For qualified investors only

First State Investments

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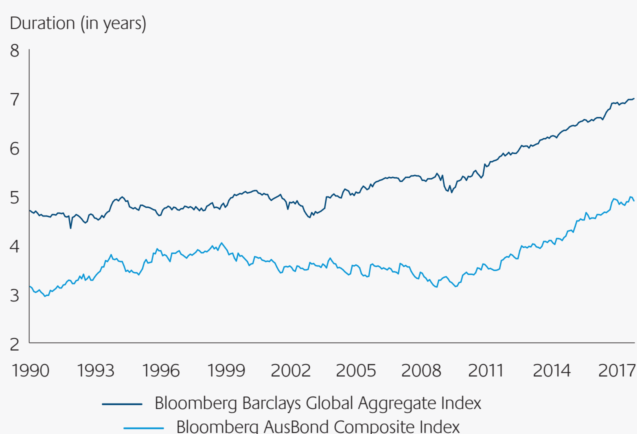
Global Fixed Income

Taming your unconstrained manager

Traditional fixed income... we need to talk

Fear can often be an extremely powerful motivator, particularly in the investing world. The secular trends of falling yields combined with increasing interest rate risk, or duration, have certainly struck fear into the hearts of fixed income investors around the world (see below).



Source: Bloomberg, Bloomberg Barclays Indices; Duration = Modified Duration; Yield = Yield-to-Maturity

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The first chart shows the **duration** history of both the Global and Australian investment grade fixed income markets. Following the Global Financial Crisis, we have seen a continued duration extension in developed fixed income markets. For those invested in strategies that use traditional fixed income benchmarks, this means that the neutral duration exposure in these strategies is more than 50% higher than levels seen prior to 2008. Said another way (trust us; we'll spare you the bond math in this particular article*), the interest rate risk for those investments that track the bond market is relatively high. How high? Well, simply stated, if interest rates were to rise by 1%, then the global bond market would subsequently fall by around 7%. Needless to say most bond investors would be shocked at suffering a 7% negative return in a basic fixed income portfolio. Those who fully appreciate the risk here are fearful not just of this scenario but also one of sustained increases in bond yields where the losses could multiply quickly. No one likes to still be standing when the music stops.

The second chart shows average bond **yields** for the same Global and Australian investment grade fixed income markets. What has been striking about the 30+ year "bull market" in rates has been the relentlessness of the fall in yields, particularly in the period since 2008 when economic growth has been recovering and equity markets exuberant, albeit with low inflation. Just when markets think structural forces have turned (remember the "Taper Tantrum" or the "Trumpoline"?), a dose of reality sets in and yields fall again. While real (after-inflation) yields have been negative for some time across many bond markets, some regions have even seen significant negative nominal yields (e.g. Japan, Germany, etc). This further compounds the duration problem in that there is a smaller yield buffer to absorb potential capital losses. Also, there are serious question marks as to the capacity for yields to fall "enough" if faced with another economic downturn. If traditional fixed income doesn't behave defensively, doesn't provide much yield, and doesn't even beat inflation, then why would anyone own it?

But fear not! Enterprising investment managers quickly identified this problem and have been working feverishly over the course of the past several years on building out their non-traditional fixed income suite of products. Greed can be a good motivator too! The sales pitch has gone something like this:

Imagine a world of investing where your manager could be unshackled from arbitrary constraints imposed by blindly following market capitalisation weighted indices? Imagine fixed income strategies were able to exploit ALL global market opportunities, regardless of the country or sector? Wouldn't it be great if instead of marching straight into a guaranteed environment of rising interest rates (and associated falls in price), you gave your manager the freedom to deliver outperformance in positive AND

*If interest rates rise 1%, returns will lose 7% is because the duration of the index is 7, the standard formula is for every 1% increase in interest rates, the total return of a bond or index will decrease by the duration.

negative markets? At XYZ company, we believe an active, go-anywhere approach that focuses on client outcomes, not benchmarks, can deliver strong risk-adjusted returns in a consistent manner. We call this revolutionary new approach: **Global Fixed Income***.*

We understand this can be a compelling sales pitch and most points are sensible. Although we would argue with the certainty of rising interest rates (just ask anyone who has tried shorting Japanese Government Bonds over the past 20 years). Regardless, this plays to investors' fears and has seen a huge amount of money transition from traditional fixed income strategies to non-traditional approaches.

