positive returns over a cash rate, as opposed to a benchmark index. However, in comparison to ARFI strategies, Unconstrained Bond portfolios have a greater tolerance for structural market exposures to different bond asset classes, such as government bonds, investment grade credit and, in some cases, high yield or emerging market debt (EMD). This has the potential to boost target returns to, say, 3%–5% per annum over the prevailing cash rate. However, this also diminishes the ability of an asset manager to prioritize capital preservation as a primary objective.



WHY INVEST?

Unconstrained Bond strategies give investors the flexibility to gain access to a broad set of fixed income betas and alphas, without the constraints and restrictions of a benchmark. Given the current environment, these strategies are likely to exhibit lower interest rate sensitivity than traditional benchmark-relative bond mandates. Returns are expected to be driven more by asset allocation and security selection than would be the case for traditional mandates. The strategies also tend to be liquid, and have the potential to provide exposure to asset classes that many would deem “off-benchmark,” such as high yield credit or EMD. We believe that increasing an asset manager’s flexibility in this manner, and allowing an opportunistic approach, can lead to better risk-adjusted return outcomes.

These types of strategies can also be seen as a variant of a “core plus” or “opportunistic” approach favored by many US-based investors. The major difference is a larger opportunity set and greater flexibility around a reference benchmark.

ASSET MANAGER APPROACHES

This universe contains a variety of approaches, as well as different risk and return objectives. Selecting a manager can therefore be very dependent on the type of asset class exposures desired. However, we would expect most unconstrained bond managers to have broad-based capabilities in the majority of underlying fixed income asset classes.

PERFORMANCE MEASUREMENT

Similar to ARFI strategies, performance can be measured versus a cash rate. However, given that Unconstrained Bond strategies introduce more structural bond market exposures, the broader market environment will have more of a bearing on the total return stream. Many funds would therefore quote a “reference index” as a further source of comparison.

MULTI-ASSET CREDIT

WHAT IS IT?

Multi-Asset Credit (MAC) strategies generally focus on the sub-investment grade sector of the credit market. They typically invest in a mix of bank loans, high yield bonds and securitized credit, with some strategies also investing in EMD, distressed debt and convertibles. Portfolios are typically long-biased but managed in an unconstrained manner, allowing the asset manager to take advantage of different asset classes across a cycle. Asset managers can therefore take advantage of beta rotation as well as issue selection. Although they can vary, generally return targets in the region of 4%–6% per annum over a cash benchmark are typical. However, returns will be somewhat dependent on the prevailing yield levels at the time of investment.

WHY INVEST?

MAC strategies offer investors access to sub-investment grade debt in a more diversified and better managed way than simply allocating directly to one or more particular asset classes. Although the underlying asset classes are correlated, the difference in returns from one year to the next can be quite large. By rotating across these different asset classes, managers can take advantage of these differences and both add value and protect capital in times of excessive valuations.

This strategy type should be considered by investors as part of their growth portfolio. Those with outright allocations to high yield or leveraged loans, for example, might consider a MAC approach as a means of achieving a better risk-adjusted return outcome. Investors considering de-risking or diversifying their growth portfolio — for example, if it is equity-heavy — might also consider MAC as a lower volatility source of return.

ASSET MANAGER APPROACHES

This universe of strategies is quite heterogeneous. For example, a number of asset managers are specialist credit houses and their strategies focus on bottom-up, “deep credit” analysis, with returns driven primarily from issue selection. Managers in this space look to take advantage of “under-loved” and therefore undervalued sectors and issuers.

Other asset managers provide a strategy that can be quite broad in terms of the range of asset classes covered, and these typically have more formal asset allocation processes. Such strategies tend to come from the larger, more established investment houses. Another grouping of asset managers are those that include EMD in their portfolios. Any potential investment should therefore consider potential overlap with other parts of the portfolio.

PERFORMANCE MEASUREMENT

Although most strategies have a return target over a cash rate, MAC strategies will be heavily dependent on the performance of sub-investment grade debt markets. They are certainly likely to underperform cash when credit markets materially sell-off.

Return targets will be more meaningful over longer periods, and we would expect MAC strategies to deliver high yield-like returns, but with lower volatility, over a full cycle. Over a shorter timeframe, performance should be looked at in the context of broader market movements — in which case, a blended benchmark of some form might give a better representation of how well a manager has performed.

EMD TOTAL RETURN

WHAT IS IT?

EMD Total Return strategies generally allocate across the spectrum of EMD securities in an unconstrained manner. The aim is to achieve returns broadly consistent with EMD markets (including local currency, hard currency and corporate debt) but with lower volatility. Some approaches have the flexibility to use derivatives or to raise levels of cash in portfolios to manage downside risks.

WHY INVEST?

Investors seeking to gain access to EMD with a lower risk/volatility tolerance than might be associated with a traditional EMD mandate may consider this type of strategy. A total return approach is also more likely to suit an investor with a shorter-term investment horizon.

