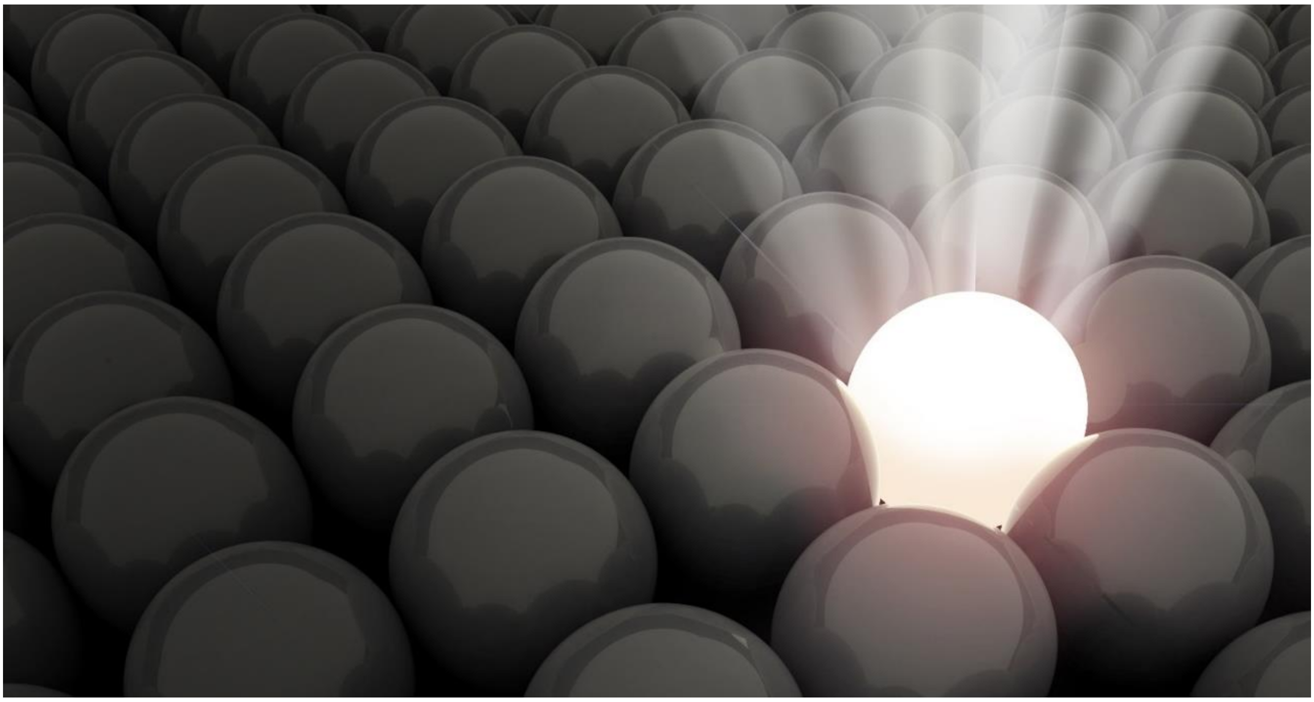
The Frontier Line

Thought leadership and insights from Frontier Advisors

Fixed is Changing

Issue 98, **June 2014**



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Multi-sector fixed income

Developments in fixed income markets coupled with the current needs of investors are changing the landscape of fixed income product offerings. The increasing breadth of debt markets accessed by institutional investors (e.g. bank loans, structured credit) is making way for products that provide managers with the flexibility to access a diverse range of debt sub-sectors in one dynamic product offering. A broad label for this type of investing is multi-sector fixed income.

In this edition of Frontier Line, we highlight key differences between multi-sector and traditional fixed income investing, discuss what multi-sector fixed income investing is, how to categorise the universe and some approaches to benchmarking, assessing and monitoring managers and strategies. Finally, we cover off on the opportunities in the current market and strategies and approaches that can best capitalise on this environment.

Traditional versus new fixed income

There are a number of key differentiating factors between multi-sector and traditional fixed income strategies, detailed in Chart 1. Traditional fixed income managers typically invest with a set market in mind (e.g. investment grade credit), as defined by a particular benchmark, with the performance of these strategies being measured against an index of assets from the permitted universe. Managers utilising a multi-sector approach do not typically invest with a set universe in mind, but rather invest in the best risk/return opportunities, with these products generally structured to produce cash or CPI plus returns.

Multi-sector fixed income investing is a philosophical shift from the traditional benchmark aware investment framework to a more risk controlled absolute return framework.

This shift has implications for a manager's approach to portfolio construction, risk management and investment team structure and interaction.

In general, some managers' approach to investing in fixed income aligns better or translates more easily to a total return framework compared with others.

