Defining Absolute Return Investing in Fixed Income

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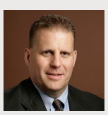

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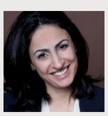

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WHILE TRADITIONAL INVESTING IN EQUITY AND FIXED INCOME markets has played a primary role in portfolio construction, investors have increasingly looked to alternative strategies to complement their market beta exposure. Within alternatives, absolute return strategies have been utilized for many years, with the category growing tremendously since the credit crisis.

These types of strategies have been attractive to investors as they provide diversified sources of return, can reduce portfolio volatility, and typically do not need to rely on strong beta markets for positive returns. The category has developed from hedge funds accessed by institutional investors, to include daily liquidity vehicles available to a wider range of investors.

Most investors are familiar with absolute return strategies within equities, the futures markets (CTA, global macro), FX strategies and commodities. However, investors are generally less familiar with absolute return strategies in the context of fixed income. This paper aims to define why absolute return fixed income is a useful component in portfolio construction, what characteristics these strategies should entail, and what kind of results should be expected.

WHAT IS ABSOLUTE RETURN?

Absolute return investing has different meanings depending on the asset class and strategy. Broadly speaking, there are two central characteristics:

- Low correlation to traditional asset classes
- Focus on producing positive returns regardless of underlying market direction

The techniques employed to achieve these objectives include short selling, the use of options and derivatives, relative value investing, leverage and non-traditional instruments.

Whether these strategies produce positive returns is generally not dependent on the direction of the underlying market, but on the manager's investing and trading skills. There are many approaches—some exploit one specific factor; others attempt to blend different ideas together for diversification. Some approaches use fundamental analysis, while others rely on quantitative tools. Managers also invest with varying time horizons. Considering this wide range of approaches, it is important to understand the manager's objectives, philosophy and strategy, and to appropriately evaluate their results.

FIXED INCOME: UNCONSTRAINED OR ABSOLUTE RETURN?

In some respects, investors have always thought of fixed income as an "absolute return" asset class. For decades they have relied on it to deliver capital preservation, income, and diversification from risk assets. Barring an event of default, usually reserved for low-quality credit, investors have viewed this asset class as a source of stability and an anchor for portfolios.

Favorable market conditions for fixed income over the last 30+ years have fostered an environment where implementing alternative techniques was not vital to drive positive returns. Investors were used to outsized returns and low volatility from traditional long beta exposure.

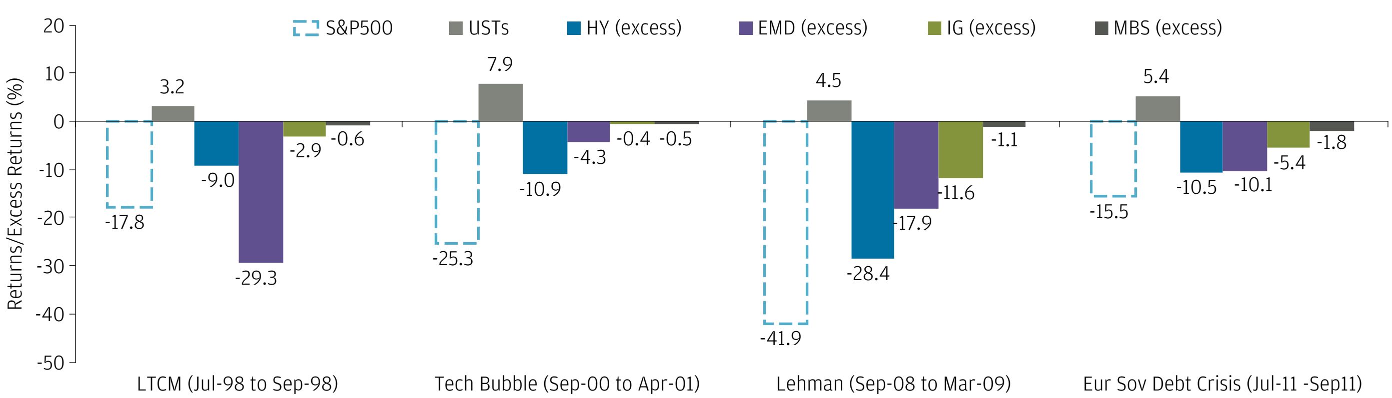
Upon closer examination it becomes clear that the major source of that stability has been duration or interest rate risk. As the chart below shows, interest rate risk (its proxy below is US Treasuries) was the common stabilizing force in fixed income and the only real source of diversification vs. risk assets. All other risks (spread risk, default risk, liquidity risk, etc.) are captured in the excess returns for each sector. Those returns were consistently negative and highly correlated with equities during periods of market stress.