Unconstrained investing continues to grow in popularity – from both a supply and demand perspective. With this growth comes the need for improvement in how to align expectations and measure and compare products. Comparing returns across products is always important, but this universe demands increased scrutiny due to a lack of standardization seen across unconstrained products. The category represents almost all asset classes, and a variety of investment methods and techniques – virtually anything is fair game! Unfortunately, in this space product comparisons using historical returns in isolation have the potential to mislead investors and may result in disappointment relative to expectations.

With a plethora of new products and players in the unconstrained arena, many lacking long-term performance history, purely looking at short-term past performance could steer investors towards an unsuitable product. Stated another way, when comparing products with strong recent returns, the analysis would likely favour products exploiting a narrow, but positive returning, market sector which is an opportunity that may have no lasting value.

The rest of this article focuses on more clearly defining Global Unconstrained Fixed Income and explaining the value proposition along with the criticisms of these approaches. Finally, we seek to tame your unconstrained manager by providing tips to compare products and concrete recommendations to avoid disappointment.

Absolutely, Totally Awesome!

Before getting to the important business of taming your unconstrained manager, we would like to demystify some language. We really need to agree on some common terminology. In a post-fact, "fake news" world where a common set of facts doesn't seem to exist, we are hoping to at least give our interpretation of some of the jargon thrown around in the market to allow for a more substantive debate.

To properly evaluate unconstrained managers, we must first briefly explore the differences between various styles of investing including Benchmark Relative, Absolute Return, and Total Return investment strategies. Fully understanding these terms and how they apply to various objective-based strategies is critical to their application within a broader portfolio.

Benchmark Relative

Benchmark Relative investment management is one of the best known approaches. It has been the bread and butter of active management for many years. Pick an appropriate benchmark to manage to and then place some "bets" around the benchmark to seek some additional outperformance such as going overweight financials or underweight mining. The typical outcomes of such portfolios tend to be correlated to the overall direction of the bond market but to a mildly lesser extent if the active management calls are successful (getting more return from making the right calls). But given that the majority of the exposure of a Benchmark Relative portfolio will remain aligned with the broader market index, performance will ultimately be more aligned than a portfolio which is not aligned to a specific benchmark.

Investing in a Benchmark Relative portfolio makes it a lot easier to compare other managers who are also managing towards that benchmark. Any outperformance comparisons are easily made given the underlying investment universe is ultimately the same. Benchmark Relative investing is also useful for investors who want to gain specific exposure to a subsection of the market e.g. they only want Australian fixed income exposure because they have other portfolios with global fixed income exposure. This allows the investors themselves to make tactical calls on specific sectors e.g. credit versus government, emerging debt or high yield.

Of course by choosing this approach the investor has to have faith not only in their ability to choose appropriate tactical allocations but have flexibility in their investment model to react to changes in the market. This is difficult when allocations are in separate portfolios and can result in high transactions costs related to increasing and decreasing allocations to individual portfolios. Hence many investors are turning towards skilled investment managers who are able to offer a more benchmark-unaware / unconstrained approach to fixed income. In this approach, the manager themselves has the ability to tactically position the portfolio to the current market environment and is also allowed a broader opportunity set to seek additional return.

In the current environment where there is potential for negative returns from bond markets (if interest rates begin to move consistently higher), investors are moving away from a "match the benchmark" approach, seeking instead positive returns over the whole investment cycle. This change of investment objectives has increased interest in Absolute Return and more flexible investing.

Absolute return

In recent years Absolute Return portfolios have gained popularity both for fixed income and multi-asset investment markets. Absolute Return strategies aim to generate a positive return regardless of underlying market conditions, typically with a pre-specified target (eg. cash + 5%) without the constraints of focusing on a traditional benchmark. These "all-weather" approaches do not necessarily rely on positive capital market performance in order to deliver on the objective.

In fact, Absolute Return strategies – in their purest form – should exhibit low correlations to traditional asset class returns given that they should not have structural biases over time (i.e. market neutral). Furthermore, in falling markets these strategies typically afford the manager sufficient flexibility to profit by implementing short positions. Of course, while the market risk should be low (in theory), the manager risk is high given the reliance on highly active investment strategies. Historically, these strategies have been reserved for the hedge fund universe, which meant they were largely unregulated, utilised leverage, and charged high

fees. However, these strategies are increasingly accessible to a wide set of investors, not just sophisticated hedge fund clients.

Certainly Absolute Return strategies sound fantastic on paper – who doesn't want to earn positive performance in all market conditions? They are also easy to compare manager to manager by simply seeing who has a similar absolute return target and comparing who hit the target and at what levels of risk. However, in reality, delivering an absolute return portfolio to the prescribed mandate can be a lot harder than it sounds. Hence, while promising a low correlation they have in fact remained tied to the performance of the global bond market – probably due to the strong returns on offer during this period. This makes it hard to determine how they would fair in a world of diminishing total returns and potentially negative yields.

