By Richard Westlund

Investors need to take a careful approach to the fixed-income market in 2016. Along with seeking to improve yields, risk management should be a priority in the months ahead, according to professionals who focus on bonds, mortgage-based securities, bank credits, Treasuries and other fixed-income securities.

"We look at the coming year as a challenge," says Roger A. Early, managing director and head of fixed income investments, Delaware Investments. "While there are some attractive income opportunities, the underlying credit landscape will be challenging."

One of the most serious downside risks is how the lower price of oil will affect issuers in the energy sector. "The fixed-income market had a very volatile year in 2015, with events in Greece and China roiling markets," says Michael Taylor, senior managing director, Wellington Management. "However, the big theme was the continued decline in oil and other commodity prices. We see that as the dominant question for this year, as well."

Early notes that the strength of the dollar is putting pressure on some borrowers in international markets. "Investors should pay close attention to the value of the dollar, because that could hurt principal performance on emerging market debt," he says.

On the upside, the U.S. banking sector appears to be stronger and may offer an appealing play for fixed-income investors, says Early. "Because of greater regulation, the banks have been forced to take a more conservative approach," he adds. "Therefore the banks have not been growth engines for equity investors, but they are more attractive from a credit investment standpoint."

Other opportunities may be found in both developed and emerging markets, depending on monetary policies, new issuances, and the shape of the yield curve from short- to long-term durations.

"Investors in 2016 should take a disciplined approach to the fixed-income market," says Craig MacDonald, head of credit, Standard Life Investments. "Be nimble and flexible, and look at the global opportunity set. Don't get locked into a large duration or asset allocation risk. Instead, look at your options and focus on building a diverse fixed-income portfolio."

Monetary policies

The Federal Reserve's decision to raise short-term rates in December has changed the landscape for fixed-income investors in 2016. "We are already observing the impact in terms of wider credit spreads and a weaker high-yield market over the last few months," says

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Creating New Fixed Income Betas Built Around Investors' Needs

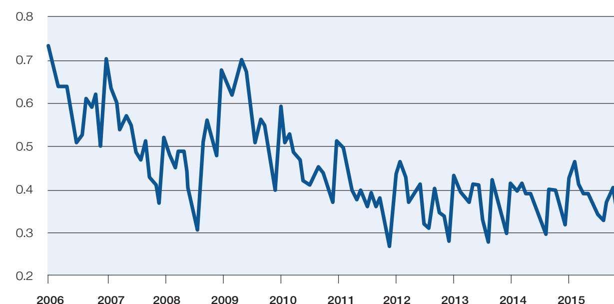
Many investors assume that outperforming a market benchmark should be their main objective. This can only be true, though, if the benchmark is designed to meet the investor's needs. Yet by ignoring credit quality, duration, volatility, diversification, and liquidity, traditional capitalization-weighted indexes generally do not incorporate the factors that really drive fixed income investment outcomes. In our view, an appropriate benchmark starts with a clear understanding of the investor's objectives.

Many of the arguments against the use of cap-weighted indexes as portfolio benchmarks are familiar. The largest issuers are precisely the ones most heavily represented, even though high levels of indebtedness can have a negative impact on an issuer's credit quality. Since the financial crisis, policy accommodation and quantitative easing by key central banks have further distorted the relative weightings of issuers in global indexes. The duration of broad-market indexes has been lengthening in recent years as interest rates remain low globally, spurring worries about capital losses as rates rebound.

Furthermore, the post-crisis era has seen a significant constriction in secondary-market liquidity. Though liquidity pressures are most pronounced in credit markets, they have also surfaced in the market for government bonds, as evidenced by the "flash crash" of 15 October 2014 in US Treasuries. Investment strategies that seek to track a cap-weighted index are compelled to trade securities each time the index rebalances in order to achieve their objective. Such "forced" transactions can unnecessarily impair after-fee returns under normal conditions, and be even more costly in periods when market liquidity conditions are stressed. The annual cost of rebalancing can be meaningful. For example, Barclay's Liquidity Cost Score estimates the cost of executing a round-trip trade in US investment-grade credit as of 31 December 2015 to be 0.83%. *(See chart.)*

Liquidity conditions in secondary markets can be challenging

Daily turnover of outstanding US corporate bonds (%)



Sources: SIFMA, Barclays, Wellington Management

These circumstances call for new forms of market exposure that are responsive to investors' goals. Such goals could include a desire to fine-tune market exposure by consciously balancing risks; adoption of low-turnover strategies to reduce investment costs and enhance after-fee returns; and moving beyond rules-based approaches to build in forward-looking, fundamental insights.

