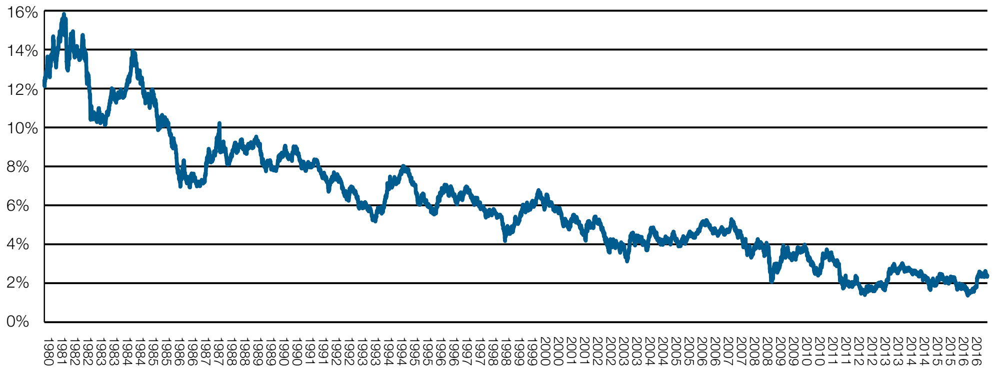
Unconstrained Fixed Income:

Why Now?

MACKAY SHIELDS

Investors today find themselves in an unusual quandary. Historically, they have thought of fixed income investments as a relative safe haven to offset more volatile and risky investments in other parts of their portfolios, including equities. The risk of capital loss in bond portfolios was generally viewed as limited. That premise no longer holds. After decades of falling interest rates and the past several years of unprecedented global monetary intervention, investors in conventional bond strategies are becoming increasingly concerned about risk of loss as interest rates potentially renormalize. They are reviewing the role of traditional fixed income and are seeking alternatives that better avoid uncompensated risk. We believe that unconstrained fixed income strategies are a potential answer to these concerns. Unconstrained approaches are able to allocate capital and adjust their risk exposures dynamically, across the fixed income spectrum, with fewer constraints.

Historical US 10-Year Treasury Yield



Through 07/04/2017, Source: Bloomberg, MacKay Shields

The Investment Landscape Has Changed

The risk-return trade off offered by duration-sensitive assets has changed. The most obvious aspect is the scarcity of yield has made things increasingly difficult for income investors. More fundamentally, the whole concept of high grade bonds as “safe haven” assets is being called into question.

In the past, investors have been well compensated for taking interest-rate risk through both income and capital appreciation. For 30 years, institutional investors were commonly advised to have between 20 and 40% of their portfolio in bonds because of their negative correlation to equities and ability to provide ballast in times of stock market upheaval. And, historically, Treasuries and other high quality sovereign bonds have been an effective safe haven.

However, Treasuries’ usefulness as a diversifier rests on their potential to appreciate and, given today’s low level of yields, that potential is now more limited, irrespective of whether risk aversion increases. It’s not safe to assume that the periods of strong negative correlation with equities we’ve seen in the past will be repeated in the future.

One way to think about the risk/return tradeoff is breakeven levels: how much of an increase in interest rates can a bond investor absorb before incurring a loss? For example, in 1999, rates rose dramatically and bond prices fell by more than 7%, but coupon income was high enough to absorb most of that, and the total return on the Barclays US Aggregate fell by just -0.83%. Today, that layer of insulation is awfully thin. At the end of March 2017 the average yield on the index was only 2.6%—less than half of what it was at the start of 1999. At those levels, yields would only need to rise 0.43% before the Barclays Aggregate would start to suffer a loss.

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A Different Landscape Calls for a Different Approach

Concern about rising rates and a desire to manage downside risk are fueling investors' interest in unconstrained bond strategies. As the name suggests, unconstrained is a "go anywhere" approach that gives managers the flexibility to allocate capital more efficiently, taking the risks that offer the best compensation at different stages in the economic cycle. They are able to invest in a broad global opportunity set spanning sectors such as emerging markets and high yield corporates as well as investment grade securities. They are not tied to a traditional benchmark so they can choose how much interest-rate exposure they take. To varying degrees, they typically also use hedging instruments and short positions to manage risk.

