

Unconstrained Fixed Income: Why Now?

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 potential losses if interest rates rise. They are reconsidering the role of fixed income as a "return seeking" component of an asset allocation, and are seeking strategies that 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.

The Trouble with Treasuries

Fixed income returns are made up of compensation for taking interest-rate exposure (duration and convexity)—essentially the yield on government bonds—and compensation for taking exposure to credit risk, in the form of credit spreads. Historically, most bond investors have used a broad market index as their portfolio benchmark. These indices are usually dominated by high-quality assets: government and government-related bonds, asset backed securities and investment grade corporate debt. What these assets have in common is that they are all highly interest rate sensitive. (For example, Treasuries are essentially pure duration, and even investment-grade corporate bonds are relatively sensitive to interest rates.)

This duration sensitivity used to be a good thing for index investors. They participated in a phenomenal 30-year rally as interest rates declined from double digits in the early 1980s to the record lows of recent years (*Display 1*). Since the 2008/09 financial crisis, markets have been driven by massive liquidity injections by central banks, with bond purchase programs driving down the yields of government and other high-quality bonds. The trouble now is that yields don't have much further to fall. In the current environment, the risks and opportunities have changed, and investors have to look beyond interest rate exposure for their returns.

DISPLAY 1: HOW MUCH MORE UPSIDE IS LEFT FOR INTEREST-RATE SENSITIVE SECURITIES?



Through April 30, 2015
Source: Bloomberg

The Investment Landscape Has Changed

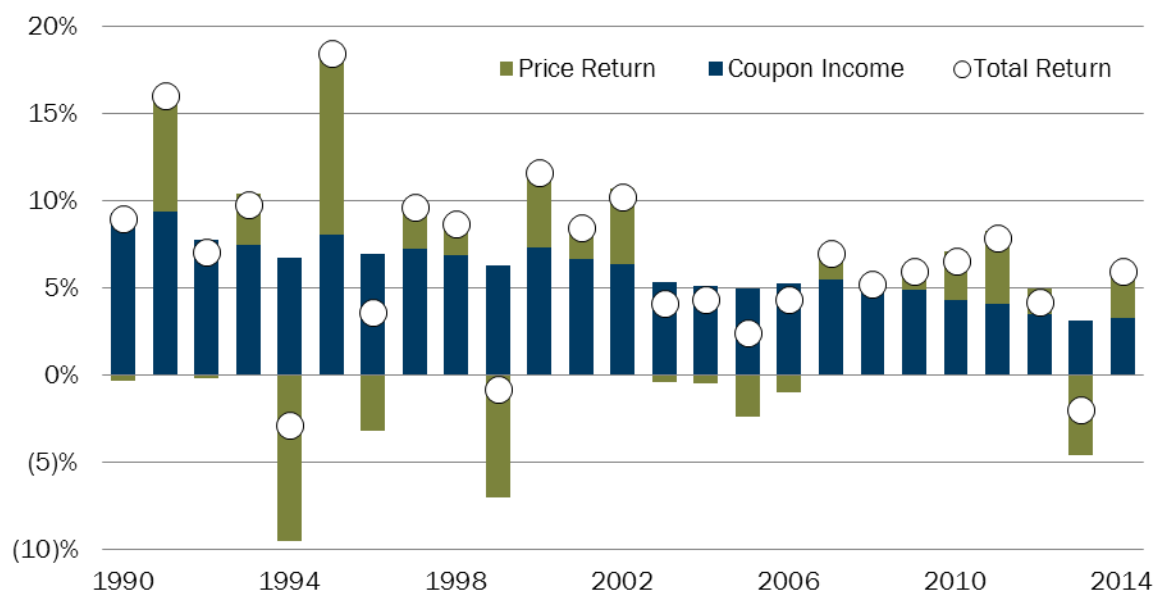
The risk-return trade off offered by duration-sensitive assets has changed. The most obvious aspect is the scarcity of yield as falling coupon rates have made things increasingly difficult for income investors. More fundamentally, the whole concept of high grade bonds as “safe haven” assets is being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

In the past, investors have been well compensated for taking interest-rate risk, not just in the form of income but also—as yields fell—in the form of capital appreciation. For 30 years, investors were commonly advised to have 40% of their portfolio in bonds because these were negatively correlated to equities and provided ballast in times of stock market upheaval. And, historically, Treasuries have been an effective safe haven. Most recently, they massively outperformed equities when risk aversion spiked during the Lehman Brothers collapse in 2008.

However, Treasuries’ usefulness as a diversifier rests on their potential to appreciate and, given today’s low level of yields, that potential is now severely 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 (for example, the correlation between US Treasury prices and the S&P500 was positive for much of 2014.)

One way to think about the risk/return trade off is breakeven levels: how much of an increase in interest rates would it take for bond investors to suffer 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% (*Display2*). Today, that layer of insulation is awfully thin. At the end of April 2015 the average yield on the index was only 2.1%—less than half of what it was at the start of 1999. At those levels, yields would only need to rise 0.4% before the Barclays Aggregate would start to suffer a loss.