With yields at all time lows globally—the interest rate risk is a significantly less powerful stabilizer in portfolios. Furthermore, it is potentially a source of losses should rates begin to normalize.

The lower return expectations and potential for capital losses have led to an explosion of growth in less traditional styles of fixed income investing. With the proliferation of styles came confusion regarding where investors should set expectations with respect to risk and return.

Due to their cash benchmark many investors think all unconstrained fixed income strategies are analogous to absolute return approaches. However, being an "unconstrained fixed income strategy" merely describes the opportunity set,

EXHIBIT 1: STABILITY IN FIXED INCOME ATTRIBUTED TO DURATION OR INTEREST RATE RISK



Source: Bloomberg and Barclays. Time periods vary: Long-term Capital Management bailout (LTCM): Jul-98 to Sep-98, Internet Technology Bubble burst (Tech Bubble): Sep-00 to Apr-01, Lehman Brothers collapse (Lehman): Sep-08 to Mar-09, European Sovereign Debt Crisis (Eur Sov Debt Crisis): Jul-11 to Sep-11. For illustrative purposes only.

but tells nothing about the manager's goals, risk tolerance or willingness to use leverage.

Absolute return fixed income strategies are a subset of unconstrained and have two purposes:

- To diversify the fixed income allocation, and/or
- To add a different investment style into their alternatives allocation, *without significantly amplifying correlation to risky assets*.

In other words—investors seek traditional fixed income benefits such as capital preservation and consistent returns but achieved through alternative instruments and techniques with low correlation to traditional market betas. This distinction is what sets absolute return strategies apart from simply unconstrained.

WHAT ARE THE DEFINING CHARACTERISTICS OF AN ABSOLUTE RETURN FIXED INCOME STRATEGY?

Absolute return fixed income is focused on delivering a low volatility, low correlation, steady return stream. Below are some of the key characteristics that allow it to achieve that goal.

- *Does not structurally eliminate interest rate and credit risk*

Interest rate risk and credit risk can be thought of as fixed income market beta. In many other asset classes, absolute return managers aim to systematically reduce, remove or even go short the market beta. However, fixed income is different—investors generate returns even if prices don't move. This means that the compensation for long beta exposure is potentially significant while the cost of short beta exposure can also be considerable. This makes the timing around beta exposure so critical.

There are also environments when interest rate risk may be the only source of positive return, such as dramatic risk off periods and/or disinflationary periods. If an absolute return strategy is intended to be able to deliver positive returns *independent* of market direction, it needs to be tactical in its exposure to interest rate and credit risk.

- *Accesses return sources uncorrelated with broader fixed income and equity beta*

Delivering a return stream that is uncorrelated to traditional fixed income and equity markets is one of absolute return's key objectives. An absolute return strategy should be a true diversifier in an asset mix and is only relevant if improving the overall risk-adjusted return across an investor's broad portfolio. To achieve this, managers can employ relative value techniques to generate alpha such as trading credit long/short or yield curves. Strategies can also access less correlated sources of income from niche areas such as structured products, insurance linked securities, and non-traditional instruments in the private markets.

- *Employs a risk management process focused on 'dollars-at-risk' scenario analysis*

While many qualitative and quantitative concepts can describe and evaluate investment risks, the fundamental investor concern is the risk of losing the value of their investment. This goes beyond strong security selection to minimize defaults in portfolios. Drawdown management and the path to returns are just as important, since periods of volatility often coincide with investor liquidity needs causing investors to monetize drawdowns before the investment has the opportunity to recoup its mark-to-market loss. This is especially true of the more recent growth in daily liquidity vehicles.

