JPM – *Fixed Income Sept.* – Transcript – TIME: 5:51

[techno music]

Mr. **Manoukian**: Welcome to the September edition of Markets Monthly. This month, I'm really lucky to be joined by Irena Alagic who's a fixed income specialist. Thanks for joining me.

Ms. **Alagic**: My pleasure.

Mr. **Manoukian**: So earlier this year, uh, you joined my colleague Andy Goldberg and you had basically an outlook for how the year might, uh, transpire in the fixed income markets. And the key takeaway that I had from that conversation was that you wouldn't be able to set it and forget it in your fixed income portfolio.

Ms. **Alagic**: Yeah.

Mr. **Manoukian**: There was going to be a lot of dispersion between subsectors in fixed income and that has really played out.

Ms. **Alagic**: It has.

Mr. **Manoukian**: It seems pretty prescient.

Ms. **Alagic**: Mm-hmm.

Mr. **Manoukian**: So can you just give us some of the drivers of that dispersion in the fixed income markets?

Ms. **Alagic**: Yeah, so one of the things that Andy and I spoke about was just how poor, at the time, the risk/reward was for traditional core benchmarked fixed income. So sectors like the Barclay's Agg for example. And we really felt that that segment of the market would underperform because rates were really low so yields were low and you were taking on a lot more interest rate risk than before. And that has largely played out especially if you look at this year, the 10-year just recently pierced 3%- so as you alluded to what you've seen is that a lot of the longer duration segments of the fixed income market, the higher quality ones, with less spread cushion have underperformed. So areas like Treasuries, the Agg

and even investment grade corporates. High yield has held in quite well largely because there's less interest rate risk there. We had a really strong economy and expectations of defaults have been low. So that's really supported spreads. And then munis have their own story, which is that the value of tax-exempt income is as high as ever, potentially even higher for retail investors on the back of recent tax reform. So they have outperformed Treasuries as rates have risen. So you're right, there's really been a ton of dispersion.

Mr. Manoukian: So the way that you described that investors could take advantage of this dispersion is by investing in unconstrained fixed income managers. Can you just remind us what an unconstrained fixed income manager does?

Ms. Alagic: Yeah, absolutely. An unconstrained manager has a flexible mandate. That means that they operate outside of the constraints of a benchmark so they can go and invest wherever they see the best opportunity in fixed income. If they don't like a sector, they don't have to invest in it. And theoretically, that should give them more opportunities for more diverse sources of risk and return than a traditional manager.

Mr. **Manoukian**: So they aren't beholden to invest in this skewed risk/return profile that we identified earlier.

Ms. **Alagic**: Exactly.

Mr. **Manoukian**: So where are they seeing pockets of value now in the fixed income space?

Ms. **Alagic**: So one of the things that we've observed this year is that a number of our managers have taken a fairly defensive stance with respect to the interest rate risk and so that's really helped performance because as we discussed earlier, the Agg and Treasuries and other high-quality fixed income products that are longer dated have underperformed. The other thing that we've noticed this year is that they- we've seen a lot of active managing on the part of these managers is what you really want with an unconstrained manager is the ability to be nimble and tactical. And so we did see that this year. One example, in particular, that I'm thinking of is a manager who's de-risked their portfolio recently from largely credit- so investment grade as well as high yield- into some areas of securitized

products, also very selective, higher-quality loss-remote, um, segments of that market that have a little bit of, of spread cushion.

Mr. **Manoukian**: Got it. So it seems like it's the opposite of set it and forget it fixed income investing, which is really what we want to see.

Ms. **Alagic**: That's what we want, yeah.

Mr. **Manoukian**: So looking, looking forward now, we expect the Fed to hike rates, you know, five or six more times by the end of 2019. We don't expect the long end of the curve to rise that much further though so that implies a flattening of the yield curve. How should fixed income portfolios be invested in that type of environment?

Ms. **Alagic**: Yeah, I really think of it as three main tenets for fixed income investing going forward. The first one is, as you mentioned, we expect the Fed to continue to hike so we like owning floating rate exposure. The second one is as part of our late-cycle investing playbook we are selectively adding to high-quality, longer-dated fixed income securities, but we're being very selective there. It's really specifically within the municipal

market and some areas of the preferred market that we see value. And then finally, as you and I just talked about, I think unconstrained investing is an important tool as part of this late-cycle investing environment and given how tight spreads are in credit and generally valuations across fixed income, I think it's a good way to get some credit beta and own it through the cycle.

Mr. **Manoukian**: So it seems like it's important to be tactical, be opportunistic, don't be as afraid of interest rate risk as you might have before.

Ms. **Alagic**: Exactly.

Mr. **Manoukian**: But still, we're not setting it and forgetting it in fixed income-

Ms. **Alagic**: No. Nope. Mr. Manoukian: Great. So thank you so much for taking the time-

Ms. **Alagic**: Thank you.

Mr. **Manoukian**: Thank you all very much for watching and we'll see you next month.

[END]