Advanced Beta Strategies in Fixed Income

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Advanced beta strategies at SSGA seek to extract factor-risk premia in fixed-income markets. Despite somewhat lagging equities as a formal construct, factor investing is not new to fixed income. Investors have traditionally positioned along risks related to duration, credit or term premia. These are, however, combinations of underlying risks. The corporate credit premia for example can be viewed as a combination of default and liquidity risk to be managed and exploited separately.

We find evidence of four key factor premia (See Figures 1-4). These are quality, value, momentum and volatility. Clearly liquidity plays a central role, and we often find that factors such as size are confounded by liquidity effects. We incorporate liquidity considerations within our design. We see evidence of these premia when a risk factor is priced in the cross section of bond returns. We sort the investment grade universe into decile portfolios ranked by each risk factor. We can see from the downward slope in returns for volatility or for quality, that this factor is related to higher returns in the top relative to bottom portfolio. We also find that size, for example, or momentum has much more mixed evidence of a related premium.

While empirically interesting, advanced beta strategies have to be investible and conceptually clear in their source of return. We have designed strategies to harvest the quality, risk premium in corporate and sovereign credit space. We create portfolios of corporate or sovereign bonds that are mispriced relative to the quality/value implied by the state of firm or country fundamentals.

Corporate and Sovereign Quality

While credit has always been organized along the concept of quality, until recently ratings were the only measure available to investors. These tend to be discrete and lag actual credit events. At SSGA, we use a measure that continuously evaluates a bond’s quality as a function of its default risk and firm fundamentals. We find evidence that this ‘quality premium’ is larger as we extend further into the capital structure among BBBs and further into high yield. SSGA currently manages assets in a quality corporate strategy that tilts an A and above benchmark toward names that exhibit quality premium, and we are extending this methodology to tilt toward the higher quality names in barbell type portfolios throughout the corporate credit universe.

Sovereign credit risk is very familiar to investors, and traditional market, cap-weighted indices are heavily concentrated in highly indebted nations. Clearly the degree of sovereign risk is tied to fundamentals, but countries can also sustain poor fundamentals for a long time until a loss of confidence triggers a crisis event. Our methodology relies on identifying long- to medium-term trends in macro conditions and rewarding or penalizing markets accordingly. During normal times investors are compensated for taking a measure of sovereign risk, and during extreme times, we use measures of market sentiment to position aggressively against countries with a loss of market confidence. The strategy operates on top of traditional market cap indices, and we have found steady compensation for sovereign risk through the Eurozone crisis, and consistently in emerging markets.

Conclusions

The advanced-beta field continues to develop rapidly in fixed income. At SSGA, we have made strong strides in developing quality/value based, factor-harvesting strategies both in corporate and sovereign credit. As we advance this work, we are extending to the full suite of premia and more broadly and deeply within credit and across markets.

For more information on State Street Global Advisors Advanced Beta capability or to read this paper in its entirety, please visit ssga.com

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