- *Constructs portfolios that can produce returns in a variety of scenarios*

A multi-scenario approach to portfolio construction, with the goal of delivering positive returns across a variety of market environments. The portfolio needs to have multiple sources of return and understand the impact from extreme market stress. There should be clear expectations set by the portfolio management team of what they aim to deliver across a variety of market and economic outcomes. **Absolute return investing is not base-case driven**.

Simply saying that a strategy will have a return target of LIBOR+400 basis points does not suffice, since it may require vastly different risk tolerances to reach that target in different market environments. That in turn makes for a very different path to returns. Since absolute return investing as a process is focused on the path to returns, and not just the outcome, it should not be looking to take on risk to hit a performance target at any cost. Therefore performance expectations should be clearly stated across several different market/economic scenarios, instead of saying it can deliver the same result in all investment environments.

- *Takes a systematic approach to hedging*

Inherent to the multi-scenario portfolio construction process is anticipating tail risks and identifying the least costly and most efficient hedges for those tail scenarios. In order to be able to mitigate drawdowns across a wide variety of market scenarios, the portfolio needs to be at least partially hedged at all times. The level of the hedge ratio may vary, depending on market opportunity, but **the process for identifying the right level and actual hedging instruments must be consistently present in an absolute return strategy**.

- *Managed by an experienced and dedicated team*

Absolute return investing is a different ballgame from long-only, benchmark oriented investing. The toolkit needed to identify and manage both risks and opportunities across multiple sectors, geographies, instrument types and long/short exposures is quite distinct from that of a traditional, manager trying to beat the Barclays Aggregate. In addition, the experience of managing through different cycles, including stressed environments such as 2008, 2011 and the "taper tantrum", is crucial to be able to anticipate risks that might not be picked up by a traditional risk management process.

WHAT ARE THE PROSPECTS FOR ABSOLUTE RETURN FIXED INCOME STRATEGIES IN THE FUTURE?

Much of what is currently said and written about absolute return fixed income strategies revolves around mitigating interest rate risk, as the bond market prepares for a potential rate rise. However, absolute return is an evergreen proposition—as long as there are risks in portfolios, investors will continue to look for ways to diversify and create differentiated return streams. With the tremendous evolution in fixed income markets—from new types of instruments to more accessible global markets—there are more diverse ways than ever to express investment views, capitalize on opportunities, and protect against risks.

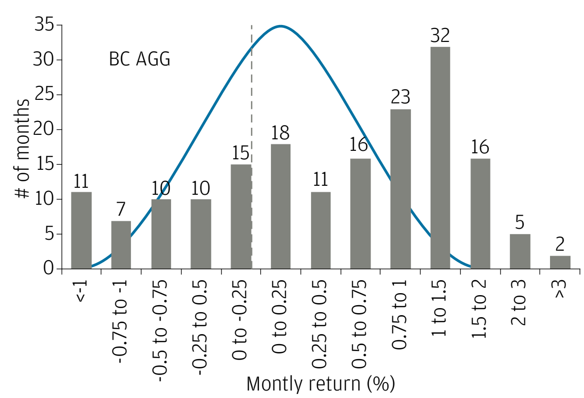
For those investors that use this type of strategy, the allocation size should reflect the absolute return strategy's range of outcomes combined with the investors' own views on potential market scenarios. The ultimate decision should be based on how the strategy might complement the rest of the portfolio across these scenarios.

A DIFFERENT APPROACH TO RISK MANAGEMENT

Effective risk management is a critical tool for an absolute return manager in any asset class. The ability to identify sources of risk within a portfolio, exploit them for returns and understand their impact during periods of stress, enables managers to produce returns which are lowly correlated with broad market movements. There are various measures of risk within portfolios, including the overall volatility of returns, liquidity risks, position concentration risk, and the extent of potential drawdown.

- The mathematical nature of fixed income instruments and the (generally) defined time horizons, allow managers to isolate specific factors and build more robust models to measure and control exposure to them.
- The ability to isolate these specific factors means that scenario analysis is generally a more effective tool to understand the future path of returns. Value at Risk (VaR) is a useful tool across certain strategies, but requires stable market conditions to be effective, and has certain limitations such as estimating the size of the tail risk. The limitations stem from the fact that **fixed income returns are not normally distributed and unlike other asset classes compensation moves *higher* (yields increase) as volatility increases.**
- Scenario analysis provides a pathway to capitalize on volatility and reposition portfolios opportunistically. VaR simply provides controls to cut risk. Absolute return fixed income managers should utilize a combination of the two methodologies.