Total Return

On the other hand, Total Return strategies tend to incorporate some element of structural market exposure which makes outperformance in down markets more difficult. Traditional Benchmark Relative strategies usually fall into this category since investors either expect passive replication of a market (beta) or market exposure plus excess returns (alpha) in the case of active management. However, if markets are strongly positive, these strategies are more likely to keep up given the structural market beta exposure.

Similarly, Total Return strategies seek to deliver on a pre-specified target above cash, operate a flexible, unrestrained investment strategy, and have little reference to a traditional capital market index. Importantly, these strategies tend to incorporate some element of structural market exposure, thereby increasing the time horizon (typically 3-5 years) and increasing the possibility of a negative return over shorter periods. While these strategies may lag in up markets, the flexibility afforded means that they have the potential to outperform in down markets.

The entire aim of Total Return strategies is to make investors' money and minimise capital losses, so wherever possible they will mitigate market falls using an unconstrained approach (i.e. moving heavily into more defensive or safer asset classes and sectors), derivatives and flexible cash limits. This means that Total Return portfolios may not participate as fully in market rallies as traditional funds. Total Return portfolios are also designed to meet the needs of different investor risk/return profiles. For example, there are riskier Total Return products that target cash plus 5% to 7% per annum. At the other end of the scale, customers requiring consistent smaller positive returns may find a Total Return product that aims for cash plus 2% to 3% more appropriate.

A typical feature of Total Return strategy performance is that they will never be as good as the best performing market segment but are not expected to be amongst the worse. Hence a key contributor to the success of the portfolio is the investment manager's ability in active asset allocation and creating a diversified portfolio. That being said, Total Return strategies tend to deliver over time on their investment objectives given the ability to seek investments delivering return streams aligned with the portfolios objectives. Furthermore, it's likely they will be more lowly correlated to global bond markets than traditional Benchmark Relative strategies.

Unfortunately, the investment world continues to consistently conflate Absolute Return and Total Return strategies. Throwing in the term Unconstrained has only made things worse. The issue here is that Global Unconstrained products can include elements of all these classifications (e.g. total return product that has a reference benchmark and adds relative value alpha overlay strategies to boost returns) which makes it even more confusing for investors. So, the first order of business is understanding what you are buying and what to expect in different environments. If bond markets are down 10%, would you consider a -5% return a success? If the High Yield market delivers double digit positive results, then would a +3% return from your portfolio be acceptable?

Global Unconstrained

So what is Global Unconstrained Fixed Income? Well really it's undefined rather than unconstrained! It can be a bit of anything and everything. Though typically there are some common features such as a high outperformance (alpha) target and a broad investment universe and discretion. Products in this space can be difficult to compare as they may have different benchmarks (cash, composite/core index, etc.), be income based, or have very different liquidity profiles.

To us, the key to a successful Unconstrained Fixed Income fund is having an unconstrained opportunity set to invest in. If you have true skill to be able to deliver true alpha (more on that later), then you can deliver this in an absolute return framework, against a traditional benchmark, and have the ability to scale up or down the risk/return objectives.

Value Proposition of Global Unconstrained approaches

- Attractive performance targets without hedge fund leverage and lock-up
- Broad discretion to take advantage of opportunities away from native benchmark and currency
- Performance target not dependent on market direction and therefore more consistent over time
- Alpha can be tactically extracted when opportunities arise

Criticisms of Global Unconstrained approaches

Without a construction discipline:

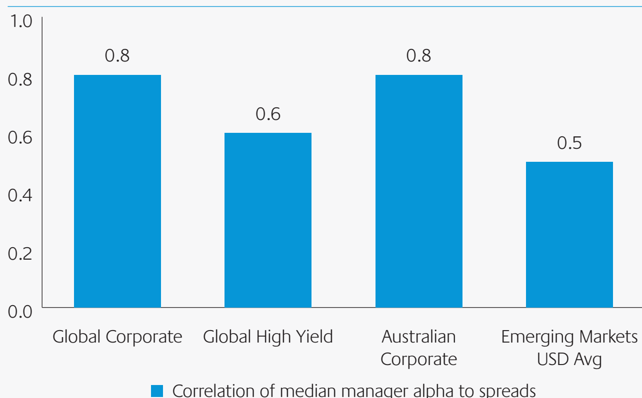
- Unconstrained approaches can suffer from 'Product Creep' and become credit funds in disguise
- Thematic views can lead to concentrated and correlated positons while filtering out contrarian ideas
- The advantage of breadth requires expanded skill. 'Go anywhere' can 'Go nowhere' as a manager extends into areas where they lack skill
- Paying for alpha and getting beta