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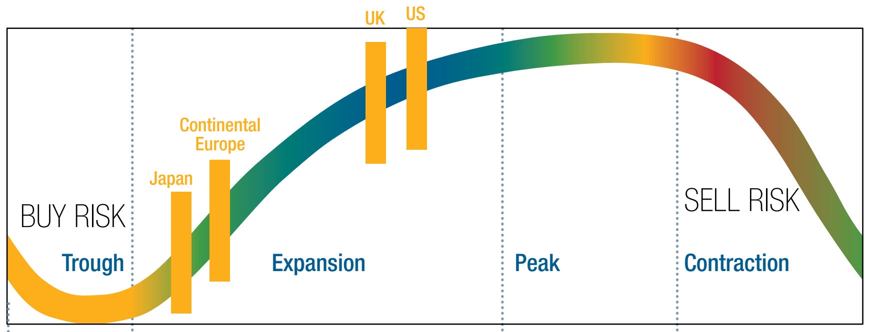
History has shown that no single fixed income sector performs well in every environment, so increased flexibility and a dynamic approach can enhance returns. For example, if the economy is moving into an expansion phase, credit-risk driven securities such as high-yield corporate bonds have historically tended to outperform Treasuries. Conversely, if the economy is heading into a slump or risk appetite is falling, managers might choose to reduce their credit exposure and take on more duration. The 2008/09 financial crisis is a good example: Duration assets outperformed credit during the crisis, then credit sharply outperformed Treasuries in the recovery.

Some market participants argue that unconstrained investing is simply about replacing interest rate risk with credit risk. But the reality is much more nuanced. We'd argue that it's more a case of shifting away from uncompensated risk in favor of compensated risk. The landscape is a moving target: duration is of great concern in the current environment and investors are better compensated for credit risk. So today, many unconstrained portfolios hold more credit than duration (for example, we think high yield bonds currently continue to offer an attractive risk/return tradeoff.) But the opposite is likely to happen at some point down the road. A key objective of unconstrained managers is to correctly identify shifts in the landscape and adjust the portfolio accordingly, and flexible mandates allow them to do so.

Real GDP



	Trough	Expansion	Peak	Contraction
Central Bank Action	• Fed loosening • Low interest rates • Wide credit spreads	• Fed on hold/tightening • ↑ Interest rates • ↓ Credit spreads	• Fed on hold/tightening • High interest rates, but falling • Narrow credit spreads, but widening	• Fed loosening • ↓ Interest rates • ↑ Credit spreads
Sector Emphasis	• High Yield • Emerging Market • Equities • Convertibles	• Investment Grade • Asset-Backed Securities • Commercial Mortgage-Backed Securities	• Agencies • Agency Mortgage-Backed Securities • Global Government	• Treasuries
Duration	Shorten	Short	Lengthen	Long
Yield Curve	Steepener	Steepener to Flattener	Flattener to Steepener	Steepener

As of 1Q 2017

The Outlook for 2017 and Beyond

We believe there will be continued upward pressure on short-term US interest rates in 2017 as the Federal Reserve tightens monetary conditions and the new administration embarks on looser fiscal policies. The fundamental economic backdrop in the US has been durable; consumption is being supported by a healthy consumer enjoying wage gains from a tighter labor market, and an increase in wealth from a burgeoning housing market. President Trump's fiscal platform calls for an increase in spending, especially on infrastructure, and lower taxes for households and businesses. While tax cuts should be stimulative for the US economy in the short-to-medium term, some of the other proposals may not have the same impact, in our view. In particular, protectionist trade policies would likely curtail global growth and incite trade wars.

We do believe credit spreads could tighten modestly given our tempered outlook for corporate earnings and high levels of idiosyncratic risk. Valuations generally remain fair across the credit sectors but greater vigilance is required as we navigate the late stages of the current economic cycle.

Written by

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