EXHIBIT 2: FI RETURNS ARE NOT NORMALLY DISTRIBUTED



Source: Barclays. As of December 31, 2014. For illustrative purposes only.

HEDGING AND THE VARYING OF EXPOSURE

Absolute return-oriented investing in fixed income markets devotes tremendous resources to anticipating tail scenarios as detailed in the risk management section. Portfolios are constructed to be resilient during normal markets conditions as well as periods of stress. This means that absolute return managers give up some return on an ongoing basis to employ a systematic hedging component. This can be used to mitigate large, unforeseen market movements and smooth the path of returns. For example, in the table below, the impact of a 25% allocation to a hedge is shown on both a generic portfolio allocation for stocks and bonds, and also a bond-only portfolio.

At first glance, a portfolio which is continuously hedged looks to offer less return. Indeed, a static allocation to portfolio protection can be costly to implement. However, the volatility and the maximum drawdown decrease considerably while risk adjusted returns increase. It is important to note:

- For the stocks/bonds portfolio, while the Sharpe ratio remains flat with the hedge, the maximum drawdown is reduced to 29.9% from 32.5%
- For the bond-only portfolio, there are clear benefits; the Sharpe ratio improves, overall volatility is reduced by 1% lower and the maximum drawdown is reduced by over 25%

	Stock/Bond Portfolio Scenario			Bond-only Portfolio Scenario	
Characteristics	*Exposure ex-hedge*	*Exposure w/hedge*	**Characteristics**	*Exposure ex-hedge*	*Exposure w/hedge*
Stocks	*60%*	*60%*	High Yield	*30%*	*30%*
Bonds	40%	40%	BC Agg	70%	70%
Hedge	*0%*	*25%*	Hedge	*0%*	*25%*
Volatility	8.94%	7.74%	Volatility	4.29%	3.33%
Return (cumulative)	94.8%	77.9%	Return (cumulative)	73.8%	57.7%
Return (annualized)	6.90%	5.93%	Return (annualized)	5.68%	4.66%
Sharpe ratio	0.77	0.77	Sharpe ratio	1.33	1.40
Max drawdown	-32.5%	-29.9%	Max drawdown	-10.90%	-7.58%

Source: Bloomberg. Barclays. For illustrative purposes only. December 31, 2004 through December 31, 2014.

This analysis is for a static allocation. By dynamically adjusting the level of the hedge and the instruments used, managers can very often reduce the overall cost, while maintaining its protective characteristics. It is important to maintain hedges that are extremely efficient, cost effective, liquid, and react to a variety of scenarios.

When the market beta opportunity set is not compelling, there are two ways to reduce exposure to it: Hedge or increase the level of cash. While hedging is an effective tool, as can be seen above, the short exposure is significantly more expensive in fixed income, as you owe a coupon to someone on the other side of that trade. This will lead to varying levels of cash held in the portfolio as well as gross and net exposure through leverage (for those that utilize it).

Another advantage of holding cash is the concept of 'dry powder'. In periods of stress in fixed income markets, when liquidity needs are highest, the compensation for risk is generally the greatest. If a manager can stay disciplined, and raise the levels of dry powder when the opportunity set is limited, they are able to deploy it when other investors are forced or panic sellers. These times are often when the investments are at their most attractive. Given the mathematical nature of fixed income instruments, it is a very effective strategy.

Absolute return strategies have long been used to diversify broad portfolios, and seek to produce positive returns irrespective of the direction of the underlying markets. Fixed income investors had generally shied away from these techniques due to the tremendous returns experienced from falling interest rates, coupled with the reluctance to think more creatively about a traditional staid asset class.

The fixed income landscape is changing and presenting investors with new risks and opportunities. While the forward path of interest rates is unknown, the need for diversification and steady returns will continue to make absolute return fixed income investing relevant.

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