Chart 1: Traditional versus multi-strategy fixed income

Approach	Traditional Fixed Income	Total Return or MS Fixed Income
Return	Maximise Information Ratio	Maximise Absolute Risk Adjusted Return
B'Mark	Benchmark Aware / Constrained	Unconstrained Universe & Allocations
Alpha	Industry & Stock Selection Alpha	Security, Sector, Industry, Asset Allocation Alpha
Risk	Risk Control Relative to Benchmark	Holistic Approach to Risk Management

The spectrum of approaches

Multi-sector fixed income investing can be classified into two broad "buckets", namely a multi-sector fixed income/credit or an absolute return approach. However, it is difficult to draw a line in the sand between the two.

The investment universe for multi-sector fixed income/credit strategies is expansive and the strategies utilised by managers can vary significantly.

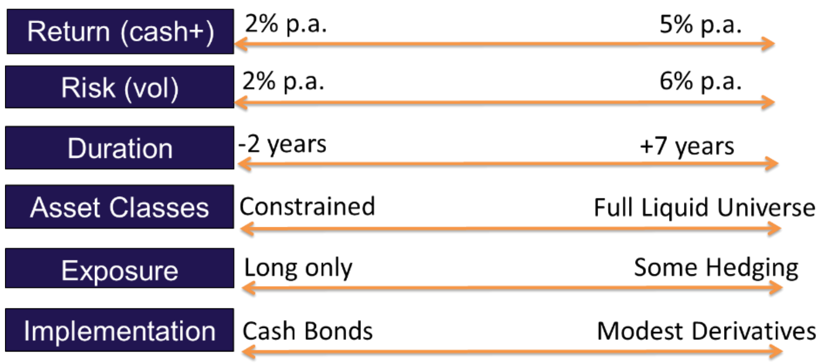
Typically multi-sector credit strategies asset allocate globally across the liquid credit spectrum (investment grade credit, high yield, bank loans, emerging market debt, currencies and/or structured credit) with ideally the flexibility to allocate to government bonds or cash if the outlook for credit is poor.

Multi-sector fixed income (as distinct from just credit) strategies tend to allocate across a similar universe but will also actively invest across the global government bond spectrum (e.g. rates, inflation and currency). Chart 2 provides a broad overview of the parameters of multi-sector fixed income/credit strategies.

We see most multi-sector approaches as sitting outside of the traditional core fixed income allocation and continue to believe that the core fixed income allocation should have a strong focus on longer-duration government bonds and downside protection.

There are also strategies that allocate across the illiquid credit spectrum (e.g. infrastructure, property, distressed and private LBO debt) with these types of approaches further out the risk and illiquidity spectrum.

Chart 2: Multi-sector fixed income/credit approach



The spectrum of approaches

The universe of absolute return managers (both domestic and global) is also diverse and strategies can have quite different structures, objectives and risk/return targets.

For example, one manager might employ a concentrated but defensive, tail risk oriented strategy, whereas another, while risk controlled, might have a higher return target that aims to deliver a diverse range of alpha. In the charts below, we have limited the descriptions to those strategies that are considered to be more liquid and at the lower end of the risk/return spectrum and therefore would sit somewhere within the traditional fixed income, credit, or alternative debt “buckets” in most portfolios.

Chart 4 outlines the likely parameters of a lower risk approach to absolute return fixed income investing.

This lower risk end of the spectrum may be appropriate for the traditional core fixed income allocation although we believe exposure to these strategies should be limited, with the majority of exposure to longer duration government bonds.

Chart 3: Total return (absolute return) fixed income

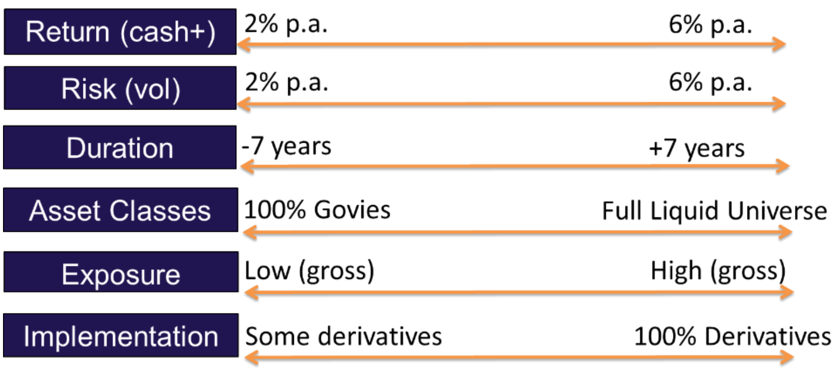
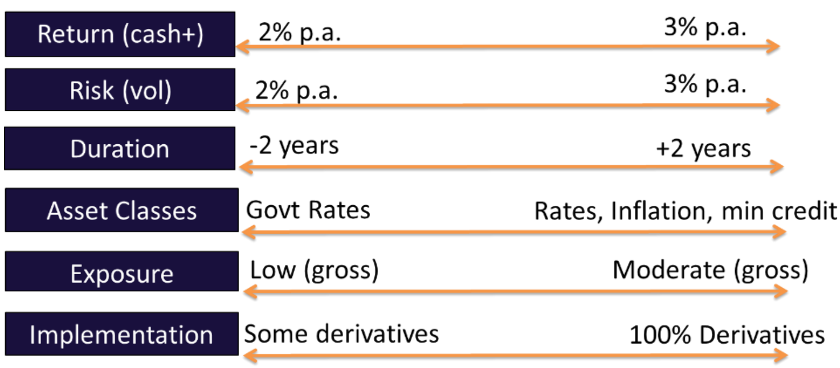