Total return EMD managers adopt a more holistic outcome-driven approach than a benchmark-relative approach to investing. This leaves them free to select their highest conviction ideas, typically from the full spectrum of emerging market fixed-income opportunities. Some may also access less traditional areas, such as local currency corporates and frontier markets.

EMD benchmarks are particularly flawed, given their high weightings to certain larger countries. Given the idiosyncratic nature of these assets, performance can sometimes be driven by positive or negative sentiment surrounding geopolitical events. A total return approach will allow the manager greater flexibility to invest or ignore benchmark weightings.

ASSET MANAGER APPROACHES

The degree of focus on each of the main sub-asset classes will vary among managers, depending on their areas of expertise.

One of the key features of total return strategies is that asset managers can tilt their portfolios dynamically to reflect their best ideas regardless of any particular market benchmark. As a result, the return profile should be driven more by "alpha" and less by "beta" than a traditional EMD mandate. In addition, some managers may invest in developed market bonds and currencies to reduce the overall volatility of the fund in times of stress.

PERFORMANCE MEASUREMENT

Like MAC, these strategies tend to generate the highest returns, compared to cash, when the underlying market is performing well. The opposite would also apply; however, in this instance, a total return fund should outperform a blended benchmark, given a modest focus on capital preservation.

Therefore, although the target return of 5%–7% over cash should apply over longer periods, in the interim a blended benchmark comparison, consisting of hard and local currency sovereign debt, and/or corporate debt, could be used for comparison.

SECURED FINANCE

WHAT IS IT?

Secured Finance strategies are focused on delivering a series of secure and stable cash-flows. Typical return targets vary in the range of 2.5%–6% per annum over a cash benchmark, and most strategies have an emphasis on income, as opposed to capital appreciation.

Typically, investments have some form of underlying collateral backing them and might include, but are not limited to, asset-backed securities, collateralized loan obligations, leveraged loans, direct lending/private debt, real estate debt, infrastructure debt, trade finance/receivables or high lease to value property.

WHY INVEST?

This strategy type might be considered by investors who require a higher level of income than is achievable by an allocation to investment grade credit, yet who can tolerate illiquidity and/or complexity. It also might be well suited for pension funds, or similar asset owners, who are cash-flow negative. Although credit risk is still a driver, factors such as illiquidity and complexity provide diversification from other return drivers.

Secured finance portfolios can be considered for cash-flow-matching purposes — in particular, in a multi-asset format, with the ability to tailor to suit bespoke requirements. Many of the asset classes and sub-asset classes accessed will also be floating-rate, and therefore have low interest rate sensitivity, which may be desirable.

Investors should consider potential overlap with other asset classes in their portfolio, such as private debt or real estate debt. These strategies should also be considered with a longer-term horizon in mind, given lower levels of liquidity.

ASSET MANAGER APPROACHES

This universe of strategies is very heterogeneous. Multi-asset portfolios will allocate across a range of debt securities, which have a form of collateral backing or secured cash flow, depending on an asset manager's skillset.

Some investors may also look to allocate to some of these asset classes on a dedicated single-asset-class basis. Multi-asset strategy variations can, however, take advantage of niche or temporary opportunities as well as relieve the governance burden associated with some of the less liquid parts of the market.

Somewhat similar to Buy and Maintain, multi-asset Secured Finance strategies are scarce in North America. North American investors may be limited to single asset class strategies or perhaps considering overseas strategies with a foreign currency hedging overlay.

PERFORMANCE MEASUREMENT

Given the varied and complex nature of the underlying assets and the difference in return targets, performance measurement and peer comparison are difficult to achieve. Investors should therefore be clear about their risk and return objectives prior to allocating capital and judge a manager's performance on this basis.

We do recognize that for many of the individual asset classes, an investor is exposed to a form of beta, and therefore returns are not fully driven by "skill," However, performance measurement in these areas is also not necessarily straightforward, given the niche nature of some securities and the lack of comparable benchmarks.

SUMMARY

IN ESSENCE, THE STRATEGY TYPES DISCUSSED IN THIS PAPER MARK A MOVE AWAY FROM TRADITIONAL BENCHMARK-RELATIVE INVESTING. THEY ARE TYPICALLY MORE ALIGNED WITH INVESTOR OBJECTIVES AND ATTEMPT TO PROVIDE GREATER DIVERSIFICATION THAN BENCHMARK-RELATIVE MANDATES, WITH A FOCUS ON REDUCING DOWNSIDE RISK AND CAPITAL PRESERVATION.

We have believed for a long time that fixed income benchmarks are inherently flawed, and these types of strategy should reduce the tail risks associated with benchmark-relative investing. This is arguably all the more relevant given the impact that central bank policy has had on traditional fixed income assets. Investors should consider whether any of these strategy types might offer an improvement on existing benchmark-relative mandates or help meet their investment objectives across their broader portfolio.