DISPLAY 2: YIELD CAN NO LONGER BE RELIED ON AS A SHOCK ABSORBER FOR PRICE VOLATILITY



Barclays US Aggregate index, through December 31, 2014
Source: Barclays Capital

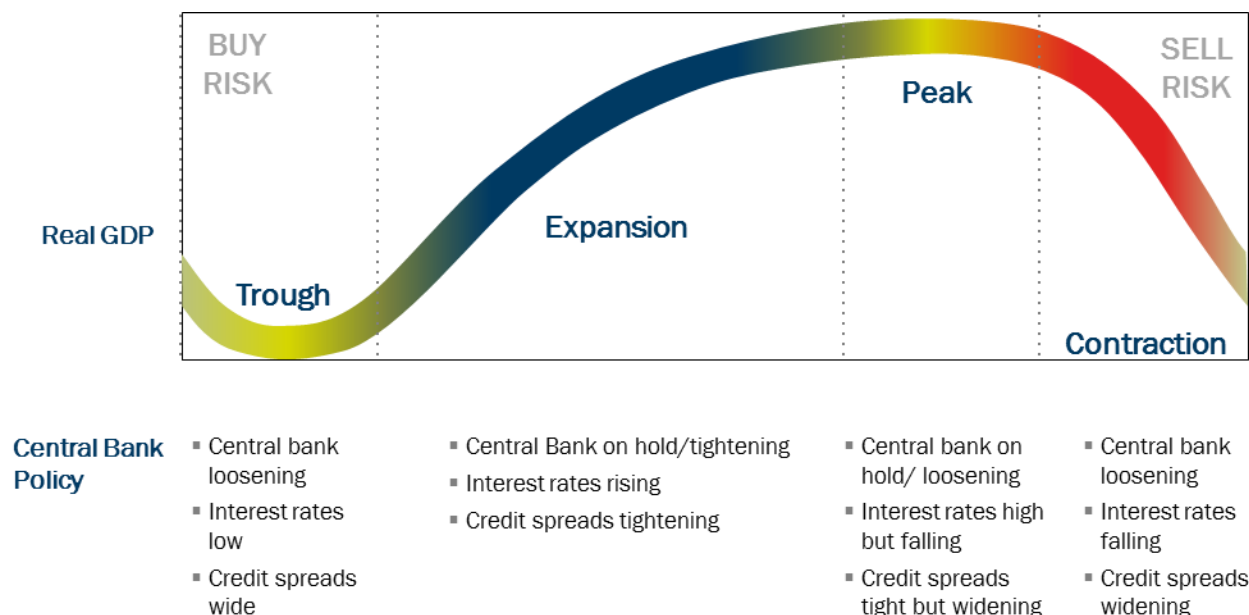
A Different Landscape Calls for a Different Approach

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.

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.

DISPLAY 3: CENTRAL BANK POLICY AND STAGES OF THE ECONOMIC CYCLE



This graphic is for illustrative purposes only. It represents a stylized economic cycle and does not represent the GDP growth of any given year. All expressions of opinion are subject to change without notice and are not intended to be a guarantee of future events.
Source: MacKay Shields

Implementing an Unconstrained Strategy

A “go anywhere” strategy seeks to identify the prevailing risks and return opportunities, whatever the stage of the economic and market cycles, so as to maximize risk-adjusted returns. This includes having some insurance in place against “tail events”—those rare but extreme market shocks that result in outsized losses, as happened in 2008/09.

The leaders of our Global Fixed Income team have worked together for more than 20 years. Based on their experience over several market cycles, they believe the best way to implement an unconstrained strategy is to integrate a rigorous fundamental bottom-up investment approach with a top-down macroeconomic overlay.

As part of the top-down element of our investment process we analyze the economic underpinnings of the market’s risk cycle. This takes into account the stages of the economic cycle, and the impact of monetary policy on the capital markets (*Display 3, above*). Central bank monetary policy action is the single largest contributor to credit availability and an important driver of the inflection points in the market cycle. Our macroeconomic analysis enables us to identify credit excesses and cross sector developments more clearly, allowing us to reposition our portfolios in anticipation of cyclical turning points.

The bottom-up component of our investment process continuously feeds into the macro analysis to help identify significant changes in financial market conditions, economic developments and areas of credit excess. Thus, the primary sources of value added (and overall portfolio performance) are asset allocation across credit sectors, and security selection within those sectors.

Our approach seeks to preserve capital by allocating to non-credit sectors (for example Treasuries or agency mortgages) during defensive periods and for liquidity purposes. Consistent with this approach, duration management is focused on downside protection and capital preservation.

Maneuverability is also important to flexible investment approaches, and in this respect we’d argue that smaller funds have a potential advantage. Large volumes of money have been put to work in the “non-traditional” space in recent years (according to Morningstar that bond category received inflows of more than \$76 billion in the two years from 2013 to 2014) and fund sizes are growing. Against this backdrop, we think the largest funds may not be as nimble as before, for example when liquidating positions and switching into new exposures.

In Summary...

In today’s environment, investors can’t afford to be passive about interest-rate risk. The fall in yields that made the traditional benchmark approach successful for 30 years is now in its late stages. The unprecedented liquidity pumped into the markets by central banks in response to the credit crisis has kept interest rates extraordinarily low, but sooner or later they are likely to rise. From now on, managers will have to choose their exposures more carefully, and they need the freedom to express their best research ideas across a broad spectrum of fixed income sectors. For many types of investor we therefore believe that an unconstrained strategy can play a powerful role as an extension of traditional bond management.

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