Giving Credit Where Credit Is Due

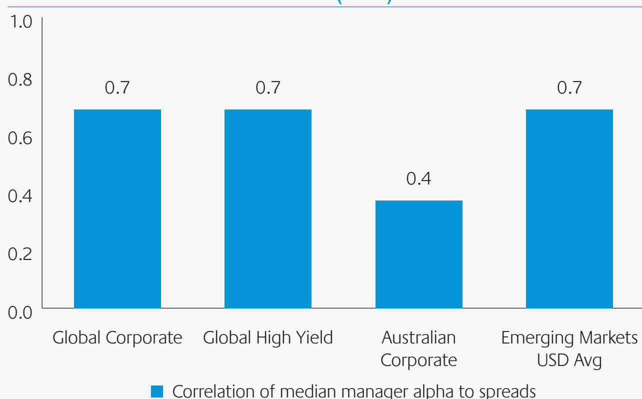
The final piece of preparation before focusing on assessing unconstrained fixed income managers is an honest discussion about credit. Don't get us wrong, we love credit! But recently the strong performance of the credit market has allowed some managers to hide behind the market return (beta) by simply being overweight to credit and hence outperforming a typical benchmark. If you have 60% allocated to credit compared to a composite benchmark of 40% and the credit market outperforms, then you're going to look great on a relative returns basis! However, is there any skill there? The manager hasn't necessary demonstrated investment skill, merely they've sat on an overweight beta position in a risk-on market environment that has benefited the entire credit market. So what happens to that fund when the credit market turns? Is that manager skilled enough and is that strategy flexible enough to continue to outperform in less favourable markets?

The charts below show the high correlation of the median manager performance to the overall credit market. It appears that past performance has been guided by a high correlation to the underlying market. All well and good when the market performs but again what happens when the credit market alone isn't offering strong investment returns?

eVestment Australian Fixed Income Core Universe



eVestment Global Fixed Income (AUD) Universe



Median manager alpha are eVestment Australian Fixed Interest – Core universe, and eVestment Global Agg Fixed Income (AUD Base) universe median manager excess returns respectively.

Median manager alpha benchmarked against Bloomberg AusBond Composite Bond index.

Spreads are Barclays Global Aggregate Corporate, Global High Yield, Australian Dollar Aggregate Corporate and Emerging Market USD Agg monthly excess returns.

Correlations calculated using monthly data from 30 April 2007 to 31 March 2017.

Source: Barclays, eVestment as at 31 March 2017.

Who's who in the zoo?

So with all that in mind how do you choose a Global Unconstrained Fixed Income manager or product? There are two key components – how is the product designed to meet its objectives and is the manager capable of delivering on the design? Measurement is really less about selecting the best performing manager, but more about determining whether the product and manager are likely to reach the right outcome.

We outline below a few questions that may help define the better products and managers.

Question #1: Has the product met its target?

Did the product meet its return outcome over the measurement period? Sounds simple, however the difficulty with this approach is that it often requires a lengthy measurement period, as typically most fund objectives are over 3-5 years and not all products have the track record and of course past performance is not an indicator of future returns! Also is the manager going to meet the target in the current climate which may be quite different to the past period of review? You could split the objective into smaller time periods to determine recent performance but performance doesn't equal skill and it doesn't equal repeatability.

Question #2: Are there other measurements or sub-objectives we can use?

The better unconstrained products are designed to serve a number of sub-objectives, for example:

1. Stability of returns i.e. low tracking error (variability of excess returns)
2. Strong risk-adjusted performance i.e. return per unit of risk or active risk taken
3. Returns that aren't overly sensitive to one or a small number of return sources or market factors

If these conditions are met, then the product is likely designed to hit its return objective. So ticking off these shorter term measures can be an indication that the product can deliver its objective over the longer term.

Question #3: Who's making the decisions and are they skilled?

To determine whether a product is likely to hit its target it pays to know the product. Specifically what decisions are being made around asset allocation and how those decisions are made – is it a computer model / program or an investment committee? The processes around decisions can highlight risks and potential for missed opportunities. Once these key decisions are made, how are they implemented? Likely there's some manager discretion involved and hence this is where we need to pay attention to the skill of the manager. How effective is the manager's decision making process? How repeatable is their skill?

