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Talking Point

Fixed income funds: spotlighting themes from the GFC

by Simon Doyle, Head of Fixed Income and Multi-Asset, Schroders

The fixed income asset class remains under close scrutiny. Consultants, researchers and clients continue to grapple with the question of how best to manage fixed income in the post-GFC environment. Two consistent themes are emerging: disaggregation and passive management.

Disaggregation is effectively the separation of the fixed income asset class into specialised buckets with the buckets managed by specialist managers. While this is not unusual in the context of the separation and specialisation of higher risk elements of the fixed income universe (for example EMD, high yield and hybrids), it has historically been less common in Australia at a core level. However, the debate is now focussed on the separation of sovereign and credit risk, with further granularity applied to duration, securitisation, geography and credit quality (to name but a few).

The motivation for disaggregation is two-fold

Firstly, there is a logical argument that specialisation should result in superior alpha within the specialist bucket. The key word here is "should", as this will of course be subject to the specialist manager having and exercising the requisite skill.

Secondly, the experience of the GFC has illuminated the dispersion of performance across the fixed income universe. Clearly plenty of investors were caught out by being overexposed to the wrong parts of the universe. By disaggregating, the investor will (in theory anyway) have greater transparency as to the underlying exposures within the portfolio, and greater control over the exposure. By default this suggests that either the investor doesn't want to change exposures, or, they think they can do a better job than a single manager running an aggregated strategy.

While this sounds intuitively appealing, there are several reasons though why this approach may not work. The first is that there is a reactionary element to this evolution. Sovereign debt clearly performed exceptionally through 2008, highlighting its merits as an important diversifier and defensive asset. Whether this can be repeated in the short term is uncertain. Sovereign supply is growing rapidly amid the fiscal reflation efforts of governments globally and officially interest rates really only have one way to go from here. While we are not bond bears (and in fact have been and remain strong advocates of sovereign risk in portfolios), there is a real danger of over exposure to sovereign risk at the wrong point in the cycle.

The second point, and I believe probably the more significant, is the question of who controls the risk across the defensive asset class. Asset allocation remains the most important driver of the total return and risk outcome of any portfolio. Adopting a static mix, as will inevitably result from the disaggregation approach, means exposure will not vary much as risk premium and therefore risks change. My observation is that even with the best intentions it is very difficult for funds to make timely and meaningful changes to portfolio asset allocation.

Furthermore the ability to monitor, measure and manage risk is compromised by viewing strategies in isolation. The more granular the asset allocation, the more difficult this task becomes. Even where risks are identified, governance structures as well as underlying friction costs may prevent effective sector rotation within the fund. At the end of the day though, the real risk is that investors get "stuck" with exposures that worked well yesterday – but are unable to adapt to the future potential for risk and return.

While I cannot claim to be impartial, I do think stock selection skill is regularly over emphasised relative to that of asset allocation (especially in fixed income). At the end of the day it will not matter much if I have the best sovereign manager in the country managing my sovereign debt portfolio if sovereign bonds collapse. The same goes for credit. That was the story of 2008.

Cost

My final point is with respect to cost. The more a portfolio is disaggregated, the harder it is to benefit from scale. Smaller mandates to a broader array of managers are simply likely to cost more. So while the intent may be to improve the after-fee outcome for the investor, the result from disaggregation may in fact be exactly the opposite.

Active versus passive

The active versus passive debate in fixed income is also raging. While there are some subtleties to this debate as it applies to fixed income, several general principles apply.

Firstly, passive investing is not risk free. It may be free of “active” risk, but in a “total” risk sense it assumes the broad risk of the underlying index (or beta). It is this risk that will be the key driver of the return experience that the client enjoys. Being active or passive at the strategy level made very little difference to the client experience during the GFC!

The nature of the index is therefore critical. This is an important distinction between the fixed income and equity asset class. Market cap based indexes mean the bigger you are the more weight you have in the index. In fixed income, this means that the more debt you’ve issued (irrespective of whether you’re a government or a corporate) the greater your weight in the index. While the biggest borrowers are not necessarily the most highly levered, they are still the biggest borrowers and the greater your exposure to these entities will be.

Following on from this is an observation about alignment. Adopting a passive approach somehow assumes that the exposure provided is the right exposure for the investor. However, it may make little sense for an Australian investor to own index exposure to global sovereign and corporate borrowers simply because they are part of the universe. There is no direct alignment between this exposure and the objective of the investor in establishing a defensive component to their portfolio in the first place¹.

At this point, I will concede that I can see some merit in passive management (or at least enhanced passive management) in the sovereign space given default risk is effectively zero and more broadly it’s the broad sovereign beta that investors in this space require (duration management aside).

However, it makes absolutely no sense in my view to index the credit component of a portfolio. Adopting an indexed approach to credit means you own all credits in the index, including those that will inevitably default. An active approach at least gives you a fighting chance of avoiding downgraded and defaulting credits. Over time this will have a material impact on returns. Given the asymmetry of credit risk, it’s always the credits you don’t own that have the greatest positive impact on portfolio returns.

My final point in regard to passive management is related to the arguments presented above with respect to the disaggregation debate. A passive approach may reduce some management costs, provide transparency and at a point in time, expose the client to the appropriate market beta. However, the big question remains unanswered. How will this beta be managed through the cycle? Who’s pulling the duration levers, who’s selling and buying credit as risk premium rapidly adjust? It is these decisions that in my view will have the biggest impact on the post fee outcome for the client.

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¹ Simon Doyle, Head of Fixed Income & Multi-Asset, Schroders. “A fundamental perspective on the fixed income benchmark debate”, The Fix, Sept 2009

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