To illustrate our belief that cap-weighted indexes can be improved upon, with reshaped market betas addressing all three goals cited above, we offer two examples from developed and emerging markets. These approaches, whose features are based on extensive empirical research, have the potential to deliver long-term returns similar to the standard indexes but with less volatility.

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Improving Emerging Local Debt Beta With Systematic, Research-Based Tilts

Evan Ouellette
Fixed Income Portfolio Manager

Robert Fuhrman
Director, Fixed Income Quantitative Research

In contrast to traditional cap-weighted indexes for emerging local debt (ELD), this strategy seeks to emphasize areas of the market that have demonstrated higher returns for the level of risk taken in investing in such areas. The approach adopts structural tilts, based on extensive empirical research on historical return patterns, such as the following:

• *Emphasis on intermediate-duration over long-duration bonds.* Intermediate-maturity securities appear generally to have offered more reward per unit of risk historically than long maturities across the world's bond markets. While long-duration bonds may make sense for the domestic investor with long-term domestic liabilities, the non-domestic investor bears significantly higher risk with little to no compensation for that extra risk.

• *Tilt towards high-carry versus low-carry currencies.* Academic studies have clearly demonstrated that currencies with high carry – that is, relatively high short-term interest rates – produce greater home-currency returns (interest plus currency effects) than low-carry currencies.

• *Mitigation of currency risk through nuanced hedging.* ELD indexes are typically either fully hedged to currency risks or not hedged at all. However, one can selectively reduce risk by hedging out certain currencies where there is no expectation of return.

• *Diversification of country exposures.* Country exposures in traditional ELD indexes, as in their developed market counterparts, are concentrated in the most indebted issuers. More balanced approaches can lessen risk through greater market diversification.

Fundamental, forward-looking qualitative judgment is applied to these structural tilts before portfolio implementation.

A Discretionary, Research-Based Approach to Improving Investment Outcomes in Global Government Bonds

Mark Sullivan, CFA, CMT
Fixed Income Portfolio Manager

John Butler
Global Bond Strategist

This unlevered, benchmark-agnostic strategy seeks to capture the benefits that government bonds have historically provided to a portfolio — diversification, liquidity, a hedge against low economic growth and disinflation — through a discretionary investment process, enhanced diversification, and a focus on downside risks.

• *Credit risk:* Our approach breaks out the analysis of credit risk into components. The process starts with data feeds into our proprietary Sovereign Risk Framework, which generates a sovereign credit score and corresponding rating for over 20 countries. We also tap the firm's broader research platform and our country specialists' knowledge to understand an issuer's short-term, cyclical dynamics. As a final step, we overlay these sovereign scores on top of current market pricing to assess valuations.

• *Interest-rate risk/duration management:* We use our strategists' global cycle research to gauge whether the strategy should be in return-seeking (longer duration) or capital-preservation (shorter duration) mode. Currently, we believe markets are in the early stages of a rising-interest-rate cycle which will likely be led by the US. Hence, we think it is prudent to lower duration in order to mitigate capital losses.

• *Currency risk:* The high degree of volatility expected from unhedged currency exposure is typically undesirable for government bond investors. Non-home currency exposure is therefore hedged back to the portfolio's base currency.

We think these low-turnover approaches, which are not beholden to a rules-based, index-oriented framework, allow flexibility in adjusting to evolving market conditions and offer attractive alternatives for investors seeking global bond and/or ELD exposure in today's liquidity-constrained environment.

For more details, please visit:
www.wellington.com/strat_gov_bonds *and* www.wellington.com/smarter_ELD

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Richard Familetti, senior portfolio manager, Ryan Labs Asset Management, a Sun Life Investment Management company.