Skill is of course hard to measure especially if there's no transparency in the investment decision making process. As with the credit example earlier, where managers can hide behind big market beta calls, skill can look like it's there when really it's just the market return again hiding the manager's true skill (or lack thereof). In positive market conditions, a manager may deliver a positive return but is that return based on truly positive skill or

have they actually been quite unskilled and lost out on additional return that a well-skilled manager would have achieved? This should be relatively easy to determine if the manager is transparent with their investment decision process.

Once you have an idea on a manager's skill levels and repeatability of skill, it is possible to determine whether or not the product has a good chance of meeting its target return. Specifically, if positive total portfolio returns are only made possible by positive outcomes from a small number of decisions (for which you can see the manager has demonstrated variable skill), then the product's chance of hitting its target is probably pretty low. If, on the other hand, there are no dominating decisions (house views) and instead a number of more balanced decisions (all of which contribute a little), then the product may have a better chance of providing better returns.

Question #4: Is skill transferable?

Many Global Unconstrained Fixed Income product rely on the concept of skill transferability. In other words, there is a leap of logic that posits that a manager who is skilled in one part of the market will naturally be skilled in another area. For example, an expert and successful manager of mortgage-backed securities will now have the freedom to make asset allocation decisions and ultimately make the call on a number of fixed income and credit sectors.

As a simple analogy – imagine a world-class symphony where the conductor suddenly asked the trombone section to swap with the violas. While each musician is likely accomplished in their particular instrument after a lifetime of experience and practice, they will not be able to successfully move into another section. Perhaps brass players can get by within another area of the brass section (e.g. trumpets playing French horns), but they will unlikely be competent in the percussion or woodwind sections. Although it sounds absurd, this is exactly what many go-anywhere investment products attempt to do.

Unfortunately, skill is usually not transferable, especially as a portfolio manager gets further away from his or her expertise. Therefore, accurately assessing a manager's skill in all areas they will be responsible is critical to a product's success. And we would recommend a model whereby specialists stay focused on their proven area of expertise.

Question #5: What about traditional risk-adjusted measures? How sharp is your Sharpe?

Finally, some managers measure the Information Ratio (or Sharpe Ratio) of their important decisions – that is the ratio of return per unit of risk taken. A higher (and positive) Information Ratio demonstrates an efficient use of risk. To the extent that this data is available, it provides a useful insight into the manager's capability in producing acceptable and repeatable performance outcomes. However, most risk-adjusted return measures do not typically make any reference to the opportunity available in the market. If a manager has a very high Information Ratio but hardly had any risk on during a strongly trending market, then we do not believe this is a strong outcome.

While answers to these questions can help discover the best products and managers, there is simply no single, perfect measurement process for evaluating the Unconstrained universe. Gaining access to a variety of comparative metrics and having a complete understanding of a manager's process and product design is the best solution.

Great expectations – recommendations to avoid disappointment

While common definitions continue to be elusive in the fast-moving Global Unconstrained Fixed Income space, our discussions with clients have led to several universal demands as it relates to their fixed income exposure. First, fixed income should behave like fixed income. In other words, in most cases investors in fixed income own other assets and expect fixed income to be defensive. This means that both the beta and alpha components of a portfolio should seek to counterbalance growth assets such as equities. Second, clients want diversification within their fixed income portfolio. This means that although managers should be opportunistic, this should not be confused with concentrated. Clients can invest in a specific sector-focused product (often in a very cost-effective manner) but hire a flexible global manager to take advantage of a variety of opportunities. Finally, clients are willing to pay for alpha but not for beta. While this point should be obvious, historically it has been difficult to disentangle the two.

To ensure clients are not disappointed with their Global Unconstrained Fixed Income portfolios, we would make the final recommendations to avoid disappointment:

- Align the product's objective with client's needs and explain the trade-offs
- Confirm the purpose of the benchmark - for manager comparability or to deliver a required beta profile
- Set guardrails where applicable to avoid product creep – a diversified fixed income products should not exclusively become a credit product
- Understand that income targets represent a constraint – consistent income generation requires large credit exposures and typically less asset liquidity
- "All-weather" products require derivatives use – being nimble and active should not generate undue transaction costs and derivatives are often the most cost-effective instrument

Decoding Terminology

- Strategic bond: Total Return approach (often shorter duration)
- Diversification of risks: This means derivative use. Exchange traded or cleared derivatives allow for very liquid long / short investment.
- Income Objective: This is code for 'Credit Risk'. Expect a 'long only' performance component driven by heavy allocation to credit markets.
- Liquidity: Higher income means higher illiquidity. The need for client withdrawals can be at odds with an income objective.

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