Chart 4: Low risk absolute return fixed income



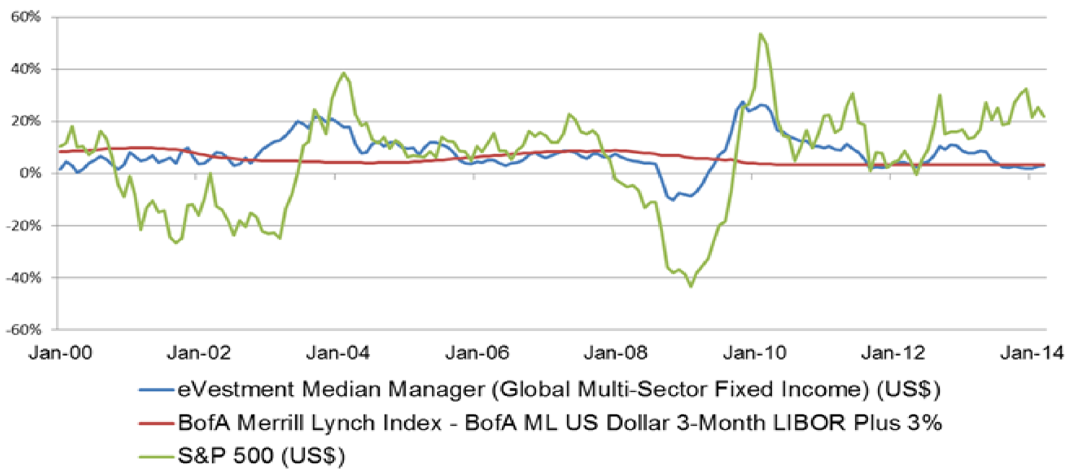
Why multi-sector fixed income?

Multi-sector and absolute return fixed income strategies make sense both from a structural and current environment perspective. The key rationale is to outsource the asset allocation decision-making to a manager who is able to make real time changes to the portfolio and is closer to the daily market dynamics. Additionally, the ability for investors to access a broad range of debt asset classes and strategies in one line item is an efficient and sensible way to access the market from a governance perspective for many investors. Finally, with credit spreads contracting to historic averages or below and government bonds offering a poor future return outlook, a more dynamic and unconstrained approach to debt investing within a cash plus framework can offer attractive returns versus traditional fixed income with low interest rate risk. However, it is difficult to identify managers that can successfully manage money in this way that also have strong enough capabilities across the debt spectrum.

As discussed, we continue to support the use of traditional longer duration government bonds as the core component of fixed interest portfolios and believe this is the best way to capture the desired characteristics of fixed interest from a total fund perspective, which are downside protection and diversification. We do not view multi-sector and absolute return fixed income as a replacement for government bonds but believe it can provide another source of return and diversification benefits at the broader portfolio level.

Chart 5 shows the performance of the eVestment Global Multi-Sector Fixed Interest universe compared with equity market performance and a cash plus benchmark. This analysis, whilst not perfect given the broad range of approaches within the universe, shows that multi-sector fixed income has broadly delivered on its cash plus objective but shows a reasonable correlation with equity markets and at the broad universe level does not provide downside protection during stressed equity market environments.

Chart 5: Global multi-sector fixed income eVestment median manager performance



Source: eVestment, March 2014
Strategies exhibiting volatility (standard deviation) levels above 6% p.a. have been excluded.

Benchmarking, assessing & monitoring managers

The broad range of approaches used by managers, means using a common benchmark is difficult. In determining the most appropriate benchmark to use, the manager's stated return objective is a good starting point.

For allocations that have been funded from a more traditional fixed income investment, that is benchmarked to the global aggregate index for instance, performance can be monitored to the relevant benchmark from an opportunity cost perspective.

In terms of measuring performance against peers, this is challenging given the broad range of strategies and product parameters, and as a result, time may be spent explaining and understanding out or underperformance. Instead, when comparing strategies with different risk and return objectives, reviewing the risk-adjusted return may be useful.