Familetti adds that the Fed is very sensitive to market conditions, and further rate increases may be more gradual than expected. "If so, that might create opportunities for fixed-income credit investors," he says. "At the same time, a more aggressive scenario for Fed tightening could have a positive impact on the long-duration segment of the fixed-income market."

Unlike the Federal Reserve, the European Central Bank and Bank of Japan will continue to inject liquidity to stimulate their economies, notes Taylor. "We think current valuations of global investment-grade corporate bonds are attractive and expect spreads to tighten," he says. "Corporate credit fundamentals are also positive."

In the U.S., a healthy real estate market, gains in employment and lower energy prices are driving consumer demand, and a similar trend is occurring in Europe, Taylor says. "However, uncertainty regarding the outlook for China could contribute to a mid-cycle economic slowdown and will likely be a source of continued volatility for the next few months. But we don't believe the credit cycle is coming to a close."

Investment-grade bonds

If stocks are volatile, high quality-bonds may have a good year and provide a solid anchor against the ups and downs in the equity market, says Early, adding that the Fed's rate increase may boost pricing for high-quality issuers.

"In terms of spreads, U.S. investment grade bonds are near recession levels, despite economic growth," says MacDonald. "Since growth is expected to continue in 2016, this sector is looking like a reasonably good entry point for fixed-income investors."

Familetti, who focuses on investment-grade, liability-driven investing (LDI) and total return investing, says some energy companies may become fallen angels, with downgraded bonds. But many of their issues are already trading at levels that reflect that credit risk. "So, we see opportunities in long-duration investment-grade energy bonds," he says. "If an investment grade corporate bond is trading at 50 to 60 cents on the dollar – no matter the yield or spread – there is much less downside risk on that debt if you are comfortable with the company's long-term prospects."

Investment-grade investors are also concerned about event risks, such as leveraged mergers, acquisitions or recapitalizations that result in the issuance of new debt and make it more difficult to repay current bondholders. "With credit markets under pressure, it may be harder to finance large, lower quality debt deals in this new environment, and so it's possible that event risk will be less of a problem this year," Familetti says.

Last year, new issues in investment-grade corporate bonds surpassed $1 trillion, and that total could be repeated again in 2016, says Early. "There was a large backlog of M&A deals at the end of the year that will result in new issues, and the banking sector is also likely to go into the bond market to raise capital," he says. "That will offset a reduction in the energy sector."

Other fixed-income sectors

In-depth research and analysis is particularly important when looking for opportunities in the global high-yield sector, says Taylor. "There is a tremendous bifurcation in the high-yield market between commodities and non-commodities issuers," he says. That's because some emerging markets like the Philippines, Poland and India benefit from dramatically lower oil prices, while oil-producing countries like Venezuela have seen their credit ratings plummet. A few commodity exporters like Indonesia have carried out economic and policy reforms to adjust to lower prices, Taylor adds.

"Defaults in the high-yield market have increased in the last six months and are bound to rise in the months ahead," says Early. "Currently, we are light on fixed-income credits in metals, mining and heavier industrials. We are also careful in healthcare, where M&A activity has been heavy."

Familetti says fixed-income investors may want to consider the structured credit markets, including asset-backed securities (ABS) and convertible mortgage-backed securities (CMBS). "Post-2008, structural and collateral quality is much better and we see opportunities relative to corporate credit," he says. "After all, these issuers are not drilling for oil."

Demand from taxable investors remains steady in the municipal bond market, says Early. "The market has done an excellent job at ring-fencing problems such as Puerto Rico or Detroit," he says. "The rest of the market has largely been a positive credit story. However, the relative yields now are less attractive than in the past."

Finally, Familetti suggests a conservative approach to the fixed-income market, especially in the long-duration sector. "There is nothing wrong with owning more U.S. Treasuries or cash than your benchmark," he says. "That reduces your credit risk and mitigates overall portfolio risk, which can be critical if you seek to outperform your benchmark in a volatile environment." ■

Michael Taylor
Wellington Management

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