Unconstrained Fixed Income:

Is Now The Time To Embrace Non-traditional Solutions?

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Fixed income markets are currently undergoing profound paradigm shifts. Many investors believe central banks are stretched to their capacity to stimulate markets and are instead looking to governmental fiscal policy to boost global economic growth. Recently,

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anticipation of increased government spending signalled higher inflation projections, consequently leading to higher interest rates.

Many of the world's largest bond managers view this as a possible indicator that the bond market's three-decade bull run is finally coming to an end and are beginning to favour unconstrained bond solutions that possess the freedom and flexibility required to handle rising rates and increased volatility. Traditional benchmark-driven approaches benefited from widespread global monetary stimuli which drove government bond yields to historically low levels and shrunk credit and liquidity premiums. But these strategies are benchmarked against the overall fixed income universe, which remains subject to increased interest rate risk.

Are institutional investors ready to significantly loosen investment constraints on duration, geography, or even credit quality to provide their fixed income managers with greater investment flexibility to better preserve capital in a rising rate environment? The following aims to provide a general overview of unconstrained bond strategies from a Canadian investor perspective.

Unconstrained Explained

There is little consensus on the exact definition of what unconstrained fixed

income strategies are as terminology varies across managers, consultants, geographies, etc. One thing that is common to all bond funds classified in this category is that they are not managed against a specific benchmark and, therefore, do not have typical fixed income constraints on duration, maturity, geography, or credit quality. For example, core fixed income funds generally hold a mix of federal, provincial, municipal, and investment-grade corporate securities, whereas unconstrained funds generally invest opportunistically in global bonds (including emerging market debt), currency, high-yield and structured bonds, commodities, and sometimes even equity. Also, an unconstrained manager's toolkit often includes access to and/or use of derivatives, swaps, leverage, and taking short positions. By being unconstrained, these 'go-anywhere' funds should have the potential to navigate, and generate gains in, almost any market environment.

Allocating capital on the basis of a benchmark that does not take into consideration the relative risks of the underlying assets can be hazardous. Most fixed income indices are constructed using a series of rules (geography, rating, currency, sector, etc.) that are applied to the existing universe of debt securities. As organizations issue more bonds that meet these pre-defined rules, these securities become a larger component of the respective index. Consequently, benchmark-driven portfolios will tend to be weighted and concentrated towards the most indebted issuers. Also, by only being comprised of outstanding bonds, indices tend to limit portfolio manager flexibility. For example, derivatives can be an effective tool in hedging some portfolio risk exposures, but are not included in fixed income benchmarks. Finally, on the subject of risk, current bond indices exhibit greater duration, carrying more interest rate risk, especially in Canada where the overall universe's duration extended more than 2.5 years since 1994. Over the same period, yields compressed more than seven per cent, significantly diminishing the 'income' cushion that would offset future rate increases.

Unconstrained bond funds were in existence before the 2008 global financial crisis (GFC). The GFC, and the unprecedented accommodative monetary policies that followed, played a major role in drawing attention to these alternative fixed income strategies. These accommodative policies, and the notion that interest rates were being held artificially low for so long, drove a whole new set of fears within the investment community. Due to the flexibility they may offer in duration management, unconstrained bond funds are equipped with the ability to better preserve capital in a rising rate environment. Therefore, during the 'taper tantrum' episode when interest rates rose swiftly in response to fears of faster-than-expected Fed tightening, unconstrained bond funds' popularity surged. Many investors began pouring billions of dollars into these unconstrained bond funds in an attempt to sidestep interest rate risk.

By 2015, their patience had worn thin because these strategies had failed to deliver consistently over the years. According to Morningstar Inc. data, after six consecutive years of net inflows, unconstrained bond funds experienced over US$15 billion of net outflows in 2015 – a year that saw the category post an average decline of 1.41 per cent. Furthermore, in 2016, despite recording one of their best performing years with an average 5.15 per cent return, non-traditional bond funds have seen redemptions ballooning to over US$20 billion in the first 11 months of the year.

Lagging performance compared to traditional bond or high yield strategies partially explains why investors seemed to have temporarily abandoned the category. Exploring the factors that drove demand for unconstrained approaches, and looking at their associated risks, may provide some clarity on why they have a reputation, fairly or unfairly, for taking undue risks to chase returns. Beyond capital preservation, investors also expect unconstrained fixed income strategies to provide higher yields.