We believe the use of multiverse or spliced benchmarks is less helpful as there is a risk that this may constrain managers, although investors may choose to use a spliced benchmark for internal monitoring purposes.

Given an absolute or cash plus approach to investing requires a philosophical shift, it is important for investors to gain comfort with the team and understand the investment approach utilised.

For instance, how does the team manage information flow of ideas, how long has the team been working together, do the key people have a proven ability to asset allocate and manage portfolios in this way and does the team follow a disciplined investment process with robust and appropriate risk systems in place?

In the current environment, with the pricing of credit sub-sectors like bank loans, high yield and emerging market debt a lot less compelling (as highlighted in the following chart), a multi-sector approach has particular appeal.

The challenge is finding managers that can cover the spectrum well, with proven track records.

While there are a large number of managers offering products in this space, there are a limited number with a solid longer-term track record and sufficiently broad capabilities.

Understanding the drivers of historical performance is also important, particularly given the number of different levers a manager can "pull".

Fees tend to be higher in this space so having an understanding of what you are paying for is important. (That is, how active is the approach, what is the breadth of markets and strategies being covered and how much of the return is driven by beta?)

Market environment & opportunities

From a multi-sector fixed income/credit perspective, those strategies with the flexibility to hedge credit risk make sense given where credit spreads have moved to (see chart below). This still allows investors to benefit from the reasonable current yield but reduces the risk somewhat. Total return and cash plus strategies should also provide a level of protection against rate rises and offer sufficient flexibility not to leave investors overly exposed to credit beta or a particular market or strategy.

We are increasingly in an environment of divergent macroeconomic outlooks in terms of interest rates, inflation and growth expectations, with Europe still easing, the US and UK most likely beginning to tighten, emerging markets a mixed bag and Japan still trying to reflate its economy. In this type of environment, managers with proven top down skills, broad global coverage and implementation flexibility should outperform from a risk-adjusted perspective. In particular, approaches that use a range of different alpha sources, including having the ability to go long and short should provide reasonable returns in a low/rising interest rate environment.

Finally, the past few years has seen indiscriminate buying of higher yielding assets as demonstrated by the historically low spread difference between lower quality and higher quality credits in a number of markets.

As such, we believe managers with strong security and sector selection should generate alpha going forward.

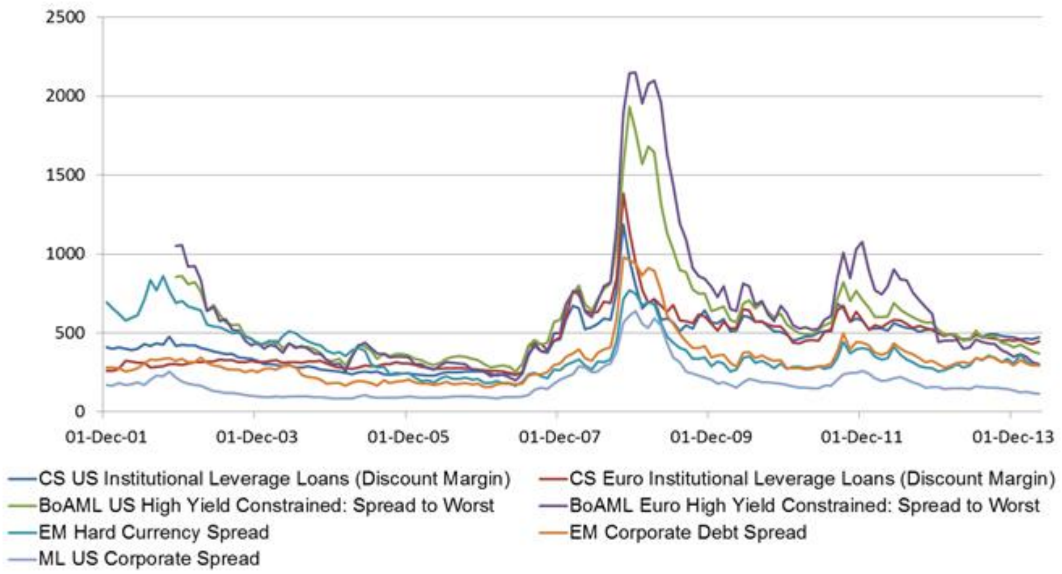
Conclusion

There are a number of worthwhile strategies within the multi-sector and total return fixed income universe that have merit as structural allocations.

While most will not provide the same downside protection as government bonds and we do not view these strategies as replacements for government bonds, they do provide some diversification benefits with a reasonable return profile exhibiting much lower levels of volatility compared with equities.

While identifying strong offerings in this space is challenging, we have identified a select range of product offerings that we believe are compelling.

Chart 6: Credit spreads as at 30 April 2014



Source: Bank of America Merrill Lynch, Credit Suisse, JP Morgan

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