For those investors seeking cash flows, investment grade credit has traditionally provided a reliable income stream. In this segment of the credit market, we advocate a Buy and Maintain approach due to the greater diversification by sector and issuer when compared against benchmark-relative mandates. The additional flexibility and reduced costs associated with this approach should also be a benefit to the end investor. However, given low yields and spread levels, some investors may find secured finance strategies of interest. These strategies can help to boost income levels while, at the same time, providing cash flows with a degree of security. In exchange for higher starting yields, investors will need to be able to tolerate higher levels of illiquidity and complexity.

For those considering the role that fixed income plays in their growth portfolio, we believe that MAC strategies are a superior way to access sub-investment grade markets, given their diversified and opportunistic nature. They can also be used to diversify existing equity market allocations, thereby reducing risk while maintaining a higher target return than can be found in traditional fixed income assets. Given the lower yield levels available in these asset classes currently, the added focus on capital preservation in several of these products adds an additional benefit to the end investor. We also believe that EMD markets can offer attractive risk-adjusted returns on a forward-looking basis, either on a standalone basis or as part of a diversified MAC portfolio. However, investors with a lower tolerance for volatility may find an EMD Total Return approach more attractive.

Some investors may look to allocate to ARFI or Unconstrained Bond strategies within their growth portfolio, or as part of a defensive fixed income allocation. These strategies are often hard to classify in either bucket due to their focus on manager skill. However, in our opinion, they are less likely to be considered a growth asset, given their focus on capital preservation. What they do provide in the context of an overall portfolio is a lower correlation to other asset classes. Given their typically high levels of liquidity, ARFI strategies can also act as a dry powder allocation in the absence of other attractive beta opportunities.

Investors should, of course, note any potential overlap between the risk exposures in their overall portfolio and the strategy types discussed earlier. In addition, investors will also need to consider issues such as liquidity, manager diversification and fees. The table on the next page outlines some of these high-level characteristics.

	RETURN TARGET/ YIELD[1]	VOLATILITY[1]	DOMINANT RETURN SOURCES	LIQUIDITY	CORRELATION ESTIMATE VERSUS EQUITIES[2]	INDICATIVE FEES[3]
Buy and Maintain Credit	1%–1.5% above duration return	Lower than investment grade credit benchmark, duration adjusted, over the long term	Credit spread	High	0.15	15 bps
Absolute Return Fixed Income	Cash + 2%–4%	2%–4%	Alpha, perhaps some investment grade credit beta	High	0.25	35 bps
Unconstrained Bonds	Cash + 3%–5%	3%–5%	A mixture of bond market beta and alpha	High	0.5	45 bps
Multi-Asset Credit	Cash + 4%–6%	5%–7% or roughly two-thirds of high yield	Sub-investment grade credit beta	Medium	0.5	55 bps
EMD Total Return	Broadly achieve EMD market returns over time	6%–9% or roughly two-thirds of blended benchmark	EMD beta	Medium	0.4	60 bps
Secured Finance	Cash + 2.5%–6%	Difficult to measure and highly dependent on nature of strategy	Securitized credit, complexity and illiquidity risk premia	Low	n/a	55 bps
Investment Grade Credit	3.2%	4.0%	Index beta	High	0.15	25 bps
High Yield	5.7%	5.2%	Index beta	Medium	0.65	50 bps
Leveraged Loans	5.2%	2.4%	Index beta	Medium-low	0.5	50 bps
EMD Hard Currency	5.3%	6.2%	Index beta	Medium	0.4	55 bps
EMD Local Currency	6.2%	11%	Index beta	Medium	0.4	55 bps
Convertible Bonds	n/a	5.2%	Index beta	Medium	0.8	65 bps

(1) In the lower half of the table, in place of target return, we show the yield on the following indices as at December 1, 2017, as well as five-year index volatility using monthly return data to September 30, 2017 — Bloomberg Barclays US Corporate Investment Grade (USD), Bloomberg Barclays US High Yield (USD), S&P Leveraged Loan (USD), JP Morgan EMBI Global Diversified Composite (USD), JP Morgan GBI EM Global Diversified Composite (USD), Thomson Reuters Convertible Bond Global Focus Hedged (USD). Note that we do not show the yield for convertible bonds, as the asset class tends to deliver a "total return" rather than yield per se. Note that other regional/global index variations will give different statistics.

(2) Correlation estimates are based on five years of monthly return data to September 30, 2017, versus the S&P 500. A correlation estimate is not presented for Secured Finance where there are not enough data to analyze, and has been estimated for Buy and Maintain Credit based on the correlation of an investment grade credit index with equities, given that the duration profile of individual Buy and Maintain portfolios can vary significantly.

(3) Indicative fees are based on both median universe data from MercerInsight, and also Mercer's experience with various strategy types.

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