Most unconstrained bond funds do lean hard on their principal objective to mitigate interest rate exposure which inevitably translates into increased exposure to credit risks. According to latest Morningstar data, the average exposure to below investment grade or unrated securities in unconstrained strategies was around 40 per cent. In addition, ***Table 1*** shows high correlations between non-traditional bond funds, high-yield bonds, and leveraged loans as well as U.S. and emerging market equities since before the GFC. When equity markets decline, this is when the diversifying effect of the fixed income component should come to the rescue. Historically, unconstrained approaches haven't been able to fulfill that duty. In addition, the complexity and opacity of some non-traditional bond strategies sometimes makes their evaluation difficult. Ironically, unconstrained bond funds often appeal to investors who want to avoid interest rate risk, while other risks assumed by these funds might be overlooked.

Should debt investors really fear a multi-year period of sustained losses? Nobody will dispute that the last three months of 2016 were brutal for bond returns. In fact, it was the worst quarter for government bonds since 1987, according to data compiled by Bloomberg. In Canada, the overall bond universe was down -3.44 per cent, with 10-year Canadian Government bond yields up 72.5 basis points over that period. Other 'catastrophic' years for bond investors over the past three decades include 1994, 1999, and 2013, with the Barclays U.S. Aggregate Bond Index returning -2.92 per cent, -0.82 per cent, and -2.02 per cent respectively.

Putting things into perspective, we are not trying to diminish the impact that negative bond returns can have in trying to achieve a target objective or to reach a liability hurdle rate. But, when looking at broad fixed income indices' historical returns, bonds produced a negative outcome only three years out of 37 since 1980. The average annual gain for the same U.S. bond index over the period was eight per cent! Canada faces a similar situation, with only three years of negative returns and an average annual gain of nine per cent since 1980.

In all fairness, as demonstrated previously, today's current low rate environment, with indices carrying more interest rate risk and providing much less income, is a reminder that we are not

Table 1

UNCONSTRAINED BOND FUNDS' CORRELATION MATRIX, 1/1/2007 To 12/31/2016

High Correlation Coefficients With High Yield, Leveraged Loans, U.S. And Emerging Markets Equities

	1	2	3	4	5	6	7	8	9
1. US Fund Nontraditional Bond									
2. BBgBarc US Agg Bond TR USD	0.17								
3 S&P 500 Composite TR USD	0.70	0.02							
4. BofAML US HV Master II TR USD	0.93	0.25	0.73						
5. S&P/LSTA Leveraged Loan TR	0.87	-0.01	0.59	0.86					
6. BBgBarc US Corp IG TR USD	0.58	0.81	0.34	0.64	0.41				
7. JPM EMBI Global TR USD	0.71	0.60	0.58	0.78	0.53	0.78			
8. BBgBarc US Treasury TR USD (1972)	-0.31	0.85	-0.32	-0.25	-0.46	0.42	0.19		
9. BBgBarc US MBS TR USD	-0.05	0.87	-0.13	0.03	-0.16	0.54	0.43	0.81	
10. BBgBarc US Treasury US TIPS TR USD	0.36	0.76	0.17	0.43	0.24	0.67	0.66	0.57	0.63

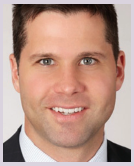
Source: Morningstar Inc., as of 12/31, 2016.

positioned at the same starting block as we were 30 years ago. Historical bond return information should provide a context and background on which investors base decisions. However, the past is not indicative of the future and the long-term can also be very 'long' in arriving.

Replacing Benchmark Risk

With such a short performance history, unconstrained bond strategies don't compare or fare very well thus far versus more traditional fixed income approaches. Traditional core bond funds have fared better based on five-year annualized returns, with a much better Sharpe ratio. A transition or an allocation from core fixed income to non-traditional bond strategies might be viewed as replacing benchmark risk with manager risk. As a result, a thorough due diligence process must be conducted prior to embracing this newer category. Investors should carefully assess the risks embedded in unconstrained approaches and evaluate within their asset mix framework if the potential rewards can offset those risks.

We believe that current market conditions demand greater active management and more flexibility to not only produce superior risk-adjusted returns, but to better preserve capital. For example, one potential solution might be a core plus strategy with an opportunistic allocation exposure to global bonds, with the ability to move down the credit quality spectrum and/or provide some discretion to currency hedge. You then get to keep one hand on the wheel and both eyes on the road instead of blindly handing the keys to your fixed income manager. **BPM**



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